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PACIFIC GAS AND ELECTRIC COMPANY

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	No. 01-30923 DM Chapter 11 Case Date: June 17, 2002 Time: 1:30 p.m. Place: 235 Pine Street, 22nd Floor San Francisco, California Judge: Hon. Dennis Montali

DEBTOR'S NOTICE OF MOTION AND MOTION FOR ORDER APPROVING DEBTOR'S EXECUTION AND PERFORMANCE UNDER THE FIRST AMENDED AND RESTATED SUMMARY OF TERMS WITH RESPECT TO FORBEARANCE AND PROPOSED REVISED TREATMENT OF LETTER OF CREDIT BANK CLAIMS IN THE PLAN OF REORGANIZATION; SUPPORTING MEMORANDUM OF POINTS AND AUTHORITIES

[SUPPORTING DECLARATION OF MICHAEL J. DONNELLY FILED SEPARATELY]

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NOTICE OF MOTION AND MOTION

PLEASE TAKE NOTICE that on June 17, 2002, at 1:30 p.m., or as soon thereafter as the matter may be heard, in the Courtroom of the Honorable Dennis Montali, located at 235 Pine Street, 22nd Floor, San Francisco, California, Pacific Gas and Electric Company, the debtor and debtor in possession in the above-captioned Chapter 11 case ("PG&E" or the "Debtor"), will and hereby does move the Court (the "Motion") for entry of an order approving PG&E's execution of, and performance under, a First Amended and Restated Summary of Terms With Respect to Forbearance and Proposed Revised Treatment of Letter of Credit Bank Claims in the Plan of Reorganization (the "Term Sheet") by and between PG&E, on the one hand, and various counterparties who have provided credit support for the outstanding bonds that are the subject of the Motion.

This Motion is made pursuant to Sections 105(a) and 363 of the United States Bankruptcy Code (11 U.S.C. §§105(a) and 363) and Rule 9019(a) of the Federal Rules of Bankruptcy Procedure, and is based on the facts and law set forth herein (including the accompanying Memorandum of Points and Authorities beginning on the next page), the Declaration of Michael J. Donnelly filed concurrently herewith (hereinafter referred to as the "Donnelly Declaration" and cited as the "Donnelly Decl."), the record of this case and any evidence presented at or prior to the hearing on this Motion.

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

TABLE OF CONTENTS

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
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TABLE OF AUTHORITIES

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
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MEMORANDUM OF POINTS AND AUTHORITIES

INTRODUCTION

Pacific Gas and Electric Company, the debtor and debtor in possession in the above-captioned Chapter 11 case (the "Debtor" or "PG&E"), submits this Memorandum of Points and Authorities In Support Of Debtor's Motion For Order Approving the Debtor's execution of, and performance under, a First Amended and Restated Summary of Terms With Respect to Forbearance and Proposed Revised Treatment of Letter of Credit Bank Claims in the Plan of Reorganization (the "Motion"). By this Motion, PG&E seeks the Court's approval of PG&E's execution of, and performance under, the First Amended and Restated Summary of Terms With Respect to Forbearance and Proposed Revised Treatment of Letter of Credit Bank Claims in the Plan of Reorganization (the "Term Sheet," a true and correct copy of which is attached as Exhibit A to the Donnelly Declaration), which PG&E has entered into with the various counterparties described below, subject to Bankruptcy Court approval, in order to maximize the chance that PG&E can preserve for the bankruptcy estate and the anticipated reorganized Debtor the benefits of favorable tax-exempt bond financing. This Motion is related to, but distinct from, the Debtor's Motion For Order Approving Debtor's Execution and Performance under the Summary of Terms with Respect to Forbearance and Proposed Revised Treatment of Letter of Credit Bank Claims in the Plan of Reorganization dated March 20, 2002 (Docket No. 5351), which was granted by this Court's Order dated April 9, 2002 (Docket No. 5879) (hereinafter the "Prior Motion and Order").

OVERVIEW

As described more fully below, PG&E is currently benefiting from certain below-market-rate loans made to PG&E by the California Pollution Control Financing Authority with the proceeds from the sale of certain tax-exempt revenue bonds. The bonds are secured by certain letters of credit, and PG&E is obligated to repay the loans by reimbursing the

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Letter of Credit issuing banks for all draws made on the letters of credit that are used to pay the bonds.

PG&E derives substantial benefit, in the form of reduced borrowing costs, by maintaining the bonds and the resulting loans outstanding. However, pursuant to their terms, the bonds cannot remain outstanding unless they continue to be secured by letters of credit or certain other forms of credit enhancement.

Under their terms of the documents under which the bonds were issued, due to certain defaults by PG&E as debtor in possession, the letter of credit issuing banks have the right to cause the bonds to be redeemed through draws on their letters of credit. However, under the terms of the Prior Motion and Order, PG&E and the letter of credit issuing banks entered into a term sheet (the "Prior Term Sheet") pursuant to which the letter of credit issuing banks agreed, among other things, to extend the terms of their respective letters of credit and to forbear from exercising such remedies under the terms of the bond documents for a limited period in exchange for the payment of certain increased letter of credit fees and certain other concessions by the Debtor as set forth in the Prior Term Sheet and approved by the Prior Motion and Order.

Under the terms of the Prior Term Sheet, among other things, the letter of credit issuing banks are, subject to certain conditions, required to maintain their letters of credit securing the bonds and forbear from exercising remedies that would result in the redemption of the bonds unless, among other things, a plan of reorganization which provides for the treatment of their claims in the manner presently set forth in the Debtor's plan of reorganization or for alternative treatment which is acceptable to the letter of credit issuing banks, is not confirmed on or before September 30, 2002. The Debtor has requested, and the letter of credit issuing banks have agreed, subject to certain terms and conditions, to waive the condition for the letter of credit issuing banks' continued forbearance that a plan of reorganization which so provides for the treatment of their claims be confirmed by September 30, 2002.

Further, under the terms of the Prior Term Sheet, the letter of credit issuing banks have continued to permit monthly draws under their letters of credit for the payment of interest on the bonds. Under the terms of the bond documents, PG&E is obligated to reimburse the letter of credit issuing banks for the amounts so drawn on their letters of credit, together with interest on such amounts until paid. Given the relatively high rate at which such reimbursement obligations continue to accrue interest, as compared to the significantly lower rate of return that the Debtor is receiving on the short-term investments that the Debtor has available to pay such obligations, the Debtor believes that it would realize substantial interest cost savings by currently reimbursing the letter of credit banks for the amounts drawn on their letters of credit for the payment of interest on the bonds.

Accordingly, PG&E desires to enter into a new consensual arrangement with the letter of credit issuing banks, as set forth in the Term Sheet, which would amend and restate the agreement set forth in the Prior Term Sheet, pursuant to which, among other things, in exchange for the current payment of certain fees and expenses of the letter of credit issuing banks and the current reimbursement of certain amounts drawn under the letters of credit for the payment of interest on the bonds, the letter of credit issuing banks would agree to maintain their existing letters of credit for the benefit of PG&E for an extended period, waive the condition for the letter of credit issuing banks' continued forbearance that a plan of reorganization which provides for the treatment of their claims as provided in the Prior Term Sheet be confirmed by September 30, 2002, allow the existing letters of credit to continue to be drawn to pay accruing interest on outstanding tax-exempt bonds, refrain from taking certain actions and agree to take certain other actions in cooperation with PG&E to keep the tax-exempt bonds (and the related below-market-rate loans to PG&E) outstanding.

For the reasons set forth above and as more fully described below, PG&E believes that the agreement set forth in the Term Sheet is beneficial to the Debtor and its estate and, accordingly, should be approved by the Court.

I. GENERAL BACKGROUND

PG&E is an investor-owned utility providing electric and gas services to millions of California residents and businesses. Beginning approximately in the summer of 2000, as a result of the partial deregulation of the power industry, PG&E was forced to pay dramatically increased wholesale prices for electricity, but was prevented from passing these costs on to retail customers, resulting in a staggering financial shortfall. In the face of the deterioration in PG&E's financial condition and with little progress having been made toward a resolution of the crisis, PG&E by early April 2001 determined that a Chapter 11 reorganization offered the best prospects for protecting the interests of its customers, creditors, employees and shareholders alike. Accordingly, PG&E filed a voluntary petition under Chapter 11 of the Bankruptcy Code on April 6, 2001. PG&E continues to manage and operate its business and property as a debtor in possession pursuant to Sections 1107 and 1108 of the United States Bankruptcy Code. 11 U.S.C. §§1107-1108. On September 20, 2001, PG&E and its parent company, PG&E Corporation, jointly propounded and filed a Plan of Reorganization Under Chapter 11 of the Bankruptcy Code for Pacific Gas and Electric Company (the "Plan"), which plan has been amended by, among other things, a Plan of Reorganization filed April 19, 2002 (the Plan, as so amended and as may be further modified prior to the hearing on this Motion, being hereinafter referred to as the "Amended Plan").

