JAMES L. LOPES (No. 63678)
GARY M. KAPLAN (No. 155530)
JULIE B. LANDAU (No. 162038)
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

50-275/323

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

In re PACIFIC GAS AND ELECTRIC COMPANY, a California corporation, Debtor. Federal I.D. No. 94-0742640	Case No. 01 30923 DM Chapter 11 Case Date: December 23, 2002 Time: 1:30 p.m. Place: 235 Pine Street, 22nd Floor San Francisco, California

DECLARATION OF ROY M. KUGA IN SUPPORT OF MOTION FOR AUTHORITY TO RESUME POWER PROCUREMENT, INCLUDING PROCUREMENT OF THE RESIDUAL NET SHORT POSITION AND TO INCUR POST-PETITION SECURED DEBT RELATED THERETO

A001 Add: Rids Ogc Mail Center

I, Roy M. Kuga, declare as follows:

1. I am the Lead Director of Gas and Electric Supply for Pacific Gas and Electric Company ("PG&E"), a position I have held since September 2000. I have been employed by PG&E for 22 years. I make this declaration in support of PG&E's Motion for Authority to Resume Power Procurement, including Procurement of the Residual Net Short Position and to incur Post-Petition Secured Debt Related Thereto (the "Motion"). I make this declaration based on personal knowledge, except where otherwise indicated, and if called as a witness, could and would testify competently to the matters set forth herein.

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

change or prove incorrect, PG&E reserves all rights to seek injunctive or other appropriate relief from any obligation to resume procurement in the event that such procurement may adversely impact its ability to confirm its Plan of Reorganization, to implement the Plan of Reorganization once confirmed, or otherwise interfere with PG&E's rights under the Bankruptcy Code.

3. PG&E is in bankruptcy today due to skyrocketing wholesale power prices during 2000 and the first quarter of 2001 and the failure of state and regulatory officials to address cost recovery in a timely fashion. In order to successfully exit bankruptcy, PG&E will need to have the financial strength to support power procurement for its customers, among other things. PG&E's Plan of Reorganization addresses this central concern by identifying five requirements for its resumption of the procurement function. The first is the requirement that PG&E return to an investment grade credit rating before it starts procuring power for its customers again. PG&E will not regain an investment grade credit rating by January 1, 2003, when the CPUC has ordered it to resume procurement. However, under current and forecast 2003 conditions, PG&E anticipates that it can resume the procurement function on an interim basis. The 2003 Residual Net Short Position is forecast to be small, unlike the substantially larger net short position in 2000 and 2001. Also, wholesale power prices are at much lower levels than California experienced during the height of the energy crisis in 2000 and 2001. SB 1976 has been enacted requiring the CPUC to implement prompt rate recovery mechanisms, strictly limit reasonableness reviews, and mandate up-front standards and procurement plan approvals. In combination, these factors create a current situation where PG&E believes it can resume power procurement on an interim basis. However, the interim procurement PG&E proposes to undertake beginning January 1, 2003 is not an unqualified, long term resumption of the procurement function. PG&E is not in a position to resume permanent, on-going power procurement except under the terms specified in its Plan of Reorganization. Consequently, PG&E does not believe that this Motion requires any change to its Plan of Reorganization. The Plan of Reorganization's conditions for PG&E's resumption of power procurement must still be satisfied before PG&E can

resume the power procurement function on a permanent, on-going basis.

4. Due to a number of events that occurred prior to the filing of PG&E's Chapter 11 petition, including the downgrading of its credit ratings and resulting loss of its investment-grade status, market participants were unwilling to sell power to PG&E and PG&E became unable to serve its customers' net short position in early 2001. In January 2001, the California Department of Water Resources ("DWR") was authorized to purchase power to maintain the continuity of supply to retail customers of PG&E and other investor owned utilities (collectively, the "IOUs"). In February 2001, California Assembly Bill No. 1 of the first extraordinary session ("AB 1X") was enacted into law. With the authority granted to it under AB 1X, DWR entered into a large number of bilateral power contracts with third party power suppliers to obtain power for the purpose of supplying the retail customers of PG&E and other IOUs ("DWR Contracts"). In 2001 and 2002, DWR also purchased power in the default and short-term markets operated by the California Independent System Operator ("ISO") as needed to meet the utilities' customer loads not otherwise met by the utilities' own resources and the DWR Contracts executed prior to January 1, 2003. This additional amount of power required to serve an IOU's customers, beyond the IOU's own generation and power purchase contracts (including power from the DWR Contracts allocated to the IOU for operational purposes, as described further below), is referred to as the "Residual Net Short Position". However, AB 1X prohibited DWR from entering into new contracts to purchase energy on and after January 1, 2003. In light of the large amount of power under contract in the existing DWR Contracts allocated to PG&E for operational purposes, PG&E anticipates that there will be a relatively small Residual Net Short Position during portions of 2003, as explained further below.

