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PACIFIC GAS AND ELECTRIC COMPANY

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

In re PACIFIC GAS AND ELECTRIC COMPANY, a California corporation, Debtor. Federal I.D. No. 94-0742640	Case No. 01-30923 DM Chapter 11 Case HEARING Date: June 18, 2001 Time: 10:00 a.m. Place: 235 Pine St., 22nd Floor San Francisco, California Judge: Hon. Dennis Montali

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A Professional Corporation

DEBTOR'S NOTICE OF MOTION AND MOTION FOR ORDER AUTHORIZING (1) CONTINUATION OF PRE-PETITION EMPLOYEE SEVERANCE AND DISPLACEMENT PROGRAMS, (2) ESTABLISHMENT OF MANAGEMENT RETENTION PROGRAM, AND (3) HONORING OF CERTAIN PRE-PETITION EMPLOYEE COMPENSATION, SUPPORTING MEMORANDUM OF POINTS AND AUTHORITIES

[SUPPORTING DECLARATION OF RUSSELL JACKSON FILED SEPARATELY]

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NOTICE OF MOTION AND MOTION

PLEASE TAKE NOTICE that on June 18, 2001, at 10:00 a.m., or as soon thereafter as the matter may be heard, in the Courtroom of the Honorable Dennis Montali, located at 235 Pine Street, 22nd Floor, San Francisco, California, Pacific Gas and Electric Company, the debtor and debtor in possession in the above-captioned Chapter 11 case ("PG&E" or the "Debtor"), will and hereby does move the Court for entry of an order granting the following relief (the "Motion"):

(1) authorizing PG&E to maintain its existing employee severance and displacement program with respect to certain non-bargaining unit employees at electricity generation plants of which PG&E is divesting itself pursuant to California's electricity deregulation laws;

(2) authorizing PG&E to maintain its existing employee severance program with respect to other non-bargaining unit employees;

(3) authorizing PG&E to establish an employee retention program for certain members of PG&E's management team to help ensure that they remain with the company during this critical reorganization period; and

(4) authorizing PG&E to honor certain pre-petition compensation to certain non-bargaining unit personnel consistent with compensation already paid to other similarly-situated employees.

This Motion is based on the facts and law set forth herein, the Declaration of Russell Jackson filed concurrently herewith ("Jackson Decl."), the record of this case and any evidence presented at or prior to the hearing on this Motion.

PLEASE TAKE FURTHER NOTICE that pursuant to Rule 9014-1(c)(2) of the Bankruptcy Local Rules for the Northern District of California, any written opposition to the Motion and the relief requested therein must be filed with the Bankruptcy Court and served upon appropriate parties (including counsel for PG&E) at least five (5) days prior to the scheduled hearing date. If there is no timely objection to the requested relief, the Court may enter an order granting such relief without further hearing.

MEMORANDUM OF POINTS AND AUTHORITIES

PG&E currently faces several challenges, including the development of a successful reorganization plan in the midst of economic turmoil and a severe energy crisis. The filing of PG&E's Chapter 11 petition and its resulting inability to honor certain employee obligations have injected a significant sense of uncertainty among PG&E's workers at a time when PG&E requires the total dedication of its skilled and experienced personnel. By this Motion, PG&E respectfully requests that the Court authorize it to honor certain pre-petition severance and incentive payments and to implement a management retention program designed to ensure the continued employment and dedication of essential personnel. Absent the requested relief, PG&E may be unable to retain personnel necessary to the continued provision of safe, reliable and responsive service to its customers and the development of a successful reorganization plan.

I.

GENERAL BACKGROUND.

PG&E is an investor-owned utility providing electric and gas services to millions of California residents and businesses. PG&E employs more than 19,000 people. Beginning approximately last summer, as a result of the partial deregulation of the power industry, PG&E was forced to pay dramatically increased wholesale prices for electricity. PG&E has, however, been prevented from passing these costs on to retail customers, resulting in a staggering financial shortfall. In the face of the deterioration in PG&E's financial condition, and with little progress having been made toward a resolution of the crisis, PG&E by early April 2001 determined that a Chapter 11 reorganization offered the best prospects for protecting the interests of its customers, creditors, employees, and shareholders alike. Accordingly, on April 6, 2001 (the "Petition Date"), PG&E filed a voluntary petition under Chapter 11 of the Bankruptcy Code. PG&E continues to manage and operate its business and property as a debtor in possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code (11 U.S.C. §§1107-1108). No trustee has been appointed.

