

50-275/323

1 JAMES L. LOPES (No. 63678)
2 GARY M. KAPLAN (No. 155530)
3 JULIE B. LANDAU (No. 162038)
4 HOWARD, RICE, NEMEROVSKI, CANADY,
5 FALK & RABKIN
6 A Professional Corporation
7 Three Embarcadero Center, 7th Floor
8 San Francisco, California 94111-4065
9 Telephone: 415/434-1600
10 Facsimile: 415/217-5910

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

13 UNITED STATES BANKRUPTCY COURT
14 NORTHERN DISTRICT OF CALIFORNIA
15 SAN FRANCISCO DIVISION

16 In re
17 PACIFIC GAS AND ELECTRIC
18 COMPANY, a California corporation,
19 Debtor.
20 Federal I.D. No. 94-0742640

21 Case No. 01-30923 DM
22 Chapter 11 Case
23 Date: December 23, 2002
24 Time: 1:30 p.m.
25 Place: 235 Pine Street, 22nd Floor
26 San Francisco, California
27 Judge: Hon. Dennis Montali

HOWARD
RICE
NEMEROVSKI
CANADY
FALK
& RABKIN
A Professional Corporation

28 NOTICE OF MOTION AND MOTION FOR AUTHORITY TO RESUME POWER
PROCUREMENT, INCLUDING PROCUREMENT OF THE RESIDUAL NET SHORT
POSITION AND TO INCUR POST-PETITION SECURED DEBT RELATED THERETO;
MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

[SUPPORTING DECLARATION OF ROY KUGA FILED SEPARATELY]

29
30
31
32
33
34
35
36
37
38
39
40
41
42
43
44
45
46
47
48
49
50
51
52
53
54
55
56
57
58
59
60
61
62
63
64
65
66
67
68
69
70
71
72
73
74
75
76
77
78
79
80
81
82
83
84
85
86
87
88
89
90
91
92
93
94
95
96
97
98
99
100
101
102
103
104
105
106
107
108
109
110
111
112
113
114
115
116
117
118
119
120
121
122
123
124
125
126
127
128
129
130
131
132
133
134
135
136
137
138
139
140
141
142
143
144
145
146
147
148
149
150
151
152
153
154
155
156
157
158
159
160
161
162
163
164
165
166
167
168
169
170
171
172
173
174
175
176
177
178
179
180
181
182
183
184
185
186
187
188
189
190
191
192
193
194
195
196
197
198
199
200
201
202
203
204
205
206
207
208
209
210
211
212
213
214
215
216
217
218
219
220
221
222
223
224
225
226
227
228
229
230
231
232
233
234
235
236
237
238
239
240
241
242
243
244
245
246
247
248
249
250
251
252
253
254
255
256
257
258
259
260
261
262
263
264
265
266
267
268
269
270
271
272
273
274
275
276
277
278
279
280
281
282
283
284
285
286
287
288
289
290
291
292
293
294
295
296
297
298
299
300
301
302
303
304
305
306
307
308
309
310
311
312
313
314
315
316
317
318
319
320
321
322
323
324
325
326
327
328
329
330
331
332
333
334
335
336
337
338
339
340
341
342
343
344
345
346
347
348
349
350
351
352
353
354
355
356
357
358
359
360
361
362
363
364
365
366
367
368
369
370
371
372
373
374
375
376
377
378
379
380
381
382
383
384
385
386
387
388
389
390
391
392
393
394
395
396
397
398
399
400
401
402
403
404
405
406
407
408
409
410
411
412
413
414
415
416
417
418
419
420
421
422
423
424
425
426
427
428
429
430
431
432
433
434
435
436
437
438
439
440
441
442
443
444
445
446
447
448
449
450
451
452
453
454
455
456
457
458
459
460
461
462
463
464
465
466
467
468
469
470
471
472
473
474
475
476
477
478
479
480
481
482
483
484
485
486
487
488
489
490
491
492
493
494
495
496
497
498
499
500
501
502
503
504
505
506
507
508
509
510
511
512
513
514
515
516
517
518
519
520
521
522
523
524
525
526
527
528
529
530
531
532
533
534
535
536
537
538
539
540
541
542
543
544
545
546
547
548
549
550
551
552
553
554
555
556
557
558
559
560
561
562
563
564
565
566
567
568
569
570
571
572
573
574
575
576
577
578
579
580
581
582
583
584
585
586
587
588
589
590
591
592
593
594
595
596
597
598
599
600
601
602
603
604
605
606
607
608
609
610
611
612
613
614
615
616
617
618
619
620
621
622
623
624
625
626
627
628
629
630
631
632
633
634
635
636
637
638
639
640
641
642
643
644
645
646
647
648
649
650
651
652
653
654
655
656
657
658
659
660
661
662
663
664
665
666
667
668
669
670
671
672
673
674
675
676
677
678
679
680
681
682
683
684
685
686
687
688
689
690
691
692
693
694
695
696
697
698
699
700
701
702
703
704
705
706
707
708
709
710
711
712
713
714
715
716
717
718
719
720
721
722
723
724
725
726
727
728
729
730
731
732
733
734
735
736
737
738
739
740
741
742
743
744
745
746
747
748
749
750
751
752
753
754
755
756
757
758
759
760
761
762
763
764
765
766
767
768
769
770
771
772
773
774
775
776
777
778
779
780
781
782
783
784
785
786
787
788
789
790
791
792
793
794
795
796
797
798
799
800
801
802
803
804
805
806
807
808
809
810
811
812
813
814
815
816
817
818
819
820
821
822
823
824
825
826
827
828
829
830
831
832
833
834
835
836
837
838
839
840
841
842
843
844
845
846
847
848
849
850
851
852
853
854
855
856
857
858
859
860
861
862
863
864
865
866
867
868
869
870
871
872
873
874
875
876
877
878
879
880
881
882
883
884
885
886
887
888
889
890
891
892
893
894
895
896
897
898
899
900
901
902
903
904
905
906
907
908
909
910
911
912
913
914
915
916
917
918
919
920
921
922
923
924
925
926
927
928
929
930
931
932
933
934
935
936
937
938
939
940
941
942
943
944
945
946
947
948
949
950
951
952
953
954
955
956
957
958
959
960
961
962
963
964
965
966
967
968
969
970
971
972
973
974
975
976
977
978
979
980
981
982
983
984
985
986
987
988
989
990
991
992
993
994
995
996
997
998
999
1000

