

50-275/323

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12  
13 UNITED STATES BANKRUPTCY COURT  
14 NORTHERN DISTRICT OF CALIFORNIA  
15 SAN FRANCISCO DIVISION

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16 In re  
17 PACIFIC GAS AND ELECTRIC  
18 COMPANY, a California corporation,  
19 Debtor.  
20 Federal I.D. No. 94-0742640  
21

No. 01 30923 DM

Chapter 11 Case

Date: October 29, 2001

Time: 9:30 a.m.

Place: 235 Pine Street, 22nd Floor  
San Francisco, California

Judge: Hon. Dennis Montali

22  
23 NOTICE OF MOTION AND MOTION REGARDING REQUEST BY  
CALIFORNIA DEPARTMENT OF WATER RESOURCES AND ORDER BY  
24 CALIFORNIA PUBLIC UTILITIES COMMISSION THAT PACIFIC GAS AND  
ELECTRIC COMPANY ENTER INTO SERVICING AGREEMENT WITH THE  
25 CALIFORNIA DEPARTMENT OF WATER RESOURCES;  
SUPPORTING MEMORANDUM OF POINTS AND AUTHORITIES

26 [SUPPORTING DECLARATIONS OF RUSSELL E. JORGENSEN, ROY M. KUGA  
27 AND STEVEN W. FRANK, AND REQUEST FOR JUDICIAL NOTICE FILED  
SEPARATELY]

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V. CONCLUSION

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1           Although mindful and respectful of the CPUC's order compelling PG&E to implement  
2 the Servicing Agreement and to obtain promptly this Court's permission to do so if PG&E  
3 so desired, PG&E maintains that the Servicing Agreement—which is being forced upon  
4 PG&E by the DWR and CPUC—fails to protect PG&E's assets and revenues. Rather, the  
5 Servicing Agreement functions as a State-approved vehicle designed to facilitate a diversion  
6 of PG&E's assets and revenue to the detriment of PG&E's estate and for the pecuniary  
7 benefit of DWR, a sister agency to the CPUC. Specifically, the Servicing Agreement is an  
8 integral part of an overall package of proposed actions regarding the financial and  
9 commercial relationship between DWR and PG&E that are pending before the CPUC for  
10 decision. Based on the proposed DWR and CPUC actions, PG&E has a reasonable basis to  
11 believe that the DWR's and CPUC's determinations of DWR's and PG&E's revenue  
12 requirements may have the effect of diverting PG&E's assets and revenue to DWR. PG&E  
13 believes it has a legal right to retain such assets and revenue for the benefit of its estate and  
14 its creditors. If PG&E is forced to implement the Servicing Agreement, it will be allowing  
15 DWR access to PG&E's assets and funds for DWR's use, to the detriment of its estate, its  
16 creditors and its shareholders.

17           PG&E submits that it cannot and should not be ordered to disable itself and to damage  
18 its efforts to reorganize its business. PG&E maintains that such outcomes would result from  
19 implementing the Servicing Agreement as ordered by the Servicing Agreement Decision. In  
20 addition, the Servicing Agreement contains terms detrimental to the estate, including terms  
21 expressly different from those that had been negotiated by the DWR and PG&E. PG&E  
22 therefore respectfully asks this Court to decline to authorize PG&E to enter into the  
23 Servicing Agreement at this time and under the terms and conditions stated in the Servicing  
24 Agreement Decision.

25           Beginning in February 2001, and extending over a period of several months, PG&E  
26 and DWR engaged in lengthy discussions as to how best to facilitate the goals of Assembly  
27 Bill 1 ("AB 1X-1"), the emergency legislation the California Legislature adopted on  
28 February 1, 2001. Declaration of Steven W. Frank ("Frank Decl.") ¶3. Under certain

1 circumstances, AB 1X-1 requires PG&E and other utilities to collect and remit funds to  
2 DWR for electric power purchased by DWR and sold to their customers, and also to provide  
3 revenues to DWR to pay interest and principal on bonds which DWR is authorized to issue  
4 to finance its power supply program.<sup>1</sup> In particular, AB 1X-1 provides that DWR may  
5 contract with the utilities "to transmit or provide for the transmission of, and distribute the  
6 power and provide billing, collection, and other related services, as agent of the  
7 department . . . ." Cal. Water Code §80106(a). Section 80106(b) permits DWR to request  
8 that the CPUC order a utility to enter into such an agreement.

9 Under AB 1X-1, the CPUC views its role as acting more as DWR's agent for the  
10 purpose of implementing DWR's financial and commercial relationship with PG&E and  
11 other utilities, than as an independent arbiter. For example, the CPUC has stated that "[AB  
12 1X-1] specifically provides that other state agencies are to provide DWR 'reasonable  
13 assistance or other cooperation' in carrying out the statute. Cal. Water Code §80016. The  
14 statute further provides for DWR to consult with the Commission. Given these provisions,  
15 DWR cannot be understood to be a party in our proceedings, implementing [AB 1X-1].  
16 Rather, the Commission and DWR are working together." Order Denying Rehearing Of  
17 Decision (D.) 01-04-005 (D.01-05-037at 16 (May 3, 2001)) (Exhibit 3 to RJN).

18 While reserving the issue as to whether an obligation to transmit and deliver power and  
19 to bill and collect charges and revenues for DWR could lawfully be imposed upon PG&E by  
20 AB 1X-1, PG&E diligently negotiated in good faith with DWR the terms and conditions  
21 under which the parties would implement AB 1X-1. The parties worked to negotiate an  
22 agreement that would provide for recovery of DWR's legitimate power purchase costs while  
23

24  
25 <sup>1</sup> In this regard, the CPUC has described the DWR's power supply program as "a business  
26 model under which DWR will operate as a state governmental enterprise that buys and sells power  
27 for the entire life of the bonds. Under this business model, DWR will use the revenues that it  
28 receives from the sale of power to pay for its costs to procure the power it sells before DWR pays  
the principal and interest on the bonds." Opinion Adopting Rate Agreement Between The  
Commission And The California Department Of Water Resources at 11 (Aug. 28, 2001) (Exhibit 2  
to RJN).

1 at the same time protecting PG&E's legitimate property interests in its assets. Frank Decl.  
2 ¶3.

3 However, in May and June 2001, PG&E became increasingly concerned during its  
4 negotiations with DWR that the parties would not be able to agree on the terms of a  
5 servicing agreement that would fully protect PG&E's assets and revenues from being  
6 unfairly burdened or diverted for DWR's benefit and use. Frank Decl. ¶4. On June 27,  
7 2001, DWR filed a contested draft servicing agreement ("June 27 Servicing Agreement")  
8 with the CPUC and asked the CPUC to order PG&E to implement the Agreement. (Exhibit  
9 4 to RJN). In response, the CPUC, in its Servicing Agreement Decision issued on  
10 September 10, 2001, ordered PG&E to provide DWR with access to PG&E's utility facilities  
11 and to pay DWR under the terms set forth in the Servicing Agreement. (Exhibit 4 to RJN).  
12 In so deciding, the CPUC disregarded the comments and objections – filed by PG&E – to  
13 the form and substance of the June 27 Servicing Agreement.<sup>2</sup> The CPUC, moreover, made  
14 modifications to the June 27 Servicing Agreement that adversely affects PG&E's estate.