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II. THE SUBJECT BONDS AND THEIR CREDIT ENHANCEMENTS[1]

A. Background and Mechanics of Subject Bond Issuances.

Pursuant to the terms of various separate trust indentures (each, an "Indenture") each between the California Pollution Control Financing Authority, a public instrumentality and political subdivision of the State of California (the "Issuer") and Deutsche Bank Trust Company Americas (formerly known as Bankers Trust Company), as trustee (the "Bond Trustee"), and various corresponding loan agreements between the Issuer and PG&E, as of the commencement of this Chapter 11 case, the Issuer had issued and outstanding 15 series

[1]The evidentiary support for the facts set forth in this memorandum of points and authorities are contained in the Donnelly Declaration filed herewith.

of its revenue bonds in aggregate principal amount of approximately $1.69 billion. As of the filing of this Motion, 11 series of such revenue bonds in the aggregate principal amount of approximately $1.24 billion remain outstanding. Of this $1.24 billion, the revenue bonds that are the subject of this Motion consist of four series of credit-enhanced revenue bonds in the aggregate principal amount of approximately $613,550,000, as set forth more specifically on Schedule 1 attached to the Term Sheet (collectively, the "Letter of Credit Backed PC Bonds").[2]

The Issuer loaned the proceeds from the sale of each series of Letter of Credit Backed PC Bonds (each a "Bond Loan" and collectively the "Bond Loans") to PG&E for the purpose of financing or refinancing the acquisition and/or construction of certain pollution control, sewage disposal and/or solid waste disposal facilities of PG&E located within the State of California. The Bond Loans were made pursuant to the terms of various loan agreements (each, a "Loan Agreement" and collectively the "Loan Agreements") between the Issuer and PG&E, pursuant to which PG&E agreed, among other things, to repay the Bond Loans at the times and in the amounts necessary to enable the Issuer to make full and timely payment of the principal of, premium, if any, and interest on, each series of Letter of Credit Backed PC Bonds when due and to pay the purchase price of any Letter of Credit Backed PC Bonds tendered for purchase by PG&E in accordance with the terms of the applicable Indenture.

Pursuant to the terms of each of the Indentures, the Issuer has assigned to the Bond Trustee, for the benefit of the holders of the respective series of Letter of Credit Backed PC Bonds, certain of the Issuer's rights under the various Loan Agreements, including, but not limited to, the Issuer's right under the Loan Agreements to receive payments from PG&E of the principal of, and premium (if any) and interest on, the Bond Loans. In this manner, the Issuer has acted solely as a conduit, loaning the proceeds from

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[2]The seven series of revenue bonds representing the difference between the $1.24 billion total revenue bonds outstanding and the $613,550,000 of Letter of Credit Backed PC Bonds are not covered by this Motion because they are not supported by letters of credit, and they therefore do not raise the issues leading to the Term Sheet and this Motion.

the sale of the Letter of Credit Backed PC Bonds to PG&E and assigning its right to receive repayment of such loans to the Bond Trustee as security for the Letter of Credit Backed PC Bonds and to provide funds for the full payment of the respective Letter of Credit Backed PC Bonds.

The Letter of Credit Backed PC Bonds are special limited obligations of the Issuer payable exclusively out of the trust estates under each of the Indentures. None of the Letter of Credit Backed PC Bonds constitute a debt or liability, or a pledge of the faith, credit or taxing power of the Issuer, the State of California or any of its instrumentalities or political subdivisions. Rather, each series of Letter of Credit Backed PC Bonds is a limited obligation of the Issuer payable solely from the revenues derived by the Issuer from PG&E pursuant to the terms of the related Loan Agreement to the extent pledged by the Issuer to the Bond Trustee under the terms of the applicable Indenture and from certain other funds pledged and assigned as part of the trust estates under the applicable Indentures.

B. Letter of Credit Backed PC Bonds.

With respect to each series of Letter of Credit Backed PC Bonds, PG&E entered into a reimbursement agreement (each, a "Reimbursement Agreement") with a bank (each, a "Letter of Credit Issuing Bank") and certain banking or other financial institutions (each, a "Bank"), pursuant to which the Letter of Credit Issuing Bank has issued its irrevocable letter of credit (each, a "Letter of Credit") to the Bond Trustee, for the account of PG&E, to provide for the payment of the principal of and interest on the related series of Letter of Credit Backed PC Bonds and to support the payment of the purchase price of any Letter of Credit Backed PC Bonds tendered for purchase in accordance with the terms of the applicable Indenture. Under the terms of each Reimbursement Agreement, PG&E is obligated to reimburse the Letter of Credit Issuing Bank for all amounts drawn on the related Letter of Credit.

Each Letter of Credit was issued in an initial stated amount (the "Stated Amount") equal to the sum of (i) the aggregate outstanding principal amount of the related series of Letter of Credit Backed PC Bonds (the "Principal Portion"), plus (ii) an amount equal to the amount of accrued interest on the outstanding principal amount of the related series of Letter of Credit Backed PC Bonds at an assumed maximum annual rate for a specified period of days as set forth in the Letter of Credit (the "Interest Portion"). The Stated Amount of each Letter of Credit is reduced by the amount of each drawing paid thereunder, subject to the provision that (a) with respect to amounts drawn for the payment of scheduled interest on the related Letter of Credit Backed PC Bonds, the Interest Portion of the Stated Amount is automatically reinstated unless the Letter of Credit Issuing Bank gives notice to the contrary to the Bond Trustee in accordance with the terms of the applicable Letter of Credit, and (b) with respect to amounts drawn to pay the purchase price of Letter of Credit Backed PC Bonds, the amount so drawn is subject to reinstatement upon the terms set forth in the applicable Letter of Credit.

Under the terms of each of the Indentures pursuant to which each series of Letter of Credit Backed PC Bonds were issued, each regularly scheduled payment of the principal of, or interest on, the Letter of Credit Backed PC Bonds is made from moneys drawn by the Bond Trustee under the related Letter of Credit. The obligation of PG&E to repay the loan under the Loan Agreement is deemed satisfied to the extent of any corresponding payment made by the Letter of Credit Issuing Bank under the terms of the Letter of Credit. With respect to each such drawing, PG&E is then obligated under the applicable Reimbursement Agreement to reimburse the Letter of Credit Issuing Bank for the amount of such drawing. Only if the Letter of Credit Issuing Bank dishonors a drawing, or there is no Letter of Credit then in effect, is the Bond Trustee authorized under the terms of the Indenture to collect Bond Loan payments under the respective Loan Agreement and apply such funds to the payment of the principal of, or interest on, the related Letter of Credit Backed PC Bonds.

Accordingly, with respect to each series of Letter of Credit Backed PC Bonds for which the related Letter of Credit remains outstanding, all payments of the principal of, and interest on, the Letter of Credit Backed PC Bonds have been fully and timely made when due from draws made by the respective Bond Trustee on the respective Letter of Credit in accordance with the terms of such Letter of Credit and the related Indenture.

C. Tax-Exempt Status of Letter of Credit Backed PC Bonds.

All of the Letter of Credit Backed PC Bonds were sold in the capital markets on the basis that, assuming PG&E continued to comply with certain covenants contained in the Loan Agreements and certain of the documents, instruments and agreements executed in connection therewith (collectively, the "PC Bond Documents") and with certain exceptions, interest on such series of Letter of Credit Backed PC Bonds would not be includable in the gross income of the holders thereof for federal income tax purposes and that such interest is also exempt from California personal income taxes.