5. On September 24, 2002, California Senate Bill 1976 ("SB 1976") was signed into law as an emergency measure, immediately making effective California Public Utilities Code Section 454.5 (a copy is attached hereto as Exhibit A). SB 1976 requires the CPUC to allocate the electricity under the existing DWR Contracts among the customers of the IOUs as a precondition to returning the IOUs to the procurement function. SB 1976

specifically requires that each IOU submit, within 60 days of the CPUC's allocation, an electricity procurement plan specifying detailed plans for how the IOU intends to resume procurement of electricity for its retail customers. As part of the resumption of the procurement function, the IOU would procure power for its customers' needs that are not covered by the combination of the IOU's allocation of power from existing DWR Contracts, and the IOU's own power resources and contracts (i.e., the Residual Net Short Position). Additionally, as part of resuming procurement, the IOU would sell surplus power resulting from the DWR Contracts that have been operationally allocated to the IOU (referred to as the "Residual Net Long Position"). The Residual Net Long Position is the amount of surplus power in PG&E's combined portfolio of utility resources and DWR-allocated contracts that needs to be sold to the market or otherwise reduced. SB 1976 requires that each procurement plan include certain features designed to ensure timely rate recovery for the IOUs' costs of procurement. The critical features of SB 1976 include: (i) the CPUC is required to implement a rate-making mechanism that provides for timely recovery of procurement costs and ensures that rates are adjusted if existing revenues are not adequate to recover procurement costs; (ii) the CPUC is required to adopt pre-approval or up front standard processes that allow the IOUs to know in advance and at the time a procurement commitment occurs that the transactions are reasonable and fully recoverable in rates without the risk of after-the-fact prudence reviews; (iii) the CPUC's review of the reasonableness of utility administration of procurement contracts is limited to verification of whether the utility performed in accordance with the terms of the procurement contract and reasonably resolved any disputes with the supplier; and (iv) the CPUC is required to evaluate the impact of an approved procurement plan on the ability of the IOU to restore or maintain its investment grade creditworthiness and the CPUC is prohibited from adopting elements of a plan that would impair restoration or maintenance of investment grade creditworthiness. SB 1976 also requires the CPUC to create and implement a ratemaking cost recovery mechanism to track the differences between recorded revenues and costs incurred under an approved procurement plan. The CPUC must review, at least semi-annually, the balancing accounts,

and to adjust rates or order refunds, as necessary to amortize the balancing account. For the period prior to January 1, 2006, SB 1976 requires the CPUC to establish a schedule for amortizing the over-collections or under-collections in the power procurement balancing accounts so that the aggregate over-collection or under-collection reflected in the accounts does not exceed five percent of the utility's actual recorded generation revenues for the prior calendar year, excluding revenues collected on behalf of the DWR. This feature is referred to as the "trigger mechanism" as it requires an immediate adjustment in revenues and, if necessary, rates if the disparity between procurement revenues and costs grows too large. For PG&E, it is expected that the 5% threshold in SB 1976 results in a trigger amount of approximately $150 million.

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

7. In addition to the August 22 decision described above, on October 24, 2002, the CPUC issued its Decision 02-10-062 (the "October 24 Decision"). A true and correct copy of the October 24 Decision is attached hereto as Exhibit B. The October 24 Decision requires PG&E and the other IOUs to resume power procurement responsibilities, including procurement of the Residual Net Short Position, effective January 1, 2003, regardless

whether PG&E has regained an investment-grade credit rating, by posting collateral or providing letters of credit with the ISO and suppliers where required. The October 24 Decision sets forth requirements for PG&E and the other IOUs' future procurement activities and requires each utility to file a short-term procurement plan for 2003 on November 12, 2002 for the CPUC's review and approval. The CPUC has indicated that it will act on the November 12 procurement plan at a decision conference in mid-December 2002. PG&E has set the hearing on the Motion for December 23, 2002, with the expectation that the CPUC will act on its procurement plan no later than December 19, 2002. The Motion is premised upon the assumption that the CPUC will approve PG&E's procurement plan without any unacceptable modifications or will otherwise approve a procurement plan that fully complies with SB 1976. Because PG&E will not be able to assess whether the CPUC's decision on the procurement plan complies with SB 1976 until mid-December, PG&E reserves all rights to supplement or modify the Motion or seek injunctive or other appropriate relief from any obligation to resume procurement in the event that such procurement may adversely impact its ability to confirm its Plan of Reorganization, to implement the Plan of Reorganization once confirmed, or otherwise interfere with PG&E's rights under the Bankruptcy Code.

