JAMES L. LOPES (No. 63678)
JEFFREY L. SCHAFFER (No. 91404)
KENNETH A. NEALE (No. 126904)
HOWARD, RICE, NEMEROVSKI, CANADY, FALK & RABKIN
A Professional Corporation
Three Embarcadero Center, 7th Floor
San Francisco, California 94111-4065
Telephone: 415/434-1600
Facsimile: 415/217-5910

Attorneys for Debtor and Debtor in Possession
PACIFIC GAS AND ELECTRIC COMPANY

50-275/323

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 Date: June 26, 2001 Time: 9:30 a.m. Place: 235 Pine St., 22nd Floor San Francisco, California Judge: Hon. Dennis Montali

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

DEBTOR'S NOTICE OF MOTION AND MOTION FOR AUTHORITY TO CONTINUE ITS HAZARDOUS SUBSTANCES CLEANUP PROGRAMS; MEMORANDUM OF POINTS AND AUTHORITIES

[SUPPORTING DECLARATION OF ROBERT C. DOSS FILED SEPARATELY]

A001 0/1 Add: Rids Ogc Mail Center

TABLE OF CONTENTS

TABLE OF CONTENTS

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES

Statutes

Other Authorities

NOTICE OF MOTION AND MOTION

PLEASE TAKE NOTICE that on June 26, 2001, at 9:30 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 authorizing PG&E, without further Court order, to expend up to $22 million in each calendar year in which the above-captioned Chapter 11 case is pending to continue its hazardous substance remediation programs and procedures, all as described more fully herein. This Motion is made pursuant to 11 U.S.C. §§105(a) and 363 , and is based on the facts and law set forth herein, the Declaration of Robert C. Doss filed concurrently herewith, 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, the office of the United States Trustee and the Official Committee of Unsecured Creditors) at least five 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

I. INTRODUCTION

Pacific Gas and Electric Company, the debtor and debtor in possession in the above-captioned Chapter 11 case (the "Debtor" or "PG&E"), submits this Memorandum of Points and Authorities in Support of Debtor's Motion For Authority to Continue Hazardous Substance Cleanup Programs (the "Motion") pursuant to Sections 105(a) and 363 of the United States Bankruptcy Code, 11 U.S.C. §§105(a) and 363 .[1] In brief, PG&E seeks Court authorization to expend up to $22 million in each calendar year while this Chapter 11 case remains pending towards the cost of investigating and responding to instances of environmental contamination caused by, or alleged to be caused by, releases from the operations of PG&E or its predecessor companies, whether such releases occurred prior to or occur after the filing of this case, whether such releases occur on property owned or operated by PG&E or by third parties, and whether such investigation and/or response actions are mandated by orders issued by state or federal environmental regulatory agencies, are required by third-party agreements, or are initiated by PG&E. In addition, PG&E seeks the Court's authorization to exceed such $22 million annual limitation in emergency situations involving new post-petition releases or threatened releases of hazardous substances, as necessary to prevent imminent harm to public health and safety or the environment, in which event PG&E would agree to seek the Court's approval of such emergency expenditures at the earliest practicable time. PG&E has obtained the approval of the Official Committee of Unsecured Creditors for the authorizations sought by the Motion.[2]

---

[1]Unless otherwise specified, all Section references in this brief are to the United States Bankruptcy Code (title 11 of the United States Code).

[2]As more particularly described herein, the Motion seeks authorization to conduct and pay for environmental remediation activities on contaminated properties that are owned by PG&E and to contribute to the cost of environmental remediation of contaminated properties for which PG&E faces liability under Federal or state law, whether emanating pre-petition or post-petition. However, it is equally relevant and important to emphasize what is not addressed or covered by the Motion, as follows: First, the Motion does not request authority to pay any costs of or to settle any claims for personal injuries, property damages (including natural resource damages claims), or economic losses (including lost profits, relocation costs or lose-of-use claims) that may be related to contamination located on PG&E property or on the property of third parties, all of which are outside the ambit of the Motion. Second, the Motion is not intended to constitute and does not constitute any request or action to assume any executory contract of PG&E under

Investigating and responding to instances of environmental contamination is an ordinary and necessary component of PG&E's business. Due to the uncertainty of Ninth Circuit law as to the treatment of environmental obligations in bankruptcy (see discussion in Section IV below), however, PG&E has temporarily suspended its cleanup programs on third-party properties.[3] As part of the relief sought in the Motion, PG&E seeks the Court's permission to continue these operations on a limited basis notwithstanding that at least some of the expenditures for which PG&E is seeking authorization involve pre-petition claims and that many of these would likely not be subject to administrative priority status in the Ninth Circuit.

PG&E believes that it is appropriate for the Court to grant approval to PG&E to continue with its environmental cleanup program, subject to the financial limitations described herein, for several reasons, any of which might be compelling enough standing alone to warrant the relief sought by the Motion, and all of which, taken together, strongly militate in favor of granting the Motion. First, because the law in this area is in many cases unclear, PG&E may be required to expend considerable resources and time defending itself against proceedings brought by governmental agencies seeking to force PG&E to comply with their orders to investigate and clean up contaminated properties and the outcome of such proceedings is uncertain. Second, because many of PG&E's cleanup programs are the subject of governmental orders and consent decrees, the failure to comply with the same could result in fines the treatment of which in bankruptcy is uncertain. Third, there is a benefit to the estate in avoiding a prolonged work stoppage at its cleanup sites which could result in increased expenditures to the estate down the road. Fourth, the amount of funds for

---

Section 365 of the Bankruptcy Code, and any Order on the Motion should not be construed as authorizing an assumption of any contract. Third and finally, neither the Motion, nor any order thereon, nor any action taken by PG&E or any other person or entity pursuant thereto, should be interpreted or construed as excusing any person or entity holding or allegedly holding a pre-petition claim against the bankruptcy estate from filing a formal proof of claim as provided under the United States Bankruptcy Code and any applicable rules of the Federal Rules of Bankruptcy Procedure and the Bankruptcy Local Rules for the Northern District of California in order to preserve its rights.

