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15 UNITED STATES BANKRUPTCY COURT
16 NORTHERN DISTRICT OF CALIFORNIA
17 SAN FRANCISCO DIVISION
18

19 In re
20 PACIFIC GAS AND ELECTRIC
COMPANY, a California corporation,
21 Debtor.

Case No. 01-30923 DM
Chapter 11
HEARING
Date: February 27, 2002
Time: 1:30 p.m.
Place: 235 Pine Street, 22nd Floor
San Francisco, California

23 Federal I.D. No. 94-0742640
24

25 RESPONSE BY PACIFIC GAS AND ELECTRIC COMPANY AND PG&E
CORPORATION TO TERM SHEET SUBMITTED BY CALIFORNIA
26 PUBLIC UTILITIES COMMISSION FOR PROPOSED
CHAPTER 11 PLAN FOR PACIFIC GAS AND ELECTRIC COMPANY

27 [SUPPORTING DECLARATION OF KENT HARVEY FILED CONCURRENTLY]
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1 Pursuant to the Bankruptcy Court's Memorandum Decision Regarding Preemption and
2 Sovereign Immunity filed on February 7, 2002 (the "Preemption Decision"), Pacific Gas and
3 Electric Company, the debtor and debtor in possession in the above-captioned Chapter 11
4 case (the "Debtor" or "PG&E"), and PG&E Corporation ("Parent") (collectively, the
5 "Respondents") hereby respond (the "Response") to the "Proposed Plan Term Sheet" (the
6 "Term Sheet") submitted by the California Public Utilities Commission ("CPUC") regarding
7 the CPUC's proposed alternative to the pending First Amended Plan of Reorganization, as
8 modified to date (the "PG&E Plan"); jointly propounded by PG&E and its Parent.

9
10 I.

11 INTRODUCTION

12 The Court authorized the CPUC to file a proposed Term Sheet to allow the Court to
13 determine if the CPUC could propose a *prima facie*, confirmable alternative to the PG&E
14 Plan. The Term Sheet fails to satisfy this burden. It contains material errors and
15 deficiencies which render it neither credible nor confirmable.

16 First and most importantly, the Term Sheet overstates available cash by more than \$2
17 billion and understates claims which must be resolved by over \$2.5 billion. The resulting
18 \$4.5 billion shortfall is fatal to the CPUC's overall proposal. The Court need go no further
19 than this critical threshold fact to conclude that the plan described in the Term Sheet is
20 patently defective and unconfirmable.

21 Second, although the \$4.5 billion shortfall alone precludes confirmation of CPUC's
22 alternate plan, the Term Sheet also fails to come to grips with its own stated intention to
23 return PG&E to financial health and restore its creditworthiness. The proposal in the Term
24 Sheet in fact does the opposite. Among other things, it (1) deprives PG&E of adequate
25 funds for capital investments needed to carry on its utility functions, (2) deprives it of a
26 return on its equity capital during the period prior to the effective date and immediately
27 thereafter, (3) spawns a litigation trust for the avowed benefit of ratepayers (who this Court
28 has twice found are not creditors) with the intent of embroiling generators, other creditors

1 and PG&E and its equity holders in litigation into the foreseeable future and (4) fails to
2 address entirely how PG&E would be able to accomplish the resumption of the power
3 procurement function that the proposal contemplates.

4 II.

5 FACTUAL BACKGROUND¹

6 1. On April 6, 2001, PG&E filed a voluntary petition under Chapter 11 of the
7 Bankruptcy Code. PG&E continues to manage and operate its business and property as a
8 debtor in possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code.

9 2. On February 4, 2002, the Court filed its Amended Order Further Extending
10 Exclusivity Period for Plan of Reorganization (the "Second Exclusivity Order"). The
11 Second Exclusivity Order provides that PG&E shall maintain plan exclusivity until June 30,
12 2002, or such time at the Court enters a further order on the CPUC's motion to terminate
13 exclusivity so that it may file a competing plan. The Order further directed the CPUC to file
14 with the Court and serve on all parties by February 13, 2002, a term sheet regarding its
15 contemplated Chapter 11 plan. The Order provides (¶ 3) that:

16 "Such term sheet shall specify, *inter alia*, (i) the proposed classification of all
17 claims and interests, (ii) the proposed treatment of all claims and interests, (iii)
18 the proposed means for implementation of such plan (including, without
19 limitation, specificity regarding how particular claims will be satisfied, reinstated
20 or refinanced), and (iv) a timeline for proposing and seeking approval of the plan
21 contemplated by the CPUC."

22 3. At the January 16, 2002 hearing that resulted in the Second Exclusivity Order, the
23 Court stated that it expected the CPUC in the Term Sheet to present a credible and viable
24 plan:

25 "I think it would be enormously inappropriate and an enormous burden on this
26 estate and the professionals to allow a plan that is hopelessly unconfirmable to be
27 filed[;] not because it might be misconstrued outside of this courtroom[;] in the
28 press or in the marketplace[.] [T]hose are concerns enough indeed[;] but because
it is not appropriate in my mind as a bankruptcy matter to distract the attention of
people working on what at least at this point is still a *prima facie*, viable,
confirmable plan that PG&E has sponsored." (Tr., 95:21-96:5)

1 The evidentiary basis and support for the facts set forth in this Response are contained in the Declaration of Kent Harvey filed concurrently herewith.