II.

THE SEVERANCE AND DISPLACEMENT PROGRAMS AND RELATED COMPENSATION PAYMENTS TO EMPLOYEES.

As discussed in greater detail below, PG&E seeks authority to maintain two existing severance and displacement programs for non-bargaining unit employees[1] (a specific one for lower-level management employees at electricity generation plants of which PG&E is divesting itself pursuant to California's deregulation laws, and a general one for other management personnel and administrative and technical employees facing elimination of their jobs) and to establish a retention program for its most essential management employees. In addition, PG&E seeks authority to honor certain modest pre-petition compensation obligations to particular administrative and technical employees and management personnel in an effort to provide consistent treatment to its overall non-bargaining unit workforce, as discussed below.

A. PG&E's Severance and Displacement Program At Generating Plants Being Divested.

In 1996, the California Legislature enacted Assembly Bill 1890 ("AB 1890"), which restructured the state's electric industry by mandating that electric services be unbundled, and by mandating that wholesale markets be opened up to competition by January 1, 1998. AB 1890 generally codified a market structure prescribed by the California Public Utilities Commission (the "CPUC") in its December 1995 Preferred Policy Decision (the "1995 Policy Decision"). The 1995 Policy Decision required PG&E to divest itself of most of its electricity generating capacity. With the CPUC's approval, PG&E subsequently began divesting itself of many of its electricity generation power plants over time. Jackson Decl. ¶3.

In order to ensure safe and effective operation of critically needed generation

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[1]By separate motion to be heard the same day as this Motion, PG&E seeks to assume a contract providing for, inter alia, similar severance and displacement payments to "bargaining unit" (non-management) employees at the plants being divested.

sources during a transition of ownership, and to soften impacts on employees affected by California's transition to a deregulated environment, AB 1890 requires that any electricity generating facility sold by a utility must continue to be operated and maintained by the utility or an affiliate on behalf of the new owner for a period of two years following the sale, and that reasonable costs associated with "voluntary severance, retraining, early retirement, outplacement, and related benefits" due to plant sales are to be recovered through Competitive Transition Charges. Jackson Decl. ¶4.

To meet the requirements of AB 1890 and to retain affected employees needed to carry out PG&E's operating and maintenance responsibilities during the two-year post-sale transition period, PG&E established two severance and displacement programs—one for its impacted bargaining-unit employees and the other for its affected non-bargaining unit personnel. As noted above, the program for bargaining unit employees is the subject of a separate motion to be heard the same day as the instant Motion. The non-bargaining unit severance and displacement program (the "Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants") was required to equalize the treatment of essential non-bargaining unit personnel (lower level management workers) at the divested plants with that of bargaining unit employees. Jackson Decl. ¶5 & Ex. 1. Having these lower level management workers remain in their assignments, many of whom passed up other employment opportunities or delayed their retirement plans to stay with PG&E over the two-year transition period, has contributed significantly to the safe operation and orderly transfer of the divested plants. Jackson Decl. ¶5.

PG&E's power plants were divested in two sets of auctions that were held approximately one year apart. The two-year post-sale transition period for the first set of divested plants ended in 2000 and employees impacted at these facilities have already received all benefits due them under the programs. The second set of plant sales occurred in 1999 and the two-year transition period associated with those plant sales is ending in May of 2001. Since PG&E filed for bankruptcy protection in April, the final payments to employees impacted by the second set of plant sales are apparently pre-petition obligations that require

court approval to be honored. Should the Court not authorize payment of these pre-petition obligations, PG&E's failure to honor its commitments under this program will not only have repercussions on the impacted employees but also on PG&E's ability to retain all levels of management employees in other sectors, as well. Jackson Decl. ¶6. Accordingly, PG&E seeks authority to maintain the Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants.

Significantly, the Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants and all reasonable costs resulting from implementation of that program have already passed regulatory muster before the CPUC. In its Decision #00-02-048, issued on February 17, 2000, the CPUC reviewed the basic parameters of this Program in a contested proceeding, and concluded that such Program implementation costs reasonably incurred by PG&E are recoverable in customer rates in accordance with AB 1890. Jackson Decl. ¶7.

The Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants requires PG&E to make three types of payments to approximately 31 lower-level management employees, at a total estimated cost of approximately $5 million:

1. Severance—Upon completion of their operating and maintenance duties at the divested plants, employees who no longer have work assignments are entitled to severance payments consistent with severance benefits that PG&E typically extends to employees whose jobs have been eliminated. Under the PG&E severance program in effect at the time of its bankruptcy filing, such payments amount to three weeks' pay for each year of service (up to a maximum of 78 weeks of pay) plus a $9,000 payment to cover "COBRA" health insurance costs. The total estimated cost of such payments for the 31 impacted management employees is approximately $3.6 million. Jackson Decl. ¶8(a).

2. Enhanced Performance Incentive Plan ("EPIP")—EPIP was designed to fulfill PG&E's legal obligation to ensure the divested plants were operated and maintained safely during their transition to their new owners. The EPIP awards payments to non-

bargaining unit personnel working at the plants, provided they meet enhanced performance incentives. The EPIP is paid annually over the two-year transition period and is structured to be an addition to the payments provided to all non-bargaining employees under PG&E's previously existing Performance Incentive Plan ("PIP"). PIP payments were designed to provide a payment targeted at 10% of an eligible employee's base annual salary, with actual annual payouts ranging from 0% to 20% depending upon actual results achieved with respect to pre-specified performance goals. The EPIP was designed to increase annual PIP payments received by employees asked to work at divested plants by an additional 0% to 18% of an eligible employee's base annual salary, with the average EPIP payment amounting to 9%. All elements of the EPIP have been paid prior to PG&E's filing for bankruptcy protection, with the exception of the component based on year 2000 performance. The total cost of the earned, but unpaid, year 2000 performance EPIP for the 31 impacted employees is estimated at approximately $450,000. Jackson Decl. ¶8(b).

3. Transition Bonus—This portion of the program provides a lump sum transition bonus in an amount equal to the PIP plus EPIP for non-bargaining unit personnel working at the divested plants if such employees remain at the plant until final release by PG&E at the very end of the transition period. This final transition payment cannot exceed 75% of the employee's base annual salary. In addition, the combined amount of such transition bonus and any severance payment to which the employee is entitled cannot exceed two times the employee's base annual salary. The total estimated cost of the transition bonuses now due these 31 employees is approximately $960,000. Jackson Decl. ¶8(c).

B. PG&E's Severance Program For Non-Bargaining Unit Employees Other Than Those At Divested Plants.

PG&E originally established its "Work Force Management Program" in 1986 at a time when it was undergoing considerable restructuring and reduction in its workforce. The program serves as a tool to enable PG&E to re-size and/or re-shape its workforce to meet its

current business needs and conditions. The Work Force Management Program provides employees whose jobs have been eliminated due to PG&E's workforce changes a severance payment determined in accordance with a service and salary based formula. The payment of severance benefits to impacted employees greatly reduces potential litigation regarding their job elimination, which can be extremely time consuming and expensive (sometimes amounting to hundreds of thousands of dollars). Jackson Decl. ¶9. The payment formula and other program provisions have been periodically revised and are described in greater detail in Exhibit 2 attached to the Jackson Declaration.

The severance payment formula under the Work Force Management Program in effect at the time of PG&E's filing for bankruptcy protection provides PG&E's non-bargaining unit employees whose jobs have been eliminated as a result of operational and/or business conditions with payments equal to three weeks of pay for each year of service, with a minimum of 12 weeks and maximum of 78 weeks of pay. The program also provides for payments ranging from $9,000 to $16,500 to cover "COBRA" health insurance costs.[2] In order to receive such benefits, an employee must sign an appropriate waiver and release of claims against PG&E. Jackson Decl. ¶10. In light of the fact that years of service are a component of the severance payment calculation and most of the service that employees have rendered occurred prior to PG&E filing for bankruptcy protection, continued payments under this severance program could be construed as pre-petition obligations. PG&E is therefore seeking court approval to allow PG&E's use of this tool in the future.

