JAMES L. LOPES (No. 63678)
JEFFREY L. SCHAFFER (No. 94104)
WILLIAM J. LAFFERTY (No. 120814)
HOWARD, RICE, NEMEROVSKI, CANADY, FALK & RABKIN
A Professional Corporation
Three Embarcadero Center, 7th Floor
San Francisco, California 94111-4065
Telephone: 415/434-1600
Facsimile: 415/217-5910

ROGER J. PETERS (No. 77743)
CHRISTOPHER J. WARNER (No. 140915)
WILLIAM MANHEIM (No. 130182)
PACIFIC GAS AND ELECTRIC COMPANY
77 Beale Street, 30th Floor
San Francisco, California 94120
Telephone: 415/973-6695
Facsimile: 415/973-5520

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

- and -

Attorneys for PG&E CORPORATION
listed on attached counsel page

50-275/323

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

In re PACIFIC GAS AND ELECTRIC COMPANY, a California corporation, Debtor. Federal I.D. No. 94-0742640	Case No. 01-30923 DM Chapter 11 Case Date: May 9, 2002 Time: 9:30 a.m. Place: 235 Pine Street, 22nd Floor San Francisco, California

OBJECTIONS OF PACIFIC GAS AND ELECTRIC COMPANY AND PG&E CORPORATION TO THE DISCLOSURE STATEMENT PROPOSED BY THE CALIFORNIA PUBLIC UTILITIES COMMISSION

A001 Add: Rids Ogc Mail Center

MICHAEL P. KESSLER
OSCAR CANTU
WEIL, GOTSHAL & MANGES LLP
767 Fifth Avenue
New York, New York 10153
Telephone: 212/310-8000
Facsimile: 212/310-8007

ALAN S. GOVER
DEWEY BALLANTINE LLP
Two Houston Center
909 Fannin Street, Suite 1100
Houston, Texas 77010
Telephone: (713) 576-1500
Facsimile: (713) 576-1533

Attorneys for PG&E CORPORATION

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

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HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

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Pacific Gas and Electric Company, the debtor in possession in the above-captioned chapter 11 case (the "Debtor" or "PG&E"), and PG&E Corporation ("Parent") (collectively, the "Objectors") hereby state their objections to the proposed Plan of Reorganization and Disclosure Statement filed by the California Public Utilities Commission ("CPUC" or "Commission") on April 15, 2002.[1]

I. INTRODUCTION

Objectors filed their initial Plan and Disclosure Statement in this case on September 20, 2001. Over the past seven months, the Objectors have responded to, and ultimately resolved, numerous objections to the Disclosure Statement pertaining to their Plan of Reorganization (the "Objectors' Disclosure Statement"), culminating in the Court entering its Order Approving Disclosure Statement on April 24, 2002.

The Objectors' highest priority is to advance their Plan of Reorganization (the "Objectors' Plan") through the solicitation and confirmation stages as quickly as possible in order to expedite the payment of creditors and hasten PG&E's departure from chapter 11. In furtherance of that goal, at a hearing held on March 26, 2002, counsel for PG&E informed the Court that (a) the Objectors would consent to solicit acceptances of their Plan "in tandem" with (i.e., on the same schedule as) solicitation for the alternative Plan of Reorganization that the CPUC had committed to file on or before April 15, 2002, provided that the CPUC would meet its confirmation schedule commitment filed with the Court on February 13, 2002, to commence solicitation on its Plan on or before June 17, 2002 (March 26, 2002 Reporter's Transcript ("RT") 101-02), and (b) based upon the Objectors' review and analysis of the "Term Sheet" filed by the CPUC on February 13, 2002 (the "CPUC Term Sheet"), which purported to contain the principal terms of the CPUC Plan, and subject to review of the actual CPUC Plan when filed, the Objectors would not raise "patently

[1]The Plan of Reorganization and Disclosure Statement filed by the CPUC will be referred to herein for convenience as the "CPUC Plan" and the "CPUC Disclosure Statement," respectively.

unconfirmable" type objections to the CPUC Plan at the disclosure statement approval stage. March 26, 2002 RT at 103-04. Rather, the Objectors indicated that they would preserve all such objections to the hearing on confirmation of the CPUC Plan.

Having now had the opportunity to review the CPUC Plan and the CPUC Disclosure Statement, it is apparent that the CPUC Plan contains provisions that are materially different from those presented in the CPUC Term Sheet and that raise fundamental legal and factual issues concerning the confirmability of the CPUC Plan. Although the premise on which Objectors had determined not to raise confirmation issues at the CPUC Disclosure Statement hearing (i.e., that the CPUC Plan would closely follow the CPUC Term Sheet) has proven to be invalid, Objectors nonetheless will abide by their stated intent not to object to the proposed CPUC Disclosure Statement on the ground that the CPUC Plan is unconfirmable, and will instead fully reserve such issues for the confirmation hearing.

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However, it is important for Objectors to summarize briefly some of their key objections to confirmation in order for the Court and parties in interest to evaluate Objectors' specific objections to the adequacy of the proposed CPUC Disclosure Statement, and to understand why the CPUC Disclosure Statement must be clarified and supplemented in a number of material respects in order for the "hypothetical reasonable investor" to make an informed decision on whether to accept or reject the CPUC Plan. In some instances the CPUC Disclosure Statement does not adequately disclose the risks associated with the CPUC Plan, and in other instances the CPUC Disclosure Statement does not provide sufficient explanation or detail about basic mechanical and implementation provisions of the CPUC Plan to enable the "hypothetical reasonable investor" to make an informed judgment about the balance of potential risks and rewards associated with the CPUC Plan. Accordingly, as necessary context for the objections to the CPUC Disclosure Statement detailed in Part II.A. below, we turn now to a brief summary of some of the key issues regarding the confirmability of the CPUC Plan. In Part II.B. below, a more complete (but still abbreviated) discussion of such confirmation issues is provided.

In apparent recognition of the validity of the Objectors' critique of the CPUC Term Sheet, the CPUC has attempted in the CPUC Plan to raise an additional $8 billion in an attempt to fix the shortfalls in the CPUC Term Sheet.[2] The CPUC Plan raises these additional funds through: (1) the issuance of $3.8 billion of new PG&E debt; (2) the sale of $1.75 billion in PG&E common stock; (3) an increase of $1 billion (to $2.7 billion) in "headroom" revenues attributable to the difference between current rates (which would remain in effect through the end of January 2003) and rates which the CPUC deems to be PG&E's "cost of service;" and (4) the establishment of a new $1.9 billion secured credit facility to fund working capital and other ancillary obligations.

Each of these new sources of funds improperly burdens the Debtor and its shareholders, improperly impairs the legitimate interests and rights of equity, and in any event renders the Debtor unable to obtain the investment grade credit rating that is a necessary condition precedent to any viable reorganization of the Debtor. And in some cases, these new sources of funds coopt and transfer property from the Debtor's equity holders—frequently to the Debtor's ratepayers, who are not creditors of this estate as this Court has already ruled. The CPUC Plan would require the private or public issuance of $1.75 billion in common stock by the Debtor. In order to raise $1.75 billion from the sale of the Debtor's common stock, a significant indeterminate percentage of the Debtor's equity would have to be sold, which could result in tax deconsolidation. The consequences of such tax deconsolidation are not even alluded to in the CPUC Disclosure Statement. Further, it is readily apparent that such an issuance of equity by a debtor in possession via a plan that does

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[2]No doubt, these "modifications" were made in response to the comments by the Objectors and the Official Committee of Unsecured Creditors that the CPUC Term Sheet contained numerous factual errors and false assumptions concerning the assets and liabilities and revenues and expenses of the Debtor, the net result of which was that the CPUC Term Sheet contained a multi-billion dollar "shortfall," and the debt repayments promised in the CPUC Term Sheet were simply infeasible. Material modifications obviously were required to provide the additional cash necessary to make the CPUC's proposed plan "mathematically" feasible; whether the modifications incorporated into the CPUC Plan in fact make the CPUC even "mathematically" feasible is of course a factual issue that would have to be decided at any confirmation hearing respecting the CPUC Plan.

not repair the problems which precipitated its liquidity crisis and slide into bankruptcy, which provides for post-confirmation governance by the regulatory body that oversaw such deterioration, and which strips the Debtor of certain claims, would be priced at a material discount to the value of that equity under a plan that restored the Debtor to its value before the California energy crisis (or even one that restored it to investment grade). An equity issuance at such a discount dilutes not only the shareholders' ownership interest on an absolute basis, but the value attributable to that interest. In short, the planned equity issuance improperly impairs the interests of equity holders and is impermissible under the Bankruptcy Code.

In addition, application of the $2.7 billion in headroom revenues called for by the CPUC Plan is not possible without preempting or otherwise overriding otherwise applicable nonbankruptcy law. That is because it is not possible to obtain as a source of funds for the CPUC Plan $2.7 billion in "headroom" revenues unless the Debtor's cost levels are artificially depressed, the Debtor's prior uncollected transition costs go unrecovered and the constitutionally mandated return on and of utility investment is confiscated.[3] Nothing in the CPUC Disclosure Statement adequately addresses these issues. The CPUC Plan further drains the Debtor of cash necessary to fund its utility capital improvements and other working capital needs, and requires the Debtor to obtain a new secured line of credit to supplement the cash resources of the Debtor that the CPUC Plan would severely deplete.

