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12 PACIFIC GAS AND ELECTRIC COMPANY

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

16 In re
17 PACIFIC GAS AND ELECTRIC
18 COMPANY, a California corporation,
19 Debtor.

Case 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

Federal I.D. No. 94-0742640

20 NOTICE OF MOTION AND MOTION OF PACIFIC GAS AND ELECTRIC
21 COMPANY FOR ORDER AUTHORIZING INCURRENCE OF POST-
22 PETITION SECURED DEBT IN CONNECTION WITH AGREEMENT
23 WITH NATURAL GAS EXCHANGE; MEMORANDUM OF POINTS AND
24 AUTHORITIES IN SUPPORT THEREOF

25 [SUPPORTING DECLARATION OF RAYMOND WELCH FILED SEPARATELY]

26 PLEASE TAKE NOTICE that on October 29, 2001, at 9:30 a.m., or as soon
27 thereafter as the matter may be heard, in the Courtroom of the Honorable Dennis Montali,
28 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 (the "Motion"), for an

PG&E'S MOT. FOR AUTH. TO INCUR POST-PET. SECURED DEBT UNDER AGREEMENT WITH ENERGY EXCHANGE

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1 order pursuant to Bankruptcy Code Section 364 (11 U.S.C. §364) authorizing PG&E to incur
2 post-petition secured debt in favor of Union Bank of California, N.A. ("Union Bank") in
3 connection with the issuance of a letter of credit to NGX Financial, Inc., a Canadian
4 corporation, as beneficiary, and further authorizing PG&E to enter into an agreement with
5 NGX Financial and National Gas Exchange, Inc. concerning PG&E's participation in a
6 Canadian exchange for the purchase and sale of natural gas (the "Exchange Agreement").

7 Pursuant to the provisions of the Exchange Agreement, PG&E will agree, subject
8 to the approval of this Court, to provide credit support for any obligations it may incur as a
9 participant in this Canadian natural gas exchange by providing an irrevocable standby letter
10 of credit (the "L/C") in the maximum amount of \$10 million, to be issued by Union Bank for
11 the account of PG&E in favor of NGX Financial as beneficiary. As consideration to Union
12 Bank for issuing the L/C, PG&E will also agree, subject to this Court's approval, to pay
13 Union Bank a fee equal to one and one-half percent (1½%) of the face amount outstanding
14 under the L/C, and to collateralize any obligations to Union Bank in connection with the L/C
15 by maintaining a certificate of deposit with Union Bank in the amount of \$10 million.

16 The Motion is based on this Notice of Motion and Motion and the Memorandum
17 of Points and Authorities set forth below, the supporting Declaration of Raymond Welch
18 ("Welch Declaration") filed herewith, the record of this case and any admissible evidence
19 presented to the Court at or prior to the hearing on this Motion.

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

1 MEMORANDUM OF POINTS AND AUTHORITIES

2 I.

3 FACTUAL BACKGROUND¹

4
5 A. General Background

6 PG&E is an investor-owned utility providing electric and gas services to millions
7 of California residents and businesses. Beginning in late May, 2000, as a result of the partial
8 deregulation of the power industry, PG&E was forced to pay dramatically increased
9 wholesale prices for electricity. PG&E has, however, been prevented from passing these
10 costs on to retail customers, resulting in a staggering financial shortfall. In the face of the
11 deterioration in PG&E's financial condition, and with little progress having been made
12 toward a resolution of the crisis, PG&E by early April 2001 determined that a Chapter 11
13 reorganization offered the best prospects for protecting the interests of its creditors,
14 customers, employees and shareholders alike. Accordingly, on April 6, 2001, PG&E filed a
15 voluntary petition under Chapter 11 of the Bankruptcy Code. PG&E continues to manage
16 and operate its business and property as a debtor in possession pursuant to Sections 1107 and
17 1108 of the Bankruptcy Code. 11 U.S.C. §§1107-1108. No trustee has been appointed.

18
19 B. The Exchange Agreement

20 NGX Financial, Inc. ("NGX Financial") and Natural Gas Exchange, Inc.
21 ("Natural Gas Exchange") operate and maintain a natural gas commodities exchange (the
22 "Exchange") through which qualified entities ("Contracting Parties") may purchase or sell
23 natural gas and related financial contracts. (NGX Financial and Natural Gas Exchange are
24 sometimes referred to herein collectively as "NGX.") Contracting Parties wishing to
25 participate in the Exchange must enter into an agreement with NGX. Because NGX

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27 ¹The evidentiary basis and support for the facts set forth in this Motion are contained in
28 the Welch Declaration filed concurrently herewith.

