13 FEBRUARY 2019

# Height Commentary

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## California Wildfires

## What's the Plan, California?

### THE TAKEAWAY

Yesterday, California Governor Gavin Newsom (D) laid out his intention to develop a comprehensive strategy around the bankruptcy of Pacific Gas & Electric (PCG). We view Newsom's willingness to address the issue head-on as a positive for investors. Newsom seeks a comprehensive solution - one which allows the state to continue to pursue energy policy goals, manage wildfire risks, and support investable utilities. As we've discussed with investors, our primary concerns around PCG and the other California utilities stem from our uncertainty around whether the state has the political will to stabilize the utility investment environment. We are optimistic that Newsom's strike team can lay the foundation for a future that is both politically acceptable and investable.

- Yesterday, during his State of the State address before California's General Assembly, Governor Gavin Newsom addressed the PG&E bankruptcy head-on. He laid out his intention to retain a "team of the nation's best bankruptcy lawyers and financial experts", a strike team, to prepare a solution within 60 days (mid-April) which satisfies a series of policy priorities.
- The market should not be surprised to see the mix of sympathy and sternness on display yesterday. As we've discussed, the state's leaders take a more nuanced view of the utilities than the banner-clad mobs that routinely shut down the California Public Utility Commission's meetings. We reiterate that, at the core, the state desires investable and stable utilities, though Newsom and others are naturally constrained by political realities.
- One such political reality is the widespread support for the state's inverse condemnation law. Despite the excessive burden it foists on utilities, we do not believe that California lawmakers have the capacity to meaningfully change IC, and we find that the rating's agencies' insistence on centering a "fix" to utility financing around IC is highly self-defeating. Changing IC is not the only way to make utilities investable. From this perspective, we break down Newsom's comments in more detail and discuss our inferences of how his "strike team" make approach a more politically practical fix for utilities:

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- **"Ensure continued access to safe affordable power"** Newsom's first goal suggests that issues like continuity of service and long-term stability, which likely dominated discussions in Sacramento for the last few weeks, remain the centerpiece of any long term strategy. Rates are naturally a politically-significant issue, as high energy bills can be regressive on lower-income and older citizens. However, as we've discussed with investors on numerous occasions, we feel California's commitment to affordable power does not necessarily entail lowering rates. California electric rates (at 16.3 cents/kwh) are among the highest in the country, while power bills (at $90/month typical) are among the lowest. The state achieves this unusual result through the pursuit of aggressive energy efficiency policies that keep per capita consumption relatively low. Even California's lofty renewable portfolio standards (discussed later) are met in part through purchases of new renewable power and through reductions in aggregate sales, boosting utility compliance with the RPS goals.

- **"Justice for fire victims"** Of course, no discussion of the California wildfire problem can exist without recognizing the reality of victim remuneration. Given that Newsom is working with bankruptcy law experts, his team will understand that a "fix" to future wildfire liabilities is essential to ensuring that victims from the 2017 and 2018 wildfires don't get crammed down behind a mammoth post-petition wildfire claim. Legislators are rapidly becoming attuned to this problem, and we expect that they feel substantial pressure to work out a solution to future fire treatment in this session.

- **"Fairness for employees"** This statement is rather self-explanatory, but we'd note that "fairness" probably should include punishment of negligence and mismanagement. Newsom has repeatedly called for the complete turnover of the PCG board, and will continue to do so. While the utility has begun a process to rotate new board members in and made other leadership changes, it is by no means enough to demonstrate a commitment to better management, in our view.

- **"Protection for ratepayers"** This may be the most interesting statement in Newsom's outline of a plan. How will the state protect ratepayers while still ensuring that they're on the hook for billions in wildfire claims, renewable power purchase agreements, and obligations to creditors? The question is especially acute in light of the outcome of PG&E's 2001 bankruptcy, wherein a settlement allowed PG&E to pass through $7 billion in costs to ratepayers out of $9 billion in uncovered liabilities that bankrupted the utility. How important is ratepayer protection, really, to the statel? We continue to believe that customers will end up getting the short end of the stick as the state seeks to promote other policy goals.