The CPUC Plan, in another significant change from the CPUC Term Sheet, also inappropriately and illegally transfers billions of dollars of value in the estate to third party ratepayers who the Court has already ruled are not creditors. The CPUC Plan would have the Debtor release without consideration all of its claims against the State of California (including its multi-billion dollar filed rate case in federal court, multi-billion dollar takings and breach-of-contract claims, and other claims and lawsuits against the State related to the

[3]By contrast, the CPUC has authorized another major public utility in the State, Southern California Edison, to recover its transition costs and granted a full utility return on and of utility investment in its settlement of federal court "filed rate case" litigation.

CPUC's refusal to allow the recovery of wholesale power costs, generation related stranded costs and generation market valuation). These claims go to the heart of why PG&E was driven into bankruptcy. The potential damages, whether paid in cash collected from taxpayers, or in adjustments to PG&E's regulated revenues and expenses paid by ratepayers, constitute valid assets of the Debtor and represent a legitimate means for restoring PG&E to the full value that existed prior to the California energy crisis. The CPUC Plan would eliminate these claims from the estate in return for unspecified value. Because ratepayers and taxpayers are the ultimate beneficiaries of the waiver of claims (given that if PG&E prevails in the filed rate case, the CPUC will be required to set rates at a level to ensure PG&E's recovery of the amounts at issue, and, if PG&E prevails on its other claims, the State will be liable for damages), the waiver inappropriately and illegally transfers substantial value from the estate for the benefit of non-stakeholder third parties.

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II. OBJECTIONS TO THE CPUC DISCLOSURE STATEMENT AND PLAN

The Court is well familiar with the factors necessary to determine whether a disclosure statement contains "adequate information" within the meaning of section 1125 of the Code, and Objectors therefore will not repeat such factors in this pleading.

In view of the material financial and conceptual reconfiguration from the CPUC Term Sheet to the CPUC Plan and the lack of clarity in the CPUC Disclosure Statement as to numerous critical elements in the CPUC Plan, Objectors raise a number of objections. There are several areas in which the Disclosure Statement either fails to set forth sufficient information concerning the CPUC Plan, or where the CPUC Disclosure Statement and the CPUC Plan are ambiguous concerning the provisions of the CPUC Plan or the CPUC's intentions under the CPUC Plan. Resolution of these objections is necessary to understanding the CPUC Plan. The CPUC may resolve most, if not all, of these objections by adding additional detail or modifying aspects of the CPUC Disclosure Statement and the CPUC Plan. In many instances, Objectors have proposed specific language that Objectors

believe will address issues of adequate disclosure.[4]

A. Objections To The CPUC Disclosure Statement

1. The CPUC Disclosure Statement Fails To Explain How The CPUC Can Be Both A Plan Proponent And Continue To Assert Sovereign Immunity.

In footnote one of the CPUC Disclosure Statement, the CPUC states:

> "In submitting this Plan and its accompanying Disclosure Statement, the Commission does not waive any objections or defenses that the Commission or any agency or unit or entity of the State of California may have to this Court's jurisdiction over the Commission or the State based upon the Eleventh Amendment of the U.S. Constitution or related principles of sovereign immunity or otherwise, all of which are hereby reserved." CPUC Disclosure Statement ("CPUC DS") at 1 n.1.

Moreover, the CPUC Plan itself is even more explicit concerning the CPUC's continuing right to claim sovereign immunity. The CPUC Plan states in the preamble to Article X, "Retention of Jurisdiction":

> "Subject to the Commission's and the State of California's objections and defenses based upon the Eleventh Amendment to the United States Constitution or related principles of sovereign immunity or otherwise, *all of which are hereby reserved*, the Bankruptcy Court shall have jurisdiction of all matters arising out of, or related to, the Chapter 11 Case and the Plan pursuant to, and for the purposes of, sections 105(a) and 1142 of the Bankruptcy Code. . . ." CPUC Plan at 68 (emphasis added).

Objectors contend that, under applicable law, the filing by the CPUC of its Disclosure Statement and Plan of Reorganization is and must be, in and of itself, a waiver of sovereign immunity, but that question need not be decided here.[5] However, assuming *arguendo* that the CPUC may both file a plan and maintain sovereign immunity, the fact of doing so raises a fundamental question about plan feasibility that is material to creditors and must be disclosed in the CPUC Disclosure Statement.

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[4]Such proposed language is contained in the Appendix to this Objection attached hereto and made a part hereof. For ease of reference, where proposed disclosure language to resolve an objection is provided, the textual discussion of such objection is immediately followed by a cite to a specific section of the Appendix.

[5]Objectors also contend that the CPUC and the State have waived sovereign immunity by their other actions taken in this case.

As submitted, it is unclear whether the CPUC Plan is a present binding commitment to approve issuance and servicing of the debt, to maintain rates for headroom and for repayment of debt and pass-through liabilities and to authorize an equity issuance. Moreover, the CPUC historically has held that under the California Public Utilities Code, particularly Section 1708, the CPUC cannot bind itself to take actions in the future. Yet the CPUC Plan depends upon the CPUC's adherence to the CPUC Plan as proposed and upon the CPUC's future implementation of critical aspects of the CPUC Plan. For example, repayment of the $3.8 billion of new debt requires ongoing ratemaking recovery, maintenance of rate levels is necessary to accrue sufficient headroom for the CPUC Plan and to ensure the Debtor sustains sufficient revenues to pay pass-through liabilities and to retain access to capital markets as a financially viable entity once it is again investment grade, and approvals for issuance of securities, among other acts, will require future CPUC affirmative approvals and ratemaking commitments or adherence to existing CPUC decisions.

Because the CPUC continues to contend that it and the State of California are immune to the Bankruptcy Court's exercise of jurisdiction, and because the CPUC appears to continue to maintain that the threat of Bankruptcy Court enforcement is so pervasive a threat to sovereign immunity that the *Ex parte Young* doctrine is not available for purposes of enforcement of the CPUC Plan,[6] it is entirely unclear how the CPUC envisions that the Bankruptcy Court could enforce against the CPUC and/or its commissioners any order of the Bankruptcy Court respecting the CPUC Plan.

Given that the CPUC has taken the position that it cannot bind the actions of itself in the future, that the current scope of its commitment to act is in any event unclear, and that enforceability of the CPUC Plan in the face of the CPUC's continued assertion of sovereign immunity is problematic, the CPUC Disclosure Statement and CPUC Plan must

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[6] *Ex parte Young*, 209 U.S. 123 (1908). This Court has discussed the CPUC's position regarding the unenforceability of a Bankruptcy Court-approved plan of reorganization in some detail at pages 41-46 of its February 7, 2002 decision on preemption and sovereign immunity issues. *See* "Memorandum Decision Regarding Preemption and Sovereign Immunity," dated February 7, 2002 (Docket No. 4710).

address these issues. At a minimum, the CPUC Disclosure Statement and CPUC Plan must specify what, if any, means *do* exist to assure CPUC implementation and enforcement of the CPUC Plan, if confirmed. Barring that, the CPUC Disclosure Statement should identify as a risk factor that the CPUC may choose in the future not to comply with or otherwise implement the CPUC Plan and that so long as the CPUC asserts sovereign immunity in this chapter 11 case, the CPUC may take the position that there is no direct remedy in Bankruptcy Court or elsewhere against the CPUC for aggrieved parties to enforce or assure compliance with the CPUC Plan.

Alternatively, it is also quite possible that the Court will reject the CPUC's sovereign immunity objections, including on the ground that the CPUC and/or the State has waived sovereign immunity, including through the filing of the CPUC Plan and by actions identified in PG&E's Disclosure Statement at pages 180-84. The CPUC Disclosure Statement and CPUC Plan should state whether such an adverse determination would result in withdrawal of or any changes to the CPUC Plan.

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The Objectors' proposed insertion to the CPUC Disclosure Statement to address the objection set forth in the foregoing Section II.A.1. is set forth in **ITEM 1** of Appendix A hereto.

2. The CPUC Has Determined That Under State Law It Lacks Authority to Bind Itself, And Therefore The CPUC Disclosure Statement Must Disclose The Risk That The CPUC Plan Is Not Binding On The CPUC And May Be Amended, Altered Or Rescinded At Any Time; Alternatively, The CPUC Must State Whether It Intends The CPUC Plan To Preempt State Law To Attempt To Address This Problem.

Counsel for the CPUC has represented that the CPUC will be bound by the CPUC Plan if confirmed. February 27, 2002 RT at 62-63, 65. This statement on behalf of the CPUC is at odds with positions taken by the CPUC regarding state law.

The CPUC has determined that, under California law, the CPUC may not bind itself on matters within its regulatory jurisdiction, and in fact may, at any time, rescind, alter or amend any order or decision made by it. *See, e.g., Re Pacific Gas and Electric Company*, Decision No. 88-12-083, California Public Utilities Commission, 30 CPUC 2d 189, 223-25,

99 P.U.R. 4th 141, 173-75 (1988); *Opinion Adopting Revenue Requirements for Utility Retained Generation*, Decision No. 02-04-016, California Public Utilities Commission, April 8, 2002, mimeo at 19-20, 87-88, revoking and rejecting "benefit sharing" ratemaking for PG&E's Diablo Canyon generating plant adopted and ordered in *Re Pacific Gas and Electric Company*, Decision No. 97-05-088, California Public Utilities Commission, 72 CPUC 2d 560, 178 P.U.R. 4th 1 (1997).[7] If it is the CPUC's position that section 1123(a)(5) or any other provision of the Bankruptcy Code preempts these or any similar provisions of state law that create serious authorization and enforceability issues in the context of the CPUC Plan, the CPUC must so state in the CPUC Disclosure Statement.