1 4. As discussed below, the Term Sheet falls well below even the minimum
2 requirements established by the Court.

3 **III.**

4 **DISCUSSION**

5 **A. THE TERM SHEET IS NEITHER CREDIBLE NOR VIABLE.**

6 The Term Sheet presents a purportedly simple approach to exiting bankruptcy—
7 reinstate certain debt and other obligations, take existing cash along with cash to be received
8 from retaining existing rates in effect until January 31, 2003, and use the cash balance at that
9 date to pay the remaining claims. The Term Sheet thus starts with an adjusted aggregate
10 claim amount of \$12.659 billion, reinstates (or reestablishes obligations to be dealt with in
11 the ordinary course) \$5.795 billion of that amount, and then uses estimated cash on hand of
12 \$6.864 billion at January 31, 2003 to pay the remaining claims.

13 By Respondent's estimation, this analysis of sources and uses falls short by at least
14 \$4.5 billion dollars, based on an overstatement of available cash of \$2.0 billion and an
15 understatement of obligations to be paid out of cash on the proposed effective date of \$2.5
16 billion. The CPUC's "framework" cannot reasonably be "tweaked" to remedy this
17 tremendous gap in dollars and resulting shortfall. Under the CPUC's framework, to raise the
18 sufficient cash to emerge from bankruptcy to meet the CPUC's January 31, 2003 target date,
19 rates would have to be materially increased effective on March 1, 2002. This plainly is not
20 part of the CPUC's contemplated plan.² Alternatively, in order to correct the \$4.5 billion in
21 mistakes in the Term Sheet, the CPUC would have to revamp its proposal to finance the cash
22 shortfall on the effective date. Given that PG&E will have a sub-investment grade ("junk")
23 credit rating large capital investment requirements, and significant working capital
24 requirements, PG&E would be unable to finance a shortfall of the magnitude under the Term
25 Sheet proposed by the CPUC.

26 _____
27 ²On the contrary, the Term Sheet provides that existing rates will remain in effect until
28 at least January 31, 2003, and gives no indication that a material rate increase is
contemplated.

1 The Term Sheet also offers inadequate explanation as to the manner in which the
2 approximately \$5.8 billion of obligations will be reinstated or refinanced. Nor are there any
3 cash flow projections provided to establish PG&E's ability to service these obligations under
4 the CPUC's contemplated plan. Indeed, there is no assurance that the CPUC would establish
5 a rate structure to enable PG&E to meet such obligations, let alone earn a fair rate of return.
6 Rather, the Term Sheet contemplates that PG&E will have to wait until all Allowed Claims
7 have been "satisfied in full" to "return" to a conventional, and minimum constitutional, cost
8 of service ratemaking framework in which the utility is provided a reasonable opportunity to
9 earn a compensatory return on its capital.³ In addition to unjustifiably penalizing PG&E's
10 equity interest holders, such treatment will inevitably relegate PG&E to a sub-investment
11 grade credit rating for years. Obtaining an investment credit rating is crucial to PG&E's
12 ongoing viability and its ability to meet its utility obligations in a cost effective manner.

13 Furthermore, and equally troubling from a reliability perspective, the Term Sheet, by
14 using virtually all of PG&E's cash to repay creditors and creating an environment where
15 access to the capital markets is problematic, will hamper PG&E's ability to invest in
16 necessary infrastructure in order to continue to provide basic utility service to its customers,
17 and may at the same time force the State to stay in the power procurement business
18 indefinitely.

19 Finally, the CPUC's contemplated plan also detrimentally impairs the rights of a
20 significant body of creditors, deprives PG&E's estate of property, and impairs the rights and
21 interests of equity holders. At a minimum, even putting aside the fatal problem of the \$4.5
22 billion shortfall, the Term Sheet is a recipe for protracted litigation that will delay resolution
23 of this case far beyond any timeline associated with the PG&E Plan.

24
25 ³ The Term Sheet provides (at 3) that "[t]he [CPUC] would establish a cost-of-service
26 rate structure that will provide PG&E with an opportunity to recoup its costs and earn a
27 reasonable return on its assets consistent with state law. This cost-of-service rate structure
28 would become effective after all Allowed Claims and dividend and sinking fund payments in
respect of PG&E's Preferred Stock Equity Interests have been satisfied in full (together with
postpetition interest, where applicable)."

1 **B. THE TERM SHEET CONTAINS A SHORTFALL OF FOUR AND ONE-**
2 **HALF BILLION DOLLARS, IS NOT FEASIBLE AND IS**
3 **UNCONFIRMABLE ON ITS FACE.**

4 A Chapter 11 plan must be determined to be feasible under Section 1129(a)(11) of the
5 Bankruptcy Code in order to be confirmed.⁴ Without further analysis, the obvious and
6 material errors in the cash available and the debts to be paid on January 31, 2003 render the
7 plan contemplated by the Term Sheet fatally flawed due to lack of feasibility. For the
8 reasons set forth below, the available cash balance must be decreased by more than \$2.0
9 billion and the cash obligations must be increased by at least \$2.5 billion, leaving a shortfall
10 of over \$4.5 billion.