TABLE OF CONTENTS

	Page
1	
2	
3	
4	
5	
6	
7	
8	
9	
10	
11	
12	
13	
14	
15	
16	
17	
18	
19	
20	
21	
22	
23	
24	
25	
26	
27	
28	
NOTICE OF MOTION AND MOTION	1
MEMORANDUM OF POINTS AND AUTHORITIES	2
INTRODUCTION	2
I. FACTUAL BACKGROUND	4
A. Background Regarding Power Procurement, the Residual Net Short Position and Related Recent Legislation.	4
B. Recent CPUC Procurement Decisions.	6
C. PG&E's Procurement Plan.	8
1. Assumptions and Conditions Applicable to PG&E's Resumption of the Power Procurement Function On An Interim Basis.	9
2. Description of Transactions Contemplated in connection with Power Procurement for 2003.	11
D. Secured Debt Requirements related to Resumption of the Procurement Function.	12
1. ISO Collateral Requirements.	13
2. Collateral Requirements Related to Power and Gas Agreements, Transmission Agreements and Financial Hedge Agreements.	13
3. Consent of Indenture Trustee.	14
II. PG&E SHOULD BE AUTHORIZED TO RESUME POWER PROCUREMENT FOR 2003 PURSUANT TO BANKRUPTCY CODE SECTION 363(b)(1)	14
III. PG&E SHOULD BE AUTHORIZED TO INCUR POST-PETITION SECURED DEBT PURSUANT TO BANKRUPTCY CODE SECTION 364	15
CONCLUSION	17

TABLE OF AUTHORITIES

Page(s)

Cases

1		
2		
3		
4		
5	<u>Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)</u> , 722 F.2d 1063 (2d Cir. 1983)	14
6	<u>In re Ames Dep't Stores, Inc.</u> , 115 B.R. 34 (Bankr. S.D.N.Y. 1990)	15
7	<u>In re Crouse Group, Inc.</u> , 71 B.R. 544 (Bankr. E.D. Pa. 1987)	16
8	<u>In re Lionel Corp.</u> , 722 F.2d at 1070	14
9	<u>In re Simasko Prod. Co.</u> , 47 B.R. 444 (D. Colo. 1985)	16
10	<u>In re Tenney Village Co., Inc.</u> , 104 B.R. 562 (Bankr. D.N.H. 1989)	16
11	<u>Norris Square Civic Ass'n v. St. Mary Hosp. (In re St. Mary Hosp.)</u> , 86 B.R. 393 (Bankr. E.D. Pa. 1988)	16
12		
13	<u>Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.)</u> , 147 B.R. 650 (S.D.N.Y. 1992)	14
14	<u>Smith v. Van Gorkom</u> , 488 A.2d 858 (Del. 1985)	14
15	<u>Stephens Indus., Inc. v. McClung</u> , 789 F.2d 386 (6th Cir. 1986)	14
16		

Statutes

17		
18		
19	Bankr. Code	
	§1107	4
	§1108	4
20	§363(b)(1)	2, 14
	§364	2, 16
21	§364(d)(1)	15
22	Bankruptcy Local Rules for the Northern District of California	
	Rule 9014-1(c)(1)	1
23	California Public Utilities Code	
24	§454.5	5
	§454.5(a)	8
25		

Other Authorities

26		
27		
28	3 Lawrence P. King, <u>Collier on Bankruptcy</u> ¶363.02[1][g] (15th ed. rev. 1998)	14

1 **MEMORANDUM OF POINTS AND AUTHORITIES**

2 Pacific Gas and Electric Company ("PG&E"), the debtor and debtor in possession
3 in the above-captioned Chapter 11 case, requests authority, pursuant to Section 363(b)(1)
4 and Section 364 of the Bankruptcy Code, to resume power procurement for 2003 and to
5 incur post-petition secured debt related thereto.

