GRANT'S

INTEREST RATE OBSERVER®

Vol. 37, No.04c 233 Broadway, New York, New York 10279 • www.grantspub.com FEBRUARY 22, 2019

Dim the lights

Safety is inherent in no investment. Not in sovereign Swiss debt, e.g., the 0s of 2029, trading at 103.16 to deliver the princely yield of slightly less than nothing. Nor in our beloved gold, which has traded as high as $1,900 and as low as $869 an ounce in just 10 years. And not in the securities of many a putatively safe and secure American electric utility. Now in progress is a demonstration of how little utilities in general, and one utility in particular—the spotlight shines on PG&E Corp. (PCG on the Big Board)—answer the description of port in a storm.

Your average stock-market algorithm, well-disposed as it is toward utilities, will require some persuasion on these points. We conjecture that the algos reason thus:

Utilities are regulated monopolies, and they earn a regulated return. They earn that return as a percentage of the value of their service-providing capital assets—"rate base," it's called. The more a utility spends to grow, the bigger its rate base; and the bigger its rate base, the better its operating income and the plumper its dividends. PG&E's rate base has increased by 7.3% per annum over the past decade.

Name me, please, the algo might say if it could talk, another segment of the S&P 500 that offers 10 years of visibility on growth, translating as it does into rising earnings per share on the order of 6% to 8% a year. It only stands to reason that when the S&P 500 sold off by 19.8% between Sept. 20 and Christmas Eve, the utility component of the S&P gave up just 2.4%.

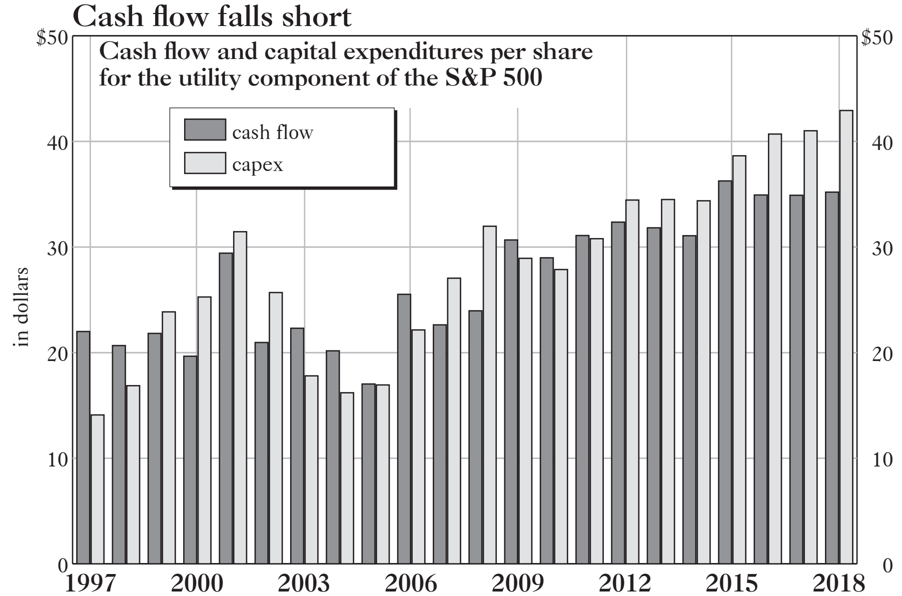
Implied in the bullish narrative is that no lasting harm can come to a regulated utility. The overseers, state public-utility commissions, wouldn't allow it—only consider how they wink at accounting practices that palpably overstate the economic lives of generating plants, transmission lines, wind farms, solar panels, etc. If the regulators and regulated do not actually share a toothbrush, their long-term interests are surely aligned.

For our part, we judge that the regulated-utility business model is vulnerable both financially and competitively. In the past 20 years, the S&P 500 utilities have covered capital expenditures out of operating cash flows in only seven years. And in only one of those seven, 2003, was free cash flow greater than common-dividend distributions. Utilities routinely spend more on property, plant and equipment than they generate in cash flow.

Accounting practices do not clarify matters. In 2016, PG&E estimated that the useful life of its electricity-generating assets ranged between 5 and 100 years. In 2017, the same company amended its estimate to between 5 and 120 years. Life-extension by the flick of a pen permits the classification of more current-period spending as growth capex, rather than maintenance spending. It's only capex for growth that expands the rate base, therefore the income with which to service debt and pay dividends.