11 **1. Projected Available Cash Must Be Reduced By Approximately \$710**
12 **Million Based on the Failure to Account for Income Taxes Payable on**
13 **Utility Residual Generation Revenues ("Headroom").**

14 The Term Sheet (in Schedule 3 of Exhibit B) forecasts approximately \$1.75 billion of
15 "utility residual generation revenues" that are projected to accrue over a 14 month period
16 (from December 1, 2001 through January 31, 2003). While Respondents have doubts about
17 the aggressive assumptions that appear to underlie the CPUC's estimates, even if accepted as
18 accurate, the Term Sheet fails to reflect the state and federal income taxes that PG&E is
19 required to pay with respect to this income. Such taxes, which are payable at the rate of
20 40.75%, would amount to approximately \$710 million.⁵ Accordingly, the initial available
21 cash projected under the Term Sheet must be reduced by at least this \$710 million amount.

22
23 ⁴ Section 1129(a)(11) provides that "[t]he court shall confirm a plan only if all of the
24 following requirements are met: . . . [c]onfirmation of the plan is not likely to be followed by
25 the liquidation, or the need for further financial reorganization, of the debtor or any
26 successor to the debtor under the plan, unless such liquidation or reorganization is proposed
27 in the plan." 11 U.S.C. § 1129(a)(11).

28 ⁵ Conceptually, this headroom is available to pay for recovery of previously incurred
power procurement costs which are tax deductible. However, PG&E has previously taken
these tax deductions, so that the resulting tax benefits are already reflected in the Term
Sheet's initial cash balance. The tax benefit associated with this deduction was transferred
from the Parent to PG&E in the first quarter of 2001.

1 2. **Projected Available Cash Must Be Reduced by Approximately \$650**
2 **Million Based on the Failure to Account for Income and Property**
3 **Taxes Paid in December 2001.**

4 The Term Sheet (in Schedules 1, 3 and 4 of Exhibit B) overstates initial projected cash
5 available by failing to reflect payments of \$650 million made by PG&E in December of
6 2001 for income and property taxes. At December 31, 2001, PG&E's cash balance
7 amounted to approximately \$4.22 billion, as compared to the approximately \$4.88 billion
8 amount as of November 30, 2001 reflected on the Term Sheet. Accordingly, the initial
9 available cash projected under the Term Sheet must be reduced by this \$650 million amount.

10 3. **Projected Available Cash Must Be Decreased by \$500 Million Based on**
11 **the Failure to Provide for the Cash Needed for PG&E's Budgeted**
12 **Capital Expenditures in 2002.**

13 The Term Sheet's analysis of cash available to pay claims fails to account for capital
14 expenditures in excess of depreciation by PG&E. PG&E's annual capital expenditures in
15 2002 (as described Appendix C to PG&E's Disclosure Statement) are expected to be
16 approximately \$1.5 billion. Based on annual depreciation of approximately \$1 billion, this
17 requires approximately \$500 million of incremental cash sources to fund annual capital
18 expenditures, such as new distribution lines or gas pipeline replacements. By assuming that
19 all of PG&E's return on investment will be accrued to fund payments to creditors, the Term
20 Sheet fails to include any funds in excess of depreciation for these capital expenditures.⁶
21 Such expenditures are critical to PG&E's fulfillment of its obligation to serve its customers.
22 PG&E anticipates that the need for increased infrastructure investment in its system,
23 particularly in electric transmission, will continue for the foreseeable future. Accordingly,
24 the initial available cash projected in the Term Sheet should be reduced by an additional
25 \$500 million to reflect expected 2002 capital expenditures, net of annual depreciation.

26 ⁶ The Term Sheet (in Footnote 8 to Schedule 3 of Exhibit B) provides that "the
27 [CPUC's] plan will provide for a credit facility to fund capital expenditures, working capital
28 and, if necessary, distributions to unsecured creditors." However, it goes on to state that
 "[t]he plan as presented assumes that the credit facility is undrawn at confirmation." There is
 no adequate basis to presume that PG&E will be successful in obtaining such a credit
 facility. In fact, given PG&E's impaired credit under the CPUC's contemplated plan, it is
 likely that no line of credit would be available.

1 **4. Projected Available Cash Must Be Decreased by Approximately \$220**
2 **Million Based on Understatement of Postpetition Interest Obligations.**

3 The Term Sheet (in Schedule 3 of Exhibit B) forecasts postpetition interest of \$282
4 million with respect to PG&E's mortgage bonds and \$746 million with respect to other
5 claims, or a total of \$1.028 billion. In fact, based on the provisions set forth in the Term
6 Sheet, the amount of postpetition interest is approximately \$1.251 billion, an understatement
7 of \$223 million. Since the Term Sheet provides for the payment of all postpetition interest
8 in cash, the initial available cash projected in the Term Sheet must be decreased by
9 approximately \$220 million to account for payment of the understated postpetition interest.