Based on a recent, comprehensive review of severance practices, the methodology used for PG&E's Work Force Management Program is consistent with severance programs at other large companies. Indeed, benchmark information provided by the highly-regarded 1998 Lee Hecht Harrison Severance and Separation Survey performed in conjunction with Workforce Magazine indicates that length of service is the predominant

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[2] As discussed above, in Part II(A), by separate motion to be heard the same day as this Motion, PG&E seeks to assume a contract providing for, inter alia, similar severance and displacement payments to "bargaining unit" (non-management) employees.

method for calculating severance amounts. That Survey also shows that large corporations with between 5,000 and 25,000 employees generally offer between 6 weeks and 44 weeks of salary as severance —amounts comparable to PG&E's obligations under the Work Force Management Program. Jackson Decl. ¶11 & Ex. 3. Furthermore, the Work Force Management Program is comparable to similar severance programs approved by courts in other large Chapter 11 cases. See Id. Ex. 4.

In 2000, PG&E terminated 199 management and administrative and technical employees, with an average severance payment of approximately $97,000. Jackson Decl. ¶12. In 2001, PG&E has no significant organizational changes underway within the utility that impact regular employees (other than the aforementioned program associated with the last set of generating plant divestitures). However, in the normal course of business, it needs to have its severance program in place so that desired organizational changes and appropriate job eliminations can be implemented. PG&E projects the severance of approximately 10 non-bargaining unit employees under the Work Force Management Program over the course of 2001 (above and beyond the 31 associated with plant divestiture discussed above), resulting in total severance payments of approximately $1 million. Jackson Decl. ¶12.

C. PG&E's Management Retention Program.

Not surprisingly, PG&E's Chapter 11 filing has injected a significant sense of uncertainty among its employees. PG&E seeks to implement a Management Retention Program to stabilize its operations and ensure the long-term continuity of its business. The Management Retention Program creates incentives for PG&E's most essential employees to remain with the company during at least the pendency of this Chapter 11 case. Jackson Decl. ¶13. Retention of these employees is particularly important in view of the significant challenges that PG&E faces, including not only bankruptcy, but also electrical blackouts, implementation of significant rate increases, and the probability of strong, negative customer reaction to the foregoing. Jackson Decl. ¶13.

PG&E depends on the dedication and continued employment of certain essential

employees for the provision of safe, reliable and responsive service to its customers. As at most corporations retention packages have been utilized in the past to address specific employment market and business situations.[3] The current situation, involving both an energy crisis in California and PG&E's entering bankruptcy proceedings, raises retention issues of a widespread nature that requires the use of a more structured program tailored to the situation and consistently applied throughout the utility. PG&E's successful reorganization depends in large part on these same employees. Moreover, if lost to other employment or retirement, these most essential employees would be difficult or impossible to replace. Jackson Decl. ¶14. PG&E expects that its Management Retention Program will significantly increase its ability to retain the critical knowledge and skills of its most essential management employees. Id. The Program is therefore in the best interests of PG&E and its estate, including all parties in interest. Id.

The Management Retention Program, which is described in greater detail in Exhibit 6 to the Jackson Declaration, provides for payments ranging from 25% to 100% of annual base salary as of the Petition Date (the "Retention Payments") to certain officers and other members of its leadership team if they stay with PG&E over the next several years and continue to contribute to PG&E's successful operation and restructuring during these difficult times. The program classifies eligible participants into four "tiers," with

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[3] PG&E Corporation utilizes a number of incentive-based compensation programs which cover officers of itself and its subsidiaries, including Pacific Gas and Electric Company, the utility. For Pacific Gas and Electric Company officers, these programs provide for incentive awards dependent upon the achievement of medium- and long-term corporate objectives. Attached as Exhibit 5 to the Jackson Declaration are copies of the relevant pages of the 2001 PG&E Corporation and Pacific Gas and Electric Company Joint Proxy Statement describing these programs, and a description of the PG&E Corporation Senior Executive Retention Program (which was adopted subsequent to the reporting period for the Proxy Statement) listing the six senior Pacific Gas and Electric Company officers who are participants in this program with their participation levels. The incentives for these six senior officers under the Pacific Gas and Electric Company Management Retention Program which is the subject of this Motion are specifically linked to performance milestones related to successful emergence by Pacific Gas and Electric Company from bankruptcy. By contrast, the PG&E Corporation Senior Executive Retention Program is designed to retain senior officers for a longer term and to incent them to achieving overall financial performance of PG&E Corporation. Jackson Decl. ¶14 n.2.