The tax-exempt status of the Letter of Credit Backed PC Bonds allowed such bonds to be issued at favorable interest rates, thus allowing PG&E to finance or refinance certain of its capital improvements and other qualified costs at rates substantially below comparable conventional taxable financing alternatives available to PG&E. Based on the tax-exempt status of the Letter of Credit Backed PC Bonds, their credit enhancement and their commensurate credit rating, the Letter of Credit Backed PC Bonds currently accrue interest at the average blended interest rate of only 1.63% per annum.[3] In the event that any of the Letter of Credit Backed PC Bonds were to be redeemed in accordance with the terms of their respective Indentures, it may not be possible under current law to reissue such bonds on a tax-exempt basis. Accordingly, PG&E has made the determination that the continued existence of such favorable tax-exempt financing is a valuable asset of PG&E's bankruptcy estate, and that it is in the best interest of PG&E's estate to keep the Letter of Credit Backed PC Bonds outstanding in order to preserve the substantial benefits of such tax-exempt financing.

D. Post-Chapter 11 Filing Status of Letter of Credit Backed PC Bonds.

Since PG&E's Chapter 11 filing on April 6, 2001 (the "Petition Date"), all of the Letter of Credit Backed PC Bonds have remained outstanding, and all of the scheduled interest payments on the Letter of Credit Backed PC Bonds have been fully and timely paid,

[3]This rate was calculated as of May 1, 2002, shortly before the filing of this Motion.

when due, through periodic draws by the Bond Trustee on the Letters of Credit provided by the Letter of Credit Issuing Banks. To date, following each such drawing, each of the Letter of Credit Issuing Banks has allowed the Interest Portion of its respective Letter of Credit to automatically reinstate in accordance with the terms thereof each month, which has resulted in automatic reinstatements each month since PG&E's Chapter 11 filing in April 2001.

Since the Petition Date, consistent with its duties as a Chapter 11 debtor in possession, the Debtor has not reimbursed the Letter of Credit Issuing Banks, as required by the terms of the Reimbursement Agreements, for any of the amounts paid by the Letter of Credit Issuing Banks to the Bond Trustee pursuant to the monthly post-petition draws on the Letters of Credit made by the Bond Trustee for the payment of interest on the related Letter of Credit Backed PC Bonds. As a result thereof, the Debtor has been in default under the terms of the respective Reimbursement Agreements.

Subject to the provisions of the Prior Term Sheet, during the period that one or more "Events or Defaults" under its Reimbursement Agreement continue to exist, each of the Letter of Credit Issuing Banks has the right upon the passage of time, the giving of notice or both, (i) to declare a default under its respective Reimbursement Agreement, (ii) to notify the Bond Trustee of such default, and (iii) to direct the Bond Trustee to call an Event of Default under the terms of the respective Indenture and, in accordance with the terms of the respective Indenture, to cause the Bond Trustee to declare the respective series of Letter of Credit Backed PC Bonds immediately due and payable. In such event the Bond Trustee would, in accordance with the terms of the respective Indentures and the respective Letters of Credit, draw upon the respective Letters of Credit, and apply such drawn funds to the full payment and cancellation of the related outstanding Letter of Credit Backed PC Bonds, with the end result that this tax-preferred financing would no longer be outstanding.

Further, pursuant to the terms of each of the Indentures, with respect to each series of Letter of Credit Backed PC Bonds, subject to certain exceptions, unless 35 days prior to the expiration of the respective Letter of Credit, the Bond Trustee shall have received either (a) a renewal or extension of the existing Letter of Credit for a period of at least one year, or (b) a substitute letter of credit or other credit facility meeting the requirements of the respective Loan Agreement and Indenture, the Bond Trustee is required to call the series of Letter of Credit Backed PC Bonds for redemption and cancellation on the last business day which is at least five calendar days preceding the expiration date of the respective Letter of Credit. In such event the Bond Trustee would again, in accordance with the terms of the respective Indenture and the respective Letter of Credit, draw upon the respective Letter of Credit, and apply such drawn funds to the full payment and cancellation of the related series of outstanding Letter of Credit Backed PC Bonds, with the end result that this tax-preferred financing would no longer be outstanding.

However, pursuant to the Prior Term Sheet and the Prior Motion and Order, each of the Letter of Credit Issuing Banks has agreed, among other things, to forbear from the exercise of such remedies, to maintain its Letter of Credit outstanding in the stated amounts set forth in the Prior Term Sheet, and not provide the Bond Trustee with notice of the non-reinstatement of its Letter of Credit or of any default under its Reimbursement Agreement or take any other action which would result in the mandatory tender or redemption, either in whole or in part, of any of the outstanding Letter of Credit Backed PC Bonds without the prior written consent of the Debtor until the earlier of (i) the last interest payment date on the related series of Letter of Credit Backed PC Bonds immediately preceding the expiration date of such Letter of Credit, as such expiration date has been extended in accordance with the terms of the Prior Term Sheet; or (ii) the occurrence of any "Termination Event," which is defined in the Prior Term Sheet to include certain payment defaults by Debtor, the failure to confirm a plan of reorganization of the Debtor which provides for the treatment of allowed Letter of Credit Bank Claims in the manner provided in the Prior Term Sheet or for alternative treatment of such claims which is acceptable to the Letter of Credit Issuing Banks on or before the September 30, 2002, the confirmation of a plan of reorganization of the Debtor which does not provide for such treatment of Letter of Credit Bank Claims, the dismissal of the Debtor's chapter 11 case or the conversion of the case to a case under chapter 7, or the Effective Date.

Further, pursuant to the Prior Term Sheet and the Prior Motion and Order, each of the Letter of Credit Issuing Banks agreed to extend the term of its Letter of Credit to a date not earlier than the first business day subsequent to the one-year anniversary of its prior expiry date.

The forbearance by the Letter of Credit Issuing Banks, together with the extension of their Letters of Credit, have allowed the Debtor to keep the Letter of Credit Backed PC Bonds and the related Bond Loans outstanding, which has resulted and will continue to result in substantial interest cost savings for the Debtor and its estate. However, each scheduled interest payment due on the Letter of Credit Backed PC Bonds has been paid through a draw on the related Letter of Credit, which pursuant to the terms of the Reimbursement Agreements, Debtor is obligated to repay, together with interest on the amount to be reimbursed at interest rates materially higher than the yield the Debtor has been able to obtain on the relatively highly rated short-term investments that the Debtor has available to satisfy such obligation.

The Letter of Credit Banks have indicated to PG&E that, subject to certain conditions, they would agree to extend the period during which they would be required to continue to forbear from exercising their remedies under their respective Reimbursement Agreements and the related Indentures in order to provide PG&E with more time to confirm a plan of reorganization that would permit the reorganized Debtor to retain the benefits of the tax-exempt exempt financing offered by the continued existence of the Letter of Credit Backed PC Bonds. Consistent with such position of the Letter of Credit Issuing Banks, during the past several weeks PG&E has engaged in discussions with the Letter of Credit Issuing Banks, culminating in the proposed Term Sheet which would amend and restate the Prior Term Sheet.

Because the exercise by the Letter of Credit Issuing Banks of their remedies under their respective Reimbursement Agreements and the related Indentures could result in the redemption of the Letter of Credit Backed PC Bonds, which in turn could result in the permanent loss to PG&E and its bankruptcy estate of the significant benefits of the tax-exempt financing afforded by the respective Letter of Credit Backed PC Bonds, and because the funding of the interest due on the Letter of Credit Backed PC Bonds through unreimbursed draws on the related Letters of Credit results in a substantially higher interest costs to PG&E than the return that PG&E is able to obtain from the highly rated, short-term investments that PG&E has available to satisfy such obligations, PG&E has determined that it is in the best interests of the estate and its creditors for PG&E to amend and restate the terms of the Prior Term Sheet by entering into the Term Sheet and to seek this Court's approval of PG&E's execution of, and performance under, the terms of the Term Sheet.