15 As a preliminary matter, PG&E stands in the unusual position of asking this Court to  
16 review a Servicing Agreement that is an agreement PG&E would neither voluntarily execute  
17 nor recommend this Court approve. The agreement: (1) fails to protect PG&E's assets and  
18 revenues from diversion to DWR; and (2) differs from the terms negotiated by PG&E and  
19 DWR. PG&E brings this Motion, however, because the CPUC ordered PG&E "to comply  
20 with the servicing agreement proposed by DWR (with certain changes)" (Servicing  
21

22  
23 <sup>2</sup> PG&E filed two sets of comments regarding the June 27 Servicing Agreement. The first set  
24 of comments was filed on July 3, 2001. See Response Of Pacific Gas And Electric Company To  
25 Chief Administrative Law Judge's Ruling Seeking Comments On Proposed Servicing Agreement  
26 With Pacific Gas And Electric Company. (Exhibit 5 to RJN). PG&E filed the second set of  
27 comments on July 12, 2001. See Supplemental Response Of Pacific Gas And Electric Company To  
28 Chief Administrative Law Judge's Ruling Seeking Comments On Proposed Servicing Agreement  
With Pacific Gas And Electric Company. (Exhibit 6 to RJN). In addition, on September 4, 2001,  
PG&E filed comments on the CPUC's draft decision concerning the servicing agreement. See  
Comments Of Pacific Gas And Electric Company On Draft Decision Ordering Pacific Gas And  
Electric Company To Enter Into And Approving The Servicing Agreement With The California  
Department Of Water Resources. (Exhibit 7 to RJN).

1 Agreement Decision at 2) subsequent to the Bankruptcy Court's review and approval if  
2 PG&E concluded that it would be necessary to obtain such approval:

3 [I]f PG&E believes that it must seek Bankruptcy Court approval for this servicing  
4 agreement, it is free to do so. In that case, the servicing agreement will not  
5 become effective until such approval has been obtained. . . . We do believe,  
6 however, that PG&E should quickly decide whether or not to seek Bankruptcy  
7 Court approval. (*Id.* at 12-13)

8 PG&E submits that the CPUC's attempt to dictate the manner and scope of PG&E's  
9 contractual relationship with DWR, thereby limiting Bankruptcy Court review and approval  
10 is impermissible. The CPUC cannot compel a debtor-in-possession to use property of the  
11 estate outside of the ordinary course of business. *See* 11 U.S.C. §363(b). Such authority  
12 belongs solely to the trustee or debtor-in-possession upon notice and a hearing. *See id.*

13 Even were the Servicing Agreement acceptable in form and function, as discussed in  
14 Part IV(A) of this Motion, approval of the Servicing Agreement at this time would be  
15 premature and could facilitate potential violations of the automatic stay of Section 362 of the  
16 Bankruptcy Code. 11 U.S.C. §362(a). The Servicing Agreement establishes the mechanism  
17 for payment of "[c]harges assessed to Customers for DWR Power and any other amounts  
18 authorized to be collected pursuant to Sections 80110 and 80134 of the California Water  
19 Code in order to meet DWR's revenue requirements under the Act, as calculated pursuant to  
20 Applicable Law." Servicing Agreement ¶1.29. Approval of the Servicing Agreement at this  
21 point is, moreover, premature as DWR's initial revenue requirement request and the  
22 mechanism for adjusting that revenue requirement in the future ("Rate Agreement") are still  
23 in bona fide dispute by many parties before the CPUC, including PG&E. The CPUC has not  
24 yet issued a final decision on these subjects. *See* Comments Of Pacific Gas And Electric  
25 Company On The Draft Decision Of ALJ Kenney Adopting A Rate Agreement Between  
26 The Commission And The California Department Of Water Resources (Exhibit 8 to RJN).

27 The Servicing Agreement also lacks the requisite business justification. This Court  
28 may not approve any use of the property of the estate if such use abridges PG&E's fiduciary  
duty to its creditors to preserve the bankruptcy estate for their benefit. *See* 11 U.S.C.  
§363(b). In Part IV(B) of this Motion, PG&E discusses why this limitation is applicable

1 here: (1) the Servicing Agreement fails to adequately protect the estate from DWR's  
2 possible misuse of PG&E's transmission and distribution facilities;<sup>3</sup> and (2) the Servicing  
3 Agreement exposes the estate to losses by restraining PG&E from separating out DWR  
4 charges on customer bills in a separate line item or its equivalent, thereby violating  
5 California law by prohibiting customers from directing partial payments of their balances.  
6 On these grounds, the Servicing Agreement lacks the requisite business justification and is  
7 harmful to the estate.

8 The Court should, therefore, at a minimum, decline to approve the Servicing  
9 Agreement until all such disputed matters relating to DWR's revenue requirement, the  
10 proposed Rate Agreement, and the relationship of the DWR and the California Independent  
11 System Operator ("ISO") have been fully and finally resolved, and the ultimate effect of the  
12 operation and payment of the amounts provided for under the Servicing Agreement on  
13 PG&E's estate may be determined, and evaluated by this Court. PG&E respectfully asks the  
14 Court to decline to approve the Servicing Agreement at this time.

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16  
17 **II.**

18 **GENERAL BACKGROUND**

19 PG&E is an investor-owned utility providing electric and gas services to millions of  
20 California residents and businesses. Beginning approximately last summer, as a result of the  
21 partial deregulation of the power industry, PG&E was forced to pay dramatically increased  
22 wholesale prices for electricity. PG&E has been, however, prevented from passing these

23 <sup>3</sup> As is set forth in Part IV(B)(2)(a) of this Motion, in recent weeks there have been allegations  
24 that DWR may be seeking or obtaining discriminatory or preferential treatment from the California  
25 Independent System Operator ("ISO"), the Federal Energy Regulatory Commission ("FERC")  
26 regulated operator of the statewide electric transmission grid. Allegations have been made that  
27 DWR may be soliciting the ISO to require utilities like PG&E to reduce the output of their own  
28 utility generating plants in order to provide space on the utilities' transmission lines for DWR's  
more expensive power. These allegations will be investigated by FERC, and implicate the "transmit  
and deliver" provisions of the Servicing Agreement. See Jason Leopold, *FERC To Examine Alleged  
Market Manipulation By California ISO*, Dow Jones Newswires, September 21, 2001 (Exhibit 9 to  
RJN).

1 costs on to retail customers, due to the regulated nature of its business, resulting in a  
2 staggering financial shortfall. In the face of the deterioration in PG&E's financial condition  
3 and with little progress having been made toward a resolution of the crisis, PG&E by early  
4 April 2001 determined that a Chapter 11 reorganization offered the best prospects for  
5 protecting the interests of its customers, creditors, employees and shareholders alike.  
6 Accordingly, PG&E filed a voluntary petition under Chapter 11 of the Bankruptcy Code on  
7 April 6, 2001. PG&E continues to manage and operate its business and property as a debtor-  
8 in-possession pursuant to Sections 1107 and 1108 of the United States Bankruptcy Code (11  
9 U.S.C. §§1107-1108). No trustee has been appointed.

### 11 III.

## 12 FACTUAL BACKGROUND AND PROCEDURAL HISTORY

### 13 A. AB 1X-1 And DWR Sales of Electricity To PG&E Customers.

14 Since January 2001, the State of California, through DWR, has been purchasing  
15 electric power from third parties to be sold directly to electric power consumers in PG&E's  
16 service territory. These DWR activities were first authorized in the Governor's Emergency  
17 Proclamation issued by Governor Gray Davis on January 17, 2001 (Exhibit 10 to RJN), and  
18 are now proceeding under AB 1X-1.

19 AB 1X-1 authorizes DWR to enter into long-term contracts to purchase electricity and  
20 sell it to consumers. Under AB 1X-1, DWR sells power directly to consumers, with the  
21 utilities, as appropriate, acting solely as distribution, transmission, billing, and collection  
22 agents with respect to the energy provided by DWR to each of the utility's customers. *See*  
23 *Cal. Water Code §§80110, 80106(a), 80104.* Pursuant to AB 1X-1, PG&E and other utilities  
24 are required to collect from their customers and remit funds to DWR for electric power  
25 purchased by DWR.  
26

27 AB 1X-1 allows DWR to seek reimbursement for its energy purchases through a  
28 "revenue requirement" determined by DWR. DWR "shall be entitled to recover, as a

1 revenue requirement, amounts and at the times necessary to enable it to comply with Section  
2 80134, and shall advise the commission as the department determines to be appropriate.”  
3 See Cal. Water Code §80110; see also *id.* §80134 (DWR shall “at least annually, and more  
4 frequently as required, establish and revise revenue requirements sufficient, together with  
5 any moneys on deposit in the fund, to provide” the costs of acquiring power, repaying bonds,  
6 and a number of other listed items).