[3]PG&E has generally continued its cleanup programs on its owned properties because, as discussed further below, it believes the law is more certain in this area.

which authorization is sought (i.e., $22 million annually) is relatively modest. Fifth and finally, there are obvious social benefits in allowing PG&E's cleanup activities to continue, including the prevention of further dispersal of contaminants into the environment.

II. GENERAL BACKGROUND

PG&E is an investor-owned utility providing electric and gas services to millions of California residents and businesses. 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, but has 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, PG&E filed a voluntary petition under Chapter 11 of the Bankruptcy Code on April 6, 2001. PG&E continues to manage and operate its business and property as a debtor in possession pursuant to Sections 1107 and 1108 of the United States Bankruptcy Code (11 U.S.C. §§1107-1108). No trustee has been appointed.

III. PG&E'S CLEANUP PROGRAMS[4]

A. History.

PG&E has a long history of operations. PG&E or its predecessors have been in existence since the mid-1850s. Its operations include or have included manufactured gas plant sites, natural gas gathering system sites, natural gas compressor station sites, electric transmission and distribution facilities, steam-electric power plant sites, hydroelectric power

[4]The evidentiary support for the facts set forth in this Section III is found in the Declaration of Robert C. Doss filed concurrently herewith (hereinafter referred to as the "Doss Declaration" and cited as the "Doss Decl.").

plant sites, nuclear power plant sites and service centers. PG&E owns numerous separate parcels of real property and is a tenant under more than 250 leases. As a necessary part of its business, PG&E has used and continues to use a variety of different hazardous materials in a number of its sites. Given the size and nature of PG&E's business operations, its long operating history, and the many properties PG&E owns and leases, the cleanup of sites containing hazardous substances is an ordinary and recurring part of PG&E's business and will be for many years to come.

B. Overview Of PG&E's Hazardous Substances Cleanup Programs.

The development of PG&E's hazardous substances cleanup programs largely parallels, and is in response to, the emergence of environmental laws which govern the management and cleanup of hazardous wastes and hazardous substances. With the promulgation of federal Resource Conservation and Recovery Act regulations in 1979, PG&E began an overall examination of its operations to determine which facilities may contain historic sites of waste disposal. This effort was intensified in the early 1980s upon discovery of residues from gas manufacturing operations at two PG&E properties. During the same period, the promulgation of a major regulatory program under the Toxic Substances Control Act regarding the use and disposal of polychlorinated biphenyls ("PCBs") led to PG&E's implementation of voluntary programs to replace the two major categories of PCB-containing electrical equipment on its system, and placed increasing emphasis on the cleanup of releases from in-service equipment and from historic discharges. California's regulations regarding testing, upgrading and cleanup of releases from underground tanks which store hazardous substances led to a major PG&E program to remove over 500 such tanks from service, and to conduct investigations and, where appropriate, remedial actions to mitigate the effects of any historic leaks or releases from the tanks. Finally, the development of regulatory programs under the Federal Comprehensive Environmental Response, Compensation and Liability Act of 1980 (commonly referred to as "CERCLA" and the Federal "Superfund" statute) and similar state statutes enacted under the California Health and Safety Code have led PG&E to develop a comprehensive program,

operating under state and federal regulatory oversight, to evaluate known sites of historical operations and potential releases, and to perform remedial measures at sites where necessary to address ongoing or potential exposure risks.

PG&E maintains a staff of environmental professionals to manage its hazardous substance cleanup programs. These include professional engineers, registered geologists, certified engineering geologists, and personnel with training or certification in related environmental fields. The large number of sites involved, as well as the specialized expertise mandated in site investigations, requires that the PG&E staff serve as "project managers," setting the technical framework for site investigations, serving as the liaison with regulatory agencies, local officials and the public, directing the performance of the investigations and remedial actions, and managing all aspects of contracting, budgeting and cost reporting. By and large, PG&E uses the services of environmental consulting firms to perform site investigations, conduct human health and ecological assessments, and to design and implement any required remedial measures. From time to time, specialized environmental services are obtained, such as studies of biological habitat and development of measures to provide protection of endangered or threatened species, or forensic analyses of residues to obtain information on their possible sources.

PG&E's environmental professionals are supported in these programs by internal PG&E legal counsel, who assist in the development of environmental policies, provide guidance and direction on legal and regulatory issues, and manage regulatory and third-party claims with respect to environmental issues. Where appropriate, PG&E counsel utilize the services of outside legal firms to assist in responding to claims.

PG&E's overall approach to the cleanup of hazardous substances sites is predicated on full compliance with all applicable environmental laws. Remedial measures are developed with the oversight of local, state or federal environmental regulatory agencies. Sites which present an ongoing exposure risk to human health or the environment are, of course, given first priority in investigation and remedial action. PG&E's policy is to provide full notice to all involved regulatory agencies of the existence of such sites, and to work

cooperatively with the agencies, and under their oversight, throughout all phases of investigation and cleanup.

