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7 PACIFIC GAS AND ELECTRIC COMPANY

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UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF CALIFORNIA  
SAN FRANCISCO DIVISION

HOWARD  
RICE  
NEMEROVSKI  
CANADY  
FALK  
& RABKIN  
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In re  
PACIFIC GAS AND ELECTRIC  
COMPANY, a California corporation,  
Debtor.

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

Federal I.D. No. 94-0742640

NOTICE OF MOTION AND MOTION OF PACIFIC GAS AND  
ELECTRIC COMPANY FOR ORDER AUTHORIZING USE OF  
CASH COLLATERAL TO FACILITATE COMPLIANCE WITH  
APPLICABLE LAW; MEMORANDUM OF POINTS  
AND AUTHORITIES IN SUPPORT THEREOF

[SUPPORTING DECLARATION OF HUDSON T. MARTIN FILED SEPARATELY]

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1 NOTICE OF MOTION AND MOTION

2 PLEASE TAKE NOTICE that on July 30, 2002, at 1:30 p.m., or as soon  
3 thereafter as the matter may be heard, in the Courtroom of the Honorable Dennis Montali,  
4 located at 235 Pine Street, 22nd Floor, San Francisco, California, Pacific Gas and Electric  
5 Company, the debtor and debtor in possession in the above-captioned Chapter 11 case  
6 ("PG&E" or the "Debtor"), will and hereby does move the Court (the "Motion"), for an  
7 order pursuant to Bankruptcy Code Sections 363(b)(1) and 364(d) (11 U.S.C. §§363(b)(1)  
8 and 364(d)) authorizing PG&E to use cash collateral in order to obtain bonds or letters of  
9 credit, or to fund escrow and/or trust accounts, all as necessary to comply with California  
10 Civil Code Section 3110.5 with respect to certain PG&E construction projects, to meet  
11 certain state-imposed environmental regulations, and for other, miscellaneous purposes, all  
12 as more fully described below.

13 The Motion is based on this Notice of Motion and Motion and the Memorandum  
14 of Points and Authorities set forth below, the supporting Declaration of Hudson T. Martin  
15 ("Martin Declaration") filed herewith, the record of this case and any admissible evidence  
16 presented to the Court at or prior to the hearing on this Motion.

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

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1 MEMORANDUM OF POINTS AND AUTHORITIES

2 I.

3 FACTUAL BACKGROUND<sup>1</sup>

4  
5 A. General Background

6 PG&E is an investor-owned utility providing electric and gas services to millions  
7 of California residents and businesses. On April 6, 2001, PG&E filed a voluntary petition  
8 under Chapter 11 of the Bankruptcy Code. PG&E continues to manage and operate its  
9 business and property as a debtor in possession pursuant to Sections 1107 and 1108 of the  
10 Bankruptcy Code.<sup>2</sup> No trustee has been appointed.

11 From time to time, in the ordinary course of its business, PG&E is involved in  
12 construction projects for which PG&E must hire outside contractors for purposes of the  
13 construction. In its capital budget for the current fiscal year, PG&E has allocated substantial  
14 funds for capital expenditures, some of which are slated for construction projects for which  
15 PG&E will hire outside contractors. As described below, California has recently enacted a  
16 law which requires PG&E to provide security to the contractor for PG&E's payment  
17 obligations under certain construction projects. In order to provide such security, PG&E  
18 will need to use "cash collateral" within the meaning of Section 363 of the Bankruptcy  
19 Code. PG&E seeks authority to use up to \$24 million of cash collateral for these purposes  
20 for projects commenced in 2002.

21 In addition, PG&E is required to provide certain financial assurances under  
22 applicable state and federal laws and regulations for environmental liability associated with  
23 closure remediation and/or post-closure monitoring and maintenance and third-party  
24 compensation. While PG&E formerly was able to self-insure such liabilities, it is currently

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26 <sup>1</sup>The evidentiary basis and support for the facts set forth in this Motion are contained in  
the Martin Declaration filed concurrently herewith.