7 AB 1X-1 explicitly contemplates that in order to recover the costs of power purchases  
8 by DWR, the CPUC may be required to raise retail electricity rates for certain customers and  
9 levels of usage. See Cal. Water Code §80110. The CPUC’s statutory role under AB 1X-1 is  
10 to cooperate with DWR in the implementation of DWR’s cost recovery plans, and the CPUC  
11 may not independently review the reasonableness of the revenue requirement formulated by  
12 DWR to recover its costs. See Cal. Water Code §§80016, 80110. Indeed, the CPUC itself  
13 has recognized that “DWR may recover, and the Commission shall approve and impose,  
14 either as part of the [existing rates] *or as additional rates*, rates sufficient to enable DWR to  
15 recover its revenue requirements on a timely basis . . . .” Interim Opinion at 5 (D. 01-03-  
16 009 (March 7, 2001)) (emphasis added) (Exhibit 11 to RJN). Thus, AB 1X-1 gives DWR  
17 the power to raise rates to recover its own costs directly from utility customers.

18 AB 1X-1 also contemplates that DWR may issue bonds to finance its purchases of  
19 wholesale electricity, and authorizes DWR to submit to the CPUC, as part of its revenue  
20 requirement, the costs of such bond financing. See Cal. Water Code §§80130, 80132,  
21 80134(a)(1), 80200(b)(3). As amended, the California Water Code authorizes DWR to issue  
22 up to \$13.4 billion in bonds. See Act of May 10, 2001, 2001 Cal. Legis. Serv. 1st Ex. Sess.  
23 ch. 9, §5 (S.B. 31) (West) (effective as of August 13, 2001). Of this amount, DWR has  
24 announced it intends to issue \$12.5 billion in DWR bonds. See *The State Rate Hike Will*  
25 *Cover Power Costs, State Says*, L.A. Times, July 23, 2001 (Exhibit 12 to RJN). The date for  
26 issuance of the DWR bonds depends on approval of DWR’s ratemaking and rate agreement  
27 with the CPUC. However, DWR received \$4.3 billion in “bridge loans” on June 26, 2001 to  
28 help finance power purchases until the DWR bonds are issued. *California Secures \$4.3B in*

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1 *Loans, The Bond Buyer, June 27, 2001 at 1 (Exhibit 13 to RJN); State Closes on \$4.3 Billion*  
2 *Interim Loan to Buy Power, L.A. Times, June 27, 2001 at B2 (Exhibit 14 to RJN).*

3 Furthermore, the State of California has represented, in connection with a recent general  
4 obligation bond and revenue anticipation note offerings, that DWR has sufficient funds  
5 available to purchase power for the rest of the 2001-2002 fiscal year, even if power bonds  
6 are not issued this year, and that the State has sufficient funds and cash reserves to fulfill its  
7 overall governmental and budgetary responsibilities as well. *Good Omen for California,*  
8 *The Bond Buyer, September 7, 2001 at 1 (Exhibit 15 to RJN); California Treasurer's Office,*  
9 *Preliminary Official Statement, August 31, 2001, \$5,700,000 State of California 2001-02*  
10 *Revenue Anticipation Notes, Appendix A, p. A-4 (Exhibit 16 to RJN).*

11  
12 **B. Ongoing And Interim PG&E Payments To DWR Under CPUC Decisions.**

13 On March 29, 2001, the CPUC issued Decision No. 01-03-081, which adopted a  
14 company-wide average generation-related rate component for each utility. The decision also  
15 ordered the utilities to pay DWR for the electricity DWR purchased and provided to utility  
16 customers. Under this decision, the amount PG&E must pay to DWR corresponds to the  
17 "generation component" of the rate PG&E is authorized to charge its customers, multiplied  
18 by the number of kilowatt-hours ("kWh") that DWR provided. *See Interim Opinion at 35*  
19 *(Dec. 01-03-081 (March 27, 2001)) (Exhibit 17 to RJN).*

20 In a separate decision also issued on March 27, 2001, the CPUC made permanent an  
21 earlier one cent per kWh rate increase, added an additional three cent per kWh surcharge to  
22 the rates that utilities could charge their customers, revised PG&E's generation-related rate  
23 to reflect the three cent surcharge, and required PG&E to pay the revised generation-related  
24 rate to DWR for each kWh that DWR delivered after the effective date of the three cent  
25 surcharge. *See Interim Opinion Regarding Proposed Rate Increases at 62-64 (D. 01-03-082*  
26 *(March 27, 2001)) (Exhibit 18 to RJN).* The CPUC required that the revenue generated by  
27 the three cent surcharge be applied only to electric power costs incurred after the effective  
28

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1 date of its order, and indicated that it could revise the portion of the surcharge paid directly  
2 to DWR at a later time when DWR submitted its revenue requirement. *Id.* at 2.

3 Since these decisions, PG&E has been paying DWR at the CPUC-authorized  
4 generation-related rate, on a daily basis (and under a full reservation of rights), for power  
5 DWR purchased and provided to PG&E's customers. Depending on the period at issue,  
6 PG&E has paid DWR at the applicable generation-related rate, ranging from 5.471  
7 cents/kWh to 9.987 cents/kWh. To date, PG&E has transferred to DWR over \$1 billion for  
8 power it purchased beginning in mid-January 2001. *Kuga Decl.* ¶3; *see also* August 7, 2001  
9 Memorandum from Thomas M. Hannigan to The Hon. Geoffrey Brown at A-5, Table A-8  
10 (Cash Receipts), col. 2 (Exhibit 19 to RJN).

11 However, PG&E has made these payments under full reservation of rights, and sought  
12 rehearing of the CPUC's interim payment decision on the grounds that the CPUC may not  
13 lawfully order PG&E to pay DWR until and unless DWR has complied with criteria  
14 established by AB 1X-1 for CPUC and public review of the justness and reasonableness of  
15 its revenue requirement. *See Application Of Pacific Gas And Electric Company For*  
16 *Rehearing Of Decision No. 01-03-081* (Exhibit 20 to RJN). The CPUC denied PG&E's  
17 request for rehearing. *See Order Modifying Decision (D.) 01-03-081 To Correct Clerical*  
18 *Errors, And Denying Rehearing Of The Decision, As Modified (D. 01-08-024 (August 2,*  
19 *2001))* (Exhibit 21 to RJN). On September 7, 2001, PG&E petitioned the California  
20 Supreme Court for review of the CPUC's interim DWR-payment decisions, asking the Court  
21 to annul these decisions because the CPUC and DWR had not complied with the statutory  
22 public interest standards of AB 1X-1 in ordering such payments. (Exhibit 22 to RJN).

23  
24 **C. Pending Disputed DWR Revenue Requirement Request.**

25 On May 2, 2001, DWR submitted its proposed revenue requirement to the CPUC to  
26 recover its cost of procuring power for the customers of PG&E, Southern California Edison  
27 Company ("SCE") and San Diego Gas & Electric Company ("SDG&E"). (Exhibit 23 of  
28 RJN). DWR sought \$9.2 billion for the period January 2001 through June 2002, of which it

1 attributed some \$4.7 billion to PG&E. *Id.* at 4. The CPUC took no action on this request.

2 On June 18, 2001, PG&E requested that the CPUC consolidate DWR's revenue  
3 requirement request with CPUC proceedings to establish rates for PG&E's own power plant  
4 generation costs and third party power procurement costs (collectively referred to as "utility  
5 retained generation" or "URG"). PG&E did so in order to ensure that the DWR revenue  
6 requirement would not divert revenues necessary for PG&E to cover its own utility retained  
7 generation costs. *See* Motion for Further Proceedings Regarding Implementation of the  
8 California Department of Water Resources (DWR) Revenue Requirement Pursuant to Public  
9 Utilities Code Section 360.5 and Water Code Sections 80022.5 and 80110 (Exhibit 24 to  
10 RJN). The CPUC rejected this request, however, and deferred ruling on PG&E's rates until  
11 at least October 2001. *See* Administrative Law Judge's Ruling Regarding Motions To  
12 Implement Proceeding On California Department Of Water Resources Revenue  
13 Requirements (Exhibit 25 to RJN).