6
7 **INTRODUCTION**

8 As explained in more detail below, PG&E seeks authorization to enter into power
9 procurement transactions for calendar year 2003, including procurement to meet the
10 Residual Net Short Position (as defined below) of its retail customers and power
11 procurement-related services. Based on present conditions and assumptions, as summarized
12 below and explained in more detail at pp. 9-10 of this Motion, PG&E believes that such
13 procurement will not create a material financial risk for PG&E and its bankruptcy estate, or
14 adversely affect the feasibility of its proposed Plan of Reorganization (as amended from time
15 to time, the "Plan of Reorganization"). PG&E's ability to resume the power procurement
16 function and to meet the Residual Net Short Position is based upon: (i) recent legislation (SB
17 1976 as described below) that requires the California Public Utilities Commission ("CPUC")
18 to implement timely rate recovery mechanisms and eliminate after-the-fact reasonableness
19 reviews associated with power procurement; (ii) present conditions that indicate the Residual
20 Net Short Position will be small and wholesale prices will remain relatively stable during
21 2003, consistent with current conditions; (iii) the adoption by the CPUC of PG&E's
22 procurement plan or a plan that otherwise fully complies with and implements SB 1976 and
23 the continuing effectiveness of the various elements of such procurement plan; (iv) limited
24 procurement-related collateral requirements in order to protect against any adverse impact to
25 PG&E and its estate; and (v) transactions limited to calendar year 2003 only. In the event
26 that the CPUC modifies PG&E's procurement plan submitted to the CPUC on November 12
27 in a manner that does not comply with and fully implement SB 1976, or other conditions or
28 assumptions change or prove incorrect, PG&E reserves all rights to seek injunctive or other

1 appropriate relief from any obligation to resume procurement in the event that such
2 procurement may adversely impact its ability to confirm its Plan of Reorganization, to
3 implement the Plan of Reorganization once confirmed, or otherwise interfere with PG&E's
4 rights under the Bankruptcy Code.

5 PG&E is in bankruptcy today due to skyrocketing wholesale power prices during
6 2000 and the first quarter of 2001 and the failure of state and regulatory officials to address
7 cost recovery in a timely fashion. In order to successfully exit bankruptcy, PG&E will need
8 to have the financial strength to support power procurement for its customers, among other
9 things. PG&E's Plan of Reorganization addresses this central concern by identifying five
10 requirements for its resumption of the procurement function. The first is the requirement
11 that PG&E return to an investment grade credit rating before it starts procuring power for its
12 customers again.

13 PG&E will not regain an investment grade credit rating by January 1, 2003, when
14 the CPUC has ordered it to resume procurement. However, under current and forecast 2003
15 conditions, PG&E anticipates that it can resume the procurement function on an interim
16 basis. The 2003 Residual Net Short Position is forecast to be small, unlike the substantially
17 larger net short position in 2000 and 2001. Also, wholesale power prices are at much lower
18 levels than California experienced during the height of the energy crisis in 2000 and 2001.
19 SB 1976 has been enacted requiring the CPUC to implement prompt rate recovery
20 mechanisms, strictly limit reasonableness reviews, and mandate up-front standards and
21 procurement plan approvals.

22 In combination, these factors create a current situation where PG&E believes it
23 can resume power procurement on an interim basis. However, the interim procurement
24 PG&E proposes to undertake beginning January 1, 2003 is not an unqualified, long term
25 resumption of the procurement function. PG&E is not in a position to resume permanent,
26 on-going power procurement except under the terms specified in its Plan of Reorganization.
27 Consequently, PG&E does not believe that this Motion requires any change to its Plan of
28 Reorganization. The Plan of Reorganization's conditions for PG&E's resumption of power

1 procurement must still be satisfied before PG&E can resume the power procurement
2 function on a permanent, on-going basis.

3
4 **I. FACTUAL BACKGROUND¹**

5 PG&E filed a voluntary petition for relief under Chapter 11 of the Bankruptcy
6 Code on April 6, 2001. A trustee has not been appointed, and PG&E continues to function
7 as a debtor in possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code.

