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Pacific Gas & Electric:

Bankruptcy Déjà Vu

SBH Fixed Income Research

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On January 29, 2019, Pacific Gas and Electric (PG&E) achieved the dubious distinction of being the only investment grade company to declare bankruptcy twice.[1] PG&E's latest filing has been a hot topic among fixed income investors. The experience has prompted us to reflect on the key lessons about corporate governance in PG&E's history that helped us avoid PG&E's bankruptcies and continue to inform the way we invest. Given the company's history of fines for negligence and mismanagement,[2] along with its 2001 bankruptcy, it is remarkable that PG&E successfully retained high ratings[3] and attracted over $20 billion from bond investors. As George W. Bush once said, *"Fool me once, shame on ... you. Fool me, you can't get fooled again."*

PG&E's recent plunge into bankruptcy sent shock waves through the investment community. This once stable utility company buckled under the weight of multi-billion-dollar liability claims related to its role in a series of historic wildfires in California.[4] What led to this turn of events? At first glance, it would appear the sole causes were climate change and California's law of inverse condemnation, which holds California utilities responsible for wildfire damage caused by their equipment — whether the companies acted negligently or not. But, looking more closely, we believe PG&E's history of weak corporate governance and poor regulatory management were the culprits. There were warning signs of trouble throughout the company's recent history, detectable as early as its bankruptcy in 2001.

PG&E entered bankruptcy for the first time on April 6, 2001. California energy markets had recently deregulated, splitting energy generation from transmission and distribution, and requiring utilities such as PG&E to purchase a large percentage of their electricity on the wholesale market. The price utility companies could charge customers for electricity was fixed by the state's commissioners; however, their cost to acquire power was variable. This mismatch left utilities exposed to price volatility. During the summer of 2000, power prices in California skyrocketed, bringing total wholesale power costs to $27 billion per year in 2000 and 2001 from $7.4 billion in 1999,[5] an increase of over 260%. All utilities in the state were forced to buy expensive power on the wholesale market and sell it to retail customers at lower fixed rates. This quickly drained their financial resources, pushing the utilities toward insolvency and bankruptcy. Their future looked bleak unless some type of regulatory reform was enacted.

By 2001, all three investor-owned utilities were in negotiations with California's Governor Davis and the Utility Commission to reach a resolution to the electricity crisis. Governor Davis had initially been hesitant to enact rate reform. In early 2001, almost a year into the crisis, he changed course and proposed rate increases and state support for the utilities. Despite this positive outlook for reform, PG&E surprised the world by announcing it was entering bankruptcy on April 6, 2001. PG&E was the only utility in California to enter bankruptcy. The others negotiated bailouts and rate packages through Governor Davis and the Utility Commission. The bankruptcy process created bad faith between PG&E and the government, Utility Commission and people of California. Loretta Lynch, the Commissioner of the California Public Utilities Commission (CPUC) at the time, summed up the bankruptcy settlement when she said, "We just gave PG&E 10 early Christmas gifts...all financed on the ratepayers' credit card."[6] After three years of default, bondholders walked

1 Bloomberg
2 https://sanfrancisco.cbslocal.com/2015/04/09/cpuc-imposes-1-6-billion-fine-on-pge-for-pipeline-violations/
3 Moody's and S&P
4 http://d18rn0p25nwr6d.cloudfront.net/CIK-0001004980/a5ad57ca-5c41-46b1-8c11-8bc058b113f2.pdf
5 https://www.ppic.org/content/pubs/report/R_103CWR.pdf page 20
6 http://articles.latimes.com/2003/dec/19/business/fi-pge19

away whole from the bankruptcy settlement. PG&E was able to exit bankruptcy through higher customer rates and possibly eased investor concerns about the company with such a positive outcome. While bond investors kept faith with the company at this point, this was not the only problem facing PG&E. PG&E had a history of governance issues dating back to the 1980s. If PG&E's bankruptcy did not make fixed income investors cautious, the chronic lack of responsible governance at the company should have.