14 On July 23, 2001, DWR filed a revised request with the CPUC, extending its revenue  
15 requirement through December 31, 2002, and seeking a total recovery of \$13.072 billion, of  
16 which DWR attributed \$5.197 billion to PG&E. (Exhibit 26 at Appendix A to RJN). DWR  
17 requested that its revenue requirement request be implemented *without increasing PG&E's*  
18 *overall retail electric rates*, even though DWR's request would require PG&E to increase  
19 the portion of its generation-related rates payable to DWR from 9.987 cents per kWh to  
20 11.38 cents per kWh. If granted, this request would have precluded PG&E from fully  
21 recovering its own 9.987 cents per kWh generation-related rate from its customers.<sup>4</sup>

22 In its July 23, 2001 filing, DWR stated that it had determined the revised request to be  
23

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24 <sup>4</sup> In a variety of contexts, DWR has emphasized that it will seek an elevated revenue  
25 requirement without seeking a increase in overall utility rates: "At this point, we can see no need to  
26 seek any rate increase for DWR to recover its past costs as well as any future purchases. . . . The  
27 analysis indicates that our cost for energy will be covered by the PUC's current rate structure." *See*  
28 July 22, 2001 "News Release" (Exhibit 27 to RJN); *see also* August 8, 2001 "News Advisory"  
(Exhibit 28 to RJN); August 7, 2001 Memorandum from Thomas M. Hannigan to The Hon.  
Geoffrey Brown, Commissioner of the California Public Utilities Commission (Exhibit 19 to RJN)  
at 2.

1 just and reasonable. *See id.* at Appendix A, 3. Despite a chorus of protests from interested  
2 parties, including PG&E, the CPUC determined that it could implement the DWR revenue  
3 requirement request without a public hearing. (Exhibit 26 at 7-8 to RJN).

4 After a number of parties filed lengthy data requests with the CPUC questioning the  
5 accuracy and reasonableness of DWR's July 23, 2001 revenue requirement request, DWR  
6 filed a third revenue requirement request on August 7, 2001. (Exhibit 19 to RJN). In this  
7 request, DWR increased its estimate of power that it would purchase on PG&E's behalf, and  
8 increased the total revenue recovery sought from PG&E from \$5.197 billion to \$5.927  
9 billion, over the relevant two-year period. *Id.* at Table A-4. Numerous parties, including  
10 PG&E, continued to protest the DWR request as inaccurate, unreasonable and insufficiently  
11 documented.<sup>5</sup>

12 On September 4, 2001, the CPUC issued for comment a draft decision revising DWR's  
13 requested revenue requirement to shift \$600 million in DWR power costs from Southern  
14 California customers of SCE and SDG&E to Northern and Central California customers of  
15 PG&E. *See Draft Decision Of ALJ Pulsifer (Sept. 4, 2001) (Exhibit 29 to RJN).* The CPUC  
16 proposed to require PG&E customers to pay rates for DWR power that were 39% to 55%  
17 higher than rates paid by customers of SCE and SDG&E for such power, and proposed that  
18 the costs shifted to PG&E's customers be recovered without any change in PG&E's overall  
19 retail electric rates thereby further reducing the revenues available for recovery of PG&E  
20 costs after remittances to DWR. The CPUC cost-shifting proposal was contrary to DWR's  
21 own recommendation that its power costs be allocated *pro rata* throughout the state at a  
22

23 <sup>5</sup> A substantial portion of DWR's August 7, 2001 revenue requirement reflects costs of *pre-*  
24 *petition* power purchases by DWR for PG&E customers. Specifically, DWR's August 7 revenue  
25 requirement request includes a claim for a \$1.823 billion "undercollection" from all three utilities  
26 combined for the period January through June 2001, of which DWR attributed \$745 million to a  
27 shortfall in collections from PG&E for the first and second quarters of 2001. *See Comments of*  
28 *Pacific Gas And Electric Company On The ALJ's Draft Decision On The California Department of*  
*Water Resources' Revenue Requirement Request, filed on September 12, 2001 at 21 (Exhibit 40 to*  
*RJN).* Thus, nearly three-quarters of a billion dollars of DWR's revenue requirement attributable to  
PG&E relates to payments allegedly due to it for the first six months of 2001, much of which  
predated PG&E's April 6, 2001 filing of its petition for relief in this Court.

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1 uniform rate. PG&E, as well as most consumer groups, protested the CPUC cost-shifting  
2 proposal as lacking any record support. (Exhibit 8 to RJN).

3 The Draft DWR Rate Order, if finalized without modification, would require PG&E to  
4 transfer to DWR, as DWR's revenue requirement under AB 1X-1, over \$6.5 billion in  
5 ratepayer revenues through December 31, 2002. *Id.* at 38. The Draft DWR Rate Order  
6 would also require PG&E to pay DWR, on a going-forward basis, 13.99 cents per kWh for  
7 power acquired by DWR and sold to PG&E customers -- over 4 cents per kWh *more* than  
8 PG&E currently is entitled to recover in rates from the same customers for power PG&E  
9 delivers from its own generation or under power purchase contracts with qualifying facilities  
10 ("QFs") and other suppliers. *Id.* at 50. The Draft DWR Rate Order would further require  
11 PG&E to pay DWR an *additional* 4 cents per kWh on power that DWR provided to PG&E  
12 customers between June 1, 2001, and September 15, 2001, for which PG&E has *already*  
13 remitted funds to DWR, for a total of \$166 million in additional funds. *Id.* at 50-51. Going  
14 forward, the net effect of the Draft DWR Rate Order for the period June 1, 2001 to  
15 December 21, 2001 would be to divert from PG&E to DWR over \$1.5 billion in projected  
16 revenues for PG&E-supplied power to which PG&E would otherwise be entitled under prior  
17 CPUC decisions—a burden that would fall directly on PG&E's bankruptcy estate, its  
18 creditors and its shareholders. Kuga Decl. ¶5.

19 Since a final determination of DWR's (and PG&E's) revenue requirement has not yet  
20 been made, PG&E is unable to assess whether such determination will, by the mechanisms  
21 of the Servicing Agreement, divert ratepayer revenues from covering PG&E's own costs  
22 associated with its power plants and third-party power contracts. Indeed, the CPUC itself  
23 has acknowledged that it "cannot be certain whether revenues now being collected by  
24 PG&E . . . through existing rates will be sufficient both to fund the DWR requirement and  
25 the [utility cost recovery] requirements," and that based on testimony submitted in a pending  
26 proceeding relating to utility retained generation, "there could be . . . a shortfall" of revenues  
27 for PG&E to cover its costs. Draft DWR Rate Order at 44 (Exhibit 29 to RJN).