10 **5. Projected Cash Needed to Pay Debt on the Effective Date Must Be**
11 **Increased by More Than \$1 Billion Based on Understatement of Class 5**
12 **(General Unsecured) Claims.**

13 The Term Sheet (in Schedule 2 of Exhibit B) "adjusts" Class 5 (General Unsecured)
14 Claims by reducing them by \$1.06 billion (from \$4.57 billion to \$3.51 billion) from the
15 amount set forth in the First Amended Disclosure Statement pertaining to the PG&E Plan (as
16 amended, "PG&E's Disclosure Statement"). Footnote 3 to Schedule 2 explains that such
17 reduction reflects the reclassification of \$1.06 billion of QF claims to administrative expense
18 claims. However, PG&E's Disclosure Statement already reflects this adjustment. Thus, the
19 Term Sheet erroneously understates Class 5 Claims by \$1.06 billion. Since the Term Sheet
20 provides for the payment of all Class 5 Claims in cash, the Term Sheet's projected cash
21 requirements on the effective date must be increased by \$1.06 billion to account for payment
22 of the understated Class 5 Claims.

23 **6. Projected Cash Needed to Pay Debt on the Effective Date Must Be**
24 **Increased Based on the Improper Proposed Reinstatement of Debt of**
25 **Over \$940 Million.**

26 The Term Sheet (in Schedules 1, 2 and 5 of Exhibit B) reflects reinstated obligations of
27 approximately \$5.8 billion. However, of these amounts, approximately \$940 million cannot
28 be reinstated. This includes the following:

(1) \$333 million (1992 Series A) of PG&E's Secured First Mortgage Bonds (Class 3)
cannot be reinstated under the CPUC's contemplated plan, because such debt matures by its

1 terms on March 1, 2002, well before the effective date of the CPUC's contemplated plan.⁷

2 (2) The Term Sheet also proposes to reinstate Letter of Credit Backed PC Bond Claims
3 and Letter of Credit Bank Claims (Classes 4d and 4e under the PG&E Plan) aggregating
4 \$610 million, although such debt cannot be reinstated. If the Letter of Credit Banks do not
5 agree to the CPUC's proposed plan, and it is unlikely that they will,⁸ such claims would not
6 be subject to reinstatement, as the Letter of Credit Banks cannot be forced to renew or
7 extend these letters of credit, all of which expire by their own terms in 2002 or 2003, and as
8 to which the Letter of Credit Banks can trigger draws on the Letters of Credit (based on
9 existing defaults under the Letter of Credit Reimbursement Agreements) and redeem the
10 Letter of Credit Backed PC Bonds.

11 Accordingly, the Term Sheet's proposed effective date cash requirements must be
12 increased by approximately \$940 million to account for payment in cash of the foregoing
13 debts which are not subject to reinstatement.

14 **7. Projected Cash Needed to Pay Debt on the Effective Date Must Be**
15 **Increased by \$500 Million Based On Improper Characterization of**
16 **Class 6 (ISO, PX and Generator) and Class 7 (ESP) Claims.**

17 The Term Sheet (in Exhibit A at 6) estimates Class 6 (ISO, PX and Generator) Claims
18 at \$1.07 billion and Class 7 (ESP) Claims at \$420 million. These are the same estimated
19 amounts set forth in PG&E's Disclosure Statement, which reflects estimated reductions of
20 \$400 million and \$100 million, respectively, for refunds that the FERC is expected to order.
21 However, the Term Sheet (at 3) provides for establishment of a litigation trust for the sole
22 benefit of PG&E's ratepayers (rather than creditors), and would assign to the litigation trust
23 "affirmative recoveries related to refund claims pending before the FERC." Thus, if the
24 CPUC intends to credit the FERC refunds to the litigation trust (for the benefit of
25 ratepayers), such \$500 million in estimated refunds necessarily would not be available to

26 ⁷ Indeed, PG&E has brought a motion, scheduled to be heard on February 26, 2002, to
27 modify the cash collateral stipulation with the indenture trustee for the mortgage bonds to
28 provide for the timely payment of the bonds maturing on March 1, 2002.

⁸ The Letter of Credit Banks are unlikely to prefer extending new letters of credit to a
sub-investment grade entity, given their ability to require a full cash payment.

1 offset Class 6 and Class 7 Claims. Accordingly, the \$500 million in estimated FERC
2 refunds already reflected as an offset in the Class 6 and 7 Claims in the PG&E Plan must be
3 added back to the Class 6 and Class 7 claims as stated in the Term Sheet, thereby raising the
4 cash requirements on the proposed effective date by \$500 million to account for payment in
5 cash of such obligations.

6 **8. Summary of Adjustments Required to Correct Errors in Term Sheet.**

7 In order to correct the foregoing errors in the Term Sheet, the following adjustments
8 aggregating more than \$4.5 billion⁹ must be made to the Term Sheet:

9 (1) Projected initial cash available to pay creditors must be reduced by more than \$2.0
10 billion (based on failure to account for approximately \$710 million of taxes payable on
11 utility residual generation revenues, failure to account for payments of approximately \$650
12 million in December 2001 for income and property taxes, failure to provide for net capital
13 expenditures of approximately \$500 million in 2002 and understatement of postpetition
14 interest of approximately \$220 million).