8
9 **A. Background Regarding Power Procurement, the Residual Net Short**
10 **Position and Related Recent Legislation.**

11 Due to a number of events that occurred prior to the filing of PG&E's Chapter 11
12 petition, including the downgrading of its credit ratings and resulting loss of its investment-
13 grade status, market participants were unwilling to sell power to PG&E and PG&E became
14 unable to serve its customers' net short position in early 2001.² In January 2001, the
15 California Department of Water Resources ("DWR") was authorized to purchase power to
16 maintain the continuity of supply to retail customers of PG&E and other investor owned
17 utilities (collectively, the "IOUs"). In February 2001, California Assembly Bill No. 1 of the
18 first extraordinary session ("AB 1X") was enacted into law. With the authority granted to it
19 under AB 1X, DWR entered into a large number of bilateral power contracts with third party
20 power suppliers to obtain power for the purpose of supplying the retail customers of PG&E
21 and other IOUs ("DWR Contracts"). In 2001 and 2002, DWR also purchased power in the
22 default and short-term markets operated by the California Independent System Operator
23 ("ISO") as needed to meet the utilities' customer loads not otherwise met by the utilities'

24
25 ¹ The evidentiary basis and support for the facts set forth in this Motion is contained
in the Declaration of Roy Kuga filed concurrently herewith.

26 ² For additional background regarding PG&E's inability to purchase wholesale
27 power, see Section IV.B of the Disclosure Statement for Plan of Reorganization Under
Chapter 11 of the Bankruptcy Code for Pacific Gas and Electric Company Proposed by
28 Pacific Gas and Electric Company and PG&E Corporation dated April 19, 2002 (Docket No.
6054).

1 own resources and the DWR Contracts executed prior to January 1, 2003. This additional
2 amount of power required to serve an IOU's customers, beyond the IOU's own generation
3 and power purchase contracts (including power from the DWR Contracts allocated to the
4 IOU for operational purposes, as described further below), is referred to as the "Residual Net
5 Short Position". However, AB 1X prohibited DWR from entering into new contracts to
6 purchase energy on and after January 1, 2003. In light of the large amount of power under
7 contract in the existing DWR Contracts allocated to PG&E for operational purposes, PG&E
8 anticipates that there will be a relatively small Residual Net Short Position during portions of
9 2003, as explained further below.

10 On September 24, 2002, California Senate Bill 1976 ("SB 1976") was signed into
11 law as an emergency measure, immediately making effective California Public Utilities
12 Code Section 454.5.³ SB 1976 requires the CPUC to allocate the electricity under the
13 existing DWR Contracts among the customers of the IOUs as a precondition to returning the
14 IOUs to the procurement function. SB 1976 specifically requires that each IOU submit,
15 within 60 days of the CPUC's allocation, an electricity procurement plan specifying detailed
16 plans for how the IOU intends to resume procurement of electricity for its retail customers.
17 As part of the resumption of the procurement function, the IOU would procure power for its
18 customers' needs that are not covered by the combination of the IOU's allocation of power
19 from existing DWR Contracts, and the IOU's own power resources and contracts (i.e., the
20 Residual Net Short Position). Additionally, as part of resuming procurement, the IOU would
21 sell surplus power resulting from the DWR Contracts that have been operationally allocated
22 to the IOU (referred to as the "Residual Net Long Position").⁴

23 SB 1976 requires that each procurement plan include certain features designed to
24 ensure timely rate recovery for the IOUs' costs of procurement. The critical features of SB

25 ³ California Public Utilities Code Section 454.5 is attached as Exhibit A to the Kuga
26 Declaration.

27 ⁴ The Residual Net Long Position is the amount of surplus power in PG&E's
28 combined portfolio of utility resources and DWR-allocated contracts that needs to be sold to
the market or otherwise reduced.

1 1976 include: (i) the CPUC is required to implement a rate-making mechanism that provides
2 for timely recovery of procurement costs and ensures that rates are adjusted if existing
3 revenues are not adequate to recover procurement costs; (ii) the CPUC is required to adopt
4 pre-approval or up front standard processes that allow the IOUs to know in advance and at
5 the time a procurement commitment occurs that the transactions are reasonable and fully
6 recoverable in rates without the risk of after-the-fact prudence reviews; (iii) the CPUC's
7 review of the reasonableness of utility administration of procurement contracts is limited to
8 verification of whether the utility performed in accordance with the terms of the
9 procurement contract and reasonably resolved any disputes with the supplier; and (iv) the
10 CPUC is required to evaluate the impact of an approved procurement plan on the ability of
11 the IOU to restore or maintain its investment grade creditworthiness and the CPUC is
12 prohibited from adopting elements of a plan that would impair restoration or maintenance of
13 investment grade creditworthiness.