28

1           **D. Pending Disputed Rate Agreement.**

2           On July 18, 2001, the CPUC requested comment on the draft Rate Agreement between  
3 the CPUC and DWR which, if executed, would have the effect of an irrevocable "financing  
4 order" (under Sections 840 and 841 of the Public Utilities Code). Such an order would  
5 support the power purchase program of DWR and would include an express pledge by the  
6 State of California not to amend, revise, or otherwise impair the obligations of the CPUC or  
7 the rights of other parties under the Rate Agreement. *See Assigned Commissioner's Ruling*  
8 *Regarding The Draft Rate Agreement Between The Commission And The California*  
9 *Department Of Water Resources (Exhibit 30 to RJN). On August 1, 2001 and August 15,*  
10 *2001, PG&E submitted comments on the draft rate agreement to the CPUC. See Comments*  
11 *Of Pacific Gas And Electric Company In Response To Assigned Commissioner's Ruling*  
12 *Regarding The Draft Rate Agreement Between The Commission And The California*  
13 *Department Of Water Resources, filed on August 1, 2001 (Exhibit 31 to RJN); Additional*  
14 *Comments Of Pacific Gas And Electric Company In Response To The Assigned*  
15 *commissioner's Ruling Regarding The Letter Submitted To The Commission By The*  
16 *California Department Of Water Resources, filed on August 15, 2001 (Exhibit 32 to RJN).*

17           Among other things, PG&E expressed concern that the Rate Agreement was designed  
18 to establish the procedures for, and rights of, DWR to recover over \$68 billion in power  
19 purchase and related costs forecast by DWR to be incurred over the next 10 years. Yet,  
20 there was inadequate prior notice given to customers and other interested parties, and no  
21 opportunity for public hearings on whether the method for approving DWR's costs under the  
22 rate agreement is reasonable or consistent with traditional utility regulatory standards.  
23 (Exhibit 31 to RJN at 2). As explained by PG&E and other parties, the Rate Agreement  
24 would serve as a blank check, providing a contractual commitment by the CPUC to ensure  
25 DWR access to utility assets and revenues until all DWR power purchase costs and bond  
26 costs are recovered, which could be as long as 15 years.<sup>6</sup>

27 \_\_\_\_\_  
28           <sup>6</sup> PG&E's concerns were echoed by many, if not all, parties who commented on the draft  
(continued . . .)

1 PG&E raised a number of other concerns, including that the Rate Agreement would  
2 deny customers their right under California law to target their partial payments to the  
3 charges of their choice. This effort to deny customers such rights is reinforced by the terms  
4 of the Servicing Agreement. See Section IV(B)(2)(b) of this Motion. PG&E also expressed  
5 concern that the Rate Agreement could be interpreted to force PG&E to take assignment of  
6 DWR's power purchase contracts and resume procuring power for its retail customers even  
7 if it is not in PG&E's best financial interest to do so and even if PG&E is not financially  
8 capable of doing so.

9 On August 15, 2001, DWR submitted comments in response to the parties' August 1  
10 comments. See Reply Comments Of The California Department Of Water Resources On  
11 The Draft Rate Agreement By And Between The California Department Of Water Resources  
12 And The California Public Utilities Commission (Exhibit 33 to RJN). DWR raised a new  
13 concern, suggesting that DWR is not responsible for franchise fees and that applicable fees  
14 should be covered by the utilities' revenue requirements. *Id.* at 9. DWR's suggestion  
15 conflicts with Section 7.3(b) of the Servicing Agreement, which requires that PG&E be  
16 reimbursed by DWR for DWR's share of the franchise fees.

17 On August 28, 2001, the Commission issued a draft decision approving the draft Rate  
18 Agreement, making only minor modifications that were supported by DWR or the State  
19 Treasurer's Office. (Exhibit 2 to RJN). On September 4, 2001, PG&E submitted comments  
20 on the draft decision reiterating PG&E's prior concerns. (Exhibit 8 to RJN). Other parties,  
21 including the City and County of San Francisco and the City and County of San Diego, also  
22 submitted comments on the draft Rate Agreement (as well as the proposed servicing  
23 agreements for the utilities), expressing concern over the uncertainty introduced by DWR's  
24 suggestion that the utilities, not DWR, be responsible for franchise fees on DWR power. See  
25 Comments Of City And County Of San Francisco On The Draft Decision Adopting A Rate  
26 Agreement Between The Commission And Department of Water Resources (Exhibit 34 to

27 ( . . . continued )  
28 agreement. (Exhibit 32 to RJN).

1 RJN); Comments Of The City Of San Diego On The Draft Decision Adopting A Rate  
2 Agreement Between The Commission And The Department Of Water Resources (Exhibit 35  
3 to RJN).

4 The Commission's draft decision approving the draft Rate Agreement had been placed  
5 on the Commission's agenda for its September 20, 2001 meeting. Kuga Decl. ¶5. However,  
6 at that meeting, the agenda item was held until at least October 11, 2001, leaving the  
7 franchise fee issue, as well as the parties' other concerns with the draft rate agreement, still  
8 unresolved. *Id.*

9  
10 **E. The Servicing Agreement.**

11 Beginning in February 2001 and continuing over a period of several months, and in  
12 anticipation that DWR revenues would be collected by PG&E and ultimately voluntarily  
13 turned over to DWR pursuant to AB 1X-1, DWR and PG&E worked diligently and in good  
14 faith to negotiate terms and conditions under which PG&E would provide transmission,  
15 distribution, billing, collection, and related services for power sold by DWR to PG&E  
16 customers. These discussions took place jointly with SCE and SDG&E, with the common  
17 intent of developing a servicing agreement consistent among the three utilities. Separate  
18 discussions also took place between DWR and each utility to address cost recovery,  
19 operational and servicing issues unique to each utility, as reflected in differing attachments  
20 to each utility's servicing agreement. Frank Decl. ¶3.

21 Beginning in May 2001, however, PG&E became increasingly concerned that PG&E's  
22 servicing agreement would require PG&E to provide transmission, distribution, billing and  
23 collection services in a manner obliging PG&E to divert its existing generation related rates  
24 to DWR's use. *Id.* ¶4. More recently, PG&E also became concerned that DWR would use  
25 the servicing agreement to require that PG&E deliver DWR power on a priority basis, even  
26 if utility retained generation could be provided more cheaply and efficiently and irrespective  
27 of whether such prioritization would result in losses. *Id.*

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1 In late June 2001, DWR sent to PG&E, for execution by PG&E, a draft servicing  
2 agreement that did not address PG&E's concerns. PG&E declined to execute this draft until  
3 its concerns were satisfied. Frank Decl. ¶5. Instead of meeting these concerns, on June 27,  
4 2001, DWR filed a contested draft Servicing Agreement with the CPUC and asked the  
5 CPUC to order PG&E to implement the Agreement. *Id.* PG&E filed comments before the  
6 CPUC on July 3, 2001, objecting to the June 27 Servicing Agreement. (Exhibit 5 to RJN).

7 PG&E also noted that its execution of a servicing agreement in any form was  
8 premature without a determination of both DWR's and PG&E's respective revenue  
9 requirements. *Id.* at 4-6. As explained above, determining the manner in which DWR and  
10 PG&E revenue requirements are set and allocated in PG&E's overall electric rates is an  
11 essential prerequisite to determining whether the Servicing Agreement would impermissibly  
12 require PG&E to pay DWR at the expense of recovering PG&E's own costs. This is  
13 because the terms of the Servicing Agreement require PG&E to bill and collect "DWR  
14 Charges" from its customers. The definition of DWR Charges, and the Servicing Agreement  
15 generally, do not put any cap on the amounts constituting DWR Charges. Therefore, the  
16 Servicing Agreement does not prevent diversion of PG&E assets and revenue to DWR to the  
17 extent DWR sets a revenue requirement that effectively requisitions such assets and  
18 revenues as DWR Charges.

19 The CPUC nonetheless issued a Draft Decision ordering that PG&E provide access to  
20 PG&E's utility facilities to DWR and remit funds to DWR under the terms set forth in the  
21 Servicing Agreement, with a number of modifications none of which even attempted to  
22 provide any protection for PG&E's own assets, revenues, and ability to recover its costs.  
23 *See* Draft Opinion Ordering Pacific Gas And Electric Company To Enter Into and  
24 Approving the Servicing Agreement with the California Department of Water Resources  
25 (August 27, 2001) (Exhibit 36 to RJN). While acknowledging that the Servicing Agreement  
26 it ordered PG&E to implement could be subject to review and approval by this Court (*id.* at  
27 12-13), the Draft Decision dismissed PG&E's concerns regarding the parties' uncertain  
28 revenue requirements (*id.* at 11). As well, the Draft Decision modified the Servicing

1 Agreement to require that DWR and PG&E charges be shown as a single line item on each  
2 retail customer's bill, instead of being presented as separate line items as proposed by DWR.  
3 *Id.* at 17.