15 (2) Projected cash requirements for creditor payments on the effective date must be
16 increased by over \$2.5 billion (based on understatement of \$1.06 billion in Class 5 (General
17 Unsecured) Claims, required payment of approximately \$940 million of debt not subject to
18 reinstatement and understatement of \$500 million in Class 6 (ISO, PX and Generator) and
19 Class 7 (ESP) Claims).

20 The necessary adjustments to the CPUC's figures will result in a shortfall of more than
21 \$4.5 billion between the obligations under the CPUC's contemplated plan and the resources

22
23 ⁹ In addition to the clear and demonstrable significant factual errors discussed above
24 resulting in a \$4.5 billion shortfall, several assumptions underlying the Term Sheet appear to
25 be highly optimistic, and if not achieved, would require, on top of this \$4.5 billion gap, yet
26 additional sources of cash to pay claims on the proposed effective date. The CPUC assumes
27 that \$1.7 billion in "utility residual generation revenues" will be raised over the 14-month
28 period ending January 31, 2003. Commonly referred to as "headroom," these revenues are
equal to the difference between the Debtor's overall rate level (*i.e.*, the frozen rate) and the
various utility costs that have been authorized for recovery in rates. Headroom is difficult to
estimate because it requires a forecast of all of the events that will affect the costs a utility
will incur. Given the lack of back-up data accompanying the Term Sheet, Respondents are
unable to assess whether the CPUC's forecast is realistic.

1 available to satisfy such obligations. Moreover, this \$4.5 billion gap cannot be financed
2 under the CPUC's framework. Thus, the CPUC's contemplated plan is not feasible and is
3 unconfirmable on its face.

4 While the foregoing, by itself, makes the CPUC's contemplated plan infeasible, there
5 are a number of additional grounds that prevent such a plan from being viable.

6 **C. THE PLAN CONTEMPLATED BY THE TERM SHEET WOULD**
7 **SERIOUSLY IMPAIR PG&E'S OPERATIONS.**

8 PG&E would not be a viable utility company under the CPUC's contemplated plan.
9 The CPUC has not proposed a single step in its Term Sheet to help restore PG&E's
10 investment grade credit rating or address the fundamental cause of its financial decline, *i.e.*,
11 the failure of the regulatory process, which is critical to the feasibility of any plan. The
12 capital markets and the rating agencies currently have no basis to believe that the CPUC will
13 implement structural regulatory reforms to restore the financial health of PG&E.¹⁰ Indeed,
14 the CPUC's proposal appears to make matters worse by requiring significant spending
15 reductions or forcing PG&E to attempt to borrow money with no clear means of repaying it.

16 While the Term Sheet apparently contemplates compelling PG&E to resume power
17 procurement on behalf of its customers, it fails to deal with the fact that PG&E will be
18 hampered as an effective participant in power markets until it has regained an investment
19

20 ¹⁰ Standard & Poor's recently opined: "although the [CPUC's] reorganization plan
21 purports to address [PG&E's] defaulted obligations, it is silent as to whether PG&E will
22 exhibit long-term financial performance consistent with investment grade ratings.
23 Therefore, under the CPUC proposal, it remains unclear whether and when PG&E's ratings
24 will be restored to investment grade If the CPUC plan is adopted, future credit quality
25 will hinge upon the CPUC's establishment of a clear track record of regulatory decisions that
26 translates into strong and predictable cash flows following the conclusion of the bankruptcy
27 proceedings and the end of bankruptcy court oversight. PG&E's defaulted obligations and
28 its bankruptcy filing were caused by power-procurement costs that greatly exceeded
revenues in 2000 and 2001. The financial challenges created by the extreme difference
between revenues and expenses were compounded by the absence of timely redress by state
officials, including, but not limited to, the CPUC." ("Regulator's Plan for Pacific Gas &
Electric Reorganization May Not Help Credit Quality" (Standard & Poor's 2/14/02))

1 grade credit rating.

2 In short, Respondents do not believe that the Court will be able to make the required
3 findings that the entity that would emerge from reorganization protection under the CPUC's
4 alternative plan would be a financially viable going-concern.

5 **1. The CPUC's Contemplated Plan Would Impair PG&E's Ability to**
6 **Invest in Infrastructure to Ensure System Reliability.**

7 As discussed above, PG&E expects to invest approximately \$1.5 billion each year in
8 its electric and gas systems for the next several years to ensure utility service to the
9 approximately 13 million persons it serves in Northern and Central California.¹¹ The plan
10 contemplated by the Term Sheet would, at a minimum, risk drastic cuts in PG&E's capital
11 budgets for 2002 and several years thereafter, which could have significant impact on system
12 reliability.