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1 Financial "clears" all accounts for all Contracting Parties in the Exchange, the debts which
2 Contracting Parties incur as a result of transactions entered into through the Exchange are
3 deemed to be owed by the Contracting Parties to NGX Financial. Accordingly, the form of
4 agreement contains provisions concerning the payment of debts incurred by Contracting
5 Parties to NGX Financial as a consequence of Exchange transactions, as well as a number of
6 stringent requirements concerning the creditworthiness of Contracting Parties.

7 Prior to the commencement of this bankruptcy case, PG&E was a Contracting
8 Party on the Exchange, pursuant to an agreement with NGX dated February 27, 1998 (the
9 "Pre-Petition Agreement"). Up until the time that NGX terminated its relationship with
10 PG&E in January, 2001, for reasons described below, PG&E regularly participated in
11 purchase and sale transactions through the Exchange. PG&E found the Exchange to be a
12 particularly favorable means of purchasing and selling gas supplies, for a number of reasons.
13 The Exchange is immediately accessible to Contracting Parties, and Contracting Parties may
14 electronically view and post in "real time" bid and sale prices for natural gas traded on the
15 Exchange. There are approximately 80 Contracting Parties, giving PG&E immediate access
16 to many possible sources of supply. The Exchange is also available to Contracting Parties
17 seven days a week, which PG&E believes is an especially valuable aspect for weekend
18 transactions, when there is often a need to balance supplies with demand due to unforeseen
19 changes in temperature, yet when there may be few available counterparties to buy from or
20 sell to. In addition, all bids and quotes are submitted anonymously, which PG&E believes
21 contributes to fairer pricing.

22 As previously described, PG&E's financial condition deteriorated dramatically
23 beginning in late May, 2000. On or about January 18, 2001, in response to a variety of
24 factors, credit reporting agencies down-graded PG&E's credit rating status to a level below
25 that permissible under the Pre-Petition Agreement. Although the Pre-Petition Agreement
26 did provide that Contracting Parties whose creditworthiness was not within permissible
27 standards could continue to qualify to trade on the Exchange through a variety of credit-
28 enhancing measures, PG&E was unable at that time to obtain any such credit enhancements.

1 NGX accordingly terminated its relationship with PG&E by letter dated as of January 19,
2 2001.

3 NGX is willing to enter into a new form of Agreement with PG&E, pursuant to
4 which PG&E would again become a Contracting Party on the NGX Exchange. A true and
5 correct copy of the proposed form of Agreement is attached as Exhibit "A"² to the Welch
6 Declaration (the "Proposed Exchange Agreement"). (The actual agreement that will be
7 signed by PG&E may differ from the form of the Proposed Exchange Agreement in that it
8 may contain certain limitations consistent with PG&E's credit standing; however, PG&E
9 does not expect that the final agreement will contain material deviations from the form.)
10 PG&E's maximum aggregate liability to NGX under the Proposed Exchange Agreement as a
11 Contracting Party on the Exchange would be limited to \$10 million.³ However, NGX's Risk
12 Management Policy (attached as Schedule "C" to the Proposed Exchange Agreement)
13 requires that non-investment grade Contracting Parties, such as PG&E, deposit certain
14 acceptable types of collateral with NGX as security for performance of such party's
15 obligations to NGX pursuant to the Proposed Exchange Agreement before such Contracting
16 Party is entitled to enter into physical or financial contracts with the Exchange. One such
17 acceptable form of collateral from PG&E is a letter of credit in the amount of PG&E's
18 maximum aggregate liability to NGX (i.e., \$10 million). The letter of credit must be an
19 irrevocable standby letter of credit from an institution acceptable to NGX, and may be drawn
20 upon by NGX Financial upon default by PG&E, including partial draws for amounts less
21 than the total amount available under the L/C.

22 Because of the importance to PG&E of securing gas supplies for its customers

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24 ²Exhibits are not attached to the service copies of this document. You may obtain
25 copies of the Exhibits in one of the following ways: through the "Pacific Gas & Electric
26 Company Chapter 11 Case" link accessible on the Bankruptcy Court's website
(www.canb.uscourts.gov), or by written request to Howard, Rice, Nemerovski, Canady,
27 Falk & Rabkin, Attn: Racquel N. Lopez, Three Embarcadero Center, 7th Floor, San
28 Francisco, California 94111-4065.