4 PG&E filed comments on September 4, 2001 reiterating its prior objections to entering  
5 into the Servicing Agreement, and objecting to the commingled presentation of DWR and  
6 PG&E charges as a single line item on PG&E customer bills. (Exhibit 7 to RJN).  
7 Nevertheless, the CPUC approved and issued the Draft Decision without material change on  
8 September 10, 2001. *See* Opinion Ordering Pacific Gas and Electric Company to Enter Into  
9 and Approving the Servicing Agreement with the California Depar[t]ment of Water  
10 Resources (September 10, 2001) (Exhibit 1 to RJN).

#### 11 IV.

#### 12 ARGUMENT

13  
14 PG&E stands in the anomalous position of asking this Court to review a Servicing  
15 Agreement that PG&E would not agree to on its own accord. The Servicing Agreement fails  
16 to protect PG&E's assets and revenues from diversion to DWR. Specifically, the Servicing  
17 Agreement would implement proposed determinations of DWR's revenue requirements and  
18 access to PG&E's facilities that, if adopted, are likely to divert PG&E assets and revenues to  
19 DWR. In addition, the Servicing Agreement that the CPUC has ordered PG&E to  
20 implement includes detrimental changes to terms negotiated, and supported, by both DWR  
21 and PG&E.

22 PG&E seeks this Court's review, however, because the terms of the Servicing  
23 Agreement, and the CPUC's order, require this Court's approval of the arrangement before it  
24 shall become effective: "[I]f PG&E believes that it must seek Bankruptcy Court approval  
25 for this servicing agreement, it is free to do so. In that case, the servicing agreement will not  
26 become effective until such approval has been obtained." Servicing Agreement Decision at  
27 12. Notwithstanding PG&E's acknowledged interest in seeking this Court's review of the  
28 Servicing Agreement, PG&E submits that the CPUC's concession with respect to

1 Bankruptcy Court review lacks meaning. The CPUC cannot compel a debtor-in-possession  
2 to use property of the estate outside of the ordinary course of business. *See* 11 U.S.C.  
3 §363(b). Such authority belongs solely to the trustee or debtor-in-possession upon notice  
4 and a hearing. *See id.* Specifically, PG&E, by this motion, asks the Court to decline to  
5 approve the Servicing Agreement on the following grounds: (1) approval at this time would  
6 be premature as the CPUC will not be issuing final decisions on DWR's and PG&E's  
7 revenue requirements and the proposed Rate Agreement until October 2001—at the  
8 earliest—and even then, PG&E has serious concerns that if the CPUC were to order PG&E  
9 to remit payments to DWR on the terms set forth in its Draft Decision of September 4, such  
10 orders will violate the automatic stay and other provisions of the Bankruptcy Code, issues  
11 which can not be adjudicated at the present time; (2) the Servicing Agreement lacks the  
12 requisite business justification and PG&E's execution of it would abridge the company's  
13 fiduciary duty to its creditors in violation of 11 U.S.C. Section 363(b); and (3) DWR will not  
14 be prejudiced if execution of the Servicing Agreement is deferred until PG&E's concerns are  
15 resolved.

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16  
17 **A. The CPUC's Order Requiring PG&E To Comply With The Servicing**  
18 **Agreement Is Premature.**

19 Preliminarily, the Servicing Agreement provides for more than the means by which  
20 PG&E shall transmit and deliver DWR's power to its customers. Of great import to PG&E's  
21 bankruptcy estate and its creditors, the Servicing Agreement also establishes the mechanism  
22 for payment of "[c]harges assessed to Customers for DWR Power and any other amounts  
23 authorized to be collected pursuant to Sections 80110 and 80134 of the California Water  
24 Code in order to meet DWR's revenue requirements under the Act, as calculated pursuant to  
25 Applicable Law." Servicing Agreement ¶1.29. DWR's revenue requirements are, however,  
26 the current subject of vigorous disputes among the parties (including PG&E and DWR), and  
27 the CPUC will not be issuing a final decision on this subject until October 11, 2001 at the  
28 earliest. Kuga Decl. ¶5. In the meantime, however, PG&E has serious and substantial

1 concerns that implementation of the DWR revenue requirement, in the manner called for by  
2 the CPUC in its Draft (and, therefore, not final) September 4 Decision, would violate the  
3 automatic stay of Section 362(a), and other provisions of the Bankruptcy Code. The Court  
4 should therefore decline to approve the Servicing Agreement until at least such time as the  
5 CPUC has issued a final decision implementing the DWR's Revenue Requirement and this  
6 Court has had the opportunity to consider and resolve whether such orders comport with the  
7 Bankruptcy Code.

8  
9 **B. The CPUC's Order Requiring PG&E To Comply With The Servicing  
10 Agreement Contravenes Section 363(b) Of The Bankruptcy Code.**

11 The Bankruptcy Court's discretion in approving or disapproving a debtor-in-  
12 possession's use of estate property is circumscribed by a requirement implicit in the  
13 language of Section 363(b): in approving any use of the property of the estate outside the  
14 ordinary course of business, the court must find that the transaction at issue is in the best  
15 interest of the estate. *See Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel  
16 Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983). "That is, for the debtor-in-possession or trustee  
17 to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some  
18 articulated business justification for using, selling, or leasing the property outside the  
19 ordinary course of business. Whether the proffered business justification is sufficient  
20 depends on the case." *Institutional Creditors of Continental Air Lines, Inc. v. Continental  
21 Air Lines, Inc. (In re Continental Air Lines)*, 780 F.2d 1223, 1226 (5th Cir. 1986). This  
22 limitation is applicable here because complying with the CPUC's decision to implement the  
23 Servicing Agreement would abridge PG&E's fiduciary duty to its creditors to preserve the  
24 bankruptcy estate for their benefit.

25  
26 **1. Implementation Of The Servicing Agreement Is Outside PG&E's  
Ordinary Course Of Business.**

27 The preliminary requirement of Section 363(b) that the subject use of the property of  
28 the estate be outside the debtor-in-possession's ordinary course of business is clearly met

1 here. The Bankruptcy Code does not define the term "ordinary course of business." Courts  
2 have, however, interpreted the term to establish two tests for determining whether use of the  
3 property of the estate is outside the ordinary course of business: (1) the horizontal  
4 dimension test; and (2) the vertical dimension test. *See Burlington Northern R.R. Co. v.*  
5 *Dant & Russell, Inc. (In re Dant & Russell, Inc.)*, 853 F.2d 700, 704 (9th Cir. 1988). The  
6 horizontal dimension test compares the debtor's business to that of other like businesses to  
7 determine whether the post-petition transaction is of a type that other similar businesses  
8 would engage in as ordinary business. *See id.* The vertical dimension test, or creditor's  
9 expectation test, views the disputed transaction from the perspective of hypothetical  
10 creditors to evaluate whether the transaction subjects them to economic risks different from  
11 those the creditors accepted when they decided to extend credit. *See id.* at 705. Under either  
12 test, the implementation of the Servicing Agreement would most certainly be outside of  
13 PG&E's ordinary course of business.

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14 The horizontal dimension test is aimed at determining whether the transaction is  
15 abnormal or unusual, in which case it is generally not in the ordinary course of business. *See*  
16 *id.* at 704. This test involves an *industry-wide* perspective through which the debtor's  
17 business is compared to other like businesses. *See id.* This test is clearly satisfied here in  
18 light of the extraordinary set of circumstances presented by the California energy crisis and  
19 the unprecedented role of DWR. No other utility company outside of the confines of  
20 California's energy crisis has executed a comparable servicing agreement. The agreements  
21 executed by SCE and SDG&E with DWR in the midst of the California energy crisis cannot,  
22 by any stretch of the imagination, comprise an industry-wide standard. Under the horizontal  
23 dimension test, then, there should be no question that compliance with the Servicing  
24 Agreement would be outside of PG&E's ordinary course of business.