participation ranging from 25% to 100% of eligible employees in each tier. Jackson Decl. ¶15. To place a cap on the cost of this program and to ensure that it is employed as a retention tool only where it is needed, no more than one third of the approximately 682 management employees occupying eligible positions in these four tiers (*i.e.*, 226 employees) would be entitled to payments under the Management Retention Program (collectively, the "Participants"). The 226 maximum participation figure is about 1% of PG&E's total workforce. Participants will be selected and approved for participation based on several factors, including their role and impact on the company, their job performance and the degree of risk PG&E faces in losing them over this critical period.[4] Jackson Decl. ¶15.

Under the program, Retention Payments will be made to Participants in two installments. For all Participants except PG&E's six senior officers (i.e., "Tier I"), the first of two equal installments is payable on the earlier of (i) the first business day after the one-year anniversary of PG&E's Chapter 11 filing (April 8, 2002), or (ii) upon PG&E's filing of a Chapter 11 plan of reorganization. The second installment is payable on the earlier of (i) the first business day after the two-year anniversary of PG&E's Chapter 11 filing (April 7, 2003), or (ii) upon the Court's confirmation of a Chapter 11 plan.[5] Jackson Decl. ¶16.

In contrast, PG&E's six senior officers in "Tier I" will be entitled to receive the first installment (equal to one-third of their total potential Retention Payment) only if PG&E files a Chapter 11 plan of reorganization by January 1, 2002 (i.e., if PG&E does not file a Chapter 11 plan by this date, such senior officers will not be entitled to one-third of their total potential Retention Payment), and will be entitled to receive the second installment (equal to two-thirds of their total potential Retention Payment) only upon the confirmation of a Chapter 11 plan of reorganization. Jackson Decl. ¶16.

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[4] The administrator for the Management Retention Program, who, inter alia, determines the eligibility of PG&E's employees for benefits under the Program, is the chairman of the board of PG&E or his designee.

[5] However, the first installment for Participants in "Tier II" (which includes PG&E's officers other than its six most senior officers classified in Tier I) with less than two years of credited service with PG&E as of the Petition Date will equal one third of their Retention Payment, and their second installment will equal two-thirds of their Retention Payment.

With certain limited exceptions, to receive Retention Payments, Participants must be employed by PG&E at the time of such payments.

Implementation of retention programs for essential employees is common for companies in bankruptcy proceedings or other difficult transition periods, and the Management Retention Program is comparable (if not less generous) to similar retention programs approved by courts in other large Chapter 11 cases, when the relative size of the various debtors, number of covered employees, and amount of payments are taken into account. Jackson Decl. ¶17 & Ex. 4.

The total estimated cost of all of the Retention Payments under the Management Retention Program is approximately $17.5 million, or an average of approximately $77,000 for each of the 226 Participants. Jackson Decl. ¶18.

D. Pre-Petition Compensation To Non-Bargaining Unit Employees.

By this Motion, PG&E also seeks authority to pay miscellaneous recognition payments and business incentive program payments that were being processed on the Petition Date and were interrupted due to the bankruptcy filing.

PG&E's recognition payments and business incentive programs are designed to strengthen PG&E's position in the marketplace, improve customer service and reduce operating costs. Jackson Decl. ¶19. At the time of the Petition Date, approximately 1,000 miscellaneous pre-petition wage-related payments owed to non-bargaining unit employees (collectively, the "Miscellaneous Pre-Petition Employee Payments") were in varying stages of being processed by PG&E. Most employees received these payments, but, as a result of its bankruptcy filing, PG&E was unable to complete the Miscellaneous Pre-Petition Employee Payments to all such employees, with the result that a handful of employees did not receive these payments. Virtually all of these Payments are owed to administrative and technical and lower-level management employees. Jackson Decl. ¶19.

The Miscellaneous Pre-Petition Employee Payments, which are described in greater detail in Exhibit 7 attached to the Jackson Declaration, total approximately $2 million (or an average payment of about $2,000) and fall into the following three

categories:

1. Corrections to short-term incentive payments and recognition payments for superior work performance paid to employees prior to the Petition Date (63 payments totaling approximately $236,000);

2. Recognition payments for superior work performance prior to the Petition Date (195 payments totaling approximately $238,000); and

3. Business incentive program payments based on pre-petition achievement of specified business goals (729 payments totaling approximately $1,540,000).