One of the most significant events displaying PG&E's lack of governance occurred on September 9, 2010. A gas explosion from PG&E's natural gas pipeline in San Bruno, CA killed eight people. The National Transportation Safety Board (NTSB), after conducting its investigation, characterized the event as "a failure of the entire system." The investigation revealed that PG&E had not only put the pipe in the ground incorrectly, it had falsified records, skipped inspections, and lacked emergency response procedures. Similar events had occurred at the company in 1981 and 2008. Particularly disheartening was NTSB's conclusion that for years, "PG&E exploited weaknesses in a lax system of oversight. The NTSB identified that regulators had placed a blind trust in the companies that they were charged with overseeing – to the detriment of public safety."[7] A clear failure in PG&E's governance led to repeated exploitation and manipulation of the regulatory bodies overseeing PG&E.

PG&E was fined a record $1.6 billion by the CPUC for the gas explosion event, more than ten times the previous largest fine and one of the biggest utility sanctions in U.S. history.[8] The company was convicted of six felony charges and sentenced to a five-year probation period, which included independent safety monitoring. In addition, as a very public form of punishment, PG&E was ordered by a San Francisco judge to take out full-page ads in the San Francisco Chronicle and Wall Street Journal, in addition to 60-second television ads, detailing the nature of its offenses.[9] The investigation and convictions of PG&E for the San Bruno gas explosion revealed the company's history of maximizing profit to the detriment of public interest and safety. It also exposed the collusive relationship that had developed between PG&E and the CPUC, thus publicly humiliating this state agency. Reasonable investors could assume that the CPUC, government and people of California were going to make sure PG&E was held accountable for its actions moving forward.

Notwithstanding the above, in 2019 PG&E has filed for bankruptcy for a second time and is potentially liable for billions in claims tied to its role in the historic California wildfires in 2017 and 2018.[10] These liabilities stem from the state law of inverse condemnation, which, as mentioned previously, holds utilities responsible for wildfire damage caused by their equipment, regardless of fault. Investigations of the fires showed that PG&E equipment started at least 17 of the fires.[11] While the bankruptcy process has just begun, we believe there is an important lesson to learn from this and other events in PG&E's recent history: the consequences resulting from PG&E's lack of governance ultimately damaged the company's political capital.

As a regulated utility, PG&E's relationships with the CPUC, state legislators and the people of California are critical to its long-term success. PG&E significantly damaged these relationships over the years and drained its political power, culminating in PG&E's failure to get legislative change to the law of inverse condemnation in 2018. This was not a surprise, as the legislators and public viewed a change to this law as a bailout of PG&E. By the time the second wave of wildfires hit in 2018, PG&E had no allies left and few financial options. Bankruptcy remained the last card that PG&E could play to try to force regulatory reform.

7 https://www.aga.org/sites/default/files/legacy-assets/our-issues/safety/pipleinesafety/Technicalreports/Documents/Final%20Report%20of%20NTSB%20San%20Bruno%20Accident%20Investigation.pdf
8 https://sanfrancisco.cbslocal.com/2015/04/09/cpuc-imposes-1-6-billion-fine-on-pge-for-pipeline-violations/
9 https://www.courthousenews.com/pge-ordered-to-advertise-pipeline-blast-conviction-on-tv/
10 http://d18rn0p25nwr6d.cloudfront.net/CIK-0001004980/a5ad57ca-5c41-46b1-8c11-8bc058b113f2.pdf
11 https://calfire.ca.gov/communications/downloads/newsreleases/2018/2017_WildfireSiege_Cause.pdf

As with many lessons from history, it is easy in hindsight to see warning signs that were not visible at the time. Given PG&E's tumultuous track record, however, the evidence that the corporate governance function was flawed was there, and that should have dissuaded the bond market from investing over $20 billion in PG&E debt or at the very least, should have forced it to trade at higher rates to reflect the risk. Going back to George W. Bush's quote, PG&E repeatedly fooled investors, and unfortunately it was "shame on them."

At SBH, we believe companies with healthy corporate governance are better positioned to weather volatility and to outperform in the long run. For utilities in particular, it is precisely during a crisis when a company needs to rely on its political capital, which is built through a track record of strong governance. Given the growing importance of ESG (Environmental, Social and Governance) investing, it has never been more important for utilities to leverage that strong governance to ensure they are acting in the public's interest and protecting public safety. At bedrock, fixed income investing is an exercise in assessing and pricing risks of any and everything that can go wrong for the investor. At best, after all, all an investor gets back at maturity is the original par value. Understanding all the risks, even the qualitative ones that might not lend themselves to quantitative techniques, is part of the way we approach our research in order to best protect our clients' capital.

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