27 <sup>2</sup>Unless otherwise indicated, all statutory references in this Motion are to the United  
28 States Bankruptcy Code (Title 11 of the United States Code).

1 not able to meet the state's requirements for self-insurance, and thus is required to either  
2 provide escrow or trust accounts, letters of credit or bonds for such liabilities. PG&E could  
3 have up to \$30 million in such obligations over the next twelve months.

4 Finally, PG&E from time to time is required to provide financial assurances to  
5 various local, state and federal agencies in connection with the ordinary course of its  
6 business. Where previously PG&E provided such financial assurances in the form of  
7 performance bonds, it no longer has the ability to obtain such bonds on an unsecured basis.

8 In each instance, PG&E has determined that it will be required to post cash  
9 collateral for the required financial assurance arrangements—either to the bonding company,  
10 the letter of credit issuer, an escrow or trust account, or the direct beneficiary of the financial  
11 assurance arrangement. In general, PG&E intends to use cash escrow accounts or trust funds  
12 for these obligations whenever possible, as it believes that escrow accounts and trust funds  
13 represent the most cost-effective and readily available method for providing the necessary  
14 financial assurances.

15  
16 B. California Civil Code Section 3110.5

17 California Civil Code Section 3110.5 is a new law which became effective on  
18 January 1, 2002. The main purpose of this law is to protect contractors from the failure of an  
19 owner to pay the amount required under a construction contract. The law requires an owner  
20 who contracts for a private work of improvement for construction, alteration, addition to or  
21 repair upon real property in an amount exceeding \$5,000,000 (if the owner's interest is a fee  
22 simple interest) or \$1,000,000 (if the owner's interest is less than a fee simple interest), to  
23 provide one of three specified forms of security for the project. The security must be in the  
24 form of (i) a payment bond from a California admitted surety meeting certain credit  
25 requirements; (ii) a letter of credit from a financial institution; or (iii) a cash payment to an  
26 escrow account maintained in California in which the contractor would have a first priority  
27 security interest. The law requires collateral in the amount of 25% of the total amount of the  
28 contract if the contract is scheduled to be substantially completed within six months of

1 commencement of the work, or 15% of the total amount of the contract in all other cases.

2 In the event that PG&E decides to use a payment bond or letter of credit to meet  
3 its obligations under Section 3110.5 with respect to a particular construction contract, PG&E  
4 has determined that it will have to post cash collateral to secure its obligations to the surety  
5 or financial institution issuing such instrument. The use of an escrow account in which the  
6 contractor would have a security interest also would require PG&E to use cash collateral, but  
7 would be less expensive than the bond or letter of credit alternative arrangements.

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9 C. Environmental Regulations.

10 Under state and federal regulations, certain financial responsibility requirements  
11 are imposed on entities such as PG&E for environmental liability associated with  
12 remediation, third party compensation, closure, and/or post-closure monitoring and  
13 maintenance.<sup>3</sup> For example, PG&E is required to place \$4,425,997 in trust for the benefit of  
14 the State of California Department of Toxic Substances Control for the Diablo Canyon  
15 Power Plant and the Martin Service Center by August 1, 2002. The trust is designed to  
16 cover closure and post-closure cost estimates and third party compensation for bodily injury  
17 and property damage, at certain sites. Further, on or before August 1, 2002, PG&E must  
18 place \$1,010,000 in trust for the benefit of the State of California Water Resources Control  
19 Board for third party compensation at petroleum underground storage tank sites (pursuant to  
20 the Code of Federal Regulations, Title 40, Part 280, Subpart H and the California Code of  
21 Regulations, Title 23, Division 3, Chapter 18, Article 3). PG&E anticipates that a number of  
22 other, similar requirements may be imposed in the future.

23  
24 D. Miscellaneous Cash Deposits.