Jackson Decl. ¶20 & Ex. 7.

While the dollar amounts for the Miscellaneous Pre-Petition Employee Payments are relatively modest, they are significant to the employees involved. Jackson Decl. ¶21. Furthermore, by honoring the Miscellaneous Pre-Petition Employee Payments, PG&E will be able to remedy a perception of unfair treatment among the affected employees due to the fact that other employees were paid for substantially similar work performance or achievement of business goals. Jackson Decl. ¶21. Finally, the payments will boost employee morale generally, since PG&E's inability to pay wage-related debts to its employees has caused anxiety and has led many of PG&E's employees to question the viability of working for a company in bankruptcy. Jackson Decl. ¶21.

III.

DISCUSSION.

A. The Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants And The Work Force Management Program Are Reasonable Obligations That PG&E Should Be Entitled To Honor In The Ordinary Course Of Business.

A debtor's relationship with its employees, including the terms and conditions of employment, are matters that are subject to the business judgment of the debtor and may be managed by the debtor in the ordinary course of business. See In re All Seasons Indus., Inc., 121 B.R. 822, 825-26 (Bankr. N.D. Ind. 1990). The court in that case, in approving the debtor's application to continue its pre-petition compensation policies, stated:

> "The continued employment of existing management of a debtor-in-possession constitutes part of the operation of debtor's business and is within the ordinary course of business authorized by the Bankruptcy Code. Where post-petition operations are concerned, as long as it confines itself to operating within the ordinary course of business, a debtor-in-possession's actions are cloaked with an aura of propriety and, thus, the debtor is entitled to a presumption concerning the reasonableness of its decisions. The presumption extends to all aspects of the debtor's ordinary, day-to-day operations . . . .This presumption is rebuttable, however, if 'exigent circumstances are present' or 'there is the potential for, and the prima facie appearance of, abuse.' . . .Viewed from this perspective, the initial burden rests with the objectors to produce evidence, beyond the fact of bankruptcy or financial troubles, which would tend to indicate that the compensation being received by management is not reasonable or is somehow improper." (Id. at 825-26 (internal citations omitted))

Likewise, in In re Landmark Land Co., 136 B.R. 410, 414 (D.S.C. 1992), the debtor moved the court for approval of certain employee benefits, including severance pay. The court granted the motion, stating:

> "Loyal employees who have remained and will remain on the job need to be assured that should the debtors reorganization efforts require areas of service to be streamlined and employees discharged, the discharged employees will be treated fairly and in accordance with the same policy provisions under which they initially agreed to be employed and under which they have remained with the debtor companies through this period of financial strife." (Id. at 414)

See also Michigan Bureau of Workers' Disability Comp. v. Chateaugay Corp. (In re Chateaugay Corp.), 80 B.R. 279, 281 (S.D.N.Y. 1987) (approving bankruptcy court's "first-day" order authorizing continued payment of prepetition wages and salaries, employee reimbursement expenses and benefits estimated to exceed $250 million).

The Court here should likewise authorize PG&E to honor the Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants and the Work Force Management Program in the ordinary course of its business. As discussed above, PG&E adopted the Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants to provide critical skilled workers at the divested plants with an incentive to remain with the company, in order to ensure that the plants continued to operate safely and efficiently and in compliance with relevant law. Similarly, PG&E adopted the Work Force Management Program to allow itself the necessary staffing

flexibility to meet its business needs while providing affected employees facing job elimination with limited financial support as they transition to external opportunities. The Workforce Management Program also reduces litigation expenses traditionally associated with employee layoffs. Thus, PG&E's continuation of these Programs constitutes a reasonable exercise of its business judgment in the ordinary course of business.

B. The Court Should Authorize PG&E To Implement The Management Retention Program And To Honor The Miscellaneous Pre-Petition Employee Payments As A Proper Exercise Of Its Business Judgment.