"The useful lives of the Utility's property, plant, and equipment are authorized by the [California Public Utilities Commission] and the [Federal

Cash flow falls short



source: The Bloomberg

Energy Regulatory Commission], and the depreciation expense is recovered through rates charged to customers," PG&E relates in its footnotes.

As the utilities don't retain cash, they must find the funds with which to grow. The regulators tell them how to finance: so much equity in relation to so much debt; in the case of the California PUC and PG&E, the mandated proportions are 52:48.

A prolific securities issuer, PG&E has pumped up its share count to 518.7 million from 445 million in 2013. It has likewise boosted its leverage, measured by net debt to earnings before interest, taxes, depreciation and amortization over the same span, to 5.9 from 3.7 times.

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Pacific Gas and Electric Co., PG&E's most headline-prone and economically consequential subsidiary, owns and operates hydroelectric, nuclear, natural-gas and renewable-energy plants with a combined generating capacity of 7.687 gigawatts (a GW is one billion watts). It's the owner of 19,200 miles of high-voltage transmission lines, 107,200 miles of distribution lines, 6,400 backbone natural-gas pipelines and 42,800 miles of gas-distribution lines. It serves a 70,000-square-mile area in northern and central California and serves 16 million people, many of whom are mad at it.

"PG&E's financials are a miniature of the industry—not a good thing," Lorenz observes. "From 2013 through the first nine months of 2018, the company generated $25.5 billion in cash flow from operations. It was $5.9 billion less than the $31.4 billion in capital expenditures over the same span. Capex over this period represented 2.1 times the sum of depreciation and amortization. Even after suspending the dividend in 2018 out of concern for the ultimate cost of the 2017 fires, combined payouts since 2013 came to $4.4 billion, which PG&E borrowed to pay."

Bulls contend there's nothing improvident about these methods. A utility operates in growth mode or cash-flow mode, they say. In growth mode, it spends to enlarge the rate base. In this phase of the cycle, it may spend more on capex than it earns in cash flow from operations. It ought to do just that if the return on equity resulting from that growth is greater than the cost of the invested funds.

Cash-flow mode eventually follows, they insist, though 2005 was the last year in which free cash flow covered the dividend payment at PG&E. The optimists cite management's projections that, between 2018 and 2023, the rate base will rise at a 5.9% compound annual rate to somewhere around $54 billion, taking earnings-per-share growth up along with it. The market would be happy to finance that growth, Stephen Byrd, who follows PG&E for Morgan Stanley, tells Lorenz—that is, if PG&E did not have its current legal overhang relating to inverse condemnation, on which more later.

Not everyone agrees that PG&E was insolvent when it filed for Chapter 11 protection on Jan. 29. And while, on Jan. 31, in support of that petition for relief, CFO Jason Wells testified under oath that the potential wildfire liability could top $30 billion or more, there's a reasoned argument that the cost could be lower. The bulls point to instances in which California utilities and insurers have settled disaster-related claims at between 35% and 57.5% of face value. On Sept. 30, PG&E showed $19.7 billion of book equity.

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PG&E is an old hand at adversity. Not only did the company settle a famous 1993 lawsuit for allegedly contaminating the drinking water of Hinkley, Calif. at a record-setting cost of $333 million, but it also had to watch Julia Roberts reprise the role of their beautiful tormenter in the 2000 movie eponymically titled *Erin Brockovich*. The great California drought of the early 2000s shut down hydroelectric generation, forcing management into costly purchases of power in the open market. Denied commensurate relief on the rates it levies, PG&E filed for bankruptcy in 2001, exiting court protection in 2004. In 2010, gas lines owned by PG&E exploded in San Bruno, Calif., killing 8 and injuring 58, a disaster for which, in 2017, the company was found criminally negligent.

All but 4 of the 15 analysts who follow PG&E call the stock a hold; two say buy, two sell. Short interest constitutes 3.7% of the float. Insiders sold 17,804 shares for net proceeds of $750,527 in the past year though the selling stopped as the 2018 wildfires raged.