HOWARD
RICE
NEMEROVSKI
CANADY
FALK
& RABKIN
A Professional Corporation

14 SB 1976 also requires the CPUC to create and implement a ratemaking cost
15 recovery mechanism to track the differences between recorded revenues and costs incurred
16 under an approved procurement plan. The CPUC must review, at least semi-annually, the
17 balancing accounts, and to adjust rates or order refunds, as necessary to amortize the
18 balancing account. For the period prior to January 1, 2006, SB 1976 requires the CPUC to
19 establish a schedule for amortizing the over-collections or under-collections in the power
20 procurement balancing accounts so that the aggregate over-collection or under-collection
21 reflected in the accounts does not exceed five percent of the utility's actual recorded
22 generation revenues for the prior calendar year, excluding revenues collected on behalf of
23 the DWR. This feature is referred to as the "trigger mechanism" as it requires an immediate
24 adjustment in revenues and, if necessary, rates if the disparity between procurement
25 revenues and costs grows too large. For PG&E, it is expected that the 5% threshold in SB
26 1976 results in a trigger amount of approximately \$150 million.

1 **B. Recent CPUC Procurement Decisions.**

2 To address power procurement for the period beginning January 1, 2003, the
3 CPUC instituted a proceeding entitled *Order Instituting Rulemaking to Establish Policies*
4 *and Cost Recovery Mechanisms for Generation Procurement and Renewable Resource*
5 *Development* (the "Procurement Proceedings"). On August 22, 2002, the CPUC issued
6 Decision 02-08-071 in the Procurement Proceedings. This decision sets forth procedures for
7 PG&E (and the other IOUs) to follow for an expedited procurement process for electric
8 procurement beginning January 1, 2003. Under the decision, PG&E was authorized to
9 obtain new contracts with third party suppliers by using DWR as the creditworthy purchaser
10 until such time as PG&E regains an investment-grade credit rating. Based thereon, PG&E
11 filed its Motion for Authority to enter into Certain Power Procurement Contracts on October
12 25, 2002 (Docket No. 10697), requesting authority to enter into certain power procurement
13 contracts, which motion was approved by the Court at the hearing conducted on November
14 14, 2002.

15 In addition to the August 22 decision described above, on October 24, 2002, the
16 CPUC issued its Decision 02-10-062 (the "October 24 Decision").⁵ The October 24
17 Decision requires PG&E and the other IOUs to resume power procurement responsibilities,
18 including procurement of the Residual Net Short Position, effective January 1, 2003,
19 regardless whether PG&E has regained an investment-grade credit rating, by posting
20 collateral or providing letters of credit with the ISO and suppliers where required.

21 The October 24 Decision sets forth requirements for PG&E and the other IOUs'
22 future procurement activities and requires each utility to file a short-term procurement plan
23 for 2003 on November 12, 2002 for the CPUC's review and approval. The CPUC has
24 indicated that it will act on the November 12 procurement plan at a decision conference in
25 mid-December 2002. PG&E has set the hearing on this Motion for December 23, 2002, with
26 the expectation that the CPUC will act on its procurement plan no later than December 19,

27 _____
28 ⁵ The October 24 Decision is attached as Exhibit B to the Kuga Declaration.

1 2002. This Motion is premised upon the assumption that the CPUC will approve PG&E's
2 procurement plan without any unacceptable modifications or will otherwise approve a
3 procurement plan that fully complies with SB 1976. Because PG&E will not be able to
4 assess whether the CPUC's decision on the procurement plan complies with SB 1976 until
5 mid-December, PG&E reserves all rights to supplement or modify this Motion or seek
6 injunctive or other appropriate relief from any obligation to resume procurement in the event
7 that such procurement may adversely impact its ability to confirm its Plan of Reorganization,
8 to implement the Plan of Reorganization once confirmed, or otherwise interfere with
9 PG&E's rights under the Bankruptcy Code.

10
11 **C. PG&E's Procurement Plan.**

12 In connection with the October 24 Decision, PG&E filed its short-term
13 procurement plan for 2003 with the CPUC on November 12, 2002 (the "Procurement
14 Plan").⁶ The Procurement Plan includes various elements, including: (i) a risk management
15 strategy; (ii) identification of the types of products to be procured, and types and quantities
16 of transactions proposed to meet the Residual Net Short Position and to offset the Residual
17 Net Long Position; (iii) an assessment of price risks across the utility portfolio; (iv) use of a
18 competitive bid system for new power contracts; and (v) standards and criteria to guide
19 procurement transaction cost recovery.

20
21
22
23
24 ⁶ Public Utilities Code Section 454.5(a) specifies that after approval of a procurement
25 plan for a utility, the CPUC shall allow not less than 60 days before the utility resumes
26 procurement. As the CPUC will not issue a decision on PG&E's Procurement Plan until late
27 December, the CPUC is restrained by law from ordering PG&E to procure power under the
28 plan on January 1, 2003. However, PG&E states in its Procurement Plan that it is prepared
to waive this 60-day requirement provided that the CPUC approve its Procurement Plan or a
procurement plan that otherwise fully complies with and implements SB 1976, and further
provided that PG&E receives advance authorization from this Court to resume procurement
on an interim basis for 2003.