PG&E's approach to hazardous substance cleanup claims made by third parties is to first ascertain whether the claims arise from conditions which are, or could be, due to operations for which PG&E is responsible. For those sites where PG&E determines it may be responsible for the environmental conditions, its preference is to work cooperatively with the claimant in investigating site conditions and developing a mutually agreeable plan for remedial actions. Under certain circumstances, PG&E will agree to share in financing the costs of investigation and cleanup that meet the requirements of the overseeing environmental agency, or will agree to a negotiated, fair and equitable allocation of costs already incurred. This approach avoids the inefficiencies and extra cost involved in litigating site cleanup responsibility, while at the same time providing some reasonable assurance that PG&E is assuming responsibility only for those conditions brought about by its operations. In those instances where an equitable allocation based on current California and federal law cannot be reached, PG&E will litigate the claim.

C. Components Of A Typical Site Investigation And Cleanup.

Although sites rarely qualify as "typical" in all respects, the following is a brief discussion of the most common study and mitigation elements of a cleanup program at sites where releases of hazardous substances have occurred.

1. Preliminary Studies.

A site whose operations potentially could have contributed to hazardous substances contamination typically first undergoes one or more preliminary studies, termed "preliminary assessments" or "Phase 1 environmental site assessments." In these studies, site operations are summarized and the potential for chemical release is evaluated, spills or other known releases are identified, known disposal repositories are identified and described, interviews are conducted with former employees or local officials to determine the likelihood that a release of a hazardous substance occurred on the site, and nearby sites of known hazardous substance releases are identified. These assessments generally include a

review of public documents in the files of environmental regulatory agencies.

2. Sampling Of Environmental Media.

The chemical data that forms the core of the site investigation process is obtained through remedial, or "Phase 2," investigations, which involve the sampling of environmental media (soils, sediments, groundwater, surface water, air) to determine the nature and extent of chemical contamination on a site. These investigations also require that site hydrologic, geologic and geochemical conditions are defined, so that the fate and transport of chemical contaminants can be assessed.

3. Human Health And Environmental Risk Assessments.

Using data obtained during the remedial investigation, an assessment may be made of the extent of risk posed by chemicals present at a site to human health or to ecological receptors, such as indigenous plant or animal species. These assessments seek to determine the theoretical increase in the probability of developing disease from exposure to the chemical at the site under study. The use of theoretical risk studies to assess the likelihood of adverse human health effects is widely accepted in both federal and state regulatory programs. So-called "risk-based cleanups" represent a scientifically defensible, and health-protective, means of establishing how "clean" a site must be made for a given purpose.

4. Other Specialized Studies.

The investigation of a site may involve the conduct of highly specialized studies necessary to establish the historical framework for site responsibility or to ascertain specific data on biological or cultural resources. Historical studies of all site operations, as well as site ownership, are often necessary to determine whether or not, or to what extent, materials present at a site are the responsibility of PG&E, and whether operations of others may be responsible for site conditions. Forensic chemical analysis is often useful in establishing the likely origins of hazardous substances, particularly organic substances. Species diversity and habitat studies help identify sites where threatened or endangered species issues may arise.

5. Feasibility Studies.

A feasibility study is a formal evaluation of all alternatives (including taking no action), which may be employed at a site to achieve remedial goals. Remedial goals may include the reduction of human health risk to a level below an established threshold and/or the reduction in concentration of a chemical to a level below an adopted standard. Alternative actions are identified and described in the feasibility study, and are evaluated on the basis of diverse criteria including efficacy in achieving remedial goals, effects of the action on public health and safety, effects of the action on beneficial uses of resources, cost, ease of implementation, and permanence. The feasibility study concludes with a description of the recommended remedial alternative, based on the detailed analysis and ranking of the range of remedial alternatives available.

6. Remedial Action Plans.

A remedial action plan is a conceptual design-level plan for responding to exposure risks posed by hazardous substances at a site. When prepared following a feasibility study, a remedial action plan will be concerned with the recommended remedial option identified in the feasibility study. In cases where no feasibility study has been prepared (as in the case of relatively uncomplicated sites where cleanup is expected to be below certain statutorily established cost thresholds) a "remedial action workplan" may be prepared, which combines a brief analysis of a limited range of remedial measures with the identification and conceptual design of a preferred alternative.

Remedial action plans are adopted as part of a public notice and hearing process conducted by environmental regulatory agencies. Following a public hearing to introduce and receive comments on a remedial action plan, a formal comment and response period will commence. At the conclusion of that period, the plan may be adopted by the agency as a final plan.

7. Remedial Design Documents.

Upon adoption of a final remedial action plan, a detailed engineering design must be prepared to implement the approved remedial measures. In addition, and depending on

the types of remedial measures proposed, workplans may be required for various elements of the remedial measures, including the transportation of wastes and materials to or from the site, the protection of on-site workers and the public during implementation of the remedial measures, and the monitoring of ambient air, water or soil during the remedial actions to ensure that hazardous substances are not dispersed by the remedial actions.

8. Remedial Actions.

Upon the conclusion of the investigation phase at a hazardous substance release site (as represented by the various activities described above), remedial measures are implemented in accordance with the approved plans. The basic remedial options are: (1) containment of hazardous substances to eliminate future human health or environmental exposure risks, (2) removal of hazardous substances to an appropriate disposal or treatment facility, and (3) treatment of hazardous substances in-situ to reduce their quantity, mobility, or toxicity.

9. Post-Remedial Measures.

Following implementation of remedial measures at a site, a number of post-remedial actions are generally required. Active remedial systems, such as groundwater control, extraction and treatment systems, must be maintained throughout their operating lives (which can range to 30 years or more). Passive remedial facilities, such as soil caps or hydraulic slurry walls, must undergo regular inspections to ensure their continued efficacy. Groundwater monitoring often must continue at a site, and in the vicinity of that site, to ensure the containment and/or reduction of groundwater contamination continues according to the remedial plans. Access restrictions must be maintained at sites where such restrictions are a feature of the remedial measures.