25 The vertical dimension test measures the types of risks that creditors impliedly agreed  
26 to when they extended credit to the debtor, and determines whether the transaction at issue is  
27 within the range of risks reasonably expected by creditors. *See id.* at 705. One method of  
28 measurement is to compare the debtor-in-possession's pre-petition activities with the subject

1 activities. *See id.* (citing *In re DeLuca Distrib. Co.*, 38 B.R. 588, 594 (Bankr. N.D. Ohio  
2 1984)). But for the energy crisis and PG&E's ensuing financial shortfall, PG&E, prior to  
3 filing its bankruptcy petition, would have never acted as an agent of DWR in any fashion, let  
4 alone the indefinite term arrangement included in the Servicing Agreement. Similarly,  
5 PG&E's creditors could not have imagined or anticipated this functional and financial  
6 arrangement. A proper application of the case law compels this Court to determine that  
7 PG&E's compliance with the Servicing Agreement would be outside of its ordinary course  
8 of business under either the vertical or the horizontal dimension test.

9  
10 **2. The Proposed Servicing Agreement Lacks The Requisite Business**  
11 **Justification.**

12 In defining the contours of Section 363(b), the Second Circuit explained that "a  
13 bankruptcy judge . . . should consider all salient factors pertaining to the proceeding and,  
14 accordingly, . . . act to further the diverse interests of the debtor, creditors and equity holders  
15 alike." *In re Lionel Corp.*, 722 F.2d at 1071; *see 240 North Brand Partners, Ltd. v. Colony*  
16 *GFP Partners, L.P. (In re 240 North Brand Partners, Ltd.)*, 200 B.R. 653, 659 (B.A.P. 9th  
17 Cir. 1996); *In re Ernst Home Ctr., Inc.*, 209 B.R. 974, 979 (Bankr. W.D. Wash. 1997); *In re*  
18 *America West Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994); *In re Wilde Horse*  
19 *Enters., Inc.*, 136 B.R. 830, 841 (Bankr. C.D. Cal. 1991); *Travelers Ins. co. v. Plaza Family*  
20 *P'ship (In re Plaza Family P'ship)*, 95 B.R. 166, 173 (E.D. Cal. 1989). The Court's analysis  
21 need not be limited to examining the terms of the proposed transaction. Rather, the court  
22 should readily consider and evaluate the effect of the proposed transaction on the future  
23 plans of reorganization. *See In re Lionel Corp.*, 722 F.2d at 1071. In balancing the interests  
24 of PG&E and its creditors, PG&E asks the Court to conclude that compliance with the  
25 Servicing Agreement lacks the requisite business justification.

26 Specifically, the Servicing Agreement, if implemented, will damage the estate in two  
27 primary ways: (1) the Agreement fails to protect the estate from DWR's possible misuse of  
28 PG&E's transmission and distribution facilities; and (2) the Agreement exposes the estate to

1 losses by commingling the presentation of PG&E and DWR charges on customer bills and,  
2 thereby, violating California law by prohibiting customers from directing partial payments of  
3 their balances to the party of their choice. PG&E, as a debtor-in-possession, has a fiduciary  
4 obligation to its creditors to refrain “from acting in a manner which could damage the estate,  
5 or hinder a successful reorganization.” *Petit v. New England Mortgage Servs., Inc.*, 182  
6 B.R. 64, 69 (D. Me. 1995). Pursuant to this obligation and for the reasons discussed below,  
7 PG&E asks the Court to decline to approve the Servicing Agreement at this time.

8  
9 **a. The Servicing Agreement Fails to Protect The Estate From  
10 DWR’s Possible Misuse Of PG&E’s Transmission And  
11 Distribution Facilities.**

12 As PG&E explained in its September 4, 2001 comments before the CPUC, the  
13 Servicing Agreement is defective because it fails to adequately protect PG&E from DWR’s  
14 possible misuse of PG&E’s transmission and distribution assets. The Servicing Agreement  
15 purports “to set forth the terms under which [PG&E] will provide for the transmission and  
16 distribution of DWR Power as well as billing and related services.” Servicing Agreement at  
17 1. The only substantive provision in the Servicing Agreement that addresses transmission  
18 and distribution is Section 2.1:

19 Pursuant to the Act and Applicable Commission Orders, [PG&E] covenants and  
20 agrees to transmit, or provide for the transmission of, and distribute DWR Power  
21 to Customers over [PG&E’s] transmission and distribution system in accordance  
22 with Applicable Law, Applicable Tariffs and any other agreements between the  
23 Parties. *Id.* at 6.

24 While this provision may appear innocent on its face, PG&E is concerned that the State will  
25 rely on it to claim a priority right of transmission and distribution of DWR Power. Such a  
26 priority would adversely impact PG&E’s ability to recover the costs of running its remaining  
27 generation assets.

28 PG&E’s concern is not groundless. Recent published reports have described actions  
in which the ISO—acting apparently at DWR’s request—required SCE to reduce output at  
its Mohave Generating Station in order to give priority to the transmission and distribution  
of higher-priced DWR power. In other words, according to these reports, the ISO has been

1 forcing utilities to transmit and distribute (and, for that matter, ratepayers to buy) more  
2 expensive power that the state previously secured under contracts in preference to electricity  
3 that is available from the utilities at lower cost. Citing these actions, Bill Jones, the  
4 California Secretary of State, has requested that the Federal Energy Regulatory Commission  
5 (“FERC”) investigate “possible significant price and market manipulation by several energy-  
6 related entities.” Letter from Bill Jones to FERC Chairman Wood, August 31, 2001.  
7 (Exhibit 37 to RJN). The letter expresses concern “that CalISO, in concert or collusion with  
8 the Department of Water Resources, is abusing its broad authority over the transmission of  
9 electrical power over interstate power lines . . . .” *Id.* at 1. In response, FERC has scheduled  
10 a meeting to investigate and review these allegations regarding the possible misuse of utility  
11 facilities. *See* note 3, *supra*. Depending on the outcome of the FERC investigation, the  
12 “transmit and deliver” provisions of the Servicing Agreement would be implicated and  
13 PG&E may seek specific protections in the Servicing Agreement in order to ensure that  
14 DWR does not misuse PG&E’s facilities in a manner that impairs the value of the facilities  
15 or fails to compensate PG&E fairly for their use.

16 If DWR or the ISO were to undertake similar actions to misuse PG&E transmission  
17 and distribution facilities, these actions could seriously harm the estate. For example,  
18 PG&E’s ability to make effective use of its generation assets would be compromised.  
19 Generation assets (such as the Diablo Canyon Power Plant) make money only if they are  
20 generating power. Frank Decl. ¶4. To the extent that PG&E is forced to curtail output at  
21 such plants, revenues could drop materially. Furthermore, the process of shutting down and  
22 restarting such facilities can be extremely expensive, thereby exposing PG&E to the risk of  
23 further actual out-of-pocket losses. *Id.*

24 Under any circumstances, PG&E would forcefully challenge any attempt by DWR or  
25 the ISO to exercise a priority right to transmit and distribute DWR power by claiming  
26 ambiguity in the agreement. Given these recent actions of the ISO and DWR to the clear  
27 detriment of a utility, however, the Bankruptcy Court here has an obligation to protect the  
28 estate and should ensure that no such steps are taken against PG&E. This Court should

1 approve a servicing agreement in the future only in the event the terms provide that delivery  
2 and transmission of DWR power shall not be accorded any preferential treatment.

3 The Court should not force PG&E to execute a contract which forfeits its right to use  
4 its system to its benefit and requires PG&E instead to deploy its system in a manner that  
5 allows the DWR "business enterprise" to obtain priority usage of PG&E's facilities.  
6 (Exhibit 3 at 11 to RJN) (the CPUC describing the DWR's power supply program as "a  
7 business model under which DWR will operate as a state governmental enterprise that buys  
8 and sells power for the entire life of the bonds").