The Management Retention Program constitutes a proposed use of property of the estate "other than in the ordinary course of business" pursuant to Section 363(b)(1) of the Bankruptcy Code. In determining whether to authorize the use, sale or lease of property of the estate under Section 363(b)(1), courts require a debtor to show that a sound business purpose justifies such actions, applying the so-called "business judgment" test. See, e.g., Stephens Indus., Inc. v. McClung, 789 F.2d 386, 389-90 (6th Cir. 1986); Committee of Equity Sec. v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1062-64 (2d Cir. 1983); In re Lady H Coal Co., Inc., 193 B.R. 233, 243 (Bankr. S.D. W. Va. 1996); In re Delaware & Hudson Ry. Co., 124 B.R. 169, 176 (D. Del. 1991); 3 Lawrence P. King, Collier on Bankruptcy §363.02[1][g] (15th ed. rev. 1998).

The burden of establishing a valid business purpose for the use of property of the estate outside the ordinary course of business falls upon the debtor. See In re Lionel Corp., 722 F.2d at 1070-71. Once the debtor has articulated a rational business justification, however, a presumption attaches that the decision was made on an informed basis, in good faith and in the honest belief that the action was in the best interest of the debtor. See, e.g., Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.), 147 B.R. 650, 656 (S.D.N.Y. 1992) (citing Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)).

Sound business justifications exist for adoption of the Management Retention Program. PG&E is confronted with a clear risk that a number of its most essential senior management personnel will leave to seek more secure employment or retire during the

pendency of this Chapter 11 case. PG&E believes that its continued provision of safe, reliable and responsive service to its customers and its ability to reorganize successfully depend upon the retention of such critical members of its management team throughout the Chapter 11 process, until at least the confirmation of a reorganization plan. Accordingly, the Management Retention Program is structured to assure continuity in PG&E's operations by establishing incentives for its most essential personnel to remain in their current leadership positions through the reorganization process.

The current crisis justifies implementation of the Management Retention Program as an exercise of PG&E's sound business judgment. PG&E faces several challenges, including the various issues raised by its bankruptcy, electrical blackouts, implementation of significant rate increases, and the probability of strong, negative customer reaction to the foregoing. Senior management will be critical to PG&E's ability to ensure continued business operations and successful reorganization in the face of these challenges. Were any of the most essential senior managers that PG&E seeks to include in the Management Retention Program to leave their current positions for other employment or retirement, it would be difficult, and costly, for PG&E to replace them. At best, obtaining replacement personnel would require an expensive and time-consuming recruitment effort. At worst, replacements possessing the requisite knowledge and skills simply would not be available. See In re Landmark Land Co., 136 B.R. 410, 413 (D.S.C. 1992) ("[t]he debtor-in-possession reaps the benefits, post-petition, of retaining competent loyal employees. If post-petition there were a mass exodus, the debtor would have to start again with new employees at every level and operations would slow to a near halt as personnel adjusted to their new work environment, duties and routines").

In light of the importance of a Chapter 11 debtor's key employees to its continued business operations and the prospects of a successful reorganization, the implementation of employee retention programs such as the Management Retention Program is commonly approved as proper exercises of a debtor's business judgment. See, e.g., Dai-Ichi Kangyo Bank Ltd. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.),

242 B.R. 147, 155 (D. Del. 1999) (approving plan to "retain key employees who would be essential to the Debtors' reorganization"); In re America West Airlines, Inc., 171 B.R. 674, 678 (Bankr. D. Ariz. 1994) (adoption of plan granting success bonuses to certain officers and employees of the debtor held within debtor's sound business judgment); In re Interco, Inc., 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991) (authorizing debtor to assume prepetition severance contracts and approving performance-based retention program). Furthermore, as discussed above, PG&E's proposed Management Retention Program compares favorably to court-approved plans in other large Chapter 11 cases, when the relative size of the various debtors, number of covered employees, and amount of payments are taken into account. Jackson Decl. ¶17.

Likewise, PG&E's payment of the modest Miscellaneous Pre-Petition Employee Payments constitute an exercise of PG&E's sound business judgment. As discussed above, such payments will improve employee morale by remedying unfair treatment affecting PG&E's administrative and technical and management personnel because other employees were paid for substantially similar work performance or achievement of business goals. In addition, by making such payments, PG&E will reduce employee anxiety arising from the uncertainty of working for a company in bankruptcy.

