PG&E And The Year Of ESG And Sustainable Finance

February 4, 2019

PRIMARY CREDIT ANALYSTS

Karl Nietvelt
Paris
(33) 1-4420-6751
karl.nietvelt
@spglobal.com

Michael Wilkins
London
(44) 20-7176-3528
mike.wilkins
@spglobal.com

Environmental, social, and governance (ESG) matters are climbing the business agenda and investors are increasing their focus in their investment mandates on companies that are seen as acting more sustainably.

S&P Global Ratings believes ESG has become more relevant to credit quality for three reasons:

- ESG-related impacts on a company's performance are becoming increasingly obvious as climate change is causing more extreme weather events. Similarly, the broader public's desire for a sustainable future is having a greater direct influence on product and brand acceptance by customers.
- Environmental and social regulations are evolving to address the shift in societal priorities, and a company's management of political and regulatory relationships are increasingly intertwined with ensuring broader public acceptance.
- The frequency and severity of financial consequences have surged, as the physical impacts of climate change have increased and ESG-related breaches or perceived lack of focus on customers and communities are triggering more decisive action and litigation.

For example, U.K. water utility Thames Water, at our November Infrastructure & Utilities Conference in London, underscored how ESG had changed the company's strategic direction to emphasize delivering operational performance targets (including customer satisfaction), aligned with objectives set out by the regulator.

The most recent case of how each of the three ESG factors contributed to a severe deterioration in creditworthiness is California-based utility PG&E Corp. (D/--/D). The company filed for bankruptcy on Jan. 29, 2019, under Chapter 11 of the U.S. Bankruptcy Code. In its press release of the same date, PG&E stated that throughout the forthcoming process, it remains committed to "Working with customers, civic leaders, regulators, policymakers, the financial community and other key stakeholders to consider alternatives to provide for the safe delivery of natural gas and electricity and new safety solutions in an environment challenged by climate change." (For more on PG&E, see the box below.)

Financing was a focal point, too, at COP24, the latest U.N. climate change conference, held in Katowice, Poland, in December 2018. On a global scale, financing from public, private, and multilateral sources is scaling up, which we expect could broaden climate-aligned asset types and financing vehicles across geographies. But financing such efforts, particularly in the developing world, is still lacking--and climate finance remains a relatively small portion of the overall global finance market.

This, we believe, is partly because demonstrating to decision makers the "resilience benefit" of committing to capital-intensive projects can prove difficult. In our view, however, this perception

may begin to shift. In articles published this month, we set out why it makes economic sense to tackle global warming--and offer the case study of China, which has positioned pollution control and an environmentally conscious society at the forefront of its development agenda (see our most recent "
Quarterly Infrastructure Outlook
," published on Jan. 30, 2019, which summarizes those articles.)

Also see "S&P Global Ratings Launches ESG Sections In Corporate Credit Rating Reports," published on Jan. 31, 2019, which announces our plan to include ESG sections within our issuer credit rating reports on about 2,000 corporates through the course of the year, which represents about 40% of our rated universe.

The Impact Of Recent ESG Events On PG&E

After having already experienced three rating downgrades in 2018 due to escalating wildfire risks, a combination of events hastened the deterioration in credit quality of PG&E, which, together with its utility subsidiary Pacific Gas and Electric Co., filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code on Jan. 29, 2019.

In the immediate aftermath of the 2018 Camp Fire in California, we believed that credit risk had increased but also expected that regulatory and political support for the utility's credit quality remained. This was reflected in our downgrade on Nov. 15, 2018, of PG&E's issuer credit rating to 'BBB-', and our CreditWatch listing with negative implications. At this time, we indicated that increasing financial, political, and operational risks related to the Camp Fire had increased the probability of a downgrade of one or more notches over the next few months. Still, legislators and regulators appeared to us to remain supportive, as we believed that they recognized that having financially healthy utilities is not only in the best interest of ratepayers but also necessary for the state to reach its ambitious renewable portfolio standards. Some indicated that they were looking into the possibility of extending the state's bill SB 901, which addresses the utilities' 2017 wildfire liabilities to include the 2018 wildfires.

However, public anger further intensified in November and December as the full extent of the catastrophic Camp Fire became more evident. The negative public sentiment toward the utility intensified and the California Public Utility Commission opened a new and unrelated proceeding to consider potential penalties against the utility for the alleged falsification of natural gas safety records. Following this disclosure, some of the political and regulatory officials who previously supported the utility expressed their distrust of the utility.

These events culminated with PG&E issuing a press release on late Jan. 4, 2019, indicating that its board of directors was reviewing its structural options, including its operations, finances, management, and governance. The announcement was a clear indication, in our view, that governance and oversight are needed to improve to account for the company's unique enterprise risks. Later that evening, media reports speculated that PG&E could be preparing for a voluntary bankruptcy filing as part of its contingency planning. It was the totality of these events that led us, on Jan. 7, to downgrade the issuer credit ratings on both PG&E and Pacific Gas and Electric to 'B' and, one week later, to 'CC' following the company's announcement earlier that day of the intention to file for Chapter 11 protection on or around Jan. 29.

This report does not constitute a rating action.