13 While the Term Sheet contemplates PG&E securing a credit facility to fund, *inter alia*,
14 capital expenditures and working capital, based on the lack of assurance regarding PG&E's
15 creditworthiness, such a credit facility, in combination with the more than \$4.5 billion
16 necessary to fund the Term Sheet, would not be available to PG&E under the Term Sheet
17 proposed by the CPUC. This assumed credit facility is critical to the viability of the CPUC's
18 contemplated plan, for if PG&E is unable to adequately address its working capital needs,
19 PG&E cannot fulfill its obligations as a utility to serve its customers.

20 **2. The Term Sheet Fails to Resolve the Power Procurement Problem.**

21 The Term Sheet states that its contemplated plan will allow PG&E to resume
22 procurement of power for its customers, but fails to describe how it will allow this to
23 happen. Under the tariffs of the California Independent System Operator ("ISO"), PG&E is
24 foreclosed from purchasing power through the ISO's markets unless it is rated investment
25 grade or is able to post collateral, including cash, letters of credit or surety bonds. The

26 _____
27 ¹¹ This is somewhat higher than recent spending levels, which have averaged \$1.25
28 billion over the last three years, principally due to greater investments in electric
transmission capacity additions.

1 CPUC's contemplated plan does neither. First, nothing in the CPUC plan will restore PG&E
2 to investment grade status.¹² Second, the CPUC's contemplated plan and PG&E's
3 noncreditworthy status thereunder would leave PG&E with inadequate resources for posting
4 collateral or pre-paying for necessary obligations (e.g., natural gas supplies for core gas
5 customers, electrical energy and ancillary services procured for electric customers and
6 workers compensation liabilities). At best, PG&E would be unable to procure sufficient
7 power and gas on anything other than a monthly or "spot" basis. Therefore, its customers
8 would be directly exposed to the price volatility of the gas and power markets beyond the
9 current month. PG&E would also be unable to engage in any price risk management
10 activities on behalf of customers. As a result, under the CPUC's contemplated plan, the
11 State's exit from the power procurement business is put at risk.

12 **D. THE CPUC'S CONTEMPLATED PLAN IMPROPERLY SEEKS TO**
13 **TRANSFER VALUE FROM PG&E'S EQUITY SECURITY HOLDERS**
14 **TO RATEPAYERS.**

15 The overriding theme of the CPUC's contemplated plan is to transfer value from
16 PG&E's equity security holders to the ratepayers, whom the Court has previously
17 determined are not creditors of the bankruptcy estate.

18 For example, the Term Sheet provides for the transfers of numerous claims belonging
19 to the estate (including proceeds from the Rate Recovery Litigation, recoveries from refund
20 claims pending before the FERC and other claims against sellers of electricity in the
21 wholesale market) to a litigation trust for the benefit of ratepayers.

22 The Term Sheet, by appropriating the value of PG&E's Rate Recovery Litigation
23 against the CPUC and transferring the first \$1.75 billion in recovery to ratepayers through
24 the litigation trust, attempts to use the Bankruptcy Court to take an asset owned by the estate

25 ¹² In fact, the CPUC's contemplated plan would leave PG&E in worse financial
26 condition than Southern California Edison ("Edison"), which has recently been rated sub-
27 investment grade by both Moody's and Standard & Poor's under its settlement with the
28 CPUC. See "Southern California Edison's Rating Raised, Off Credit Watch; Outlook
Developing (Standard & Poor's 2/8/02); "Moody's Assigns a (P)Ba2 Senior Secured Rating
to Southern California Edison Company's Credit Facilities" (Moody's Investors Service
2/8/02).

1 (whose value would otherwise inure to the Debtor's equity holders in view of the full
2 payment of creditor claims) to seek recompense for the CPUC's illegal refusal to allow
3 PG&E to recover FERC-approved wholesale power costs. This aspect of the CPUC's
4 contemplated plan is designed to moot the significant financial exposure that the CPUC
5 faces in the Rate Recovery Litigation.

6 The CPUC fails to articulate any basis for the transfer of these valuable estate assets
7 without consideration for the benefit of parties who are not entitled to receive any property
8 of the estate under controlling bankruptcy law.

9 **E. THE CPUC'S PLAN WOULD DETRIMENTALLY IMPAIR THE**
10 **RIGHTS OF A SUBSTANTIAL BODY OF CREDITORS AND EQUITY**
11 **HOLDERS, WHICH, AT A MINIMUM, WILL LEAD TO PROTRACTED**
12 **LITIGATION THAT WILL DELAY RESOLUTION OF THIS CASE.**

13 The Plan contemplated by the Term Sheet proposes to reinstate more than \$4 billion of
14 claims that would not be subject to reinstatement under the PG&E Plan, including \$3.3
15 billion of mortgage bonds that would be paid fully in cash under the PG&E Plan. Given that
16 these bondholders originally purchased bonds that were rated "A" or better (by both
17 Moody's and Standard & Poor's) and the CPUC's contemplated plan would have their credit
18 rating be well into the speculative range, the Debtor and its financial advisors estimate that,
19 based on current market conditions, the mortgage bonds would reasonably be expected to
20 trade at a material discount of their par value upon consummation of the CPUC's
21 contemplated plan. This reflects a *de facto* diminution of value and economic impairment
22 that, at best, would lead to protracted litigation by such creditors seeking to protect their
23 interests in a solvent debtor case under bankruptcy law.