For the foregoing reasons, the Court should authorize payment of the Miscellaneous Pre-Petition Employee Payments and implementation of the Management Retention Program as an exercise by PG&E of sound business judgment.

C. Alternatively, The Court Should Exercise Its Equitable Powers To Allow PG&E To Honor The Severance And Displacement Program For Non-Bargaining Unit Employees At Divested Plants, The Work Force Management Program And The Miscellaneous Pre-Petition Employee Payments.

Even if the Court determines that PG&E's continuation of the Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants and the Work Force Management Program, and its payment of the Miscellaneous Pre-Petition Employee Payments are not authorized as a reasonable exercise of its business judgment, it should nonetheless allow PG&E to honor such payments pursuant to Section 105 of the

Bankruptcy Code[6] and the Court's inherent equitable powers.

As the United States Supreme Court has established, "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity." Pepper v. Litton, 308 U.S. 295, 304 (1939) (citation omitted). Numerous courts have recognized a bankruptcy court's ability and obligation to allow payment of pre-petition wages and benefits, irrespective of statutory priorities, where such payment is in the best interests of the estate. See, e.g., Crafts Precision Indus., Inc. v. U.S. Healthcare, Inc. (In re Crafts Precision Indus., Inc.), 244 B.R. 178, 183 (B.A.P. 1st Cir. 2000) (vacation payments that did not qualify under Section 507 "approved pursuant to §105, irrespective of them being non-priority obligations" because there existed a "substantial risk" of employee defection absent payment); Cohen v. KDC Fin. Servs. (In re Miller Mining, Inc.), 219 B.R. 219, 223 (Bankr. N.D. Ohio 1998) ("'[t]his Court often permits the payment of prepetition wages so that the debtor-in-possession may maintain an effective work force . . .'") (quoting In re Quality Interiors, Inc., 127 B.R. 391, 396-97 (Bankr. N.D. Ohio 1991)); Pension Benefit Guar. Corp. v. Sharon Steel Corp. (In re Sharon Steel Corp.), 159 B.R. 730, 736-37 (Bankr. W.D. Pa. 1993) (upholding authorization of pre-petition wages where "necessary to avert serious threat to Chapter 11 process"); Michigan Bureau of Workers' Disability Comp. v. Chateaugay Corp. (In re Chateaugay Corp.), 80 B.R. 279, 287 (S.D.N.Y. 1987) (allowing payment of certain pre-petition workers' compensation claims; "[a] rigid application of the priorities of §507 would be inconsistent with the fundamental purpose of reorganization and of the Act's grant of equity powers to bankruptcy courts, which is to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors . . ."); In re Gulf Air, Inc., 112 B.R. 152, 153-54 (Bankr. W.D. La. 1989) (granting ex parte motion to pay employee-related expenses); see also Burchinal v. Central Washington Bank (In re Adam's Apple, Inc.), 829 F.2d 1484, 1490 (9th Cir. 1987) ("[c]ases

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[6]Section 105(a) provides, in relevant part, as follows: "[t]he court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title. . . ." 11 U.S.C. §105(a).

have permitted unequal treatment of pre-petition debts when necessary for rehabilitation, in such contexts as (i) pre-petition wages to key employees; . . . and (iv) peripheral benefits under labor contracts").

In the present case, PG&E's continuation of the Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants and the Work Force Management Program, as well as its payment of the Miscellaneous Pre-Petition Employee Payments, are all in the best interests of the bankruptcy estate. The loss of important personnel due to economic uncertainty or sagging employee morale may threaten PG&E's continued provision of safe, reliable and responsive service to its customers and jeopardize its reorganization efforts. Accordingly, the Court should exercise its equitable powers to allow PG&E to continue such Programs and honor such payments.

IV.

CONCLUSION.

For the foregoing reasons, PG&E respectfully requests that this Court enter its Order:

1. Authorizing PG&E to maintain the Severance and Displacement Program For Non-Bargaining Unit Employees At Divested Plants;

2. Authorizing PG&E to maintain the Work Force Management Program;

3. Authorizing PG&E to implement the Management Retention Program;

4. Authorizing PG&E to honor the Miscellaneous Pre-Petition Employee Payments; and

5. Granting such other relief as this Court determines to be equitable and just.

DATED: May 25, 2001.

Respectfully,

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