The CPUC is subject to two pending proceedings in which its authority to propose and implement its plan of reorganization is subject to challenge. These proceedings include: (1) *Foundation for Taxpayer and Consumer Rights ("FTCR") v. CPUC*, Case No. S105807, California Supreme Court, pet. for writ of mandamus filed April 11, 2002; and (2) a proceeding that the CPUC itself commenced, *Order Instituting Investigation into the Ratemaking Implications for Pacific Gas and Electric Company (PG&E) Pursuant to the Commission's Alternative Plan of Reorganization under Chapter 11 of the Bankruptcy Code for PG&E, in the United States Bankruptcy Court, Northern District of California, San Francisco Division, In re Pacific Gas and Electric Company, Case No. 01-30923 DM ("CPUC Bankruptcy Investigation")* Docket No. I.02-04-026, California Public Utilities Commission, April 22, 2002.

The *FTCR v. CPUC* and *CPUC Bankruptcy Investigation* proceedings are directly related to each other and to the question of whether the CPUC under state law has

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[7]The CPUC's determination is based on its interpretation of California Public Utilities Code §1708 ("The commission may at any time, upon notice to the parties, and with opportunity to be heard as provided in the case of complaints, rescind, alter, or amend any order or decision made by it. Any order rescinding, altering, or amending a prior order or decision shall, when served upon the parties, have the same effect as an original order or decision.") and California Public Utilities Code §728 ("Whenever the commission, after a hearing, finds that the rates . . . charged . . . by any public utility . . . are . . . unjust [or] unreasonable . . . , the commission shall determine and fix, by order, the just, reasonable, or sufficient rates . . . to be thereafter observed and in force").

bound itself to the actions required by the CPUC Plan. On April 11, 2002, the FTCR filed a petition for writ of mandamus in the California Supreme Court, commencing the *FTCR v. CPUC* action. The mandamus action alleges that the CPUC lacks legal authority to file the CPUC Plan in the Bankruptcy Court as described in the CPUC's February 13, 2002 Term Sheet because, *inter alia*, the CPUC has not held public proceedings, nor provided an opportunity for public comment, nor issued a publicly noticed decision authorizing the filing of its alternative plan. *See* "Petition For Writ of Mandamus; Memorandum of Points and Authorities" filed April 11, 2002 in *FTCR v. CPUC*.

On April 17, the CPUC filed its response to the FTCR mandamus in the California Supreme Court and represented to the Court that it would initiate a formal proceeding at the CPUC to "review" the CPUC Plan (and indeed had previously planned to do so prior to filing the CPUC Plan), to "address any ratemaking impacts" of the CPUC Plan, and to directly consider the FTCR's challenges to the CPUC's legal authority to propose the CPUC Plan in the first place:

> "Contrary to FTCR's fundamental premise—that the Commission's filing of a Plan of Reorganization for PG&E constitutes ratemaking without public participation or input—*the Commission is in fact holding a proceeding to review its proposal in the Pacific Gas and Electric ("PG&E") bankruptcy, and to address any ratemaking impacts of the proposal*. . . This proceeding will provide interested parties an opportunity to be heard concerning the Commission's Alternate Plan and its impact on PG&E's rates. . . . *[T]he proceeding was planned in advance of FTCR's petition*. . . . Because there will be hearings and a proceeding considering the bankruptcy plan issues of concern to FTCR, FTCR's entire Petition, arguing that there is no opportunity for public input, is moot.
>
> "Most significantly, FTCR now has a clear administrative remedy, and remedy in the ordinary course of law, that it has not yet pursued. Because the Commission plans to consider issuance of the Bankruptcy OII on April 22, 2002, FTCR should participate in that proceeding *and raise any concerns about the Commission's Plan at that time. There is no indication that participation in that proceeding and pursuit of any necessary appeals would not adequately address FTCR's concerns.*" *See* Letter dated April 17, 2002 from CPUC to California Supreme Court, April 17, 2002, Case No. S105807 (*FTCR v. CPUC*), at pp. 1-2 (emphasis added).

Subsequently, on April 22, 2002, the CPUC issued Investigation No. 02-04-026, initiating the formal proceeding referenced in its pleading in the California Supreme Court in the *FTCR v. CPUC* action. In Investigation No. 02-04-026, the CPUC expressly asks for

comments from parties by May 10, 2002 on both the CPUC Plan and Objectors' Plan, "on whether proceedings must be initiated at this Commission in furtherance of the Reorganization Plans," and "to provide any alternatives which they believe would be preferable to the Plans." *CPUC Bankruptcy Investigation*, Order Instituting Investigation at 2.

Thus, the CPUC has determined that state law does not bind the CPUC or require the CPUC to commit to the CPUC Plan, and the *CPUC Bankruptcy Investigation*, in addition to highlighting the serious issues as to whether the CPUC has properly propounded the CPUC Plan, also underscores the tentative and protean nature of the CPUC Plan. The Objectors urge that this Court not countenance anything less than a direct undertaking by the CPUC that it has duly and fully authorized, will be bound by, and will fully implement the CPUC Plan, if approved at confirmation. If, on the other hand, the CPUC Plan is illusory because it is still subject to public proceedings and does not bind the CPUC either currently or into the future under state law, then that material fact should be fully disclosed in the CPUC Disclosure Statement.

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To address the objection set forth in the foregoing Section II.A.2., Objectors propose the addition to the CPUC Disclosure Statement set forth in **ITEM 2** of Appendix A hereto.

3. The CPUC Is Subject To Proceedings To Determine Whether It Has The Legal Authority To Propose Or File Its Plan, And Therefore The CPUC Disclosure Statement Must Disclose The Risk That The CPUC Plan Is Null And Void Because The CPUC Lacked The Legal Authority to Propose It.

The *FTCR v. CPUC* and *CPUC Bankruptcy Investigation* proceedings referenced in Section II.A.2. immediately above also raise issues as to whether the CPUC has the legal authority to propose the CPUC Plan in the first instance, and whether the CPUC complied with statutory procedural due process requirements before adopting and filing the CPUC Plan. On April 17, in its response to the *FTCR v. CPUC* mandamus action in the California Supreme Court, the CPUC represented to the Court that it would initiate a formal proceeding

at the CPUC to directly consider the FTCR's challenges to the CPUC's legal authority to propose the CPUC Plan.

Thus, both the California Supreme Court and the CPUC itself will consider arguments that the CPUC lacks authority under state law to propose the CPUC Plan and that therefore the CPUC Plan is null and void. Consequently, the CPUC Plan at this point is not fully authorized and must await the outcome of the *CPUC Bankruptcy Investigation*. In the *CPUC Bankruptcy Investigation*, the CPUC has set a deadline of May 10, 2002 for initial comments and May 22, 2002 for reply comments. In addition, the *CPUC Bankruptcy Investigation* indicates that the CPUC may hold public hearings before issuing a decision. Thus, the CPUC will not be in a position to act on the issues raised regarding its legal authority to propose the CPUC Plan until well after the May 9, 2002 Bankruptcy Court hearing on objections to the CPUC Disclosure Statement and CPUC Plan.

Accordingly, the CPUC Disclosure Statement should be modified to disclose: (1) whether authorization of the CPUC for the CPUC Plan is subject to any conditions, restrictions or other limitations, such as may be considered in the CPUC Bankruptcy Investigation; (2) whether in filing the CPUC Plan the CPUC is representing that the CPUC Plan is lawfully authorized in accordance with California law; (3) whether the CPUC commissioners' actions in approving the filing of the CPUC Plan reflect a present commitment by the CPUC to be bound by the CPUC Plan; (4) the existence and status of the *FTCR v. CPUC* mandamus action and *CPUC Bankruptcy Investigation* proceedings, and the risk that if the proceedings are decided adversely to or by the CPUC, the CPUC Plan may not be confirmable as a matter of law; (5) whether in filing the CPUC Plan the CPUC is representing that it has determined that the allegations in the *FTCR v. CPUC* action regarding the CPUC's legal authority to propose the CPUC Plan are without merit; and (6) whether the *CPUC Bankruptcy Investigation* and pleading filed in the *FTCR v. CPUC* action in the California Supreme Court constitute a representation that the CPUC will reconsider and may withdraw or amend the CPUC Plan as part of the *CPUC Bankruptcy Investigation*, or alternatively, whether it is the CPUC's position that the Bankruptcy Code

would preempt any adverse decision issued by the California Supreme Court (or by any other court) ruling that the CPUC did not have the authority to propound or file, or otherwise is not bound by, the CPUC Plan.