24 The CPUC's contemplated plan would also deprive PG&E's common shareholders
25 from receiving any dividends until at least 2004 and transfer numerous valuable claims
26 belonging to the estate (whose value would otherwise inure to equity holders in view of the
27 full payment of creditor claims) for the benefit on non-stakeholders, without any
28 consideration.

Such creditors and equity security holders are extremely unlikely to accept this inferior

1 treatment. Thus, at a minimum, the CPUC's contemplated plan is likely to result in
2 protracted litigation regarding the proposed treatment of a substantial body of creditors and
3 equity security holders, in addition to litigation regarding feasibility and other confirmation
4 issues .

5 **F. THE TAKING OF THE DEBTOR'S RETURN ON INVESTMENT**
6 **VIOLATES STATE AND FEDERAL LAW.**

7 The CPUC's contemplated plan proposes to deprive PG&E of approximately \$1.2
8 billion attributable to the Debtor's authorized utility return on investment and use these
9 funds to pay creditors.¹³ The proposal violates the fundamental tenet of the "regulatory
10 compact" that public utilities are entitled to recovery of their costs of service plus the
11 opportunity to earn a reasonable rate of return.¹⁴ The CPUC proposal would appropriate not
12 only the Debtor's return on utility distribution operations subject to the CPUC's jurisdiction,
13 but would further take the returns authorized by the FERC for PG&E's electric transmission
14 business (which is subject to exclusive FERC ratemaking jurisdiction).¹⁵

15 The CPUC has long recognized under *Bluefield Water Works & Improvement Co. v.*
16 *Public Service Commission*, 262 U.S. 679 (1923), and the *Federal Power Commission v.*
17 *Hope Natural Gas Co.*, 320 U.S. 591 (1944), that PG&E's return "should also be reasonably
18 sufficient to assure confidence in the financial soundness of the utility, and adequate, under

19 _____
20 ¹³ The "cash on hand" balances relied upon by the CPUC also include PG&E's return
21 on ratebase stretching back to December 2000. Thus, the CPUC's contemplated plan would
22 deprive PG&E of any return on investment for over three years.

23 ¹⁴ Under the Fourteenth Amendment of the United States Constitution, a utility cannot
24 be forced to continue operations at a loss. *Napa Valley Elec. Co. v. Railroad Comm'n*, 251
25 U.S. 366, 369(1920). Rather, rates must be set at a level that allows a utility a reasonable
26 opportunity to recover its cost of service. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308
27 (1989) ("if the rate does not afford sufficient compensation, the State has taken the use of
28 utility property without paying just compensation and so violated the Fifth and Fourteenth
Amendments.")

¹⁵ The proposed deprivation of the Debtor's return on investment authorized for
electric transmission service under federally filed and approved rates violates the "Filed Rate
Doctrine" and is therefore inconsistent with federal law, unlawfully interferes with interstate
commerce and would result in an unlawful taking of the Debtor's property. See *Nantahala
Power & Light Co. v. Thornburg*, 476 U.S. 953 (1986); *Mississippi Power & Light Co. v.
Moore*, 487 U.S. 354 (1988).

1 efficient management, to maintain and support its credit, and to enable it to raise the money
2 necessary for the proper discharge of its public duties.”¹⁶

3 The CPUC proposal is unlawful and would require bankruptcy court preemption of
4 the CPUC’s own decisions, state law, the California Constitution, federal law and the United
5 States Constitution. But for potential bankruptcy court preemption, the CPUC would be
6 legally estopped from implementing the ratemaking that is proposed in the Term Sheet.¹⁷

7 **G. THE CPUC’S FORECASTED TIMELINE FOR CONFIRMING ITS
8 CONTEMPLATED PLAN IS UNREALISTIC.**

9 In its Term Sheet (in Exhibit C), the CPUC forecasts filing its proposed plan and
10 disclosure statement by April 15, 2002, having a confirmation hearing by September 16,
11 2002 and having its plan become effective by January 31, 2003. The projected timeline is
12 completely unrealistic, in view of, *inter alia*, (1) the facial unconfirmability of the plan
13 contemplated by the Term Sheet based on feasibility and other grounds, (2) the CPUC’s
14 acknowledged failure to even begin negotiating with PG&E, the Creditors’ Committee or
15 any creditor or interest holder constituency regarding its proposed contemplated plan,¹⁸ and
16 (3) the anticipated protracted litigation with respect to the CPUC’s contemplated plan and
17 disclosure statement.

18 Based on the CPUC’s failure to propose a viable alternative to the PG&E Plan,
19 authorizing the CPUC to file a detailed plan and disclosure statement would not only be

20
21 ¹⁶ The CPUC’s contemplated plan violates state law. Public Utilities Code Section
22 399.2(c) specifies that “[e]ach electrical corporation shall have a reasonable opportunity to
23 fully recover from all customers of the electrical corporation . . . : (1) Reasonable
24 investments in its electric distribution grid. (2) A reasonable return on the investments in its
25 electric distribution grid. (3) Reasonable costs to operate its electric distribution grid.”

