JAMES L. LOPES (No. 63678)
JEFFREY L. SCHAFFER (No. 91404)
JANET A. NEXON (No. 104747)
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

Attorneys for Debtor and Debtor in Possession
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

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

DECLARATION OF MICHAEL J. DONNELLY IN SUPPORT OF 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

Aoo1
Add
Red Oje Mail Cnte

I, Michael J. Donnelly, declare:

1. I am the Assistant Treasurer of Pacific Gas and Electric Company, the debtor and debtor in possession in the above-captioned Chapter 11 case (the "Debtor" or "PG&E"). I make this Declaration in support of the Debtor's 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 (the "Motion"). Except as otherwise stated herein, all capitalized words and terms used herein have the same meanings ascribed to them in the Motion. I know the following of my own knowledge (except as to any matters stated on information and belief, and as to such matters, I am informed and believe they are true) and, if called upon as a witness, could and would testify competently thereto.

<u>In General</u>:

2. By the Motion, PG&E seeks the Bankruptcy 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 hereto), 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, which was granted by this Court's Order dated April 9, 2001 (hereinafter the "Prior Motion and Order").

3. 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

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

are secured by certain letters of credit, and PG&E is obligated to repay the loans by reimbursing the Letter of Credit issuing banks for all draws made on the letters of credit that are used to pay the bonds.

4. 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.

5. Under their current terms, due to certain defaults by PG&E as debtor in possession, the letter of credit issuing banks currently 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.

6. 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.

7. 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.

8. 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.

9. 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.

10. 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").

Background and Mechanics of Subject Bond Issuances:

11. 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 of its revenue bonds in aggregate principal amount of approximately $1.69 billion. As of the filing of the 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 the 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").[1]

12. 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

---

[1]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 the Motion because they are not supported by letters of credit, and they therefore do not raise the issues leading to the Term Sheet and the Motion.

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN A Professional Corporation

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.

13. 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 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.

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

14. 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.

Letter of Credit Backed PC Bonds.

15. 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.

16. 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.

17. 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 Letter of Credit 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.

18. 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.

Tax-Exempt Status of Letter of Credit Backed PC Bonds:

19. 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.

20. 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 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.[2] 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.

Post-Chapter 11 Filing Developments Re Letter of Credit Backed PC Bonds:

21. 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, 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.

22. 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.

23. 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

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

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN A Professional Corporation

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.

24. 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.

25. 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.

26. 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.

27. 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.

28. 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.

29. 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.

30. 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.

31. 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.

32. 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.

33. 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.

34. 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.

35. Pursuant to the terms of the Prior Term Sheet, each Letter of Credit Issuing Bank agreed to extend 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.

36. 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.

37. 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.

38. 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.

39. 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

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN A Professional Corporation

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.

40. 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.

41. 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.

42. 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.

43. 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.

44. 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. 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.[3] 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,

---

[3]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.

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, in the opinion of PG&E, given the substantial benefits to PG&E from this deal, such concession by PG&E was, and continues to be, minor and justified.

45. 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.

46. 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 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.

47. 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:

a. 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;

b. 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

c. 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 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.

48. In addition, regardless of the treatment option selected by the Debtor, the Term Sheet provides that 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

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN A Professional Corporation

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.

49. 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.

50. 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.

51. 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.

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN A Professional Corporation

52. 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.

53. 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.

54. 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.

I declare under penalty of perjury under the Federal laws of the United States of America that the foregoing is true and correct, and that this declaration was executed on May 28, 2002 at San Francisco, California.

Michael J. Donnelly

MICHAEL J. DONNELLY

WD 052802/1-1419903/gtf/997346/v1

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

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