To address the objection set forth in the foregoing Section II.A.3., Objectors propose the additions to the CPUC Disclosure Statement set forth in **ITEM 3** of Appendix A hereto. In addition to such proposed changes, to the extent that the *CPUC Bankruptcy Investigation* proposes to examine the ratemaking implications of the CPUC Plan or the Objectors' Plan (or any other aspect of this chapter 11 case), the CPUC should be required to disclose its intentions with respect to the effect of any of its findings or rulings in the OII on the confirmation process generally. For example, only this Court, and not the CPUC, is empowered to make binding, valid determinations with respect to core proceedings. *See generally* 28 U.S.C. §157(b). If the CPUC intends in the OII to make any findings or rulings concerning plan confirmation or implementation (with respect either to the CPUC Plan or the Objectors' Plan)—matters that Congress left within the exclusive jurisdiction of bankruptcy courts through the confirmation process—then it should expressly so state, along with any legal basis for such an extraordinary result.

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4. The CPUC Disclosure Statement Fails To Identify The Regulatory Approvals Required For Plan Effectiveness And The Anticipated Time Frame Associated With Such Approvals.

The CPUC Plan states that Debtor will timely seek all regulatory approvals from all applicable governmental entities, including the CPUC, which are necessary to effectuate the transactions specified in the CPUC Plan. CPUC DS, at 93; CPUC Plan §§7.5, 8.2(h). The CPUC Disclosure Statement is silent as to what approvals are necessary. It is unclear whether the CPUC Plan reflects the CPUC's prior authorization for any or all of the actions proposed in the CPUC Plan. At a minimum, parties in interest are entitled to know what regulatory approvals Debtor will be required to obtain under the CPUC Plan, which agencies must issue such approvals, how long the CPUC estimates that it will take to obtain such approvals, whether there is any material risk that one or more of such approvals will not be

forthcoming or is not legally obtainable or may be materially delayed, and the effect on the occurrence of the Effective Date of the CPUC Plan, or the viability of the CPUC Plan, in the event such approvals are not obtained or are materially delayed. The CPUC must indicate now whether it intends to or is legally committed under the CPUC Plan to grant any necessary CPUC approvals or whether it reserves the right to withhold those approvals pending completion of any required public hearing process.

The CPUC should also specify any laws that the CPUC proposes to preempt or override under the Bankruptcy Code in order to implement the CPUC Plan. If the CPUC does not intend to preempt any such laws, the CPUC Disclosure Statement should so provide and should include a representation from the CPUC that it has full power and authority under law to propose and implement the CPUC Plan as proposed. The issue of plan feasibility in light of existing laws that are not preempted or subject to override under the CPUC Plan then can be tested at confirmation.

To address the objections in the foregoing Section II.A.4., Objectors propose the additions to the CPUC Disclosure Statement set forth in **ITEM 4** of the Appendix hereto.

5. The CPUC Disclosure Statement Fails To Disclose Why The Release Of Claims By The Debtor Is Appropriate.

Section 7.2 of the CPUC Plan states that on the Effective Date, the Debtor shall "dismiss all Claims Against the State, with prejudice." The CPUC Plan defines "Claims Against the State" to include all causes of action that are to be filed as part of a plan supplement and all causes of action against the State, the Commission, and/or any of their commissioners, officers, employees resulting from "actions (or inactions) of the State of California and the Commission relating to the recovery of transition costs, the failure to conclude timely that the conditions for ending the rate freeze had been satisfied, and/or Debtor's claimed inability to recover in retail rates its wholesale power procurement costs, including, without limitation, the Rate Recovery Litigation." CPUC Plan at 7. The release has the direct effect of eliminating two of the estate's most significant assets for the benefit of third parties. More specifically, dismissal with prejudice of the Rate Recovery Litigation

benefits ratepayers (whom the Court has previously found are not creditors), because ratepayers would ultimately bear the costs of any judgment favorable to the Debtor in the proceeding, through adjustments to retail rates that necessarily would follow. Dismissal with prejudice of Debtor's breach-of-contract and other claims is for the benefit of the State of California, as it is the State that would be responsible for any judgment on such claims. While Objectors strongly contest the assertion in the CPUC Disclosure Statement that the CPUC Plan "effectively provides PG&E with the relief it seeks in the Rate Recovery Litigation" (CPUC DS at 92:2-3), Objectors will address this issue (as well as the assertion that adequate value is provided in return for the release) at confirmation.

However, in light of the significant value of the claims to be dismissed and waived by the estate under Section 7.2 of the CPUC Plan, the CPUC Disclosure Statement should be modified to specify the Claims Against the State to be dismissed and waived, rather than providing this information following the vote as currently proposed. The Disclosure Statement should also discuss the estimated value to the Debtor of each of these claims and the character and value of the consideration to be paid to the Debtor in exchange for the releases. In particular, the CPUC Disclosure Statement should describe precisely how and in what manner the CPUC Plan "effectively provides" in full the relief the Debtor seeks in the Rate Recovery Litigation other than from the assets of the Debtor's estate.

More fundamentally, the CPUC Disclosure Statement and the CPUC Plan are wholly inadequate in their discussion of why the State and the CPUC commissioners, among others, can and should be released. During the Debtor's disclosure statement process, the State has repeatedly asserted that the State of California is not a unified entity and thus that its appearances as a creditor are limited to those entities that have filed proofs of claims. If these positions are correct, it is unclear why or how the State, which by its own assertion is not a single unified entity and which continues to assert that there has been no waiver of the State's sovereign immunity other than as to specific state agencies, should or could be granted a release as "the State." Further, even putting aside this point, there is no explanation in the CPUC Disclosure Statement as to supposed consideration to the estate for

these waivers of valuable claims. As such, the CPUC should modify the CPUC Disclosure Statement to explain why it is appropriate and within the Bankruptcy Court's authority to approve the waiver of claims of significant value to the estate for the benefit of third parties. Finally, to the extent that the State is a creditor of this estate and the State, like any other creditor of this estate, will be paid in full, the releases constitute "additional value," which has the effect of paying more than one hundred per cent of the State's allowed claims. The CPUC Disclosure Statement should disclose the basis for this extraordinary result.

To address the objections set forth in the foregoing Section II.A.5., Objectors propose the changes to the CPUC Disclosure Statement set forth in **ITEM 5** of the Appendix hereto.

6. Section 9.4 Of The CPUC Plan Providing The CPUC The Right To Determine Whether The Proceeds Of Causes Of Action Should Be Paid To Ratepayers Must Be Explained.

Section 9.4 of the CPUC Plan states that all proceeds of all Causes of Action (which is defined broadly to include any claims before and after the petition date) shall be subject to diversion by the CPUC to ratepayers. There is no explanation of the appropriateness of this provision of the CPUC Plan or why it is reasonable to have a continuing right to divert to ratepayers—who are non-creditors—all past and future revenues stemming from claims and judgments. This provision would appear to immunize the CPUC and ratepayers from all future claims regardless of merit, because any future judgment Debtor might obtain against these entities would be diverted by the CPUC to ratepayers. Debtor believes that this unlawfully benefits non-creditors at the expense of the estate and resolves these matters without due process and in violation of the Debtor's rights. PG&E will take up the reasonableness and illegality of this provision at confirmation, but believes a fuller explanation of the CPUC's rationale and logic under bankruptcy law must be provided respecting this provision. In particular, if the intent of this provision is simply to reaffirm the Debtor remains subject to provisions of state law, including the California Public Utilities Code, that govern the allocation of such proceeds between shareholders and the

Debtor's ratepayers in connection with the CPUC's authority to regulate the Debtor's public utility rates, then the provision is unnecessary and improperly included in the CPUC Plan.

To address the objections in the foregoing Section II.A.6., Objectors propose the changes to the CPUC Disclosure Statement set forth in **ITEM 6** of Appendix A hereto.

7. The Investment Grade Credit Rating Condition Is Waivable.

Although the CPUC Plan contains in Section 8.2(g) as a condition precedent to effectiveness that "S&P and Moody's shall have issued credit ratings for the Reorganized Debtor and its debt securities of not less than BBB- and Baaa3, respectively," this condition may be omitted or waived by the CPUC at any time under Section 8.4 of the CPUC Plan. This very same condition precedent may not be waived under Objectors' Plan and has been the subject of specific representations by the CPUC to the Court. The CPUC Disclosure Statement should be clarified in every place where the investment grade condition is described to indicate that this condition may be waived by the CPUC, and to specify the conditions and circumstances under which the CPUC intends to exercise its right to waive the investment grade condition, the consequences to the CPUC Plan and the future financial viability of the Debtor if the condition is waived, and the risk that such a waiver would render the CPUC Plan infeasible.

The CPUC recognizes (at page 128 of the CPUC Disclosure Statement) that investment grade credit ratings will be established by independent credit-rating agencies, and the CPUC cannot state with certainty the credit ratings that will be assigned by the agencies. The CPUC then notes that "the Commission is committed to policies and mechanisms to allow PG&E to experience predictable cash flows, which are important qualitative factors rating agencies consider when assigning credit ratings." However, the CPUC Disclosure Statement does not describe what these "policies and mechanisms" are or explain how or in what manner it is "committed" to them. As the CPUC apparently believes these "policies and mechanisms" will be important factors in the credit-rating agencies' determinations of the credit rating to be assigned to the Debtor under the CPUC Plan, Section X.B.1. of the

CPUC Disclosure Statement should be supplemented to describe these "policies and mechanisms," whether they are now in effect or will be implemented in the future, how they will be implemented (i.e., whether through the CPUC Plan or separate CPUC actions), and to what extent, if any, the CPUC is "committed" to them.

To address the objections in the foregoing Section II.A.7., Objectors propose the changes to the CPUC Disclosure Statement set forth in **ITEM 7** of Appendix A hereto.