³Although NGX calculates the aggregate amount of liability by any Contracting Party
on a daily basis, Contracting Parties on the Exchange, including PG&E, are billed for such
amounts on a monthly basis.

1 and the desirability to PG&E of being able to participate on the Exchange, PG&E is willing
2 to provide a letter of credit for the benefit of NGX Financial in order to become a
3 Contracting Party on the Exchange. Union Bank, a bank with which PG&E maintains a
4 deposit account as well as disbursement accounts, has agreed to provide such a letter of
5 credit (the "L/C"), in exchange for a fee equal to one and one half percent (1½%) of the face
6 amount of the L/C, payable quarterly in advance, provided that PG&E secures any
7 obligations to reimburse Union Bank for amounts drawn by NGX Financial under the L/C
8 and other obligations arising under or in connection with the issuance of the L/C
9 (collectively, the "Reimbursement Obligations") by a certificate of deposit maintained at
10 Union Bank, in an amount equal to the maximum amount available under the L/C (i.e., \$10
11 million). PG&E believes that the terms and conditions for the issuance of the L/C by Union
12 Bank are reasonable and are the most favorable terms available to PG&E at this time.⁴
13 Attached to the Welch Declaration as Exhibits "B" and "C" respectively, are the form of
14 Letter of Credit Agreement and the form of Security Agreement to be entered into by PG&E
15 for the issuance of the L/C and the maintenance of the certificate of deposit as security for
16 the payment of the Reimbursement Obligations.

17 Based upon current market prices, \$10 million worth of gas purchases would
18 represent as much as one-third (1/3) of the amount of Canadian gas supply to be procured by
19 PG&E in one month. PG&E submits that the Proposed Exchange Agreement would permit
20 it access to the Exchange and thus would be in the best interests of the estate.

21 The indenture trustee for certain mortgage bonds issued by PG&E (the "Indenture
22 Trustee"), who holds a lien on substantially all of PG&E's assets for the benefit of the
23 mortgage bondholders, has consented to the securitization as described above. Such consent
24 is required under the Cash Collateral Stipulation between PG&E and the Indenture Trustee
25 (which was approved by a separate Order issued by the Court on May 9, 2001).

26
27 ⁴PG&E explored the feasibility and cost-effectiveness of providing other types of
28 collateral permissible under the NGX Risk Management Policy, and has determined that the
Union Bank L/C is the most efficient and cost-effective alternative currently available to it.

1 II.

2 PG&E SHOULD BE AUTHORIZED TO INCUR THE POST-
3 PETITION SECURED DEBT PURSUANT TO BANKRUPTCY
4 CODE SECTION 364

5 Bankruptcy Code Section 364(d)(1) provides, in pertinent part, as follows:

6 The Court, after notice and a hearing, may authorize the obtaining of
7 credit or the incurring of debt secured by a senior or equal lien on
8 property of the estate that is subject to a lien only if—

9 (A) the trustee is unable to obtain such credit otherwise; and

10 (B) there is adequate protection of the interest of the holder of the lien
11 on the property of the estate on which such senior or equal lien is
12 proposed to be granted. (11 U.S.C. §364(d)(1))

13 Thus, the only statutory prerequisites for obtaining credit on a senior secured
14 basis is that the debtor be unable to obtain such credit otherwise, and that there be adequate
15 protection for the existing lienholder. This test is clearly satisfied in this case. As discussed
16 above, PG&E has been unable to obtain comparable financing arrangements for the
17 transactions described above on any other acceptable basis. Further, the only existing
18 potential lienholder (the Indenture Trustee) is fully secured and adequately protected by a
19 substantial equity cushion, and has consented to this transaction.