1 With the operational allocation to PG&E of the DWR Contracts,⁷ PG&E's
2 existing power resources, and the new power procurement contracts obtained in connection
3 with the CPUC's August 22 Decision (with DWR having legal and financial responsibility
4 until PG&E regains its investment-grade credit rating), PG&E anticipates that it will have
5 sufficient energy to satisfy the bulk of its customers' power needs in 2003. For some time
6 periods in 2003, however, a Residual Net Short Position is likely to remain, primarily during
7 peak periods (such as periods with warmer weather and/or lower availability of power
8 resources). Depending on actual conditions during the year, at times PG&E will likely have
9 a Residual Net Long Position and be in a position to dispose of surplus power.

10
11 **1. Assumptions and Conditions Applicable to PG&E's Resumption of the**
12 **Power Procurement Function On An Interim Basis.**

13 The following assumptions and/or conditions are critical to PG&E's ability to
14 resume and continue procurement on an interim basis, including meeting the Residual Net
15 Short Position and managing the Residual Net Long Position. In the event that any of these
16 conditions change or assumptions prove to be incorrect, PG&E reserves the right to seek
17 injunctive or other appropriate relief from the Bankruptcy Court from any obligation to
18 resume procurement in the event that such procurement may adversely impact its ability to
19 confirm the Plan of Reorganization, to implement the Plan of Reorganization once
20 confirmed, or otherwise interfere with PG&E's rights under the Bankruptcy Code.

21 a. Procurement Limited to 2003. Since PG&E does not have an investment-
22 grade credit rating, it does not have the access to external credit needed to support long-term
23 procurement contracts and new facility projects. Thus, PG&E is seeking authority for
24 procurement solely for 2003 and will not be entering into any long-term contracts for

25
26 ⁷ DWR will continue to retain full legal title and responsibility under the allocated
27 contracts. Under the CPUC's decision regarding the allocation of the DWR Contracts, the
28 IOUs are directed solely to administer the DWR Contracts. PG&E has filed a request for
rehearing of the CPUC's decision regarding allocation of the DWR Contracts and reserves
all rights to challenge the decision.

1 procurement needs beyond 2003.⁸

2 b. Timely Cost Recovery and Prospective Reasonableness Standards. PG&E's
3 resumption of procurement is based on the assumption that the CPUC will timely and fully
4 comply with SB 1976 and will approve PG&E's Procurement Plan or otherwise approve a
5 procurement plan that fully complies with and implements SB 1976. This includes timely
6 cost recovery, including both revenue requirements and rate adjustments to enable PG&E to
7 collect its generation and power procurement costs from ratepayers on a timely basis. This
8 also includes clear, up-front, achievable standards to determine the acceptability and
9 eligibility for rate recovery of the costs of the proposed transactions, including no after-the-
10 fact reasonableness review except as allowed by SB 1976 to verify compliance with contract
11 terms and reasonable resolution of contract disputes. Consistent with SB 1976, PG&E's
12 resumption of procurement must be pursuant to a CPUC-approved procurement plan so that
13 (i) PG&E's actions may be in compliance with the approved procurement plan, and (ii) the
14 CPUC can determine if a feature or mechanism of the procurement plan would impair
15 PG&E's restoration to creditworthiness. PG&E's Procurement Plan incorporates the
16 necessary elements to ensure implementation of timely cost recovery consistent with the
17 requirements of SB 1976. It is critical that the CPUC order approving PG&E's Procurement
18 Plan approve and implement effective January 1, 2003 a ratemaking cost recovery
19 mechanism that satisfies the requirements of SB 1976, including, without limitation, the
20 "trigger" mechanism that requires the CPUC to adjust rates to the extent that current
21 revenues are inadequate to recover actual procurement costs. If CPUC action on PG&E's
22 Procurement Plan deviates from any material aspect of the Procurement Plan, PG&E will
23 need to carefully consider whether the CPUC's decision satisfies SB 1976 and other
24 conditions necessary to protect the bankruptcy estate and to support PG&E's return to an

25 _____
26 ⁸ The only exception is with respect to the Interim Procurement Contracts and
27 Renewable Energy Contracts described in the Motion for Authority to enter into Certain
28 Power Procurement Contracts filed on October 25, 2002, which contracts may extend
beyond 2003 but will be the legal and financial responsibility of DWR until such time as
PG&E regains its investment-grade credit rating.

1 investment grade credit rating.

2 c. Limited Residual Net Short Position and Market Stability. PG&E's current
3 forecast of power resources and customer loads produces a relatively small Residual Net
4 Short Position of no greater than two percent of its total load requirements based on current
5 assumptions and projections. PG&E is also assuming that the power market will remain
6 relatively stable through 2003, both as to supply availability and price.

7 d. Limited Collateral Requirements. Under anticipated conditions in 2003 and
8 with approval of PG&E's Procurement Plan by the CPUC, PG&E forecasts that its collateral
9 requirements will not exceed \$150 million.

10
11 2. Description of Transactions Contemplated in connection with Power
12 Procurement for 2003.