III. SUMMARY OF TERMS OF THE TERM SHEET

As noted above, a true and correct copy of the Term Sheet is attached as Exhibit A to the Donnelly Declaration. The principal terms of the Term Sheet and the changes from Prior Term Sheet are summarized and explained as follows:

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A. <u>Agreements by the Letter of Credit Issuing Banks.</u>

<u>Forbearance:</u> Each of the Letter of Credit Issuing Banks has agreed to (i) maintain its Letter of Credit outstanding in its current stated amount, and (ii) not provide the Bond Trustee with notice of any default under its Reimbursement Agreement or non-reinstatement of its Letter of Credit or take any other action which would result in the mandatory tender or redemption of any of the outstanding Letter of Credit Backed PC Bonds without the prior written consent of PG&E until the earlier of: (x) the last interest payment date on the related series of Letter of Credit Backed PC Bonds immediately preceding the expiration date of such Letter of Credit, as such expiration date shall be extended in accordance with the terms of the Term Sheet, and (y) the occurrence of a "Termination Event" (as hereinafter defined),

For such purpose, a "Termination Event" shall have occurred, and the Letter of Credit Issuing Banks will no longer be obligated to continue to forbear from the exercise of their remedies under their respective Reimbursement Agreements and the related Indentures, if (a) PG&E fails to timely remit to the Letter of Credit Issuing Banks any of the payments set forth in the Term Sheet, (b) a plan of reorganization of PG&E which provides for the treatment of Allowed Letter of Credit Bank Claims (as defined in the Plan) in the manner described in the Term Sheet or for alternative treatment of Allowed Letter of Credit Bank Claims which is acceptable to the Letter of Credit Issuing Banks does not become effective on or before June 1, 2003, (c) a plan of reorganization is confirmed in PG&E's Chapter 11 case which does not provide for the treatment of Allowed Letter of Credit Bank Claims in the manner described in the Term Sheet or for alternative treatment of Allowed Letter of Credit Bank Claims which is acceptable to the Letter of Credit Issuing Banks, (d) the "Effective Date" as defined in the Plan (the "Effective Date") occurs, or (e) the Chapter 11 case of PG&E is dismissed or converted to a case under Chapter 7.

Explanation of Forbearance: At any time there is an "Event of Default" under the terms of a Reimbursement Agreement, the applicable Letter of Credit Issuing Bank has the continuing right, pursuant to the terms of its Reimbursement Agreement and related Indenture, to notify the Bond Trustee of the occurrence or existence of one or more "Events of Default" under its Reimbursement Agreements and to direct the Bond Trustee to declare an "Event of Default" under the related Indenture, notwithstanding the Letter of Credit Issuing Bank's failure to exercise such right at any time. In addition, so long as a Letter of Credit Issuing Bank is not reimbursed in full for drawings properly honored by such Letter of Credit Issuing Bank under the Letter of Credit issued by it, such Letter of Credit Issuing Bank has, among other things, the continuing right (under both its Reimbursement Agreement and its Letter of Credit) to notify the Bond Trustee of such failure to be reimbursed in full and to state that the amount available to be drawn under the Letter of Credit to pay interest on such Letter of Credit Backed PC Bonds has not been reinstated, notwithstanding the failure of the Letter of Credit Issuing Bank to exercise such right previously.

As a Chapter 11 debtor in possession, PG&E has not reimbursed the Letter of Credit Issuing Banks for any of the payments they have made pursuant to the several post-petition draws on their Letters of Credit. Accordingly, each of the Letter of Credit Issuing

Banks has the right upon the passage of time, the giving of notice or both, to either (i) declare an "Event of Default" under its respective Reimbursement Agreement and to direct the Bond Trustee to call an Event of Default under the terms of the respective Indenture, and/or (ii) during certain periods following the monthly draws on each of the Letters of Credit to pay interest on the Letter of Credit Backed PC Bonds, to notify the Bond Trustee that the Interest Portion of the Letter of Credit will not be reinstated. In such event, the Bond Trustee would, in accordance with the terms of the respective Indentures and the respective Letters of Credit, declare the respective series of Letter of Credit Backed PC Bonds immediately due and payable, draw upon the respective Letter of Credit, and apply such drawn funds to the full payment and cancellation of the related outstanding Letter of Credit Backed PC Bonds, with the end result that the tax-preferred financing would no longer be outstanding.

Under the terms of the Prior Term Sheet, each of the Letter of Credit Issuing Banks had agreed to forbear, for a limited period, from taking such action or taking any other action which would result in the mandatory tender or redemption of any of the outstanding Letter of Credit Backed PC Bonds without the prior written consent of PG&E. This concession by the Letter of Credit Issuing Banks allows PG&E to maintain the benefits of the tax-exempt financing during the forbearance period at a significant savings to the Debtor's bankruptcy estate.

The terms of the Term Sheet maintain all of the same forbearance provisions as the Prior Term Sheet with the following exception. Under the Prior Term Sheet the Letter of Credit Issuing Banks were permitted to cease their forbearance if, among other things, a plan of reorganization which provides for the treatment of their claims either (i) in the manner set forth in the Prior Term Sheet and as presently set forth in the Amended Plan or (ii) in an alternative manner which is acceptable to the Letter of Credit Issuing Banks, is not confirmed on or before September 30, 2002 (the "Confirmation Deadline"). Under the terms of the new Term Sheet, the Letter of Credit Banks have agreed to waive the Confirmation Deadline as a condition to their continued forbearance provided that a plan of reorganization which provides for the treatment of their claims in the manner set forth in the new Term Sheet (as described below) or a plan of reorganization of the Debtor which provides for alternative treatment of their claims in a manner which is acceptable to the Letter of Credit Issuing Banks, becomes effective on or before June 1, 2003. Accordingly, the provisions of the new Term Sheet will provide the Debtor with additional time to confirm a plan of reorganization that would permit the reorganized Debtor to retain the benefits of the tax-exempt exempt financing offered by the continued existence of the Letter of Credit Backed PC Bonds.

Extension of Letter of Credit Expiration: Pursuant to the provisions of the Term Sheet, the Letter of Credit Issuing Banks have agreed that, on or before the date thirty days after the date of this Motion, each of the Letter of Credit Issuing Banks shall have extended the term of its Letter of Credit to a date not earlier than the first business day subsequent to the one-year anniversary of the prior expiration date of such Letter of Credit.

Explanation of Extension of Letter of Credit Expiration: Unless each of the Letters of Credit is renewed or replaced in accordance with the terms of the Indentures at least 35 days prior to its expiration date, the Bond Trustee will be required to call the related series of Letter of Credit Backed PC Bonds for redemption and cancellation. The Letter of Credit Issuing Banks have the right to refuse to extend the terms of their Letters of Credit beyond their respective maturities.

Pursuant to the terms of the Prior Term Sheet, each Letter of Credit Issuing Bank agreed to extended the term of its respective Letter of Credit for an additional term of not less than one year from its then existing expiration date, and to complete such extension of the term of its Letter of Credit on or before April 18, 2002. However, as of the date hereof, not all of the Letter of Credit Issuing Banks have done so, solely as the result of their excusable neglect that, so far, has been without harm to the Debtor.

The Term Sheet provides each Letter of Credit Issuing Bank that has not already done so with an additional thirty days from the date of this Motion to complete the extension of the term of its respective Letter of Credit as agreed under the provisions of the Prior Term

Sheet.

The agreement by the Letter of Credit Banks to extend the terms of their Letters of Credit for an additional year provides PG&E with necessary additional time in which to confirm and effectuate its plan of reorganization while both maintaining the benefits of the tax-exempt financing provided by the Letter of Credit Backed PC Bonds for the Debtor's bankruptcy estate, and giving the Debtor the opportunity to secure the continuing benefits of such tax-exempt financing for the reorganized Debtor.

B. <u>Agreements by the Debtor.</u>

<u>Reimbursement of Interest Draws</u>: The Term Sheet provides that commencing within 10 days after the date this Motion is approved by the Court (the "Motion Approval Date"), PG&E will reimburse the Letter of Credit Issuing Banks for the amounts drawn under their respective Letters of Credit for the payment of interest on the related Letter of Credit Backed PC Bonds, together with all accrued and unpaid interest due on such amounts, all to the extent provided in the Reimbursement Agreements. Thereafter, PG&E would currently reimburse the Letter of Credit Issuing Banks for all amounts drawn under their Letters of Credit for the payment of interest on the Letter of Credit Backed PC Bonds, which amounts will be paid by PG&E when due pursuant to the terms of the applicable Reimbursement Agreements.

<u>Explanation of Reimbursement of Interest Draws</u>: The Debtor has agreed pursuant to the terms of the Prior Term Sheet to fully reimburse the Letter of Credit Issuing Banks for all amounts drawn on their Letters of Credit for the payment of interest on the Letter of Credit Backed PC Bonds, together with interest thereon to the extent provided in the applicable Reimbursement Agreements, on the Confirmation Date (as defined in the Amended Plan), and during the period from the Confirmation Date through the Effective Date, to currently reimburse the Letter of Credit Issuing Banks for all amounts thereafter drawn under their Letters of Credit for the payment of interest on the Letter of Credit Backed PC Bonds, which amounts will be paid by PG&E when due pursuant to the terms of the

applicable Reimbursement Agreements.