20 In determining whether to approve a transaction under Section 364, courts act in
21 their “informed discretion.” In re Ames Dep’t Stores, Inc., 115 B.R. 34, 37 (Bankr.
22 S.D.N.Y. 1990). Courts have established that such discretion is to be utilized to permit the
23 debtor’s reasonable business judgment to be exercised so long as the financing agreement
24 does not contain terms that are primarily designed to benefit the secured party at the expense
25 of the estate or leverage the bankruptcy process. Id. at 39-40; In re Simasko Prod. Co., 47
26 B.R. 444, 449 (D. Colo. 1985). In undertaking such analysis, courts focus on the following
27 principal factors: proposed terms that would tilt the conduct of the bankruptcy case;
28 prejudice, at the early stages, to the powers and rights that the Bankruptcy Code confers for
the benefit of all creditors; or terms that leverage the Chapter 11 process by preventing
motions by parties in interest from being decided on their merits. In re Tenney Village Co.,
Inc., 104 B.R. 562, 567-70 (Bankr. D.N.H. 1989); Norris Square Civic Ass’n v. St. Mary

1 Hosp. (In re St. Mary Hosp.), 86 B.R. 393, 401-02 (Bankr. E.D. Pa. 1988); In re Crouse
2 Group, Inc., 71 B.R. 544, 550-51 (Bankr. E.D. Pa. 1987).

3 In this case, as discussed above, PG&E seeks to provide cash collateral to obtain
4 a letter of credit which is a prerequisite to its participation in the Exchange. Such financing
5 is clearly in the best interests of the estate and is not detrimental to parties in interest in this
6 case. The Security Agreement and related letter of credit documents do not contain terms
7 that are primarily designed to benefit Union Bank at the expense of the estate or to leverage
8 the bankruptcy process. Accordingly, the Court should authorize PG&E to incur post-
9 petition secured debt to Union Bank under Section 364, as discussed above.

10
11 III.

12 PG&E SHOULD BE AUTHORIZED TO ENTER INTO THE
13 PROPOSED EXCHANGE AGREEMENT UNDER SECTION
14 363(b)(1) OF THE BANKRUPTCY CODE

15 Entering into the Proposed Exchange Agreement clearly would be within the
16 ordinary course of PG&E's business—the purchase and sale of gas on an international
17 exchange—were it not for the requirement that PG&E provide a letter of credit to support its
18 obligations under the Proposed Exchange Agreement. To the extent that this new
19 requirement transforms the Proposed Exchange Agreement into a transaction that requires
20 Bankruptcy Court approval, PG&E believes that it should be authorized to enter into the
21 Proposed Exchange Agreement pursuant to Section 363(b)(1) of the Bankruptcy Code.

22 In determining whether to authorize a transaction under Section 363(b)(1), courts
23 require a debtor to show that a sound business purpose justifies such actions, applying the
24 “business judgment” test. See, e.g., Stephens Indus., Inc. v. McClung, 789 F.2d 386, 389-90
25 (6th Cir. 1986); Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722
26 F.2d 1063, 1071 (2d Cir. 1983); see also 3 Lawrence P. King, Collier on Bankruptcy
27 §363.02[1][g] (15th ed. rev. 1998).

28 The burden of establishing a valid business purpose for a transaction outside the

1 ordinary course of business falls upon the debtor. See In re Lionel Corp., 722 F.2d at 1070-
2 71. Once the debtor has articulated a rational business justification, however, a presumption
3 attaches that the decision was made on an informed basis, in good faith and in the honest
4 belief that the action was in the best interest of the debtor. See, e.g., Official Comm. of
5 Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.), 147 B.R. 650,
6 656 (S.D.N.Y. 1992) (citing Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)).

7 As discussed in detail above, sound business justifications exist for PG&E to
8 enter into the Proposed Exchange Agreement. PG&E believes the Exchange is
9 advantageous for the purchase and sale of gas supplies, because it is immediately accessible
10 to Contracting Parties seven days a week and Contracting Parties may electronically view
11 and post in real time bid and sale prices for commodities traded on the Exchange. In
12 addition, all bids and quotes are submitted anonymously, which PG&E believes contributes
13 to fairer pricing and benefits all Contracting Parties, including PG&E.

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21 IV.

22 CONCLUSION

23 For all of the foregoing reasons, PG&E respectfully requests that this Court make
24 and enter its order:

- 25 1. Granting the Motion;
- 26 2. Authorizing PG&E to incur post-petition secured debt in favor of Union Bank
27 as described above;
- 28 3. Authorizing PG&E to enter into the Proposed Exchange Agreement, including
the provisions requiring PG&E to provide a letter credit; and

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4. Granting such other relief as the Court deems just and appropriate.

DATED: October 9, 2001

Respectfully,

HOWARD, RICE, NEMEROVSKI, CANADY,
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By: Janet A. Nexon
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