D. Categories Of Hazardous Substances Cleanup Sites.

PG&E's hazardous substances cleanup programs generally involve sites that can be broadly grouped into the following three categories:

(1) PG&E-owned sites at which there are active operations;

(2) PG&E-owned sites at which there are no active operations; and,

(3) Third-party owned sites.

Pending the Court's hearing and ruling on the Motion, PG&E has suspended its hazardous materials cleanup programs on properties falling within the third category referenced above due to the concern that continuing with such programs may involve the payment of a prepetition claim and may be deemed not to benefit the bankruptcy estate.

E. Forecasted Expenditures At Hazardous Substances Cleanup Sites.

PG&E incurred expenditures of approximately $16 million for its hazardous substances cleanup programs in calendar year 1999 and approximately $18.5 million in calendar year 2000. PG&E has budgeted expenditures of approximately $20.6 million for its hazardous substances cleanup programs in calendar year 2001, of which $2.3 million has been spent to date.

As may be expected, the anticipated costs for these programs overall can be highly variable. Unanticipated discoveries at sites not currently in the programs, or new claims relating to formerly owned sites, can add significant costs to a given year's budget. Information gathered during site investigations and from historical or forensic studies can affect dramatically the degree to which PG&E's operations can be considered to have resulted in the presence of hazardous materials at a site, and thus may necessitate a revision of PG&E's estimated cleanup liability at that site.

IV. LEGAL ANALYSIS AND SUMMARY OF LEGAL UNCERTAINTIES

It is unclear how the United States Court of Appeals for the Ninth Circuit and Federal courts within the Ninth Circuit would approach many of PG&E's hazardous substances cleanup programs in the bankruptcy context. The law is relatively clear at the margins, but there is a large gray area in the middle. On the one hand, the law strongly suggests that on property owned by the estate from which the estate currently derives a benefit, PG&E will be required to comply with applicable laws and governmental orders respecting environmental cleanup. On the other hand, with respect to properties not owned by PG&E from which PG&E derives no benefit, it is unlikely that PG&E would be required

to expend funds towards environmental cleanup. With respect to all other situations, including non-operational properties owned by PG&E and even operational properties owned by PG&E where all contamination occurred pre-petition, it is uncertain if and to what extent PG&E would be required to pursue cleanup activities on such sites.

The relief sought in the Motion is informed in part by the uncertainties in the law regarding environmental cleanup obligations in bankruptcy and the concern that without some Court-approved parameters, substantial estate and judicial time and resources could be consumed litigating environmental issues. Accordingly, what follows is a brief summary of the law concerning environmental remediation issues in bankruptcy.

A. The Automatic Stay Provision.

Under Section 362(a) , a bankruptcy petition stays the commencement or continuation of judicial, administrative or other actions or proceedings against the debtor that were or that could have been commenced prepetition, or to recover a claim against the debtor that arose prepetition. Section 362(b)(4) exempts from this stay any proceeding by a governmental unit to enforce its police or regulatory power, including the enforcement of a non-monetary judgment that was obtained in an action or proceeding to enforce its police or regulatory power.

Many of PG&E's cleanup programs have been implemented pursuant to governmental orders, including on sites where PG&E currently has suspended its cleanup activities. With respect to these sites in particular, the government may bring an injunction action against PG&E seeking to force PG&E to comply with governmental orders and continue its cleanup activities. It is uncertain whether the automatic stay provision of the Bankruptcy Code applies to bar the enforcement of an injunction requiring a debtor to clean up a site. Several cases in various circuits, including one in the Ninth Circuit, suggest that such injunctions will be exempted if they seek to prevent future harm and do not seek to recover monetary damages. See Penn Terra Ltd. v. Department Envtl. Res., 733 F.2d 267, 278-79 (3d Cir. 1984) (state's injunction requiring debtor to clean up environmental contamination pursuant to state law exempted from automatic stay because it was action to

enforce governmental unit's police or regulatory power and sought to prevent future harm); Walsh v. West Virginia (In re Security Gas & Oil, Inc.), 70 B.R. 786, 790 (N.D. Cal. 1987) (following Penn Terra and concluding that state's injunction requiring debtor to reclaim and plug abandoned wells in compliance with state law was exempted from the automatic stay provision because "injunction was meant to prevent future harm to, and to restore, the environment").

However, at least one case from within the Ninth Circuit suggests that in certain situations, courts will not exempt an injunction from the automatic stay if it would have the effect of defeating the purpose of the discharge provision. See In re Goodwin, 163 B.R. 825 (Bankr. D. Idaho 1993). In Goodwin, the court found that an injunction requiring the Chapter 7 debtor to clean up contamination on its site was prohibited by the automatic stay. After finding that the requested injunction was a claim subject to discharge, the court then concluded that the requested injunction was prohibited by the automatic stay because permitting the government to obtain the injunction "would, in effect, deny the debtor a discharge." Id. at 834. In other words, recognizing the injunction as an exception to the stay (and thus requiring the debtor to comply with it until the obligation is actually discharged) would defeat the discharge because it would require the debtor to expend money to clean up its property in compliance with the injunction. Id.

Thus, if an order or injunction that directs PG&E to clean up its contamination on one of its sites qualifies as a claim subject to discharge (see Section IV.B. below), the Goodwin case suggests that the courts may refuse to exempt the injunction from the stay provision because permitting the injunction would require PG&E to expend funds to comply with the injunction until after the discharge occurs, which would conflict with the purpose of the discharge provision. This approach may be particularly likely in circumstances where the contamination is historical, as in Goodwin.[5]

[5]Most of the sites for which PG&E seeks authorization to clean up involve historical contamination, i.e., past contamination that is not actively continuing.