26 ¹⁷ Conversely, the CPUC, in its settlement with Edison, authorized Edison to recover
27 over \$3 billion from ratepayers to pay its debts and compensate it for other unrecovered
28 costs. Under the settlement, Edison does not forfeit its return on investment and there are
broad allowances and assurances for capital expenditures. In addition, the CPUC has
authorized Edison to recover several billion dollars in transition costs as part of that
settlement. These same costs go unrecovered for PG&E under the Term Sheet.

¹⁸ Footnote 1 to the Term Sheet states that “[t]he terms hereof have yet to be negotiated
with PG&E, the Official Committee of Unsecured Creditors appointed in this chapter 11
case, or other key constituencies.”

1 fruitless, but would be unnecessarily dilatory and wasteful. Prolonging the inevitable
2 decision to discontinue consideration of the CPUC's contemplated plan will additionally
3 cause harm to the efficient processing of the PG&E Plan. The CPUC has on two separate
4 occasions filed motions at the FERC and the other regulatory agencies urging these agencies
5 to suspend their review of the PG&E Plan implementation applications in light of the
6 potential for the CPUC's "competing" plan. These tactics threaten to damage PG&E's
7 ability to consummate the PG&E Plan and pay its creditors in full by the end of the year.
8 The Court itself has recognized that the CPUC should not be permitted to further hamper
9 PG&E's pursuit of confirmation of the PG&E Plan under such circumstances.¹⁹

10 IV.

11 CONCLUSION

12 Respondents concur that it would be "enormously inappropriate and an enormous
13 burden on this estate to allow a plan that is hopelessly unconfirmable to be filed." Tr., 95:22-
14 24. The Term Sheet is unworkable. It contains \$4.5 billion of errors and omissions that
15 result in a "sources and uses" shortfall that cannot be fixed through adjustments to the
16 financials. The contemplated plan does not make PG&E creditworthy or otherwise ensure
17 its post-reorganization viability. The contemplated plan endangers PG&E's ability to meet
18 its obligation to serve by limiting its capital expenditures and fails to restore PG&E to a
19 financial position that will allow it to effectively resume power procurement. The
20 contemplated plan takes from the equity holders and impermissibly transfers value in the
21 estate to ratepayers. The "maximum reinstatement" strategy is likely to be opposed by many
22 of the financial creditors who will assert that reinstatement of debt in a severely weakened,
23 non-investment grade company impairs their interests. The CPUC's proposed framework is

24
25 ¹⁹ In the Term Sheet, the CPUC contends that its submission of its Term Sheet for the
26 purpose of proposing a Chapter 11 plan in this case should not be deemed a waiver of its
27 sovereign immunity. The CPUC does not even attempt to explain how its submission of a
28 proposed plan for purposes of obtaining confirmation thereof by the Bankruptcy Court does
not constitute consent to this Court's jurisdiction, particularly in light of the obligations
proposed to be undertaken by the CPUC under its proposed plan.

1 patently unconfirmable. By its own admission, the CPUC has had adequate time, resources
2 and data to prepare its Term Sheet.²⁰ Therefore, it should not be granted an opportunity to
3 submit a revised Term Sheet.

4 For all of the foregoing reasons, Respondents respectfully request that this Court make
5 and enter its order:

6 1. Finding that the Chapter 11 plan contemplated by the Term Sheet is unconfirmable
7 as a matter of law.

8 2. Providing that with respect to the CPUC (as the Court has previously ruled with
9 respect to all other parties), the period during which PG&E maintains plan exclusivity
10 pursuant to Section 1121(c)(3) of the Bankruptcy Code is extended until June 30, 2002, or
11 such later date as the Court hereafter may order based upon a subsequent motion filed on or
12 before June 30, 2002.

13 3. Providing for such other and further relief as the Court deems just and appropriate.

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22 ///
23 ///

HOWARD
RICE
NEMENOVSKI
CANADY
FALK
& RAEBGIN

A Professional Corporation

25 ²⁰ For example, at the January 16, 2002 hearing on PG&E's exclusivity motion, the
26 CPUC represented as follows: "In terms of the timing, we have spent months, and the
27 [CPUC] has very extensive staff that is intimately familiar with PG&E's financial
28 affairsThe Energy Department staff has spent months putting together termsheets."
"We have the numbers. We continue to update the numbers, but this is not a pie-in the-sky
plan." (Tr., 59:16-22; 61:17-18)

1 DATED: February 20, 2002

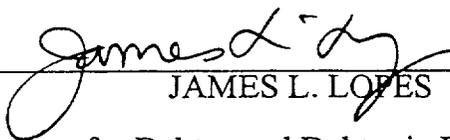
2 Respectfully,

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4 DEWEY BALLANTINE LLP

5 Attorneys for Co-Plan Proponent
6 PG&E CORPORATION

7
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10 By: 
11 JAMES L. LOPES

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

14 WD 022002/2-1419915/Y11/976829/v2

15 HOWARD
16 RICE
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19 FALK
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21 A Professional Corporation