Under the provisions of the new Term Sheet, the Debtor would commence reimbursement of the Letter of Credit Issuing Banks for amounts drawn under their Letters of Credit for the payment of interest on Letter of Credit Backed PC Bonds within 10 days after the Motion Approval Date, rather than commencing on the Confirmation Date as provided in the Prior Term Sheet, and would thereafter currently reimburse the Letter of Credit Issuing Banks for all amounts drawn under their Letters of Credit for the payment of interest on the Letter of Credit Backed PC Bonds, which amounts will be paid by PG&E when due pursuant to the terms of the applicable Reimbursement Agreements. This proposed change from the terms of the Prior Term Sheet would merely accelerate the date such payments would be made by the Debtor. It would not expand the Debtor's obligations.

Further, under the terms of the Reimbursement Agreements, the amounts due by the Debtor to the Letter of Credit Issuing Banks as reimbursement for draws on their Letters of Credit for the payment of interest on the respective Letter of Credit Backed PC Bonds accrue interest from the date of each draw until paid at an average fluctuating annual rate of interest approximately equal to one and one-half percent in excess of the prime rate. The funds the Debtor has available to satisfy such obligations have been, and in accordance with the Court's Order on Debtor's Emergency Motion for Order Authorizing Continuing Use of (1) Certain Bank Accounts, (2) Cash Management System, and (3) Corporate Investment Policy dated April 6, 2001, are expected to continue to be, invested in short-term obligations which have an average yield substantially below the prime rate. As a result, the Debtor expects to realize a net interest cost savings by accelerating the reimbursement of the Letter of Credit Issuing Banks as provided in the Term Sheet.

Accordingly, the Debtor believes that the current reimbursement of the Letter of Credit Issuing Banks for the amounts drawn on their Letters of Credit for the payment of interest on the Letter of Credit Backed PC Bonds is both a reasonable concession to make to the Letter of Credit Issuing Banks for the extensions of the term of forbearance as explained above, and is in the best interest of the Debtor's estate, as it is expected to allow the Debtor to avoid further negative arbitrage between the relatively high rate at which the reimbursement obligations would otherwise accrue interest under the terms of the Reimbursement Agreements and the lower rate of return on the invested funds that the Debtor has available to satisfy such obligations.

Additional Fees: The Term Sheet provides that if this Motion is approved by the Bankruptcy Court, then PG&E will be required to pay to each of the Letter of Credit Issuing Banks, during the period from and after the Motion Approval Date and continuing until July 1, 2002, quarterly, in arrears, the Letter of Credit fee as set forth in the respective Reimbursement Agreement (the "Original Letter of Credit Fee"), together with an amount equal to the positive difference, if any, of an amount per annum equal to two (2%) percent of the Stated Amount of the Letter of Credit, less the Original Letter of Credit Fee (together, the "Initial Letter of Credit Fee"), which total fee shall accrue from and after December 1, 2001 and until July 1, 2002, and shall be payable on the same dates as are set forth for payment of Letter of Credit Fees in the applicable Reimbursement Agreement, and during the period from and after the July 1, 2002 and continuing until the Effective Date (as defined in the Amended Plan), quarterly, in arrears, the Original Letter of Credit Fee, together with an amount equal to the positive difference, if any, of an amount per annum equal to three (3%) percent of the Stated Amount of the Letter of Credit, less the Original Letter of Credit Fee, which total fee shall accrue from and after July 1, 2002 until the Effective Date, and shall be payable on the same dates as are set forth for payment of Letter of Credit fees in the applicable Reimbursement Agreement.

The Term Sheet also provides that within 10 days after the Motion Approval Date, PG&E is required to pay to Deutsche Bank AG New York Branch an agency fee in the amount of $250,000 as additional compensation for acting as the administrative agent under the terms of its Reimbursement Agreement during the period from and after December 1, 2001 through the Effective Date; provided that if no Termination Event shall have occurred prior to June 30, 2002 and Deutsche Bank AG shall not be in default of its obligations under the Term Sheet, such agency fee shall be deemed fully earned on the earlier of the

Confirmation Date or June 30, 2002.

Explanation of Additional Fees: As set forth in the Amended Plan and the Term Sheet, the Letter of Credit Issuing Banks and the Banks will be paid their outstanding Allowed Letter of Credit Bank Claims, together with pre- and post-petition interest thereon, in full on the terms set forth therein. The Amended Plan and Term Sheet also provide for the payment of certain increased fees to the Letter of Credit Issuing Banks as consideration for their agreements to forbear and extend the maturities of the Letters of Credit.

If this Motion is approved by the Bankruptcy Court, then PG&E will make current payments of the letter of credit fees due under the terms of the respective Reimbursement Agreements, plus pay an additional fee in the amount necessary to bring the total annual fee payable to each Letter of Credit Issuing Bank up to an aggregate amount per annum equal to two (2%) percent of the Stated Amount of each Letter of Credit for the period that the respective Letter of Credit remains outstanding in the Stated Amount, which letter of credit fees will be payable with respect to the period from and after December 1, 2001 through July 1, 2002. Thereafter, during the period from and after July 1, 2002 through the Effective Date, PG&E will make current payments of the letter of credit fees due under the terms of the respective Reimbursement Agreements, plus pay an additional fee in the amount necessary to bring the total annual fee payable to each Letter of Credit Issuing Bank up to an aggregate amount per annum equal to three (3%) percent of the Stated Amount of each Letter of Credit for the period that the respective Letter of Credit remains outstanding in the Stated Amount from July 1, 2002 through the Effective Date.

The increased total letter of credit fees will be calculated, and will either accrue or be payable, in the same manner as letter of credit fees are currently provided for in each of the existing Reimbursement Agreements.

In addition, the Term Sheet provides that within 10 days after the Motion Approval Date, PG&E will pay to Deutsche Bank AG New York Branch an agency fee in the amount of $250,000 as additional compensation for acting as the administrative agent under the terms of its Reimbursement Agreement during the period from and after December

1, 2001 through the Effective Date, and that such fee will be deemed fully earned on the earlier of the Confirmation Date or June 30, 2002 and paid on the Confirmation Date.

The fees payable by PG&E under the Term Sheet are similar to the fees that PG&E has already agreed to pay under the terms of the Prior Term Sheet with the exception that (i) the aggregate letter of credit fee increases from two to three percent of the Stated Amount of each Letter of Credit per year earlier on July 1, 2002, rather than on the Confirmation Date as provided in the Prior Term Sheet, and (ii) the agency fee payable to Deutsche Bank AG New York Branch will be payable within 10 days after the Motion Approval Date, rather than on the Confirmation Date as provided in the Prior Term Sheet.

The fees payable by PG&E under the terms of the Term Sheet and the accelerated timing of the payment of such fees are, in the opinion of PG&E, fair compensation to the Letter of Credit Issuing Banks for their agreements under the provisions of the Term Sheet to, among other things, continue to forbear from the exercise of remedies under their respective Reimbursement Agreements for an extended period as described above. Even after the payment of the increased fees set forth in the Term Sheet, PG&E will continue to realize substantial interest cost savings by maintaining the benefits of the outstanding tax-exempt financing provided by the Letter of Credit Backed PC Bonds, which cost savings more than offset the cost of the fees. Thus, under the current circumstances, the Debtor believes that the increased total letter of credit fees are a reasonable and necessary component of any agreement to extend the forbearance period.

Finally, the Debtor believes that, given the additional administrative responsibilities that Deutsche Bank will have to perform as agent for its bank group in order to maintain its Letter of Credit, it is reasonable and necessary for the Debtor to pay Deutsche Bank the additional agency fee set forth in the Term Sheet, and that paying such fee earlier (within 10 days after the Motion Approval Date rather than on the Confirmation Date as provided in the Prior Term Sheet) is a reasonable concession on the part of the Debtor for Deutsche Bank's additional administrative efforts in connection with negotiating the terms of the new Term Sheet on behalf of its bank group.

Professional Fees: The Term Sheet provides that PG&E will pay the reasonable fees and expenses of unrelated third party professionals retained by the Letter of Credit Issuing Banks ("Professional Fees"), to the extent incurred subsequent to April 6, 2001 in connection with the Chapter 11 case of PG&E no later than 30 days subsequent to each date a reimbursement request therefor (with appropriate backup) is made in writing by the Letter of Credit Issuing Bank to PG&E.