25 In addition to the categories set forth above, PG&E anticipates that it will need to

26  
27 <sup>3</sup>Applicable financial responsibility requirements for closure, post-closure, and third  
28 party compensation associated with hazardous waste facilities are contained in the California  
Code of Regulations, Title 22, Division 4.5, Chapter 14, Article 8.

1 provide additional financial assurances in the nature of cash deposits for a variety of  
2 different purposes. Examples of such purposes include requirements of governmental  
3 agencies, counties and cities in connection with applications for special licenses and permits,  
4 and requirements of the Department of Motor Vehicles in connection with the ownership  
5 and operation of PG&E's vehicle fleet, and appeal bonds. Accordingly, PG&E further seeks  
6 authority to make such miscellaneous deposits in an amount not to exceed \$10 million over  
7 the next twelve-month period.

8  
9 II.

10 PG&E SHOULD BE AUTHORIZED TO ENTER INTO THESE  
11 FINANCIAL ASSURANCE ARRANGEMENTS PURSUANT TO  
12 BANKRUPTCY CODE SECTION 364

13 PG&E seeks authority to post the cash collateral required by applicable state and  
14 Federal law, as discussed above, under Section 364(d), to the extent applicable. Although  
15 the transactions for which PG&E seeks approval are not, strictly speaking, the "obtaining of  
16 credit" or "the incurring of debt" secured by a lien, as described in Section 364(d), PG&E  
17 believes that these transactions, which involve the collateralization of obligations under  
18 relevant state and federal law, are analogous to secured credit transactions under Section  
19 364. To the extent that Section 364 is not applicable, PG&E also seeks authorization for  
20 these transactions under Section 363(b)(1), as transactions outside the ordinary course of  
21 business, as explained more fully in Section III below.

22 Bankruptcy Code Section 364(d)(1) provides as follows:

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

- 26 (A) the trustee is unable to obtain such credit otherwise; and
- 27 (B) there is adequate protection of the interest of the holder of the lien  
28 on the property of the estate on which such senior or equal lien is  
proposed to be granted." (11 U.S.C. §364(d)(1)).

29 Thus, the only statutory prerequisites for obtaining credit on a senior secured  
30 basis is that the debtor be unable to obtain such credit otherwise, and that there be adequate

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1 protection for the existing lienholder. This test is clearly satisfied in this case. As discussed  
2 above, PG&E is required under existing law to provide the financial assurances, in the form  
3 of cash collateral or other credit assurance secured by cash collateral, and is unable to  
4 provide alternative arrangements or to self-insure its liabilities, as it has in the past.

5 Further, the only existing potential lienholder, the indenture trustee for certain  
6 mortgage bonds issued by PG&E (the "Indenture Trustee"), who holds a lien on substantially  
7 all of PG&E's assets for the benefit of the mortgage bondholders, has informed the Debtor  
8 that it does not object to the use of cash collateral in the manner described above. Moreover,  
9 the Indenture Trustee's interest is fully secured and adequately protected by a substantial  
10 equity cushion. In addition to its other substantial assets, the Debtor has over \$4.2 billion in  
11 cash on hand,<sup>4</sup> while the outstanding obligation under the mortgage bond indenture is  
12 approximately \$3 billion.

13 In determining whether to approve a transaction under Section 364, courts act in  
14 their "informed discretion." In re Ames Dep't Stores, Inc., 115 B.R. 34, 37 (Bankr.  
15 S.D.N.Y. 1990). Courts have established that such discretion is to be utilized to permit the  
16 debtor's reasonable business judgment to be exercised so long as the financing agreement  
17 does not contain terms that are primarily designed to benefit the secured party at the expense  
18 of the estate or leverage the bankruptcy process. Id. at 39-40; In re Simasko Prod. Co., 47  
19 B.R. 444, 449 (D. Colo. 1985). In undertaking such analysis, courts focus on the following  
20 principal factors: proposed terms that would tilt the conduct of the bankruptcy case;  
21 prejudice, at the early stages, to the powers and rights that the Bankruptcy Code confers for  
22 the benefit of all creditors; or terms that leverage the Chapter 11 process by preventing  
23 motions by parties in interest from being decided on their merits. In re Tenney Village  
24 Co., 104 B.R. 562, 567-70 (Bankr. D.N.H. 1989); Norris Square Civic Ass'n v. St. Mary  
25 Hosp. (In re St. Mary Hosp.), 86 B.R. 393, 401-02 (Bankr. E.D. Pa. 1988); In re Crouse  
26 Group, Inc., 71 B.R. 544, 550-51 (Bankr. E.D. Pa. 1987).