8. The CPUC Disclosure Statement And CPUC Plan Fail To Provide Adequate Information About The Commercial Terms And Implementation Of The Equity Sale.

A critical issue for feasibility of the CPUC Plan is whether the CPUC will indeed be able to raise: (1) $3.8 billion in a new debt issuance, (2) $1.9 billion through a new secured credit facility; (3) $600 million through the remarketing of pollution control bonds; and (4) $1.75 billion through a sale of common stock in Debtor. Further, the CPUC Plan and CPUC Disclosure Statement are silent on the anticipated terms and conditions of the $1.9 billion new secured credit facility and the $1.75 billion sale of common stock. There is an utter lack of any information by which creditors can make a judgment regarding plan feasibility on these fundamental financial underpinnings of the CPUC Plan.

The CPUC provides no detail on how it proposes to accomplish the equity sale, other than to note that it could be done through a private or public placement. Parties are unable to evaluate whether there is sufficient market depth for the volume of stock that will have to be sold. The CPUC has publicly stated that it anticipates that approximately 20% of the equity in Debtor will have to be sold in order to raise the target amount of $1.75 billion, but there is no detail as to the assumptions the CPUC has used to develop this estimate.

Objectors propose that the CPUC Disclosure Statement be supplemented or the CPUC be required to make a prompt supplemental filing in this proceeding with a summary of commercial terms for the secured debt and equity issuances and a description of how the commercial terms of the transactions are to be implemented. Additionally, the CPUC should describe its projections and assumptions as to how much of the equity in the Debtor will

have to be sold in order to raise the target of $1.75 billion.

9. The CPUC's Disclosure Statement Also Fails To Provide Adequate Information About The CPUC's Intention With Regard To The Assignment Of The DWR Contracts.

Another critical issue affecting feasibility and whether the Debtor will be investment grade under the CPUC Plan is whether the CPUC intends to seek to compel an assignment of the DWR contracts to the Debtor. This information is vital if creditors are to make an informed judgment regarding the CPUC Plan and in order to allow the Court to determine whether the CPUC Plan satisfies Section 1129(a)(11)'s feasibility requirements.[8] The CPUC Disclosure Statement must state whether the CPUC will attempt to compel the Debtor to accept an assignment of the DWR contracts and, if so, the impact of any such assignments on the feasibility of the CPUC Plan and the Debtor's status as an investment grade-rated company.

10. The Resolution Of Several CPUC Ratemaking Proceedings Will Affect Revenues Available To Pay Creditors Under the CPUC Plan, The Financial Viability Of The Debtor And The Financial Projections In Exhibit C. The CPUC Should Disclose How Its Assumptions Regarding These Proceedings Affect The Financial Projections In The CPUC Plan, And Assess The Impact Of Different Outcomes.

The CPUC Plan is premised on the Debtor recognizing $2.7 billion in "headroom" revenues (the difference between current rate levels and the cost of service rates authorized by the CPUC) payable to creditors in cash on the Effective Date. As required by the Bankruptcy Code, the CPUC Plan is also premised on "the ability of the Debtor to meet its obligations under the Plan and maintain sufficient liquidity and capital resources to conduct its business." CPUC Plan, Exhibit C, p.1. Thus, in Exhibit C, the CPUC has included financial projections for the Debtor for the years 2003, 2004 and 2005. The CPUC has stated that its financial projections "rely substantially upon the financial projections set

[8]In contrast, the Objectors' Disclosure Statement clearly states that "[i]n order to ensure the financial viability of the [Objectors'] Plan, the [Objectors'] Plan provides that the Reorganized Debtor will not accept, directly or indirectly, an assignment of the DWR Contracts." Objectors' Disclosure Statement, Section VI.G at p. 141.

forth in the PG&E Disclosure Statement," but that the CPUC Plan "applied further adjustments" and that the CPUC projections were based "on competitive, regulatory and general business conditions prevailing at the time," future changes to which "may materially impact the ability of the Debtor to achieve the Projections." CPUC Plan, Exhibit C, p.1.

At a hearing earlier this year, the CPUC indicated to the Court that it had been working on the financial modeling for the CPUC Plan for months. However, there are two gaps and inadequacies in the CPUC's financial projections which the CPUC must address in the CPUC Disclosure Statement or in a supplemental filing in this proceeding in order that creditors will have an understanding of the material assumptions that affect the feasibility of the CPUC Plan.

First, the CPUC's use of Objectors' financial projections for the CPUC Plan is facially inadequate, because the CPUC Plan is fundamentally different in its sources of revenue and cash from the Objectors' Plan. Objectors' Plan, as summarized in extensive detail in the financial projections and "valuation" sections of Objectors' Disclosure Statement, relies on disaggregation of the Debtor's assets in a manner in which the value of the assets is realized in part through transferring ratemaking jurisdiction over three of the Debtor's four major lines of business from CPUC regulation to regulation by the Federal Energy Regulatory Commission ("FERC"). As Objectors' Disclosure Statement and the CPUC's own objections to Objectors' Plan both indicate, this disaggregation enables the Debtor to realize revenues which the CPUC argues would not be realized if the assets remain under CPUC regulatory jurisdiction, which is the case with the CPUC Plan. Thus, any reliance by the CPUC on the financial projections in Objectors' Disclosure Statement is materially misleading and in fact contrary to the CPUC's own assertions in its objections to Objectors' Plan. The CPUC must provide financial projections that are the CPUC's own projections pertinent to the CPUC Plan, not the Objectors' Plan. The CPUC must specify what impact any changes in the CPUC's ratemaking to achieve the financial projections would have on the ability of the Debtor to obtain the investment grade credit rating that is a condition precedent of the CPUC Plan.

Second, the financial projections in the CPUC Disclosure Statement require the CPUC to make assumptions about future ratemaking decisions by the CPUC itself, including the outcome of pending and future CPUC rate proceedings that would materially affect the Debtor's revenues for 2003, 2004 and 2005. As a threshold matter, the CPUC should state whether or not its financial projections assume specific outcomes of these ratemaking proceedings and therefore prejudge those outcomes. The CPUC also must further state its assumptions regarding the rate levels to be approved in these proceedings, including any assumptions regarding recovery of prior undercollected transition and wholesale power costs that is assumed to be authorized by the CPUC as part of its financial projections. If the CPUC financial projections assume certain decisions in these proceedings that the CPUC itself may not adopt, the CPUC should disclose that the outcome of these ratemaking proceedings could differ from that assumed and should explain how the CPUC will adjust the CPUC Plan or the CPUC Plan will be infeasible if the results of these proceedings materially differ from that assumed. The CPUC also should describe whether consistent assumptions regarding overall rate levels were used in Exhibit C for 2003, 2004 and 2005 and in its "headroom" calculation for the period ending January 31, 2003, and should disclose the specific assumptions used. If different assumptions were used, the CPUC's rationale for this should be explained.

To address the objections set forth in the foregoing Section II.A.10., Objectors propose the changes to the CPUC Disclosure Statement set forth in **ITEM 10** of the Appendix hereto.

11. The CPUC Should Disclose That Its Plan Seeks To Preempt State Law By Requiring That The Debtor Operate Subject To "Traditional Cost Of Service Ratemaking."

Section 7.7 of the CPUC Plan states that PG&E will be regulated under the CPUC Plan "under traditional cost of service ratemaking." It is unclear whether this statement intends to commit the CPUC under the CPUC Plan to a single form of ratemaking post-confirmation. The Public Utilities Code does not require "traditional" cost of service

ratemaking and the CPUC has not heretofore committed itself to the exclusive use of this type of ratemaking. The CPUC, through its counsel, has indicated that the intent of this provision was not to commit the CPUC to a single form of ratemaking, and that the CPUC would reexamine and revise this provision as appropriate.

To address the objections set forth in the foregoing Section II.A.11., Objectors propose the changes to the CPUC Disclosure Statement set forth in **ITEM 11** of the Appendix hereto.

12. The CPUC Should Disclose That Its Plan Seeks To Preempt State Law By Overriding Statutory and Constitutional Requirements Regarding Return On Investment.

The CPUC Plan, through its ratemaking assumptions and mandated waiver of the Debtor's ratemaking claims, apparently relies on the Bankruptcy Code to preempt the CPUC's own decisions, state law and the California Constitution authorizing ratemaking recovery of the Debtor's legitimate utility costs of service and return on and of investments in utility facilities.[9] But for potential Bankruptcy Code preemption of state law, the CPUC could not implement the ratemaking that is proposed in the CPUC Plan for the reasons stated in Section II.B.2 below.[10] (The CPUC Plan also violates the United States Constitution. Obviously, the CPUC cannot invoke preemption principles to attempt to cure or sidestep such a violation, and this violation is therefore addressed separately in Section II.B.2. below.)

The CPUC Disclosure Statement should clearly set forth the extent to which it depends on principles of federal preemption to override state law that otherwise would result

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[9] *See, e.g.*, California Public Utilities Code §399.2; *Calfarm Insurance Co. v. Deukmejian*, 48 Cal. 3d 805 (1989).