"It's well and good," Lorenz notes, "that PG&E's investors can put money to work with a reasonable expectation of increasing earnings at a 6% or 8% rate, but it's debatable if those investments add corporate value. Thus, between 2008 and 2017, operating earnings at PG&E rose by $700 million, to $3 billion from $2.3 billion. Yet, between 2008 and 2018, capital employed by PG&E jumped by $30 billion, to $62 billion from $32 billion. (We use 2017 earnings figures to present the bull case in the best light; operating income dropped in the first nine months of 2018 even after adjusting for fire-related expenses.)"

"It's a 2% return on incremental capital," observes James S. Chanos, founder and managing partner of Kynikos Associates, L.P. and a short-seller of PG&E's common stock. "That is below their cost of capital. They are liquidating. The utility is in effect liquidating before your eyes before any wildfire liability."

PG&E does not contend that this spending is discretionary but on the contrary admits it's largely obligatory. In his Jan. 31 affidavit in the Chapter 11 proceedings, CFO Wells estimated that capex will exceed cash flow from operations by $1.6 billion per year in 2019 and 2020. "Due to the regulated nature of the Utility's businesses, only a small fraction of the capital spending program is discretionary," he said. "This creates an aggregate operating cash flow deficit after capital expenditures of nearly $3.2 billion over the two-year forecast period which PG&E must finance externally"—in this case, with a $5.5 billion debtor-in-possession loan.

Not many utilities would choose to pick up and move to California if that impossible opportunity presented itself. PG&E's power lines crisscross the state's northern forests, rendered tinder-dry by drought and bark-beetle infestation. Who would like to run the risk, which PG&E bears today, that a spark from some downed line does not touch off an inferno?

Under the doctrine of "inverse condemnation," it wouldn't matter if that fire were an act of God. PG&E could have followed California's safety regulations to the letter but would still be held liable for property damages, interest and attorneys' fees if its line were shown to be the source of the precipitating spark. Negligent or not, the utility is a government-regulated provider of a common good, the rationale goes, and must reimburse property owners for damages and amortize those costs over the rate base. Such rate relief is not automatically granted, though, as San Diego Gas & Electric can attest. In 2017, the California Public Utilities Commission turned down flat the utility's request for higher rates in an inverse-condemnation dispute dating from 2007.

Then there's the Golden State's own Green New Deal. California law requires that 33% of utility-generated power be sourced from renewable sources in 2020. The minimum rises to 60% in 2030 and to 100% by 2045. PG&E's nuclear and gas-fired generation assets, which account for 47% of today's capacity, are therefore doomed to economic extinction.

There is a hint of extinction, too, in the very structure of the regulated utility. In California, as in a handful of other states, municipalities and corporations may buy their juice from so-called community-choice aggregators, better known as CCAs, e.g., Marin Clean Energy, which strives to deliver electricity that is at once greener and cheaper than PG&E's.

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PG&E common trades at $17.74 per share, producing a $9.2 billion market cap, compared with the aforementioned $19.7 billion in Sept. 30 book equity. Creditors are taking a more guarded approach to the company's fortunes than the stock market is; PG&E 6.05% senior unsecured bonds of 2034 trade at 92.13 to yield 6.9%. "Full recovery for unsecured creditors is uncertain because this class of creditors is at risk given that the unsecured debt will, in all likelihood, be in the same credit class as pre-petition wildfire claims," said Moody's Investors Service on Jan. 29. Wherever this leaves the equity, it would not be ahead of the debt.

Resolution of PG&E's 2001 bankruptcy took three years and some $400 million in legal and professional costs. And while the cost of billable hours has only risen the past decade-and-a-half, PG&E faces a new, and possibly less tractable, set of problems this time around.

Geisha Williams stepped down as CEO on Jan. 13, two weeks before the Chapter 11 filing. At least half of the 11-person board has served notice they will depart at the May 21 annual meeting. Williams's interim successor, general counsel John Simon, is not the bulls' first choice to effect a makeover in PG&E's safety and operational culture. BlueMountain Capital Management, owner of 1.6% of PG&E shares, says it will propose its own slate of directors.

The state will of course have its say in how the PG&E bankruptcy plays out. The California PUC must approve any asset sale and the final plan to exit Chapter 11 protection.