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28 <sup>4</sup>See Debtor's Monthly Operating Report for May, 2002, filed herein.

1 In this case, as discussed above, PG&E seeks to provide cash collateral to comply  
2 with applicable state and federal laws and regulations. Such compliance is clearly in the  
3 best interests of the estate and is not detrimental to parties in interest in this case.  
4 Accordingly, the Court should authorize PG&E to post cash collateral or enter into  
5 alternative arrangements (such as letters of credit or performance bonds) secured by cash  
6 collateral under Section 364.

7  
8 III.

9 PG&E SHOULD BE AUTHORIZED TO ENTER INTO THE  
10 PROPOSED FINANCIAL ASSURANCE ARRANGEMENTS  
11 UNDER SECTION 363(b)(1) OF THE BANKRUPTCY CODE

12 The underlying transactions for which PG&E is seeking authority to enter into  
13 financial assurance arrangements clearly would be within the ordinary course of PG&E's  
14 business—i.e., construction of transmission and other facilities and the incurring of  
15 environmental obligations in connection with the conduct of its business. The only aspect of  
16 these transactions that deviates from PG&E's ordinary course of business is the requirement  
17 for posting financial assurances in the form of cash collateral escrow accounts, cash  
18 collateralized letters of credit, or cash collateralized performance bonds. As mentioned  
19 above, PG&E has, in the past, been able to self-insure such obligations under prevailing laws  
20 and regulations. Due to its Chapter 11 filing, PG&E is no longer eligible for such self-  
21 insurance. Accordingly, to the extent that this restriction transforms the transactions into  
22 ones that require Bankruptcy Court approval, PG&E believes that it should be authorized to  
23 enter into such transactions pursuant to Section 363(b)(1) of the Bankruptcy Code.

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

1           The burden of establishing a valid business purpose for a transaction outside the  
2 ordinary course of business falls upon the debtor. See In re Lionel Corp., 722 F.2d at 1070-  
3 71. Once the debtor has articulated a rational business justification, however, a presumption  
4 attaches that the decision was made on an informed basis, in good faith and in the honest  
5 belief that the action was in the best interest of the debtor. See, e.g., Official Comm. of  
6 Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.), 147 B.R. 650,  
7 656 (S.D.N.Y. 1992) (citing Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)).

8           As discussed in detail above, sound business justifications exist for PG&E to  
9 enter into the proposed cash collateral arrangements, and such arrangements are now  
10 required of PG&E under applicable state and federal laws and regulations. Moreover, as a  
11 debtor in possession, PG&E is required to comply with applicable state law in the operation  
12 of its property, pursuant to 28 U.S.C. Section 959(b).

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#### IV.

#### CONCLUSION

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

1. Granting the Motion;
2. Authorizing PG&E to use cash collateral in order to provide financial  
assurances as described in the Motion, such as performance bonds, letters of credit, and  
escrow and/or trust accounts, in amounts not to exceed (i) an aggregate of \$24 million for  
construction projects commenced in 2002, as necessary to comply with California Civil  
Code Section 3110.5, (ii) an aggregate of \$30 million in connection with environmental  
obligations over the next twelve months, and (iii) an aggregate of \$10 million for such  
miscellaneous financial assurance arrangements as may be necessary in order for PG&E to

1 comply with applicable state and Federal laws and regulations over the next twelve months;  
2 and

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

4 DATED: July 12, 2002

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

7  
8 By: Janet Nexon  
JANET A. NEXON

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

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