[10] Conversely, the CPUC, in its settlement with Edison, authorized Edison to recover over $3 billion from ratepayers to pay its debts and compensate it for other unrecovered costs. Under the settlement, Edison does not forfeit its return on investment for its transmission and distribution functions after September 1, 2001. In addition, there are broad allowances and assurances for capital expenditures. Further, the CPUC has authorized Edison to recover from ratepayers several billion dollars in transition costs as part of that settlement as well as its unrecovered wholesale costs. These same costs go unrecovered for PG&E under the CPUC Plan.

in a $1.6 billion return on investment, and also the basis for any assumptions about the extent to which federal law would not be violated through the elimination of such return on investment.

13. The Tax Sharing Agreement Should Be Disclosed.

Section 7.3 of the CPUC Plan requires Debtor and PG&E Corporation to enter into a "New Tax Sharing Agreement." Section VI.C.4 of the CPUC Disclosure Statement (at page 92) states that the New Tax Sharing Agreement will replace the existing tax matters agreement and appears to be intended to modify the way taxes will be allocated between the Debtor and PG&E Corporation. The CPUC further states that the New Tax Sharing Agreement shall be applied retroactively to past tax allocations, retroactive to the January 1, 1998. No further description is provided and the CPUC Disclosure Statement provides that the New Tax Sharing Agreement will be disclosed for the first time in the Plan Supplement to be filed 10 days prior to the "Confirmation Date."

Objectors have several objections regarding the New Tax Sharing Agreement. First, it is a material agreement that, depending on its terms, could materially and adversely affect existing equity. Given the potential adverse effects, the document must be disclosed with the CPUC Disclosure Statement (whether in an amended CPUC Disclosure Statement or in a supplemental document filed prior to solicitation and voting) and as part of the CPUC Plan. Second, the CPUC Plan appears to be rejecting the existing tax matters agreement between Debtor and PG&E Corporation. This is inconsistent with the portions of the CPUC Plan that indicate that the CPUC will follow the Debtor's plans for rejecting/assuming executory contracts, and will result in PG&E Corporation having a claim against Debtor for any damages resulting from the rejection of the agreement. Third, Objectors are not aware of any legal basis for the CPUC to impose upon PG&E Corporation a new tax sharing agreement (with unspecified terms). While there is authority under the Bankruptcy Code for rejecting executory contracts of this nature, Objectors are not aware of any authority for imposing a new contract under terms dictated entirely by the plan proponent upon a creditor.

Finally, Objectors do not understand the legal basis for the CPUC's apparent proposal to apply such new tax sharing arrangement retroactively.

To address the objections set forth in the foregoing Section II.A.13., Objectors propose the changes to the CPUC Disclosure Statement set forth in **ITEM 13** of the Appendix hereto.

14. All Discussion Of The Objectors' Plan Should Be Deleted From The CPUC Disclosure Statement.

In discussions pertaining to the Objectors' Disclosure Statement and the Objectors' Plan, the Court urged the Debtor to remove all discussion of the CPUC's Term Sheet and proposed plan. This admonition was based upon the premise that disclosure statements pertaining to competing plans should not contain a rebuttal of the competing plan. February 27, 2002 RT at 93-94. The CPUC Disclosure Statement contains a critique of the Objectors' Plan in several places. These sections should be deleted, consistent with the Court's expressed preference regarding Objectors' Disclosure Statement, which Objectors followed.

To address the objections set forth in the foregoing Section II.A.14., Objectors propose the changes to the CPUC Disclosure Statement set forth in **ITEM 14** of the Appendix hereto.

15. Disclaimer Regarding Admissibility Of Plan And Disclosure Statement.

The CPUC Disclosure Statement (at page 13) attempts to disclaim any effect of the Disclosure Statement or any statements made therein on the CPUC, in any context except the confirmation process for the CPUC Plan. The statements in the CPUC Disclosure Statement are to be taken as made for settlement purposes, and are expressly not to be admissible in any proceeding involving the Debtor, the Commission or any other party in interest. The disclaimer statement is extraneous and legally unsupportable verbiage and should be stricken from the CPUC Disclosure Statement.

16. The CPUC Should Disclose The Assets That May Be Sold To Raise $200 Million.

The CPUC Disclosure Statement (at page 128, footnote 33) states that an additional source of capital that may offset the size of the $1.9 billion credit facility may be realized through the sale of "non-core assets" in the amount of $200 million. However, the CPUC fails to identify the assets that would be sold or any estimates of value that led it to conclude $200 million could be raised. It is unclear how this aspect of the Plan would be implemented or whether it is at all feasible, given the lack of any information or detail. Objectors propose that section X.B.2 be expanded to discuss the assets potentially to be sold and the CPUC's estimates of value that support the $200 million amount.

B. Description Of Key Confirmation Issues

The following section addresses some of the critical confirmation issues in the CPUC Plan that the Objectors contend render the CPUC Plan unconfirmable. This discussion is not exhaustive; Objectors do not waive and expressly reserve the right to raise additional and supplemental arguments at or before the hearing on confirmation of the CPUC Plan.

Objectors request that the following reservations regarding whether the CPUC Plan can be confirmed be included in the CPUC Disclosure Statement (just as Objectors included, at the CPUC's demand, similar reservations in Objectors' Disclosure Statement regarding the Objectors' Plan):

> "Some parties, including the Debtor, are likely to dispute and challenge whether the Commission's plan can legally be confirmed by the Bankruptcy Court on numerous grounds, including, but not limited to: (1) the CPUC Plan does not meet the liquidation test as to equity and does not result in a fair and equitable treatment of equity; (2) the CPUC Plan results in an illegal transfer of value in the estate from equity to third party non-creditors; (3) the CPUC Plan is infeasible and unenforceable if the CPUC continues to object to the exercise of the Bankruptcy Court's jurisdiction over it under principles of sovereign immunity; (4) the core financial underpinnings of the CPUC Plan—the $3.8 billion new debt offering, the $1.75 billion stock sale by the Debtor and the investment grade credit rating assurances as of the Effective Date—are all infeasible; and (5) the confiscation of utility return is an illegal taking. If the Commission Plan is unconfirmable as a matter of law or null and void, no distributions under the CPUC Plan would be made, the Debtor and holders of Claims and Equity

Interests would be restored to the status quo ante as of the day immediately preceding the Confirmation Date and the Debtor's obligations with respect to Claims and Equity Interests would remain unchanged."

1. The CPUC Plan Cannot Be Confirmed Because It Will Not Meet The Best Interests Test As To Equity, And Does Not Provide Fair And Equitable Treatment Of Equity.

Section 1129(a)(7) of the Bankruptcy Code requires that any non-accepting interest holder receive or retain under the plan property, of a value as of the effective date of the plan, that is not less than the amount that the holder would receive or retain if the debtor were liquidated under chapter 7 on such date. Objectors expect to demonstrate at confirmation that the CPUC Plan fails to satisfy this standard. At a minimum, since the CPUC proposes to impair equity, it should be required to provide a liquidation analysis, which would show the different treatment which the Debtor's equity holders would receive under the CPUC Plan, as opposed to a liquidation of the Debtor's assets under chapter 7.

Separate and apart from having to meet the best interests test of Section 1129(a)(7), the CPUC obviously will need to rely on the cramdown provisions of Section 1129(b) of the Bankruptcy Code in order to confirm the CPUC Plan over the dissenting equity class consisting of PG&E Corporation. Significantly, the Bankruptcy Code does not protect and does not allow value to flow through to any party not a stakeholder in the proceeding (i.e., not a creditor or equity interest holder) to the prejudice of stakeholders.

The CPUC Plan, through its impairment of equity, fails to satisfy the requirements of the Bankruptcy Code by (1) inappropriately transferring value to non-stakeholders, and (2) significantly diluting the value of the Debtor's existing equity via the proposed equity issuance.

a. The CPUC Plan Results In An Illegal Transfer Of Value In The Estate From Equity To Ratepayers.

Section 7.2 of the CPUC Plan requires Debtor to release all of its claims against the State of California, any subdivision or agency of the State, including the CPUC, and all employees of the State (acting within the scope of employment). The claims

are not described in detail but the CPUC Plan contemplates that the waiver and release will be included in a plan supplement to be filed prior to the confirmation date. This release eliminates from the estate, *inter alia*, any and all proceeds resulting from PG&E's Rate Recovery Litigation (*Pacific Gas & Elec. Co. v. Loretta Lynch et. al.*, Case No. C-00-4128-SBA (N.D. Cal.)) and the breach-of-contract claim that PG&E filed against the state in connection with the enactment of AB X 6, as well as recoveries resulting from any other pending lawsuits, appeals, or claims related to the recovery of wholesale power costs, market valuation of generation, transition cost recovery or the appropriate ending of the rate freeze or PG&E contracts commandeered by the State. The value of these claims to the estate is in the billions of dollars. These claims go to the heart of why PG&E is in bankruptcy and constitute Debtor's best opportunity for full restoration of the Debtor's equity value.

In the case of the Debtor's filed rate claim, the waiver is for the express benefit of the Debtor's ratepayers, who would be responsible for bearing the costs resulting from judgments against the CPUC or the State, through adjustments to retail rates that would necessarily follow. In the case of the Debtor's breach-of-contract, takings and other claims, the waiver is for the benefit of the State and/or its taxpayers, as it is the State that would be responsible for any judgment on those claims. Under the "fair and equitable" standard of section 1129(b), each such transfer of value to non-stakeholders is improper because it plainly significantly impairs the residual value of the estate for shareholders.