Perhaps, the bulls venture, California authorities might consider the "municipalization" of a portion of PG&E—say, the vexatious distribution assets, including the power lines that stretch over dead trees. The state would pay just compensation in cash. It would refinance the debt. And it would have the headaches.

Does it want them? The Sacramento legislators appear unlikely to extend the hand of fellowship to the utility whose 2001 bankruptcy, according to *The Los Angeles Times*, piled $7 billion on to Californians' electricity bills in the years through 2012.

"We are all frustrated and angry that it's come to this," California governor Gavin Newsom said last week in his State of the State address. "PG&E didn't do enough to secure dangerous equipment or plan for the future. My administration will work to make sure PG&E upholds its obligations. . . . We will seek justice for fire victims, fairness for employees, and protection for ratepayers," Newsom concluded, notably omitting investors from the list of deserving stakeholders.

"The thing that jumps out at me, and the distinction here from other mega cases, is the damages and liabilities from the wildfires," Angelo Thalassinos, the deputy managing editor at Reorg Research, Inc., tells Lorenz. "It most harkens back to old Chapter 11 cases that had asbestos liabilities. . . . There is potential for continuing damages from that respect throughout the bankruptcy case and even post-emergence."

Might a white knight from Wall Street help push things in a bullish direction? Unlikely for now. The bankruptcy court has granted management's request for protection against a takeover attempt, lest a change in control cost PG&E its $4 billion in net operating loss carryforwards. In consequence, shareholders with stakes greater than 4.75% must desist from buying. The case applies only to two, and they might not even have an opinion on the matter: Vanguard Group, Inc. (9.2%) and State Street Corp. (5%).

As of the Jan. 29 bankruptcy filing, PG&E showed $24 billion in debt outstanding vs. total assets of $71.4 billion. Beyond that encumbrance, several other classes of long-term liabilities will supersede any claim by equity holders: $8.6 billion in regulatory liabilities (mostly cost-of-removal operations, notably, charges for retiring un-green generation assets), $2 billion in pension and other retirement obligations, $5 billion in asset retirement obligations (PG&E will have to retire its natural-gas and nuclear-fired generation), $5.8 billion in deferred income taxes, $2 billion in liabilities termed "other" and enough debtor-in-financing to tide the company over a two-year stay in Chapter 11—call that $3.2 billion. Add these figures to the $9.2 billion market cap, and you get a prospective enterprise value of $60.2 billion.

To the equity holders, it's a daunting figure. Wildfire claims of just $10 billion (around a third of the CFO's estimate) would impair the equity—assuming that PG&E's asset base is not overstated through overly long depreciation schedules.

Nor will exiting bankruptcy protection be easy. A write-down on the magnitude of $10 billion or more may require a partial equitization of unsecured creditors (as Moody's was speculating) or a large issuance of new shares (as the equity bulls are not speculating).

"And, finally," Lorenz hypothesizes, "if climate change is making California more fire-prone and inverse condemnation remains the law of the state, there is a question of whether PG&E can, in fact, exit court protection. Before a judge can approve a bankruptcy exit plan, the plan must be feasible."

"What that practically means," Thalassinos says, "is that there is not a likelihood of another bankruptcy or restructuring in the near term. If you are the bankruptcy judge, one of the questions you are likely asking is, 'Well, we understand what the plan is today, and it may seem feasible today, but if in the next wildfire season it is worse than 2017–18 and we have this state constitutional construct of inverse condemnation, we know how it is interpreted. Does that kick the chair from underneath the company? Is the Chapter 11 plan feasible with inverse condemnation in place?'"

"What California underscores is that the modern electric-utility business model as we know it is much more fragile than most people think," Chanos tells Lorenz. "California presents its own set of unique challenges. It seems to be the modern land of the 10 plagues: wildfires, earthquakes and a variety of things other locales don't have to face. Having said that, when you begin to look at the financial profile of these electric utilities, you realize that there is no room for error or anything going wrong.

"Very few people I've spoken to yet have analyzed the idea that these utilities are spending way more than they are depreciating," continues Chanos. "If these plants are really economically depreciating over 10 years, you should be saying that. If your capex is truly that much, and it appears to be across the industry, then the industry as a whole is misleading investors. That is a fundamental point."

And not a cheering one.

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