8. In connection with the October 24 Decision, PG&E filed its short-term procurement plan for 2003 with the CPUC on November 12, 2002 (the "Procurement Plan"). The Procurement Plan includes various elements, including: (i) a risk management strategy; (ii) identification of the types of products to be procured, and types and quantities of transactions proposed to meet the Residual Net Short Position and to offset the Residual Net Long Position; (iii) an assessment of price risks across the utility portfolio; (iv) use of a competitive bid system for new power contracts; and (v) standards and criteria to guide procurement transaction cost recovery. Public Utilities Code Section 454.5(a) specifies that after approval of a procurement plan for a utility, the CPUC shall allow not less than 60 days before the utility resumes procurement. As the CPUC will not issue a decision on PG&E's Procurement Plan until mid-December, the CPUC is restrained by law from ordering PG&E to procure power under the 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 the Court to resume procurement on an interim basis for 2003.

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

10. DWR will continue to retain full legal title and responsibility under the allocated DWR Contracts. Under the CPUC's decision regarding the allocation of the DWR Contracts, the 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.

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

a. Procurement Limited to 2003. Since PG&E does not have an investment-grade credit rating, it does not have the access to external credit needed to support long-term

procurement contracts and new facility projects. Thus, PG&E is seeking authority for procurement solely for 2003 and will not be entering into any long-term contracts for procurement needs beyond 2003. The only exception is with respect to the Interim Procurement Contracts and Renewable Energy Contracts described in the Motion for Authority to enter into Certain 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.

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

need to carefully consider whether the CPUC's decision satisfies SB 1976 and other conditions necessary to protect the bankruptcy estate and to support PG&E's return to an investment grade credit rating.

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

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

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

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

b. Transactions, Purchases and Sales through the ISO. Since PG&E lost its investment grade credit rating, DWR has been the creditworthy party transacting with the

ISO to secure services under the ISO's Federal Energy Regulatory Commission approved tariffs that are necessary for the transmission of power to serve PG&E's retail customers and to meet its wholesale obligations. Beginning January 1, 2003, DWR will cease to procure the ISO services to support PG&E's customers and wholesale obligations. Instead, PG&E anticipates resuming responsibility for obtaining the ISO services to serve its customer load, including but not limited to the Residual Net Short Position. PG&E also anticipates purchasing and selling limited amounts of real time energy through the ISO daily markets. PG&E intends to satisfy its ancillary service needs through its own resources.

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

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

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

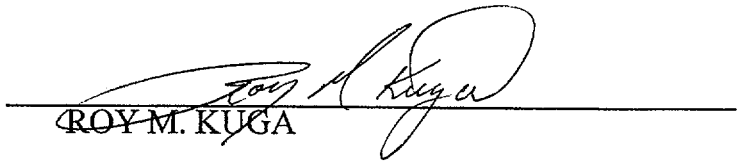
14. Under ISO Tariff 2.2.3.2, PG&E must satisfy ISO collateral requirements in order to schedule and participate in the ISO, in the absence of an investment-grade credit rating. PG&E intends to satisfy this requirement through the use of cash deposits. These deposits will be held in an escrow account, with the ISO having the right to monitor the

account and to draw from the account in the event that PG&E does not pay its ISO invoices in accordance with the ISO tariff. The amount of cash to be posted with the ISO is based on PG&E's net outstanding and estimated liability to the ISO for the time period between the ISO's provision of services and the date payment is due for such services. Based on the ISO's current invoice cycle, the time period is approximately 90 days.

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

16. The indenture trustee for certain mortgage bonds issued by PG&E (the "Indenture Trustee"), who holds a lien on substantially all of PG&E's assets for the benefit of the mortgage bondholders, is aware that PG&E is filing this Motion and that PG&E is requesting the Indenture Trustee's consent to the senior security interests described above, although such consent has not yet been obtained. PG&E will work with the Indenture Trustee to obtain such consent in advance of the hearing on this Motion. Such consent is required under the Cash Collateral Stipulation between PG&E and the Indenture Trustee (which was approved by Order entered on May 9, 2001).

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct and that this declaration was executed on November 20, 2002 at San Francisco, California.



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