Moreover, Section 9.4 of the CPUC Plan further provides that the CPUC will have an ongoing right to divert *to ratepayers* all proceeds received by the Debtor resulting from all Causes of Action (which is defined broadly to include all claims existing before and after the petition date). This provision of the CPUC Plan would give the CPUC the discretion to redirect to ratepayers $450 million in generator refunds expected to be ordered by FERC, even though ratepayers were never required by the CPUC to pay the costs of wholesale power in the first place. Further, this provision also would effectively establish a permanent, going-forward waiver of claims against the State and CPUC because any judgment the Debtor might be able to obtain related to any claims against the State or CPUC

could be rerouted to ratepayers. The CPUC Plan takes the "litigation trust" concept from the CPUC Term Sheet to an even higher confiscatory plateau. There is no basis in the Bankruptcy Code to allow the CPUC to divert assets of the Debtor to ratepayers, an act that is clearly improper and contrary to the maximization of the Debtor's estate for the benefit of the Debtor's creditors and equity security holders.

b. The CPUC Plan Significantly Dilutes The Value Of The Debtor's Equity.

In addition to the waiver of claims, the CPUC Plan would require a sale of common stock in Debtor to raise $1.75 billion. The Debtor presently has no privately or publicly held common stock other than the ownership interest held by PG&E Corporation. The CPUC fails to disclose how much stock in the Debtor would have to be sold in order to raise the required amounts, but it is clear that a substantial percentage of equity in the Debtor would be required to be sold to third parties to raise the specified $1.75 billion amount. Such an issuance of equity by the Debtor via a plan which does not meaningfully address or repair the problems that precipitated the Debtor's liquidity crisis and resulting chapter 11 filing, which provides for post-confirmation governance by the same regulatory body that oversaw such deterioration, and which strips the Debtor of valuable claims without consideration, plainly would be priced at a material discount to the value of that equity under a plan that addressed the problems that caused the Debtor's slide into bankruptcy. An equity issuance at such a discount dilutes both the shareholders' ownership interest on an absolute basis as well as the value attributable to that interest.[11] Rather than maximizing the value of the Debtor's estate, these provisions have the effect of deflating the value of equity, and

[11]The forced sale of common stock to third parties is also likely to result in deconsolidation to PG&E Corporation and the Debtor, i.e., these entities would be viewed as two separate entities for tax purposes. This tax deconsolidation is especially likely because outstanding preferred stock of the Debtor will count against the 20% tax consolidation tests. Tax deconsolidation of a utility and its parent would have severe adverse tax consequences for the parent, including multiple taxation of dividends and literally billions of dollars of lost structuring flexibility with respect to the parent's remaining interests in the utility. The CPUC should be required to fully disclose and address these impacts in the CPUC Disclosure Statement.

resulting in further unfair and inequitable treatment of the Debtor's equity security holders.

2. The CPUC Plan Cannot Be Confirmed Because Its Confiscation Of Utility Return Is An Illegal Taking.

The CPUC Plan proposes to deprive the Debtor of approximately $1.6 billion attributable to the Debtor's authorized utility return on investment and use these funds to pay creditors.[12] The proposal violates the fundamental constitutional assurances that public utilities are entitled to recovery of their costs of service plus the opportunity to earn a reasonable rate of return.[13] The CPUC proposal would appropriate not only the Debtor's return on utility distribution operations subject to the CPUC's jurisdiction, but would further take the returns authorized by the FERC for PG&E's electric transmission business (which is subject to exclusive FERC ratemaking jurisdiction).[14]

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

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[12]The "cash on hand" balances relied upon by the CPUC also include PG&E's return on ratebase stretching back to January 2001. Thus, the CPUC Plan would deprive PG&E of any return on investment for an additional two years.

[13]Under the Fourteenth Amendment of the United States Constitution, a utility cannot be forced to continue operations at a loss. *See Napa Valley Elec. Co. v. Railroad Comm'n,* 251 U.S. 366, 369 (1920). Rather, rates must be set at a level that allows a utility a reasonable opportunity to recover its cost of service. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) ("[i]f the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments"); *Calfarm Insurance Co. v. Deukmejian*, 48 Cal.3d 805 (1989).

[14]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).

and to enable it to raise the money necessary for the proper discharge of its public duties."[15] 262 U.S. at 693.

Because the CPUC Plan thus would contravene state law, federal law and the United States and California Constitutions, the CPUC Plan violates Section 1129(a)(3) and 1129(a)(11) and therefore is not confirmable.

3. The Core Financial Underpinnings Of the CPUC Plan—The $3.8 Billion New Debt Offering, the $1.7 Billion Stock Sale And The Investment Grade Credit Rating—Are All Infeasible.

At the hearing on confirmation of the CPUC Plan, Objectors will demonstrate that it is extremely improbable that: (1) the CPUC Plan would result in an investment grade credit rating on the Effective Date, (2) the $3.8 billion new debt offering would be commercially feasible; (3) the $1.75 billion common stock sale is feasible; (4) the $600 million of pollution control bonds can be successfully remarketed; and (5) the $1.9 billion new credit facility is feasible.

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

CONCLUSION

For all of the foregoing reasons, the Court should decline to approve the CPUC Disclosure Statement, unless modified as provided herein.

DATED: May 3, 2002.

Respectfully,

DEWEY BALLANTINE LLP
Attorneys for Objector PG&E CORPORATION

WEIL, GOTSHAL & MANGES LLP
Attorneys for Objector PG&E CORPORATION

HOWARD, RICE, NEMEROVSKI, CANADY, FALK & RABKIN
A Professional Corporation

By: _____
JAMES L. LOPES

Attorneys for Debtor, Debtor-in-Possession and Objector PACIFIC GAS AND ELECTRIC COMPANY

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

APPENDIX

ITEM 1

Add the following risk factor on page 129 of the CPUC Disclosure Statement:

"D. Sovereign Immunity

The Commission takes the position that the Bankruptcy Court may not exercise jurisdiction over the Commission in light of the Eleventh Amendment of the United States Constitution and related principles of sovereign immunity. In addition, under Public Utilities Code Section 1708, the Commission takes the position that it may not bind the future actions of itself. Accordingly, there is a risk that the Commission may decide not to implement aspects of the Plan or decide to take actions inconsistent with the Plan. If the Commission's position with respect to sovereign immunity is upheld, the Bankruptcy Court may not have authority to enforce the Plan against the Commission or otherwise compel it to act in accordance with the Plan.

Additionally, in the event the Bankruptcy Court for any reason rejects the Commission position with respect to sovereign immunity, the Commission reserves the right to withdraw the Plan in order to avoid such waiver. Thus, there is a risk that the Commission will decide to withdraw the Plan if the Bankruptcy Court makes such a ruling. If the Commission withdraws its Plan, no distributions under the Commission Plan would be made, the Debtor and holders of Claims and Equity Interests would be restored to the status quo ante as of the day immediately preceding the Confirmation Date and the Debtor's obligations with respect to Claims and Equity Interests under the Commission Plan would remain unchanged."

ITEM 2

Add a new risk factor on page 129 of the Disclosure Statement:

"F. Commission Commitment To Implement The Plan

The CPUC takes the position that, under state law, it is not legally bound or committed to the CPUC Plan, and the CPUC at any time may modify, alter or rescind its order approving the filing of the CPUC Plan. In addition, on April 25, 2002, after filing the CPUC Plan, the CPUC issued its Decision No. 02-04-026 initiating a formal proceeding, "*Order Instituting Investigation into the Ratemaking Implications for Pacific Gas and Electric Company (PG&E) pursuant to the Commission's Alternative Plan of Reorganization under Chapter 11 of the Bankruptcy Code for PG&E, in the United States Bankruptcy Court, Northern District of California, San Francisco Division, In re Pacific Gas and Electric Company, Case No. 01-30923 DM,*" Docket No. I.02-04-026, requesting comments from parties on whether proceedings must be initiated at the Commission in furtherance of the CPUC Plan and to provide any alternatives which they believe would be preferable to the CPUC Plan. There is a risk that the CPUC may amend, alter or rescind its order approving the CPUC Plan at any time prior to or subsequent to the Effective Date of the CPUC Plan. If the CPUC alters, amends or rescinds the CPUC Plan prior to or subsequent to the Effective Date, the CPUC Plan may be null and void, no distributions under the CPUC Plan would be made, the Debtor and holders of Claims and Equity Interests would be restored to the status quo ante as of the day immediately preceding the Confirmation Date and the Debtor's obligations with respect to Claims and Equity Interests would remain unchanged."

ITEM 3

A. The CPUC should revise the Disclosure Statement to address its legal authority to propose the CPUC Plan, including a discussion of each lawsuit or other proceeding considering such authority.