13 PG&E anticipates entering into the following types of transactions to procure
14 power, to meet its Residual Net Short Position and to manage its Residual Net Long Position
15 for 2003:

16 a. Purchases and Sales through CPUC-Approved Markets. PG&E intends to
17 balance its Residual Net Short and Residual Net Long Positions with the following types of
18 transactions: (i) purchases and sales of day-ahead and hour-ahead spot energy and gas, and
19 electric and gas transmission rights; (ii) purchases and sales of forward contracts for
20 electricity and gas, and electric and gas transmission rights; and (iii) purchase of electricity
21 and gas options and swaps. Examples of the types of markets contemplated include bilateral
22 contracts done through brokers or individual negotiations, or transactions executed via
23 transaction processing services or electronic exchanges such as Automatic Power Exchange
24 or Intercontinental Exchange. Examples of an option may include either a physical or
25 financial option; a physical option would give PG&E the right but not the obligation to take
26 physical delivery of electricity or gas at a fixed price, while a financial option would provide
27 for an equivalent cash flow without the need for physical delivery.

28 b. Transactions, Purchases and Sales through the ISO. Since PG&E lost its

1 investment grade credit rating, DWR has been the creditworthy party transacting with the
2 ISO to secure services under the ISO's Federal Energy Regulatory Commission approved
3 tariffs that are necessary for the transmission of power to serve PG&E's retail customers and
4 to meet its wholesale obligations. Beginning January 1, 2003, DWR will cease to procure
5 the ISO services to support PG&E's customers and wholesale obligations. Instead, PG&E
6 anticipates resuming responsibility for obtaining the ISO services to serve all its customer
7 load, including but not limited to the Residual Net Short Position. PG&E also anticipates
8 purchasing and selling limited amounts of real time energy through the ISO daily markets.
9 However, PG&E intends to satisfy its ancillary service needs through its own resources.

10 c. Inter-Utility Exchanges. Exchanges between utilities may be used to swap
11 power resources to each utility's benefit. Exchanges of peak for off-peak, or seasonal peak
12 for peak exchanges may be executed by PG&E if a suitable exchange counter-party can be
13 secured and the exchange provides cost/benefit ratios consistent with the Procurement Plan.

14 d. Purchases through Contracts with Suppliers for Gas and Electricity. PG&E
15 anticipates entering into contracts with suppliers and other counter parties through the
16 process of competitive bidding in order to purchase or sell power, gas or related services for
17 transactions where delivery will begin more than six months from the competitive bidding
18 solicitation date.

19
20 **D. Secured Debt Requirements related to Resumption of the Procurement**
21 **Function.**

22 PG&E estimates that up to \$150 million in cash may be utilized during 2003 for
23 purposes of posting collateral with the ISO and with counter parties to contracts, as
24 described below. PG&E expects to fund its collateral requirements from revenues generated
25 on and after January 1, 2003 and therefore funds needed for implementation of the Plan of
26 Reorganization should not be jeopardized. The only exception to the use of going-forward
27 revenues will be for any cash deposits to be made with the ISO (as described below) to cover
28 transactions for January 2003 only.

1 **1. ISO Collateral Requirements.**

2 Under ISO Tariff 2.2.3.2, PG&E must satisfy ISO collateral requirements in
3 order to schedule and participate in the ISO, in the absence of an investment-grade credit
4 rating. PG&E intends to satisfy this requirement through the use of cash deposits. These
5 deposits will be held in an escrow account, with the ISO having the right to monitor the
6 account and to draw from the account in the event that PG&E does not pay its ISO invoices
7 in accordance with the ISO tariff.

8 The amount of cash to be posted with the ISO is based on PG&E's net
9 outstanding and estimated liability to the ISO for the time period between the ISO's
10 provision of services and the date payment is due for such services. Based on the ISO's
11 current invoice cycle, the time period is approximately 90 days.

12
13 **2. Collateral Requirements Related to Power and Gas Agreements,**
14 **Transmission Agreements and Financial Hedge Agreements.**

15 PG&E also anticipates that parties to new power or gas purchase or sale
16 agreements, gas or electric transmission agreements, or to financial hedge agreements (such
17 as options and swaps), will demand collateral if and when the market goes against PG&E's
18 position in the contract. For example, if PG&E has a contract to buy power in Summer 2003
19 at \$40 per megawatt hour ("MWh"), and the market price moves downward to \$16 per
20 MWh, the contract could require PG&E to post cash collateral to cover the difference
21 between the contract and market prices. There may be similar collateral requirements in the
22 event of a PG&E sale of surplus power, for example where the market price for such power
23 moves upward. With respect to options, parties may require collateral equal to a portion of
24 the capacity or premium payment if they are concerned about PG&E not being able to
25 perform under the contract. With respect to all of the foregoing types of agreements, PG&E
26 will attempt to minimize any collateral requirements.