B. Claims Subject To Discharge.

Section 101(5) defines "claim" to mean (a) a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (b) a right to an equitable remedy for breach of performance if such a breach gives rise to a right to payment, whether or not such a right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured. Only prepetition claims are subject to discharge. 11 U.S.C. §1141(d)(1).

Whether cleanup costs or obligations to perform remediation activities, including orders, agreements and injunctions, will be treated as claims and subject to discharge will thus depend on (1) whether the claim arose prepetition; and (2) whether PG&E's breach of an obligation to perform remediation activities would give rise to a right of payment. While the Ninth Circuit has a clear test for the first factor in this analysis, it is less clear how the courts would treat various types of injunctive relief.

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN

1. Any Future Damages Or Response Costs Based On A Prepetition Release Or Threatened Release Of Hazardous Substances Will Be Considered A Claim Subject To Discharge If They Were Fairly Contemplated By The Parties Involved.

The Ninth Circuit has adopted the "fairly contemplated" test, under which "all future response and natural resource damages cost based on pre-petition conduct that can be fairly contemplated by the parties at the time of the [d]ebtors' bankruptcy are claims under the Code." Jensen v. California Dep't of Health Servs. (In re Jensen), 995 F.2d 925, 930 (9th Cir. 1993). In Jensen, the court found that the Department of Health Services ("DHS") knew of the serious environmental hazard at a site which was leased by the debtor before the bankruptcy petition was filed and therefore had sufficient prepetition knowledge of the debtor's potential liability to give rise to a contingent claim for cleanup costs. Id. at 931. Thus, the debtor's portion of the cleanup costs, which was allocated postpetition by the DHS, and the DHS's postpetition claim for reimbursement of its own remediation expenditures arose prepetition and were discharged. Id. Under the Jensen test, many of the

cleanup costs and obligations to perform remediation activities associated with PG&E's cleanup program would qualify as a prepetition claim.

2. Whether An Injunction Will Be Considered A Claim Depends On The Type Of Conduct Enjoined Or Mandated Therein.

In Ohio v. Kovacs, 469 U.S. 274 (1985), the United States Supreme Court held that the obligation of the Chapter 7 debtor to comply with a state court injunction requiring it to clean up hazardous waste was a claim subject to discharge because the debtor could only comply with the injunction by a payment of money. Id. at 276-78. In that case, a receiver had been appointed which had the effect of dispossessing the owner of the estate and preventing the owner from performing the mandated cleanup work. Id. Thus, the holding in Kovacs is limited to circumstances where the debtor is no longer in possession of the property. In fact, Kovacs makes it clear that a debtor in possession of a site "may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions." Id. at 285.

Only one case from within the Ninth Circuit appears to have addressed the issue of when an injunction requiring environmental cleanup or remediation activity will be considered a claim subject to discharge. In that case, Goodwin, supra, the court was faced with determining whether a proposed injunction requiring a Chapter 7 debtor to clean up and abate contamination on its site arising from a one-time prepetition massive petroleum leak was prohibited by the automatic stay provision of Section 362(a)(6). Part of this determination hinged on whether the injunction could be considered a claim.

Unlike courts in other circuits, the Goodwin court refused to conclude that an injunction was a nondischargeable claim merely because it required the debtor to engage in or refrain from certain conduct rather than make a monetary payment. Goodwin, 163 B.R. at 830-31. Instead, the court determined that the requested injunction was "nothing more than an attempt to collect a debt from the debtor, and as such directly contradicts the purpose for the discharge provided by the Bankruptcy Code." Id. at 831. Central to the court's decision was its finding that the government could have performed the cleanup itself and sought

reimbursement because all of the contamination arose from historic releases and the debtor was no longer engaged in any activity that was causing pollution. Id.

Goodwin implies that injunctions requiring PG&E to clean up and abate contamination resulting from an historic release would be considered claims because the State can perform the clean up and eliminate the contamination on its own without assistance from PG&E and then seek payment for its costs. 163 B.R. at 832.[6]

However, Goodwin's application to the various circumstances facing PG&E is uncertain. First and foremost, Goodwin is a bankruptcy court case from the District of Idaho that does not seem to have been given much weight in the Ninth Circuit. Second, Goodwin involved a Chapter 7 bankruptcy case of a debtor who was no longer in possession of the property, although the property remained with the estate. Id. at 832. Additionally, all of the contamination in Goodwin arose from a one-time prepetition release. Id. Thus, while Kovacs strongly suggests in dicta that a Chapter 11 debtor must comply with environmental laws with respect to properties on which it has operations, Goodwin suggests that a Chapter 11 debtor may not be forced to engage in investigation or cleanup activities at those sites owned by debtor at which there are no active operations that provide benefit to the estate and at sites owned by third parties.

Looking outside of the Ninth Circuit, the most frequently relied upon case is United States v. LTV Corp.(In re Chateaugay, Corp.), 944 F.2d 997 (2d Cir. 1991). Chateaugay held that any order that to any extent requires a debtor to end or ameliorate pollution currently existing or emanating from its own property is not a dischargeable claim. Id. at 1008-09. The Chateaugay court distinguished Kovacs, because the debtor in Chateaugay was in possession of the property and could actually clean up the site. Id. at 1009. The court recognized that when the debtor is no longer in possession of the property and must pay another party to perform the cleanup, the injunction is converted into an

---

[6]On the other hand, an injunction that requires PG&E to clean up and abate contamination resulting from current releases from the operations of PG&E would likely not be considered a claim because the State cannot take action to prevent the contamination from occurring and later seek reimbursement for its expenses. Id.

obligation to pay money and should be considered a claim. Id. Moreover, the court found that its decision was supported by Kovacs because an order requiring a property owner to remedy ongoing pollution can hardly be a dischargeable claim if Kovacs instructs that owners "may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions." Id. at 1009 (citing Ohio v. Kovacs, 469 U.S. 274, 285 (1985)).