9  
10 **b. The Servicing Agreement Exposes The Estate To Losses By**  
11 **Restraining PG&E From Separating Out DWR Charges On**  
12 **Customer Bills In A Separate Line Item Or Its Equivalent And**  
13 **Thereby Violates California Law By Prohibiting Customers From**  
14 **Directing Partial Payments Of Their Balances.**

15 The Servicing Agreement exposes PG&E's estate to losses by restraining PG&E from  
16 separating out DWR charges on customer bills in a separate line item or its equivalent, and  
17 by violating California law by prohibiting customers from directing partial payments of their  
18 balances to the party of their choice. In the Servicing Agreement Decision, the CPUC  
19 eliminated a prior requirement--set forth in the June 27 Servicing Agreement--that DWR  
20 charges be separately stated on customer bills: "We eliminate the requirement for a separate  
21 line item for DWR charges on customers' bills, as we believe this will cause undue customer  
22 confusion." Servicing Agreement Decision at 7. The requirement to show a separate line  
23 item was also consistent with language set forth in Commission Decision 01-03-081, which  
24 called upon the utilities to separately show customers their DWR charges. D.01-03-081 at  
25 23-24 (Exhibit 17 to RJN).

26 The CPUC has now reversed its earlier course as part of an unlawful two-pronged  
27 effort to protect DWR revenues at the cost of PG&E's. Existing California law allows  
28 customers the right to withhold payments to DWR without fear of losing electric service  
from PG&E. Apparently sensing DWR's vulnerability to customer protests against payment

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1 of DWR charges, the Servicing Agreement Decision (i) attempts to hide DWR charges from  
2 customers and (ii) denies customers their legal rights to withhold payments to DWR.

3 Under California law, where a billing agent provides a bill to a customer for more than  
4 one source of charges, that customer has the right to direct her or his payments to some  
5 sources but not others. The billing agent must, moreover, respect that customer's desires.  
6 *See* Civ. Code §1479 ("If at the time of performance, the intention or desire of the debtor  
7 that such performance should be applied to the extinction of any particular obligation, be  
8 manifested to the creditor, it must be so applied"). Furthermore, California law prohibits  
9 PG&E from terminating a residential customer's service for nonpayment of third-party  
10 charges if that customer has paid the PG&E portion of the bill. *See* Cal. Pub. Util. Code  
11 §779.2. Consistent with this requirement, PG&E is not allowed to disconnect customers for  
12 nonpayment of utility user's taxes or of charges imposed by their energy service providers.  
13 *See, e.g.*, PG&E Electric Tariff, Rule 22, Section O.2.

14 Without a separate line item or its equivalent to segregate DWR charges from PG&E  
15 charges, customers will find it difficult, if not impossible, to exercise their rights under  
16 California law to direct their payments to the party of their choice. Even more openly, the  
17 Servicing Agreement attempts to contravene California law by requiring that PG&E prohibit  
18 customers from directing their payments: "Utility shall not permit Customers to direct how  
19 partial payments of balances due on Consolidated Utility bills will be applied." Servicing  
20 Agreement at Service Attachment 1, Section 3. As contrary to Civil Code Section 1479, this  
21 provision of the Servicing Agreement is unenforceable.

22 A separate line item or its equivalent denoting DWR charges is critical to ensuring that  
23 PG&E is not shortchanged if customers decide to partially pay their energy bill. A separate  
24 line item or its equivalent is necessary to permit consumers the opportunity to view the  
25 DWR charges for which they are held responsible. Based on customers' adverse reaction to  
26 recent rate increases and proposed rate increases, many customers are likely to protest  
27 payment and withhold at least a portion of their energy bills. Jorgensen Decl. ¶¶3,4. Under  
28 the Servicing Agreement, PG&E's estate could be meaningfully damaged by such

1 withholdings because customers' ability to target their protest against DWR would be  
2 diminished by the commingled presentation of charges on a single line item.<sup>7</sup> PG&E will,  
3 therefore, be likely to bear the brunt of any customer protests even if they are motivated by  
4 the high cost of DWR power.<sup>8</sup>

5  
6 **C. This Court Should Not Approve The Servicing Agreement Based Solely On  
7 Concerns That The DWR May Not Obtain Necessary Financing Without  
8 Such An Agreement In Place.**

9 PG&E anticipates that DWR may argue that the Court must approve the Servicing  
10 Agreement on an expedited basis, in order to avoid interfering with the State's efforts to  
11 market bonds that will provide funds necessary to purchase the DWR power. The Court  
12 shoul\*d not be influenced by this argument.

13 DWR will not be prejudiced if this Court declines to approve the Servicing Agreement  
14 and orders the parties to take the time necessary to negotiate and resolve the issues raised in  
15 this Motion, including the very serious potential stay violations, particularly as the CPUC  
16 will not be issuing final decisions with respect to DWR's and PG&E's revenue requirements  
17 until October 2001 at the earliest.

18 The timing of California's bond offer does not rest on the approval of the Servicing  
19 Agreement. According to the State Treasurer's Office, the State has sufficient funds and  
20 cash reserves to meet its overall budget needs, including DWR's power supply program,  
21 through the end of the 2001-2002 fiscal year -- even if the DWR bonds are not issued. *See*  
22 *Motion Of Pacific Gas And Electric Company To Postpone Commission Consideration Of*  
23 *DWR-Related Draft Decisions In Light Of New Information From State Treasurer (Exhibit*

24 <sup>7</sup> Section 4.1 of the Service Attachment to the Servicing Agreement purports to require PG&E  
25 to apply any customers' partial payment to amounts due PG&E and DWR on a pro rata basis, the  
26 customer's stated intentions to withhold only from one entity notwithstanding.

27 <sup>8</sup> Similarly, DWR has taken a contradictory stand on whether or not it will reimburse PG&E  
28 for DWR's share of local government franchise fees under the Servicing Agreement. As discussed  
previously in Part III(D), DWR raised this concern in comments on the proposed Rate Agreement,  
still pending before the CPUC for decision. (Exhibit 33 to RJN). Because this franchise fee liability  
could run into the tens of millions of dollars annually (Jorgensen Decl. ¶5), PG&E cannot and  
should not be required to implement the Servicing Agreement until this issue is resolved.

1 39 to RJN); *see also Calif. Treasurer's Office: Power Bond Issue Still On Hold*, Dow Jones  
2 Energy Serv., Sept. 21, 2001 (Exhibit 39 to RJN). PG&E has been, and is currently, making  
3 payments to DWR consistent with CPUC Decision Nos. 01-03-081, 01-03-082, and 01-05-  
4 064. Kuga Decl. ¶3. In addition, DWR has obtained over \$4.3 billion in "bridge loans" with  
5 lenders based on Governor Gray Davis' Executive Order D-42-01 issued on June 18, 2001.  
6 *Finestone, California Secures \$4.3B in Loans* (Exhibit 13 to RJN).

7  
8 V.

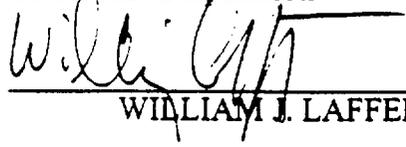
9 CONCLUSION

10 If afforded the time by this Court, PG&E is confident that it will be able to resolve the  
11 outstanding issues and is fully prepared to finalize a Servicing Agreement with DWR that  
12 does not violate the purpose of Section 363(b) of the Bankruptcy Code, which requires the  
13 debtor-in-possession to enter into only those transactions that will benefit the estate. For the  
14 foregoing reasons, PG&E respectfully asks the Court to decline to approve the Servicing  
15 Agreement until the outstanding issues discussed herein have been fully and finally resolved.

16 DATED: September 24, 2001.

17  
18 Respectfully,

19 WILLIAM J. LAFFERTY  
20 HOWARD, RICE, NEMEROVSKI, CANADY,  
21 FALK & RABKIN  
22 A Professional Corporation

23 By: 

24 WILLIAM J. LAFFERTY

25 Attorneys for Debtor and Debtor-in-Possession  
26 PACIFIC GAS AND ELECTRIC COMPANY

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