Explanation of Professional Fees: PG&E is obligated under the terms of the respective Reimbursement Agreements to reimburse the Letter of Credit Issuing Banks for the reasonable fees and expenses of unrelated third party professionals retained by the Letter of Credit Issuing Banks.[4] Moreover, in connection with both the Prior Motion and Order and the Court approved stipulation that preceded it, PG&E has agreed that, subject to certain conditions, such attorneys' fees constitute allowed claims against PG&E and its estate. Thus, this provision of the Prior Term Sheet, which has been retained in the new Term Sheet, does not expand PG&E's obligations, but, in light of the full payment of creditors proposed in the Amended Plan, only serves to accelerate the timing of the reimbursement of the Letter of Credit Issuing Banks for such costs. Again, given the substantial benefits to PG&E from this deal, such concession by PG&E was, and continues to be, minor and justified.

The Debtor's obligations with respect to the timing and payment of such professional fees are unchanged from those it agreed to in the Prior Term Sheet as approved by the Prior Motion and Order.

Purchase in Lieu of Redemption: The Term Sheet provides that, if no Termination Event shall have occurred and remain uncured prior to the Effective Date, then upon written request of PG&E, each Letter of Credit Issuing Bank shall cause the related

[4]These fees include the fees of outside counsel retained by Bank of America, N.A. ("BofA") in connection with BofA's capacity as a Letter of Credit Issuing Bank, including a reasonable allocable portion of the fees of outside counsel retained by BofA for services related to Creditors' Committee matters that at the same time are reasonably attributable to protecting BofA's interests in its capacity as a Letter of Credit Issuing Bank.

series of Letter of Credit Backed PC Bonds to be tendered for purchase through a draw upon the respective Letter of Credit and instruct the respective Bond Trustee to either register the purchased Letter of Credit Backed PC Bonds in the name of the Letter of Credit Issuing Bank or in the name of PG&E subject to a first lien security interest in favor of the respective Letter of Credit Issuing Bank to additionally secure the obligations of PG&E under the related Reimbursement Agreement.

The Term Sheet further provides that upon written request of PG&E or the Letter of Credit Issuing Banks delivered by either party to the other on or after the date the Bankruptcy Court approves this Motion, PG&E and each of the Letter of Credit Issuing Banks shall take any action as shall be reasonably necessary to amend the Loan Agreement and/or Indenture pursuant to which each series of Letter of Credit Backed PC Bonds were issued to add the right of the Letter of Credit Issuing Bank or PG&E to purchase any Letter of Credit Backed PC Bonds in lieu of redemption and to cause such purchased Letter of Credit Backed PC Bonds to be registered in the name of the respective Letter of Credit Issuing Bank or in the name of PG&E subject to a first lien security interest in favor of the respective Letter of Credit Issuing Bank to secure the related reimbursement obligation of PG&E; provided that, if certain Termination Events occur, PG&E will not, without the prior written consent of the respective Letter of Credit Issuing Bank, have the right to convert a mandatory redemption of Letter of Credit Backed PC Bonds into a purchase in lieu of redemption in accordance with the proposed amended Loan Agreement or Indenture.

Finally, in the event that a plan of reorganization which provides for the treatment of Allowed Letter of Credit Bank Claims in the manner described in the Term Sheet or for alternative treatment of Allowed Letter of Credit Bank Claims which is acceptable to the Letter of Credit Issuing Banks does not become effective on or before June 1, 2003, then each Letter of Credit Issuing Bank shall have the right, but not the obligation, to cause the related series of Letter of Credit Backed PC Bonds to be tendered for purchase through a draw upon the respective Letter of Credit and to instruct the respective Bond Trustee to either register the purchased Letter of Credit Backed PC Bonds in the name of the Letter of

Credit Issuing Bank or, at the direction of the Letter of Credit Issuing Bank, in the name of PG&E subject to a first lien security interest in favor of the respective Letter of Credit Issuing Bank to additionally secure the obligations of PG&E under the related Reimbursement Agreement, and shall not thereafter take any action which would cause the related series of Letter of Credit Backed PC Bonds to be called for redemption unless certain Termination Events occur.

Explanation of Purchase in Lieu of Redemption: For United States federal income tax purposes, Letter of Credit Backed PC Bonds which have been purchased, rather than redeemed or cancelled, remain outstanding. However, the cooperation of the Letter of Credit Issuing Banks and the Banks is necessary in order to provide a mechanism by which the Letter of Credit Backed PC Bonds can be purchased. Thus, pursuant to the terms of the Term Sheet, PG&E and the Letter of Credit Issuing Banks have agreed to cooperate in a mutual attempt to amend the related bond documents to permit the Letter of Credit Issuing Banks to purchase the Letter of Credit Backed PC Bonds under certain circumstances in which the Letter of Credit Backed PC Bonds would otherwise be subject to redemption and cancellation. Such amendments to the respective Loan Agreements and Indentures would not be adverse to the interests of the holders of Letter of Credit Backed PC Bonds and would enhance PG&E's ability to maintain the benefits of the tax-exempt financing provided by the Letter of Credit Backed PC Bonds by facilitating the orderly purchase of outstanding Letter of Credit Backed PC Bonds in certain circumstances.

The amendments to the bond documents proposed in the Term Sheet would also grant the Letter of Credit Issuing Banks the right, but not the obligation, to cause a purchase of Letter of Credit Backed PC Bonds on or after June 1, 2003, if a plan of reorganization which provides for the treatment of Allowed Letter of Credit Bank Claims in the manner described in the Term Sheet or for alternative treatment of Allowed Letter of Credit Bank Claims which is acceptable to the Letter of Credit Issuing Banks does not become effective on or before such date. This provision is again similar to the provision the Debtor agreed to in the Prior Term Sheet except that it extends the date before which the Letter of Credit

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Issuing Banks are permitted to exercise the purchase right from June 30, 2002 as provided in the Prior Term Sheet to June 1, 2003, thus again granting the Debtor additional time to confirm and consummate its plan of reorganization while maintaining the Letter of Credit Backed PC Bonds outstanding at the tax-exempt rate.

C. <u>Treatment of Allowed Letter of Credit Bank Claims.</u>

<u>Proposed Plan Treatment:</u> The Term Sheet provides that the plan of reorganization of PG&E will provide that on the Effective Date one of the following shall occur with respect to each series of Letter of Credit Backed PC Bonds and its respective Letter of Credit, at the option of the Debtor separately for each series of Letter of Credit Backed PC Bonds:

> <u>Purchase Option</u>: The respective series of Letter of Credit Backed PC Bonds shall be called for mandatory tender in accordance with the terms of the respective Indenture and shall be purchased by the respective Bond Trustee through a draw on the related Letter of Credit and, at the option of the respective Letter of Credit Issuing Bank, shall either be registered in the name of the respective Letter of Credit Issuing Bank or in the name of the Debtor subject to a first lien security interest in favor of the respective Letter of Credit Issuing Bank to additionally secure the obligations of the Debtor under the related Reimbursement Agreement.
>
> On the Effective Date, to the extent that the Letter of Credit Issuing Bank and the Banks have not been reimbursed therefor, the Letter of Credit Issuing Bank will receive Cash in an amount equal to the sum of (i) the interest portion of the purchase price of the tendered Letter of Credit Backed PC Bonds paid out of a draw on the respective Letter of Credit, and (ii) the aggregate amount paid by the respective Letter of Credit Issuing Bank to the respective Bond Trustee under the terms of the applicable Letter of Credit with respect to the payment of the interest on the respective Letter of Credit Backed PC Bonds during the period from the date 10 days after the Date of this Motion to and including the last scheduled interest payment date

on such Letter of Credit Backed PC Bonds preceding the Effective Date, together with interest at the non-default rate due on such amounts to the extent provided in the respective Reimbursement Agreement.

On the Effective Date, the Letter of Credit Issuing Bank shall transfer the related Letter of Credit Backed PC Bonds in the aggregate principal amount as set forth on Schedule 1 attached hereto to the Debtor or its assignee free and clear of all liens.

On the Effective Date, the Letter of Credit Issuing Bank will receive (i) Cash in an amount equal to the principal portion of the purchase price of the tendered Letter of Credit Backed PC Bonds paid out of a draw on the respective Letter of Credit, and (ii) a fee (the "Purchase Option Incentive Fee") in an amount equal to 0.4% of the principal portion of the purchase price of the tendered Letter of Credit Backed PC Bonds paid out of a draw on the respective Letter of Credit.