- **"Continue to invest in safety"** Wildfire prevention is expensive ($150 billion, by one formulation), and bankruptcy courts are not designed to accommodate significant discretionary spending. The state faces an uphill climb to ensure that the bankrupt utility continues to be a substantial partner in wildfire prevention and management. Newsom's team will have to put together a series of very specific obligations, in our view, to ensure that PG&E can functionally continue to make substantial investments in wildfire prevention. The co-benefit of doing so, we believe, will be that it shifts the focus away from US District Court Judge William Alsup, who appears single-mindedly focused on hammering out a way to prevent another catastrophic fire. The judge is a wild card and unlikely to substantially alter the course of PG&E's wildfire management practices. Newsom's leadership on the issue would certainly help sideline the District Court, which is in no position to dictate utility best practices, anyway.

- **"Never waver on achieving the nation's most ambitious clean energy goals"** Newsom's final promise should make renewable power providers like NextEra (**NEP**) happy. We've discussed in previous reports that

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we don't view rejection of Power Purchase Agreement contracts as a fruitful pursuit for PG&E. Doing so offers almost as little return from a political perspective as it does from a creditors' perspective in bankruptcy court. Newsom's commitment to renewable energy is impregnable, and we fully expect his strike team to discourage PPA rejection, as doing so may place additional hurdles in front of California's lofty goal of procuring 100% renewable energy by 2045.

### Tying it all Together

Newsom's statements reinforce our view that the most likely proposal for long term liability relief is a wildfire fund which would provide an additional backstop for fire liability payments. This concept would meet Newsom's requirement that victims are protected first and foremost, by providing an additional source of recovery dollars for uninsured losses. A fund concept would also give the state the ability to judge a utility's behavior to determine what portion of fire liability may be covered, which we view as an important concession to lawmakers who want to avoid shielding utilities from liability without a mechanism to force some cost pass through.

We do not expect that Newsom's proposal indicates a desire to undo inverse condemnation. We do not expect that the view of lawmakers has changed significantly since our meetings last month, and we continue to believe that inverse condemnation reform lacks significant support in the legislature. We expect that lawmakers want to preserve the ability to hold utilities accountable for bad behavior (even as they look to provide certainty around what the maximum liability burden could be moving forward), and view any change to inverse condemnation as counter to this goal.

Newsom's proposal similarly does not significantly change our expectations for a legislative timeline, which we still believe is largely dependent on the Blue Ribbon Commission report. We expect that the Commission report could be accelerated somewhat from its July 1 release date, but do not expect that it could be accelerated much before late May or early June. Rather, we believe that Newsom's goal may be to forestall a credit downgrade for Southern California Edison (**EIX**) by offering ratings agencies a path forward. Newsom's strike team is set to issue recommendations by mid-April, though the exact nature and structure of those recommendations is unknown- they may be a draft set of objectives for future legislation, or a more fully formed legislative proposal. We expect that legislators will introduce one-off bills addressing multiple parts of the wildfire issue, including some proposals related to a potential wildfire fund, but expect that the real legislative process will begin once the Commission report has been released.

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## COMPANIES MENTIONED IN THIS REPORT

PG&E Corp (PCG), Edison International (EIX), Sempra Energy (SRE), NextEra Energy Inc (NEE), Clearway Energy (CWEN.A)

## RISKS

The legislative and regulatory agendas are subject to change at the discretion of leadership. Unprecedented economic conditions could instigate unanticipated and/or sweeping shifts in policy. Predicting the future is a hazardous endeavor and economic / market forecasting is an imprecise science. Actual outcomes may differ substantially from our forecasts. The predictions and opinions expressed herein are subject to change at any time.

## ANALYST CERTIFICATION

We, Katie Bays and Clayton Allen, certify with respect to each security or issuer covered in this research report that (i) the views expressed in this research report accurately reflect our personal views about those subject securities or issuers and (ii) no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by us in this research report.

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