Chateaugay thus instructs that a debtor's obligation to comply with an injunction requiring it to remediate contamination currently existing on its own property cannot be discharged. Under this principle, PG&E would be required to perform remediation activities addressing current contamination on all sites which it currently owns. It is unclear whether and to what extent a Ninth Circuit court would follow Chateaugay. Chateaugay's reasoning was rejected in part by the Goodwin court, which disagreed with Chateaugay to the extent it holds that an order addressing prepetition historic (as opposed to continuing) pollution would not be a claim. Goodwin, 163 B.R. at 832-33.[7]

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

C. Priority Of Environmental Claims.

Assuming that an environmental obligation has been found to be a "claim" under the Bankruptcy Code, the next question that arises is whether the claim should be classified as an administrative expense, which would entitle the claim to be paid before any other unsecured claims. Section 503(b)(1) instructs that "the actual, necessary cost and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case" shall be allowed administrative expenses.

---

[7] Chateaugay's approach was followed to an extreme by the Third Circuit in In re Torwico Elect., Inc., 8 F.3d 146, 150 (3d Cir. 1993), which held that an injunction requiring the debtor to clean up hazardous waste on a site that debtor did not own or have possession of was not a claim because waste from its previous operations was still leaking hazardous material and continued to present a threat. However, it is unlikely that the Torwico decision would have any impact on Ninth Circuit jurisprudence. The Torwico decision has been criticized by many commentators as conflicting with the Supreme Court's decision in Ohio v. Kovacs. See 11 Bankr. Dev. J. 85, 92 (1995) (Torwico is "at odds with the Kovacs decision" because injunction sought to remedy contamination on property no longer owned or operated by debtor); SE71 ALI-ABA 449, 490 ("Torwico decision runs completely counter to the Supreme Court's decision in Kovacs and undermines the Bankruptcy Code's fresh start policy"). Additionally, Torwico conflicts with the approach adopted by the Sixth Circuit prior to the Chateaugay decision. See United States v. Whizco, Inc., 841 F.2d. 147, 150-57 (6th Cir. 1988) (any order which requires debtor to expend money is claim subject to discharge). Moreover, if Goodwin is any indication of the Ninth Circuit's approach, Torwico's holding that an obligation to clean up "runs with the waste" and not with ownership or possession of property would not be followed.

The Ninth Circuit has construed Section 503 strictly, holding that administrative expense is only allowed when a claim (1) is incurred postpetition, (2) is an actual and necessary expense, and (3) directly and substantially benefits the estate. Burlington N.R.R. Co. v. Dant & Russell, Inc. (In re Dant & Russell), 853 F.2d 700, 706 (9th Cir. 1988); Gull Indus., Inc. v. John Mitchell, Inc. (In re Hanna), 168 B.R. 386, 388 (9th Cir. B.A.P. 1994). With respect to the first requirement, the Ninth Circuit treats all postpetition claims based on damages arising from prepetition conduct as prepetition damages which are not administrative expenses. In re Dant, 853 F.2d at 707 (postpetition cleanup costs of lessor of property resulting from lessee's prepetition operations and prepetition breach of lease are prepetition damages not entitled to administrative expense priority); In re Hanna, 168 B.R. at 388-89 (neighbor's postpetition cleanup costs resulting from prepetition leak from debtor's petroleum tanks should be regarded as having occurred prepetition). In other words, if the cleanup costs are consequent damages of prepetition contamination, they will not be considered administrative expenses in the Ninth Circuit.

However, In re Dant gives some suggestion that postpetition cleanup costs for contamination occurring prepetition may be given administrative expenses priority if the property that is being cleaned up is owned by the bankruptcy estate. See In re Dant, 853 F.2d at 709 (although costs which result from clean up of property not owned by bankruptcy estate are not entitled to administrative expense priority, "a different result . . . is warranted when the cleanup costs result from monies expended for the preservation of the bankruptcy estate.").[8]

With respect to the second and third requirements, the Ninth Circuit has generally

---

[8]Notably, other circuits have granted administrative expense status to postpetition cleanup costs resulting from prepetition releases or environmental contamination where the property to be cleaned up is owned by the debtor or where the debtor has ongoing operations on the site. See In re Chateaugay, 944 F.2d at 1009-10 (expenditures to clean up sites owned by the debtor where damages resulted from prepetition release of hazardous waste were accorded administrative priority because expenses to remove significant health hazard are necessary to preserve estate); Lancaster v. Tennesse (In re Wall Tube & Metal Prods. Co.), 831 F.2d 118, 123 (6th Cir. 1987) (State's response costs expended to clean up prepetition release of hazardous substances were allowable as administrative expenses); In re T.P. Long Chem., Inc., 45 B.R. 278, 289 (Bankr. N.D. OH. 1985) (EPA's costs incurred to remove hazardous waste resulting from prepetition release were entitled to administrative expense priority).

held that costs that are expended to clean up off-site property or property not owned by the estate, even where such costs are the result of contamination arising from the debtor's property, are not actual, necessary costs of preserving the estate and thus not administrative expenses. In re Dant, 853 F.2d at 708-09 (cleanup costs not entitled to administrative expense where costs were expended to clean up contamination on site leased by debtor); In re Hanna, 168 B.R. at 390 (where debtor's petroleum leaked into groundwater, neighbor's remediation efforts on property adjacent to debtor not administrative expenses).