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- or -

Remarketing Option: The respective series of Letter of Credit Backed PC Bonds shall be called for mandatory tender in accordance with the terms of the respective Indenture and shall be purchased by the respective Bond Trustee through a draw on the related Letter of Credit. The Debtor will then either (i) provide or cause to be provided to the respective Bond Trustee an alternative "Credit Facility" pursuant to the terms of the respective Indenture in lieu of the existing Letter of Credit, or (ii) obtain the consent of the Issuer to remarket the respective series of Letter of Credit Backed PC Bonds without credit enhancement in accordance with the terms of the applicable Indenture. In either event the respective series of Letter of Credit Backed PC Bonds shall be remarketed, at par, in accordance with the terms of the Indenture and the other PC Bond Documents.

In such event, on the Effective Date, the Letter of Credit Issuing Bank will receive, to the extent that the Letter of Credit Bank has not been reimbursed therefor (i) from the Debtor, Cash in an amount equal to the sum of (A) the interest portion of the purchase price of the tendered Letter of Credit Backed PC Bonds paid out of a draw on the respective Letter of Credit, and (B) the aggregate amount paid by the respective Letter of Credit Issuing Bank to the respective Bond Trustee under the terms of the applicable Letter of Credit with respect to the payment of the interest on the respective Letter of Credit Backed PC Bonds during the period from the date 10 days after the date of this Motion to and including the last scheduled interest payment date on such Letter of Credit Backed PC Bonds preceding the Effective Date, together with interest at the non-default rate due on such amounts to the extent provided in the respective Reimbursement Agreement, (ii) from the Debtor, a fee (the "Remarketing Option Incentive Fee") in an amount equal to either (1) 0.5% of the aggregate principal amount of the respective Letter of Credit Backed PC Bonds remarketed on the Effective Date the payment of the principal of and interest on which are secured by either a replacement Letter of Credit, with a term of not less then one year from the Effective Date, delivered to the Bond Trustee in accordance with the terms of the respective Indenture upon terms acceptable to the Debtor or an extension of the existing Letter of Credit delivered to the Bond Trustee in accordance with the terms of the respective Indenture upon terms acceptable to the Debtor, or (2) 0.4% of the aggregate principal amount of the respective Letter of Credit Backed PC Bonds remarketed on the Effective Date the payment of the principal of and interest on which are not secured by such a Letter of Credit, and (iii) from the Bond Trustee, an amount equal to the principal portion of the purchase price of the tendered Letter of Credit Backed PC Bonds paid out of a draw on the respective Letter of Credit, which amount shall be paid from the remarketing proceeds of the respective Letter of Credit Backed PC Bonds in accordance with the terms of the respective Indenture.

-or-

<u>No Bonds Option</u>: With respect to each Letter of Credit Issuing Bank and the related Banks, if any, in the event that neither the Purchase Option nor the Remarketing Option, as applicable, can be consummated or the respective series of Letter of Credit

Backed PC Bonds are redeemed on or prior to the Effective Date as the result of the expiration of the respective Letter of Credit or otherwise, then at the option of the Debtor separately for each Letter of Credit Bank Claim (as defined in the Amended Plan) and Reimbursement Agreement, either:

(A) On the Effective Date, the Letter of Credit Issuing Bank will receive Cash in an amount equal to the sum of (i) the principal portion of the redemption price of the redeemed Letter of Credit Backed PC Bonds paid out of a draw on the respective Letter of Credit (the "Principal Reimbursement") and (ii) any and all accrued and unpaid interest owing to the Letter of Credit Issuing Bank in respect of such Principal Reimbursement, at a fluctuating rate of interest, in accordance with the terms of the applicable Reimbursement Agreement;

-or-

(B) On the Effective Date, the Letter of Credit Issuing Bank shall sell, transfer and assign to the Debtor or its assignee, without recourse, all of the Letter of Credit Issuing Bank's and the related Banks' rights, title and interest in the applicable Letter of Credit Bank Claim and Reimbursement Agreement, including, but not limited to, the right to receive repayment of the Principal Reimbursement in the aggregate principal amount as set forth on Schedule 1 to the Term Sheet, together the right to receive payment of interest thereon as set forth in the Reimbursement Agreement, free and clear of all liens. On the Effective Date, the Debtor or its assignee shall purchase from the Letter of Credit Issuing Bank and the related Banks, if any, all of their rights, title and interest in the applicable Letter of Credit Bank Claim and Reimbursement Agreement for a purchase price in Cash in an amount equal to the sum of (i) respective Principal Reimbursement and (ii) any and all accrued and unpaid interest owing to the Letter of Credit Issuing Bank in respect of such Principal Reimbursement, at a fluctuating rate of interest, in accordance with the terms of the applicable Reimbursement Agreement;

In addition to the foregoing with respect to the No Bond Option, if (i) the Letter of

Credit Issuing Bank maintains its Letter of Credit outstanding in the stated amount set forth on Schedule 1 attached to the Term Sheet through the Effective Date and does not provide the Bond Trustee with notice of default under its Reimbursement Agreement or non-reinstatement of its Letter of Credit or take any other action which would result in the redemption, either in whole or in part, of the outstanding Letter of Credit Backed PC Bonds without the prior written consent of the Debtor, and (ii) the Letter of Credit Issuing Bank and each of the related Banks, if any, take all action reasonably required by the Debtor to keep the Letter of Credit Backed PC Bonds outstanding and to facilitate either the Purchase Option or the Remarketing Option, as applicable, including, without limitation, giving direction to the Bond Trustee, providing commercially reasonably indemnification to the Issuer and Bond Trustee, and using their best efforts to consummate the proposed amendments to the terms of the Letter of Credit Backed PC Bonds as set forth herein and to consummate either the Purchase Option or the Remarketing Option as applicable, so as to maintain for the Debtor the benefits of the tax-exempt financing provided by the related series of Letter of Credit Backed PC Bonds, then, on the Effective Date (A) in the event that the Letter of Credit Backed PC Bonds were redeemed prior to the Effective Date for reasons beyond the control of the Letter of Credit Issuing Bank, the Letter of Credit Issuing Bank will receive from the Debtor, a fee in an amount equal to 0.05% of the principal portion of the redemption price of the redeemed Letter of Credit Backed PC Bonds paid out of a draw on the respective Letter of Credit, and (B) in the event that the Letter of Credit Backed PC Bonds are redeemed on the Effective Date for reasons beyond the control of the Letter of Credit Issuing Bank, the Letter of Credit Issuing Bank will receive from the Debtor, a fee (the "No Bonds Option Fee") in an amount equal to 0.10% of the principal portion of the redemption price of the redeemed Letter of Credit Backed PC Bonds paid out of a draw on the respective Letter of Credit.

In addition, regardless of the treatment option selected by the Debtor, under the terms of the Term Sheet, in the event that on or prior to the Effective Date, the Amended Plan is further amended by the Debtor to increase the amount payable to the holders of Prior Bond Claims or General Unsecured Claims (as defined in the Amended Plan) on the Effective Date, then on the Effective Date of the Debtor's Amended Plan (as so further amended), the Debtor would be required to pay to each Letter of Credit Issuing Bank an additional fee in an amount, to the extent set forth in the Term Sheet, proportionately equal to the greater of (i) the average additional cash amounts that holders of Prior Bond Claims would receive on the Effective Date in excess of the amount they would have received under the terms of the Amended Plan prior to such amendments, or (ii) the average additional cash amounts that holders of General Unsecured Claims would receive on the Effective Date in excess of the amount they would have received under the terms of the Amended Plan prior to such amendments.

<u>Explanation of Proposed Plan Treatment:</u> The Term Sheet provides that the plan of reorganization propounded by PG&E will provide for the treatment of Allowed Letter of Credit Bank Claims (as defined in the Amended Plan) in substantially the manner provided in the Prior Term Sheet and in PG&E's Amended Plan with the following three exceptions:

First, that portion of Allowed Letter of Credit Bank Claims that were to be satisfied by the delivery of long-term notes under the Prior Term Sheet and the Amended Plan, will instead be paid in Cash on the Effective Date;

Second, Allowed Letter of Credit Bank Claims with respect to Letters of Credit that may hereafter be drawn for the payment of the redemption price of Letter of Credit Backed PC Bonds will not be subject to conversion to Prior Bond Claims (Class 4f) as provided in the Prior Term Sheet and the Amended Plan, but will instead be treated under the No Bonds Option as described above; and

Finally, the Term Sheet adds the payment of certain fees to the treatment of Allowed Letter of Credit Bank Claims provided in the Prior Term Sheet and Amended Plan in decreasing amounts from the Remarketing Option Incentive Fee, to the Purchase Option Incentive Fee, to the No Bonds Option Fee, in order to induce the Letter of Credit Issuing Banks to (i) maintain their Letter of Credits securing Letter of Credit Backed PC Bonds that

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accrue interest at tax-exempt interest rates through the Effective Date, and (ii) use their best efforts to facilitate those outcomes that are most favorable to the Debtor's estate through the Effective Date and thereafter to the Reorganized Debtor.