B. Add a new risk factor on page 129 of the CPUC Disclosure Statement:

"G. Commission Authority To Propose The Plan

The authority of the Commission under California law to propose the Plan in this proceeding is currently being challenged in the state courts and considered in a proceeding at the CPUC. (*Foundation for Taxpayer and Consumer Rights ("FTCR") v. CPUC*, Case No. S105807, Calif. Supreme Court, April 11, 2002; *Order Instituting Investigation into the ratemaking implications for Pacific Gas and Electric Company (PG&E) pursuant to the Commission's Alternative Plan of Reorganization under Chapter 11 of the Bankruptcy Code for PG&E, in the United States Bankruptcy Court, Northern District of California, San Francisco Division, In re Pacific Gas and Electric Company, Case No. 01-30923 DM*, Docket No. I.02-04-026, California Public Utilities Commission, April 22, 2002.) There is no assurance that these proceedings in which legal challenges to the Commission's authority will be considered will be resolved prior to the Effective Date of the Plan. If an order no longer subject to appeal is entered by the CPUC or a state court finding that the CPUC lacks authority to propose its Plan, the Plan may be unconfirmable as a matter of law, or, if any such order is entered subsequent to confirmation, the Plan may be null and void. If the Plan is unconfirmable as a matter of law or null and void, no distributions under the Plan would be made, the Debtor and holders of Claims and Equity Interests would be restored to the status quo ante as of the day immediately preceding the Confirmation Date and the Debtor's obligations with respect to Claims and Equity Interests would remain unchanged."

ITEM 4

A. Add the following to Section C.5 of the Disclosure Statement and Section 7.5 of the CPUC Plan:

"The regulatory approvals the Debtor will be required to obtain are described on Exhibit E of the Disclosure Statement. Debtor shall be required to initiate its efforts to obtain such regulatory approvals within 30 days following entry of the Confirmation Order. The estimated time for obtaining each regulatory approval (excluding appeals) and whether such regulatory approval is obtainable as a matter of law is described in Exhibit E. In the event Debtor takes the position that Exhibit E omits a required regulatory approval, Debtor shall be entitled to obtain all additional regulatory approvals that it deems required as a matter of law. The Commission does not seek to pre-empt any state law, override any federal law or obviate the need for obtaining any regulatory approval required by law or regulation. The Commission confirms that it possesses full power and authority and is legally committed to implement the Plan as proposed."

B. Add new Exhibit E as described above.

C. Add new risk factor on page 129 of the Disclosure Statement:

"E. Regulatory Approvals

As set forth in Section 8.2 of the Plan, Plan effectiveness is conditioned upon obtaining all required regulatory approvals. The required regulatory approvals are listed in Exhibit E. Additionally, Debtor is entitled under the Plan to obtain all additional regulatory approvals that it deems required as a matter of law, even if such approvals are not listed on Exhibit E. There is a risk that Debtor will not be able to obtain all required regulatory approvals or that such regulatory approvals are not obtainable as a matter of law. In such event, the Plan will not become effective, no distributions under the Commission Plan would be made, the Debtor and holders of Claims and Equity Interests would be restored to the status quo ante as of the day immediately preceding the Confirmation Date and the Debtor's obligations with respect to Claims and Equity Interests under the Commission Plan would remain unchanged. Section 7.5 of the Plan requires the Debtor to "seek" regulatory approvals and Section 8.2(h) requires Debtor to have "received" all necessary regulatory approvals. Section 8.4 allows the CPUC to waive Section 8.2(h) regulatory approval conditions to Plan effectiveness. If the CPUC were to waive this condition, there is a risk the Debtor would be required to violate applicable law and a further risk associated with legal challenges to such actions. Because the CPUC does not

seek to preempt or otherwise avoid compliance with any state or federal law or obviate the need for obtaining any regulatory approval required by law or regulation, the regulatory approvals condition may not be waived. There is a further risk associated with delay in obtaining regulatory approvals, exclusive of appeals. Exhibit E describes whether any such regulatory approvals are unobtainable under law or subject to legal challenge.

ITEM 5

A. The following shall be added to the end of Section 7.2 of the CPUC Plan and to the end of Section C.3 of the CPUC Disclosure Statement (p.92):

> "The Claims Against The State to be waived by Debtor are specified on Exhibit F to the Disclosure Statement. Exhibit F also contains the form of the Release and Waiver to be executed by Debtor."

B. Add new Exhibit F, as described above.

C. Add supplemental discussion to Section C.3 of the CPUC Disclosure Statement describing (1) the estimated value to the Debtor of each of these claims and the character and value of the consideration to be paid to the Debtor in exchange for the releases; (2) why it is appropriate and within the Bankruptcy Court's authority to approve the waiver of claims of significant value to the estate for the benefit of a third party; (3) the specific provisions of the CPUC Plan which the CPUC claims effectively provide the Debtor the relief it has requested in the claims from sources other than the Debtor's estate; and (4) to the extent that because the State, like any other creditor of this estate, is a party to the proceeding and will be paid in full, why the release does not constitute "additional value," which has the effect of paying more than one hundred per cent of the State's allowed claim.

ITEM 6

A. The CPUC should explain in the CPUC Disclosure Statement the rationale for Section 9.4 of the CPUC Plan, the intended scope of Section 9.4, and the legal basis for Section 9.4.

B. The CPUC should include in the CPUC Disclosure Statement a list of known and potential claims which would be subject to the diversion purported authorized by Section 9.4, and the approximate value of each such claim.

ITEM 7

A. Add to the CPUC Disclosure Statement, on p. 8, line 8 and on page 65, line 23, the following:

> "Under Section 8.2(g) of the Plan, a condition precedent to effectiveness of the Plan is that 'S&P and Moody's shall have issued credit ratings for the Reorganized Debtor and its debt securities of not less than BBB- and Baaa3, respectively.' This condition may be omitted or waived by the CPUC at any time under Section 8.4 of the Plan."

B. Section X.B.1. of the CPUC Disclosure Statement should be supplemented to describe the "policies and mechanisms" referenced therein, whether they are now in effect or will be implemented in the future, how they will be implemented (i.e., whether through the CPUC Plan or separate CPUC actions), and to what extent, if any, the CPUC is "committed" to them.

ITEM 10

A. The CPUC should add new details to Exhibit C to the CPUC Disclosure Statement that identify the assumptions used in its calculations of "headroom" and in the financial projections in Exhibit C. In particular, Exhibit C should include the assumptions used in the financial projections regarding the outcome of the following proceedings:

(a) Recovery in retail rates of PG&E's undercollected investment related costs in its Transition Cost Balancing Account, which CPUC Decision 02-04-016 (URG decision) expressly commits to determine in a separate proceeding;

(b) Recovery of the revenue requirement requested for transmission and distribution costs of service in PG&E's test year 2003 General Rate Case Notice of Intent filed on April 15 and scheduled to be effective on January 1, 2003;

(c) Recovery of PG&E's 2002 Attrition Rate Adjustment rate increase request, scheduled to be effective as early as April 22, 2002;

(d) Recovery of PG&E's revised 2003 Cost of Capital, including authorized return on equity and ratebase, scheduled to be filed in early May, 2002;

(e) Recovery of PG&E's power procurement costs, beginning on January 1, 2003 and authorized in D.02-04-016, if and when PG&E resumes procurement;

(f) Recovery of PG&E's nuclear decommissioning trust fund contributions in retail rates, pursuant to A.02-03-020, filed in February, 2002 to be effective beginning 2003;

(g) Recovery of PG&E's Public Purpose Program costs for 2003, 2004 and 2005;

(h) Recovery of PG&E's FERC-jurisdictional electric transmission costs of service, for 2003 and beyond;

(i) The CPUC's assumptions regarding DWR's revenue requirement for the remainder of 2002 and 2003, 2004 and 2005;

(j) Resolution of the rehearing requests in PG&E's 1999 General Rate Case;

(k) Resolution of pending Annual Transition Cost Proceedings (ATCP) and Revenue Allocation Proceedings (RAP) through the end of record year 2002; and

(l) Assumptions pertaining to annual rate recovery of interest and principal on the new $3.8 billion debt issuance and return of and on the new $1.75 billion equity issuance under the CPUC Plan and related revenue requirement.

B. The CPUC should state in Exhibit G whether or not it has made a final determination as to the appropriate rate levels to be adopted in these rate proceedings, as

follows:

> "The assumptions described in this Exhibit C are based on the Commission's projections of the rate levels that will result from the various ratemaking proceedings. These proceedings are not final and the Commission has not made a final determination in them. Accordingly, to the extent that the outcomes in these proceedings differ from the assumptions, this will affect the revenues and cash "headroom" available under the Plan. If the differences between the assumptions and the actual determinations are material this could require changes in the Commission's Plan or render the Plan infeasible."

ITEM 11

Delete the first sentence in Section 7.7 of the CPUC Plan and the second sentence in section C.5 of the CPUC Disclosure Statement (page 93) and replace them with the following:

> "The Commission intends to regulate the Reorganized Debtor's operations consistent with applicable law."

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A Professional Corporation

ITEM 13

A. The New Tax Sharing Arrangement should be added as an Exhibit to the CPUC Disclosure Agreement.

B. Section VI.C.4 of the CPUC Disclosure Statement should be modified to discuss: (1) the rejection of the existing tax matters agreement between the Debtor and PG&E Corporation and the resulting rejection claim against the estate; (2) the legal basis for imposition of the New Tax Sharing Agreement upon PG&E Corporation; and (3) the legal basis for retroactive effectiveness of the New Tax Sharing Agreement.

ITEM 14

A. Delete the discussion of the Objectors' Plan in the CPUC Disclosure Statement, as follows: page 1, 17-22; page 2, line 26 to page 3, line 2; page 6, lines 12-16; and p. 61, line 6-13.

B. Modify Section IV of the CPUC Disclosure Statement (page 40) as follows:

> "The Commission will present a brief summary of the material facts that it believes are relevant to this case. *The Debtor disputes a material portion of the Commission's description of such events and facts.*"

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