Thus, under the Ninth Circuit approach, any postpetition costs expended to clean up a site that is not owned by PG&E, or a site at which PG&E no longer has any active operations, may not be entitled to administrative expense priority, as these costs do not benefit the estate and are not actual, necessary costs of preserving the estate. Additionally, there is some likelihood that where property is owed by PG&E and cleanup costs arise from prepetition contamination or releases, those costs will also not be accorded administrative expense priority. However, In re Dant makes this conclusion uncertain, as it implies that where costs arising from prepetition conduct are expended to clean up property owned by the debtor, they may be considered a benefit to the estate and thus an administrative expense. Because there have been no Ninth Circuit cases dealing with environmental claims to clean up property owned by the debtor, it is difficult to gauge how the Ninth Circuit would decide some of the situations facing PG&E.

Outside of the Ninth Circuit, courts have been more inclined to side with environmental interests in this context, granting administrative expense priority to clean up costs regardless of whether they derived from prepetition conduct, whenever the contamination presents a danger to the public's health and safety. See In re Chateaugay, 944 F.2d at 1009-10 (expenditures to clean up sites owned by the debtor where damages resulted from prepetition release of hazardous waste were accorded administrative priority because expenses to remove significant health hazard are necessary to preserve estate); In re National Gypsum Co., 139 B.R. 397, 413 (N.D. Tex. 1992) (postpetition response costs incurred as result of debtor's prepetition conduct entitled to administrative priority only to the extent

"such costs were necessitated by conditions that posed an imminent and identifiable harm to the environment and public health"); Pennsylvania, Dep't of Envtl Res. v. Conroy, 24 F.3d 568, 569-70 (3d. Cir. 1994) (cleanup costs to remove waste that was endangering public health and safety were entitled to administrative expense priority).

The rationale behind most of these cases is that if the debtor would have been required to expend those costs to comply with an obligation to respect state and federal hazardous substance laws—as it may be required to do under 28 U.S.C. Section 959(b)—or to comply with its obligation not to abandon property of the estate "in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards,"[9] the costs are actual, necessary costs of preserving the estate. See Lancaster v. Tennessee (In re Wall Tube & Metal Prods. Co.), 831 F.2d 118, 124 (6th Cir. 1987) (state's response costs allowable as administrative expenses because costs were necessary "both to preserve the estate in required compliance with state law and to protect the health and safety of a potentially endangered public").

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN

V. BENEFITS OF CONTINUING PG&E'S HAZARDOUS SUBSTANCES CLEANUP PROGRAMS

PG&E believes that a measured continuation of its environmental cleanup programs will provide significant benefits to the estate, to the environment and to society at large. First, PG&E will avoid what would likely be a barrage of actions by governmental agencies seeking to enforce their orders, consent decrees and regulatory requirements with respect to properties where PG&E has suspended its cleanup programs. These agencies will argue that they are exempt from the automatic stay and that their actions seeking to force PG&E to continue investigatory and remediation activities are not claims subject to discharge, notwithstanding that they would require PG&E to expend monies of the estate. The agencies may also seek to fine PG&E for its failure to comply with the agencies' orders

[9] See Midlantic Nat'l Bank v. New Jersey Dep't of Envtl Prot., 474 U.S. 494, 507 (1986).

and applicable laws. If such agencies seek to clean up sites on their own, they may assert the costs they incur are entitled to administrative expense priority. The ultimate outcome of these actions is uncertain.

Second, there is a benefit to the estate in avoiding any prolonged work stoppage at PG&E's cleanup sites. A prolonged stoppage may result in the loss of important consultants and contractors who may have to move on to other projects. It may also increase the costs of cleanup, particularly where the contamination is migrating. In allowing PG&E to continue its cleanup programs with minimal interruption, PG&E not only can avoid unproductive and lengthy squabbles with governmental agencies and third parties, it can better control the costs of the cleanup. PG&E is also benefited by cleaning up its non-operating properties in that it will be able to sell such properties at a higher price in the future. PG&E believes that in most instances the cost of the cleanup is less than the added value it brings to the property. Also, cleaning up the property minimizes the potential for a lawsuit from the buyer or subsequent owners of the property in the future. Doss Decl. ¶13.

Third, the magnitude of the costs for which PG&E seeks Court authorization is relatively modest in light of PG&E's overall operating expenses and the total assets and liabilities of the estate. Id. ¶14. Further, PG&E's request for authorization to expend up to $22 million annually in environmental remediation costs has been reviewed and approved by the Committee.

Fourth and finally, society benefits if PG&E is allowed to continue its environmental cleanup programs at the level requested in the Motion. The benefits are to the health and safety of the public and to the environment. The programs help return property to productive uses and prevent the further dispersal of contaminants into the environment.

PG&E notes that assuming the Motion is granted, PG&E does not intend to use the authorization granted by the Court as a mandate to perform all cleanup actions regardless of the degree to which PG&E is responsible, or to abandon considerations of cost-effectiveness in proceeding with investigations and remedial measures. PG&E is resolved to continue to protect the interests of its creditors, ratepayers and shareholders by insisting that

settlements with third parties be fairly predicated on a reasonable, scientifically-based assessment of PG&E's liability under applicable state and/or Federal law. Similarly, the degree of cleanup actions for which reimbursement from PG&E is sought must be based on reasonably foreseeable land uses, and must have the concurrence of the appropriate environmental regulatory agencies. Conversely, assuming the requested authorization is granted, PG&E will continue to respond without hesitation to address ongoing acute hazardous substance exposure risks which may occur at sites for which PG&E has or shares responsibility.