In addition, regardless of the treatment option selected by the Debtor, the Term Sheet provides that in the event the that on or prior to the Effective Date, the Amended Plan is further amended by the Debtor to increase the amount payable to the holders of Prior Bond Claims or General Unsecured Claims on the Effective Date, then on the Effective Date of the Debtor's plan of reorganization the Debtor would be required to pay to each Letter of Credit Issuing Bank an additional fee in an amount, to the extent set forth in the Term Sheet, proportionately equal to the greater of (i) the average additional cash amounts that holders of Prior Bond Claims would receive on the Effective Date in excess of the amount they would have received under the terms of the Amended Plan prior to such amendments, or (ii) the average additional cash amounts that holders of General Unsecured Claims would receive on the Effective Date in excess of the amount they would have received under the terms of the Amended Plan prior to such amendments. The Debtor has agreed to pay such additional fees in the event that it elects to so amend its plan of reorganization as an inducement to the Letter of Credit Banks to enter into the Term Sheet and to extend the term of their forbearance as described above.

The fees payable by PG&E under the terms of the Term Sheet on the Effective Date as a part of the treatment of Allowed Letter of Credit Bank Claims are, in the opinion of PG&E, reasonable compensation to the Letter of Credit Issuing Banks for their agreements under the provisions of the Term Sheet to continue to forbear from the exercise of remedies under their respective Reimbursement Agreements for an extended period as described above, and will give the Letter of Credit Banks the necessary financial incentive to use their best efforts to assist PG&E in its efforts to secure the benefits of the tax-exempt financing provided by the Letter of Credit Backed PC Bonds for its estate and for the reorganized Debtor. Even after the payment of all of the increased fees set forth in the Term Sheet, PG&E will continue to realize substantial interest cost savings by maintaining the benefits of the outstanding tax-exempt financing provided by the Letter of Credit Backed PC Bonds, which cost savings more than offset the cost of the fees. Under the current circumstances, the Debtor believes that the increased total letter of credit fees are a reasonable and necessary component of any agreement to extend the forbearance period.

Under the provisions of the Term Sheet, if a plan of reorganization were to be confirmed in this case which did not provide for either (i) the treatment of Allowed Letter of Credit Bank Claims in the manner set forth in the Amended Plan with the refinements set forth in the Term Sheet, or (ii) alternative treatment of Allowed Letter of Credit Bank Claims which was acceptable to the Letter of Credit Issuing Banks, then a Termination Event would be deemed to have occurred and the Letter of Credit Issuing Banks would no longer be required to forbear from the exercise of remedies under their Reimbursement Agreements that could result in the redemption and cancellation of the Letter of Credit Backed PC Bonds and the concomitant loss to PG&E of the valuable tax-free financing provided by such bonds.

The proposed treatment of the Allowed Letter of Credit Bank Claims as set forth in the Amended Plan with the refinements set forth in the Term Sheet are intended to, among other things, allow PG&E and the Reorganized Debtor the ability to maintain the benefits of the tax-exempt financing provided by the Letter of Credit Backed PC Bonds both through and after the Effective Date.

IV. THE COURT SHOULD APPROVE THE DEBTOR'S EXECUTION OF AND PERFORMANCE UNDER THE TERM SHEET BECAUSE IT IS IN THE BEST INTEREST OF THE DEBTOR AND ITS ESTATE.

The Court should approve PG&E's execution of and performance under the Term Sheet in order to provide PG&E with some additional time it may need to confirm its plan of reorganization while both maintaining the benefits of the tax-exempt financing provided by the Letter of Credit Backed PC Bonds for the Debtor's bankruptcy estate, and giving the Debtor the opportunity to secure the continuing benefits of such tax-exempt financing for the reorganized Debtor.

The tax-exempt financing provided by the Letter of Credit Backed PC Bonds provide a substantial interest cost savings to PG&E (and will provide such savings to the Reorganized Debtor) over the cost of alternative conventional taxable financing. As such, the tax-exempt bond financing is an asset of the bankruptcy estate that, in the opinion of PG&E, is best preserved through the transactions contemplated in the Term Sheet.

PG&E believes that the benefits of the extended forbearance offered by the Letter of Credit Issuing Banks and the other agreements by the Letter of Credit Issuing Banks set forth in the Term Sheet, together with the net interest cost savings that will be realized by the Debtor through the current reimbursement of draws on the Letters of Credit for the payment of interest on the related Letter of Credit Backed PC Bonds, outweigh any concessions made by PG&E in the Term Sheet. Further, the revised treatment of Letter of Credit Bank Claims as provided in the Term Sheet will provide financial incentives to the Letter of Credit Issuing Banks to both (i) maintain their Letters of Credit securing Letter of Credit Backed PC Bonds at tax-exempt rates through the Effective Date, and (ii) use their best efforts to facilitate those treatment options most favorable to the Debtor and its estate.

Section 363(b) of the Bankruptcy Code authorizes a debtor in possession, after notice and a hearing, to use, sell or lease property of the estate other than in the ordinary course of business. To the extent the proposed Term Sheet encompasses the use of estate property to resolve outstanding issues with the Letter of Credit Issuing Banks and the Banks for the benefit of the estate, it is within the ambit of Section 363(b). Further, Rule 9019(a) of the Bankruptcy Rules more specifically sets forth the procedure for a settlement or a compromise of controversy. Pursuant to Rule 9019(a), a bankruptcy court may approve, after notice and a hearing, a compromise or settlement agreement entered into by a representative of a debtor's estate and a party in interest. The standard for approval of a compromise is whether the proposed settlement is "fair and equitable" and "in the best interests of the estate." See Protective Comm. for Indep. Stockholders of TNT Trailer Ferry Inc. v. Anderson, 390 U.S. 414, 424, reh'g denied, 391 U.S. 909 (1968); Official Comm. of Unsecured Creditors v. Cajun Elec. Power Coop., Inc. (In re Cajun Elec. Power Coop., Inc.), 119 F.3d 349, 355 (5th Cir. 1997).

In making such a determination, the court "need not conduct its own investigation concerning the reasonableness of the settlement" and may consider the informed judgment of the estate's representative that the settlement is fair and equitable. In re Purofied Down Prods. Corp., 150 B.R. 519, 522 (S.D.N.Y. 1993). Furthermore, the court does not "have to be convinced that the settlement is the best possible compromise or that the parties have maximized their recovery." Nellis v. Shugrue, 165 B.R. 115, 123 (S.D.N.Y. 1994). Instead, the court need only "'canvass the issues and see whether the settlement 'falls below the lowest point in the range of reasonableness.'" In re Drexel Burnham Lambert Group, Inc., 134 B.R. 493, 497 (Bankr. S.D.N.Y. 1991) (citation omitted).

For the reasons set forth above, PG&E believes the compromise reached with the Letter of Credit Issuing Bank and the Banks, as set forth in the Term Sheet, is fair and reasonable and is in the best interests of PG&E's estate. As such, PG&E believes approval of the Term Sheet is appropriate under Rule 9019.

Finally, as yet another basis for the relief requested by this Motion, Section 105(a) of the Bankruptcy Code authorizes this Court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The purpose of Section 105 is "to assure the bankruptcy courts power to take whatever action is appropriate or necessary in aid of the exercise of their jurisdiction." 2 Lawrence P. King, Collier on Bankruptcy 105.01, at 105-6 (15th ed. rev. 2000). PG&E believes that the principal creditors of the estate and other parties in interest noticed on this Motion will support the Motion because it is plainly in the best interests of the estate, and that this Court's entry of an order granting the Motion will help facilitate the efficient administration of the estate and, as the ultimate goal of a successful Chapter 11 case, a confirmable plan of reorganization. On the present facts, the Court's approval of the Motion is consistent with both the letter and spirit of the Bankruptcy Code, in general, and Section 105(a), in particular.

CONCLUSION

For all of the foregoing reasons, PG&E respectfully requests that this Court make and enter its order granting the Motion, thereby approving PG&E's execution of and performance under the terms of the Term Sheet that PG&E has provisionally entered into with the Letter of Credit Issuing Banks.

DATED: May 28, 2002

Respectfully,

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