1 Sound business justifications support PG&E's decision to resume procurement of
2 power and related services, including those needed for the Residual Net Short Position and
3 Residual Net Long Position, and to enter into the transactions and agreements necessary for
4 such procurement. PG&E is only seeking authority to resume procurement for calendar year
5 2003, and on the basis that the conditions and/or assumptions described above will remain in
6 place, including timely cost recovery as provided under SB 1976 and PG&E's Procurement
7 Plan. On this basis, PG&E believes that it can resume the procurement function on an
8 interim basis while protecting its bankruptcy estate from any material financial risk.

9
10 **III.**
11 **PG&E SHOULD BE AUTHORIZED TO INCUR POST-**
12 **PETITION SECURED DEBT PURSUANT TO BANKRUPTCY**
13 **CODE SECTION 364**

14 Bankruptcy Code Section 364(d)(1) provides, in pertinent part, as follows:

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

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

22 Thus, the only statutory prerequisites for obtaining credit on a senior secured
23 basis is that the debtor be unable to obtain such credit otherwise, and that there be adequate
24 protection for the existing lienholder. This test is clearly satisfied in this case. As discussed
25 above, absent an investment-grade credit rating, PG&E cannot participate in the ISO market
26 without posting collateral; nor does PG&E believe it can negotiate all the necessary power-
27 related transactions without agreeing to post collateral. Further, the only existing potential
28 lienholder (the Indenture Trustee) is fully secured and adequately protected by a substantial
equity cushion, as has been demonstrated in previous motions filed by PG&E in this case.
Finally, PG&E anticipates that it will obtain the lienholders' consent (the Indenture Trustee)
to these post-petition liens in advance of the hearing on this Motion.

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

HOWARD
RICE
NEMEROVSKI
CANADY
FALK
& RABKIN

A Professional Corporation

15 As discussed above, PG&E seeks to deposit cash with the ISO in order to meet
16 the ISO collateral requirements, a prerequisite to participating in ISO market purchases. The
17 ISO tariff requires that PG&E post collateral, absent an investment-grade credit rating.

18 In addition, PG&E anticipates that it will not be able to negotiate all of the
19 necessary power purchase or sale contracts or other power-related transactions, without
20 collateral requirements and will therefore be required to post collateral in the event that the
21 market goes against PG&E's contract positions.

22 PG&E does not believe that the foregoing uses of cash will have any adverse
23 effect on the estate, including PG&E's ability to implement its Plan of Reorganization.
24 PG&E must meet the ISO credit requirements in order to participate in the ISO market
25 purchases, which are a necessary component to PG&E's ability to resume power
26 procurement. Further, to the extent PG&E cannot negotiate power-related contracts without
27 collateral requirements, PG&E will need authority to post collateral with contract parties as
28 another critical component of its procurement function. Accordingly, the Court should

1 authorize PG&E to incur post-petition secured debt up to \$150 million in favor of the ISO
2 and contract parties under Section 364.

4 CONCLUSION

5 As described in more detail above, the conditions and assumptions upon which
6 PG&E is proposing to resume procurement for 2003 include: (i) the CPUC's adoption of
7 PG&E's Procurement Plan or adoption of a procurement plan that otherwise fully complies
8 with and implements SB 1976 and the continuing effectiveness of the various elements of
9 such Procurement Plan; (ii) the CPUC establishing and maintaining provisions for before-
10 the-fact reasonableness standards and timely cost recovery as provided for by SB 1976; (iii)
11 PG&E's Residual Net Short Position remaining small and wholesale prices remaining stable;
12 (iv) collateral requirements remaining limited to avoid any adverse impact to PG&E and its
13 estate; and (v) transactions being limited to calendar year 2003 only. In the event these
14 continuing conditions and assumptions do not remain effective, PG&E reserves all rights to
15 seek injunctive or other appropriate relief from any obligation to resume procurement in the
16 event that such procurement may adversely impact its ability to confirm its Plan of
17 Reorganization, to implement the Plan of Reorganization once confirmed, or otherwise
18 interfere with PG&E's rights under the Bankruptcy Code.

13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

HOWARD
RICE
NEMEROVSKI
CANADY
FALK
& RABKIN
A Professional Corporation

1 Based on the foregoing, PG&E respectfully requests that the Court authorize
2 PG&E to take all action necessary to resume procurement of power and related power
3 products and services, including those needed to meet the Residual Net Short Position, for
4 2003 as described herein, to incur post-petition secured debt related thereto, and grant such
5 other and further relief as may be just and appropriate.
6

7 DATED: November 20, 2002

8 Respectfully,

9 HOWARD, RICE, NEMEROVSKI, CANADY,
10 FALK & RABKIN
11 A Professional Corporation

12 By: 
13 JULIE B. LANDAU

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

16
17
18
19
20
21
22
23
24
25
26
27
28
HOWARD
RICE
NEMEROVSKI
CANADY
FALK
& RABKIN
A Professional Corporation

WD 111902/1-1419905/Y1/1037858/v4