VI. THE COURT CAN AND SHOULD EXERCISE ITS EQUITABLE POWER TO GRANT THE MOTION TO FURTHER THE EFFICIENT ADMINISTRATION OF THIS ESTATE AND PUBLIC HEALTH AND SAFETY

To the extent the Motion seeks authorization to expend estate funds for hazardous substances cleanup on operating property owned by the estate that is required under the intersection of bankruptcy and environmental laws, such cleanup activities arise in the ordinary course of the Debtor's business and can be authorized by this Court pursuant to or in furtherance of Section 363(b)'s provision enabling a Chapter 11 debtor to use, sale or lease property of the estate in the ordinary course of business without notice or a hearing.

And to the extent the Motion seeks authorization to expend estate funds for hazard substances cleanup on non-operating property owned by the estate, or on property not owned by the estate on which PG&E has caused contamination, or with respect to pre-petition contamination caused by PG&E on owned or unowned property, this Court can and should grant the requested authorization pursuant to Section 105(a) and this Court's inherent equitable powers.

"'[C]ourts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.'" Pepper v. Litton, 308 U.S. 295, 304 (1939) (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934)); see also Young v. Higbee Co., 324 U.S. 204, 214 (1945). "[T]he bankruptcy court has the power to sift the circumstances

surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." Pepper, 308 U.S. at 308. It is well settled that a court of equity, exercising its discretion, may refuse or alter specific enforcement of a valid individual right if granting such a right "would be prejudicial to a paramount public interest." In re Jewish Mem'l Hosp., 13 B.R. 417, 419 (Bankr. S.D.N.Y. 1981). "The health and safety of the general public is [i]ndisputably a paramount public interest." Id. at 419.

Numerous courts have recognized the bankruptcy court's ability and obligation to allow payment of pre-petition wages and benefits, irrespective of statutory priorities, where such payments are in the best interests of the estate. See, e.g., Craft Precision Indus., Inc. v. U.S. Healthcare, Inc. (In re Crafts Precision Indus., Inc.), 244 B.R. 178, 183 (1st Cir. B.A.P. 2000); Cohen v. KDC Fin. Servs., Inc. (In re Miller Mining, Inc.), 219 B.R. 219, 223 (Bankr. N.D. Ohio 1998); Pension Benefit Garv. Corp. v. Sharon Steel Corp. (In re Sharon Steel Corp.), 159 B.R. 730, 736-37 (Bankr. W.D. Pa. 1993); Michigan Bureau of Workers' Disability Comp. v. Chateaugay Corp. (In re Chateaugay Corp.), 80 B.R. 279, 286-87 (S.D.N.Y. 1987); In re Gulf Air, Inc., 112 B.R. 152, 153-54 (Bankr. W.D. La. 1989).

The Ninth Circuit has similarly recognized the Court's equitable power to authorize a Chapter 11 debtor to deviate from the Bankruptcy Code payment priority scheme during the pendency of a Chapter 11 case where there are compelling circumstances warranting it. Thus, in Burchival v. Central Washington Bank (In re Adam's Apple, Inc.), 829 F.2d 1484, 1490 (9th Cir. 1987), the Ninth Circuit rejected the appellants' argument that a cross-collateralization clause in a post-petition agreement violated the "fundamental tenet" that "like creditors must be treated alike." Id. The Ninth Circuit observed, regarding the appellant's contention:

> It is flawed because the 'fundamental tenet' [that creditors be treated alike] conflicts with another 'fundamental tenet'—rehabilitation of debtors, which may supersede the policy of equal treatment. Cases 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. (Id.)

In the present case, the vagaries of the law governing a Chapter 11 debtor's

obligations with respect to environmental remediation, summarized in Part IV above, make it eminently sensible and appropriate for the Court to authorize environmental remediation activities within reasonable dollar limits based on PG&E's past experience, particularly where, as here, the requested authorizations are quite modest in relation to PG&E's overall post-petition operations and expenditures. Otherwise, the estate could end up consuming far more in litigation over environmental matters during the life of this case than it is "saving" by not proceeding with its usual cleanup and remediation activities. In addition, because environmental contamination problems simply do not go away, sooner or later many of the problems will have to be dealt with, and they are likely to get more expensive and difficult to deal with as time goes by for the reasons set forth in Parts III and V above. Finally, granting the Motion and providing the requested authorization for the hazardous substances cleanup program as described above will benefit virtually all constituents of the estate at a quite small cost by promoting public health and safety, and at the same time will advance the societal and governmental interests in compliance with environmental laws.

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

VII. CONCLUSION

For all of the foregoing reasons, PG&E respectfully requests that this Court make and enter its order (1) authorizing PG&E to expend, on a calendar year basis, up to $22 million for its hazardous substances cleanup programs beginning with calendar year 2001,[10] without further Court order, regardless of whether the events giving rise to such cleanup programs arose pre- or post-petition and regardless of whether the sites involved are owned and/or operated by PG&E or a third party; and (2) authorizing PG&E to exceed this $22 million limitation without further Court order only in emergency situations involving post-petition releases or threatened releases of hazardous substances if such excess expenditure is necessary in PG&E's reasonable business judgment to prevent imminent harm to public

[10]For calendar year 2001, such authorization would be retroactive to January 1, and thus would be reduced by all sums expended to date by PG&E. As of June 1, 2001, PG&E has expended $2.3 million for its hazardous materials cleanup programs.

health and safety or the environment, provided that PG&E proceeds to seek Court approval for such excess expenditure as soon as practicable following the emergency situation.

DATED: June 6, 2001

Respectfully,

JAMES L. LOPES
JEFFREY L. SCHAFFER
KENNETH A. NEALE
HOWARD, RICE, NEMEROVSKI, CANADY, FALK & RABKIN
A Professional Corporation

By: _____
JEFFREY L. SCHAFFER

Attorneys for Debtor and Debtor in Possession
PACIFIC GAS AND ELECTRIC COMPANY

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation