50-275/323

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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

Case No. 01-30923 DM

Chapter 11 Case

Date: March 27, 2003
Time: 1:30 p.m.
Place: 235 Pine Street, 22nd Floor
San Francisco, California
Judge: Hon. Dennis Montali

DEBTOR'S NOTICE OF MOTION AND MOTION FOR AN ORDER AUTHORIZING COMPROMISE OF CLAIMS OF CALIFORNIA REGIONAL WATER QUALITY CONTROL BOARD PURSUANT TO A CONSENT JUDGMENT AND MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

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NOTICE OF MOTION AND MOTION

PLEASE TAKE NOTICE that on March 14, 2003, at 1:30 p.m., or as soon thereafter as the matter may be heard, in the Courtroom of the Honorable Dennis Montali, located at 235 Pine Street, 22nd Floor, San Francisco, California, Pacific Gas and Electric Company, the debtor and debtor in possession in the above-captioned Chapter 11 case ("PG&E" or the "Debtor"), will and hereby does move the Court for entry of an order (1) authorizing PG&E to enter into, and make payments under, a Consent Judgment resolving ongoing claims by the People of the State of California, ex rel., California Regional Water Quality Control Board, Central Coast Region ("CRWQCB"), pursuant to Rule 9019(a) of the Federal Rules of Bankruptcy Procedure and Section 105(a) of the United States Bankruptcy Code (11 U.S.C. §105(a)), and (2) modifying the automatic stay, to the extent applicable, under Section 362(a) of the United States Bankruptcy Code (11 U.S.C. §362(a)) to enable the CRWQCB to file a civil action against PG&E in the California Superior Court with respect to the claims referenced in the Consent Judgment, and simultaneously therewith, file in such court the Consent Judgment settling such claims.[1]

This Motion is based on the facts and law set forth herein (including the following Memorandum of Points and Authorities), the accompanying Declaration of Terry Nelson, the record of this case, and any evidence presented at or prior to the hearing on this Motion.

The Official Committee of Unsecured Creditors has reviewed this Motion, and its signature following the Memorandum of Points and Authorities below evidences that it has no objection to the granting of the relief sought herein.

PLEASE TAKE FURTHER NOTICE that pursuant to Rule 9014-1(c)(2) of the Local Bankruptcy Rules for the Northern District of California, any written opposition to the Motion and the relief requested therein must be filed with the Bankruptcy Court and served

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[1]We note that PG&E and the CRWQCB disagree as to whether the automatic stay would apply with respect to this matter. We do not ask the Bankruptcy Court to resolve this issue, but merely ask for a modification of the automatic stay to the extent it may be applicable.

upon appropriate parties (including counsel for PG&E, the Office of the United States Trustee and the Official Committee of Unsecured Creditors) at least five (5) days prior to the scheduled hearing date. If there is no timely objection to the requested relief, the Court may enter an order granting such relief without further hearing.

MEMORANDUM OF POINTS AND AUTHORITIES

INTRODUCTION

PG&E commenced this Chapter 11 case by the filing of a voluntary petition on April 6, 2001. PG&E continues to manage and operate its property as a debtor in possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code. PG&E submits this brief in support of its Motion For An Order Authorizing Compromise Of Claims Of California Regional Water Quality Control Board Pursuant To A Consent Judgment (the "Motion"). By the Motion, PG&E seeks authorization to enter into and be bound by, and make payments under, that certain Consent Judgment with the CRWQCB, a copy of which is attached as Exhibit A to the Declaration of Terry Nelson filed concurrently herewith (the "Nelson Decl."). In addition, the Motion seeks modification of the automatic stay, to the extent applicable, to allow a civil action, and simultaneously therewith, the Consent Judgment, to be filed in the California Superior Court for the County of Monterey (the "Superior Court"). The Consent Judgment would require PG&E to pay $5,000,000 to fund various environmental projects and administrative costs within thirty (30) days after the effective date thereof, and such timely payment is a material term and condition of the proposed settlement.

FACTUAL BACKGROUND

A. General.

PG&E owned and operated the Moss Landing Power Plant (the "Plant") from 1971 through 1998, at which time the Plant was sold to Duke Energy Moss Landing Company LLC. The Plant generates electricity using natural gas for power generation and seawater

for cooling purposes. After being used for cooling purposes, the seawater is discharged into certain waterways. In connection with the discharge of heated seawater from the Plant, PG&E held certain National Pollution Discharge Elimination System Permits ("NPDES Permits") issued by the CRWQCB. In May 2000, PG&E reported to the CRWQCB that PG&E had discharged heated cooling water from certain intake structures of the Plant into the Moss Landing Harbor in a practice known as "backflushing." These discharges occurred beginning in 1974 and ending in 1998.

The CRWQCB has taken the position that the backflushing of heated cooling water into Moss Landing Harbor violated PG&E's NPDES Permits. The CRWQCB has further claimed that such discharges violated Section 301 of the Clean Water Act (33 U.S.C. §1311) and Section 13385 of the California Water Code and that such violations could subject PG&E to substantial civil penalties. PG&E disputes these allegations.

In its Proof of Claim No. 12684 filed on October 3, 2001, the CRWQCB asserted the total amount of penalties was unknown. The CRWQCB also reserved the right in its Proof of Claim to assert administrative expense claims with respect to post-petition oversight and investigation costs incurred by it with respect to the discharges and to assert injunctive relief against PG&E regarding the alleged violations, which could include the demand that PG&E clean up or ameliorate the effects of the discharges.

B. Consent Judgment.

Since the time PG&E reported the discharges to the CRWQCB, the parties have been engaged in settlement discussions. Subject to the approval of this Court and the Superior Court, PG&E and the CRWQCB have agreed to a settlement of CRWQCB's claims as described in detail in the Consent Judgment. Under the settlement, PG&E would agree to pay $5,000,000 to fund the following environmental projects:

1. Non-Point Source Projects Fund. Within 30 days of the effectiveness of the Consent Judgment, PG&E would pay the sum of $2,850,000 into a fund to be administered by the Community Foundation for Monterey County. This would be used to fund projects to reduce sediment, nutrients, pesticides and other pollutants that enter the Elkhorn Slough and

Moss Landing Harbor or watersheds tributary to the slough or the harbor.

2. Non-Point Source Monitoring And CCAMP Funds. Within 30 days of the effectiveness of the Consent Judgment, PG&E would pay $950,000 into a fund for comprehensive monitoring to evaluate implementation and effectiveness of the activities funded by the Non-point Source Projects Fund, as well as other non-point source pollution reduction activities in Elkhorn Slough and Moss Landing Harbor and watersheds tributary to the slough and the harbor. In addition, PG&E would fund $950,000 for the Central Coast Ambient Monitoring Program (CCAMP) fund, which was established to monitor water quality in the Central Coast region.

3. Administration Fund. Within 30 days of the effectiveness of the Consent Judgment, PG&E would deposit $250,000 into an account with the State Water Resources Control Board, which would be used by the California Regional Water Quality Board, Central Coast Region for oversight of the above-referenced environmental projects funded by PG&E.

PG&E would have no obligation to form, manage, administer or further fund any of the foregoing projects.

The CRWQCB would release PG&E from all claims it may assert arising out of the discharge of heated cooling water from the Plant during the period of PG&E's ownership effective at such time as PG&E has made all of the foregoing payments.

C. The Consent Judgment Is In The Best Interest Of The Estate.

The CRWQCB claims that the discharges of heated seawater from the Plant violate Section 301 of the Clean Water Act. Section 13385(b) of the California Water Code provides for penalties of up to $25,000 for each day a Section 301 violation occurs. In addition, where the volume discharged but not cleaned up exceeds 1,000 gallons, an additional liability not to exceed $25.00 multiplied by the number of gallons in excess of 1,000 gallons may be imposed. California Water Code, §13385(b). Thus, the amount of penalties that the CRWQCB might seek to impose on PG&E could be significant. While PG&E would vigorously contest the imposition of the penalties, the ultimate outcome of

such a proceeding is uncertain and, furthermore, PG&E would have to incur substantial litigation costs in defending the matter. A lawsuit would also consume considerable management resources, diverting those persons from other business of PG&E.

In addition, it is possible that the CRWQCB would seek to assert administrative priority claims against PG&E with respect to post-petition investigation and/or remediation of the effects of the seawater discharges, or that the CRWQCB would attempt to force PG&E, through injunctive proceedings, to ameliorate the effects of the discharges in ways that could prove expensive. Although PG&E believes it would have strong arguments that the CRWQCB would not be permitted to take such actions under bankruptcy law, the matter is not entirely free from doubt and there is no certainty that PG&E would ultimately prevail in this regard.

For these and other reasons, PG&E believes that the settlement of the CRWQCB claims in accordance with the Consent Judgment is in the best interests of PG&E and its estate. PG&E also notes that the public will benefit by the settlement in that the amount paid will fund various environmental projects aimed at reducing pollution in the waters near and around the Plant.

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ARGUMENT

A. The Court Should Approve The Settlement.

Bankruptcy Rule 9019(a) empowers a bankruptcy court to approve any settlement or compromise related to a reorganization or liquidation.[2] Myers v. Martin (In re Martin), 91 F.3d 389, 393 (3d Cir. 1996); Vaughn v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 134 B.R. 499, 505 (Bankr. S.D.N.Y. 1991). Indeed, compromises and settlements are a common and favored occurrence in bankruptcy cases because they allow a debtor and its creditors to avoid the financial and other burdens

[2]Bankruptcy Rule 9019(a) simply states, in part, that "[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement." Fed. R. Bankr. P. 9019(a).

associated with litigation over contentious issues and expedite the administration of the bankruptcy estate. Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968); Martin v. Kane (In re A & C Props.), 784 F.2d 1377, 1380-81 (9th Cir. 1986).

In reviewing a proposed settlement, the bankruptcy court's inquiry focuses only upon whether the compromise is fair and equitable and in the best interest of the estate. TMT Trailer, 390 U.S. at 424; A & C Props., 784 F.2d at 1380-81; Nellis v. Shugrue, 165 B.R. 115, 121 (S.D.N.Y. 1994). In making this determination, however, the bankruptcy court is not required to conduct a mini-trial on the merits of the underlying dispute or an independent investigation into the reasonableness of the settlement. Port O'Call Inv. Co. v. Blair (In re Blair), 538 F.2d 849, 851 (9th Cir. 1976); see also In re Purofied Down Prods. Corp., 150 B.R. 519, 522 (S.D.N.Y. 1993); Drexel Burnham, 134 B.R. at 505.

Rather, the standards for such approval have been described as lenient and intended to encourage approval of settlements in bankruptcy cases. See Purofied Down, 150 B.R. at 522-23. The bankruptcy court need only canvass the legal and factual issues underpinning the compromise to ensure that the proposed settlement does not fall "'below the lowest point in the range of reasonableness.'" Nellis, 165 B.R. at 121-22 (quoting In re W.T. Grant Co., 699 F.2d 599, 608 (2d Cir. 1983)); Purofied Down, 150 B.R. at 522; Official Unsecured Creditors' Comm. of Pennsylvania Truck Lines, Inc. v. Pennsylvania Truck Lines, Inc. (In re Pennsylvania Truck Lines, Inc.), 150 B.R. 595, 598 (E.D. Pa. 1992), aff'd mem., 8 F.3d 812 (3d Cir. 1993); Drexel Burnham, 134 B.R. at 505. In making this determination, significant deference may be given to the informed judgment of the debtor in possession and its counsel that a proposed compromise is fair and equitable. Martin, 91 F.3d at 395; Nellis, 165 B.R. at 122; Purofied Down, 150 B.R. at 522-23; Drexel Burnham, 134 B.R. at 505.

Over the years, four significant criteria have been developed by the courts for consideration in determining whether a proposed settlement falls below the lowest point in the range of reasonableness: (1) the probability of success on the merits; (2) the difficulties, if any, to be encountered in the matter of collection; (3) the complexity of the litigation

involved, and the expense; inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors and a proper deference to their reasonable views. A & C Props., 784 F.2d at 1381; see also Martin, 91 F.3d at 393; Nellis, 165 B.R. at 122; Pennsylvania Truck Lines, 150 B.R. at 598. As demonstrated below, each of the applicable criteria is satisfied here.[3]

1. The Probability Of Success On The Merits.

The Consent Judgment fully and finally resolves a significant dispute between the Debtor and CRWQCB without the need for expensive, distracting and time-consuming litigation. There is no dispute that PG&E did release significant quantities of heated water into Moss Landing Harbor and that such releases were not specifically permitted by its NPDES Permits. Thus, it is likely that PG&E would ultimately incur some penalties in any enforcement action brought by the CRWQCB. Furthermore, there is no guarantee that PG&E could avoid fines in excess of the amounts it would be required to pay under the Consent Judgment.

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2. The Complexity Of The Litigation, And The Expense, Inconvenience And Delay Attending It.

The Consent Judgment resolves a complicated legal dispute involving claims under the federal Clean Water Act and the California Water Code relating to conduct by PG&E occurring over a twenty-year period. Accordingly, in agreeing to the Consent Judgment, the Debtor has made what it believes is an economically prudent business judgment that the estate's assets are better utilized in facilitating a settlement rather than defending an action brought by the CRWQCB and prosecuting or defending an appeal of such an action

3. The Settlement Is In The Best Interest Of The Creditors.

The last criteria considered by bankruptcy courts reviewing a proposed settlement is the paramount interest of creditors, with a deference to their reasonable views. A & C

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[3]The second factor typically considered by courts—difficulty associated with collection—is not applicable here.

Props., 784 F.2d at 1381; Drexel Burnham, 134 B.R. at 505-06. While a creditor's objection to a proposed settlement must be considered, it is not controlling and will not bar approval of settlements that "do not fall below the lowest point in the range of reasonableness." A & C Props., 784 F.2d at 1382; Drexel Burnham, 134 B.R. at 505.

The compromise reached in the Consent Judgment benefit not only the estate but all creditors. The Consent Judgment contains a full release of claims with respect to the discharges, which will preserve estate assets by avoiding further litigation costs and fines which potentially could be quite large.

B. The Court Should Allow Payment Of Funds Prior To Plan Confirmation Notwithstanding That CRWQCB's Claims May Be Pre-Petition Claims.

PG&E acknowledges that the Motion differs from many (although not all) of its other motions seeking authority to compromise pre-petition disputes in that the Motion also seeks authority to make the payment provided for under the settlement prior to the confirmation and implementation of a plan of reorganization in this case. There are several reasons why PG&E believes it is appropriate for the Court to authorize a settlement in this instance.

First, the CRWQCB would not agree to the settlement unless PG&E would agree to fund the environmental projects promptly (i.e., within thirty (30) days) following the Bankruptcy Court and Superior Court's approval of the Consent Judgment. Without a settlement, the CRWQCB would likely file a civil regulatory enforcement action against PG&E in the Superior Court, which would subject PG&E to substantial risk of a judgment that is materially worse than the proposed settlement provided for in the Consent Judgment. In addition, PG&E would be required to expend substantial monies in defending such a lawsuit.

While PG&E could argue that any such action by the CRWQCB would be in violation of the automatic stay (11 U.S.C. §362(a)), the CRWQCB would take the position that the action was exempt from the automatic stay pursuant to Section 362(b)(4) because it is pursuant to a governmental unit's police or regulatory power. (11 U.S.C. §362(b)(4); United States v. Nicolet, Inc., 857 F. 2d 202 (3d Cir. 1988); Penn Terra, Ltd. v. Depart. of

Environmental Resources, 733 F. 2d 267 (3d. Cir. 1984); United States v. LTV Steel Co., 269 B.R. 576 (Bankr. W.D. PA 2001); Safety-Kleen, Inc. v. So. Carolina Bd. of Health & Environmental Control, 274 F. 3d. 846 (4th Cir. 2001); In re First Alliance Mortgage Co., 263 B.R. 99 (B.A.P. 9th Cir. 2001)). Furthermore, even if such an action were not subject to the Section 362(b)(4) exception, the CRWQCB could move the Bankruptcy Court for relief from stay and, because any action would help liquidate what is now a substantial contingent claim in the bankruptcy, it is likely that the CRWQCB would obtain such relief, as long as it did not attempt to enforce any monetary judgment obtained in the action. PG&E believes that it is in the best interest of the estate to avoid a full litigation of the dispute with the CRWQCB for the reasons discussed above.

Second, if the Consent Judgment is not approved, the CRWQCB could incur costs relating to the investigation and/or remediation[4] of the non-permitted discharges which could be substantial and could then seek to recover such costs as administrative priority claims in the bankruptcy. See In re Conroy, 144 B.R. 966, 970 (Bankr. W.D. Pa. 1992) (post-petition clean-up costs incurred by governmental agency on property of the bankruptcy estate were entitled to administrative priority status where action was necessary to the preservation of the bankruptcy estate and conferred an actual post-petition benefit on it). PG&E would argue that the CRWQCB would not be entitled to any administrative priority claim for any of such expenses because the claims are based on pre-petition conduct and do not benefit the estate. See Burlington N.R.R. Co. v. Dant & Russell, Inc. (In re Dant & Russell), 853 F. 2d 700, 706 (9th Cir. 1988) (post-petition clean-up costs of lessor of property resulting from lessee's pre-petition operations and pre-petition breach of lease are pre-petition damages not entitled to administrative expense priority); In re Gull Indus., Inc. v. John Mitchell, Inc. (In re Hanna), 168 B.R. 386, 388 (B.A.P. 9th Cir. 1994) (neighbor's post-petition clean-up costs resulting from pre-petition leak from debtor's petroleum tanks should be regarded as having

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[4]PG&E believes that there are no lingering effects of the non-permitted discharges from the Plant that would need to be remediated, but the CRWQCB may have other views.

occurred pre-petition). Although PG&E believes it would prevail in the event the CRWQCB seeks to assert an administrative expense claim, PG&E recognizes that there exists case law outside of the Ninth Circuit which could be construed to favor such a claim.

Third, the CRWQCB might seek an injunction against PG&E to force it to ameliorate the effects of the pre-petition seawater releases. CRWQCB would argue, as indicated in their proof of claim, that such an injunction is not a claim and, therefore, is not subject to discharge of bankruptcy. See United States v. LTV Corp. (In re Chateaugay, Corp.), 944 F. 2d 997 (2d Cir. 1991)) (holding that any order that requires the debtor to end or ameliorate pollution currently existing or emanating from its own property is not a dischargeable claim). PG&E would argue, however, that the holding in Chateaugay and similar cases relating to injunctions does not apply in the Ninth Circuit, particularly in the current situation where the release is not ongoing and is not currently creating a dangerous condition. See In re Goodwin, 163 B.R. 825 (Bankr. D. Idaho 1993) (injunction held to be a claim subject to discharge in circumstances involving historical contamination).

In short, absent a prompt payment of the project funds by PG&E, the CRWQCB would not agree to a settlement of its claims. Absent such settlement, it is likely that PG&E would be engaged in an extended and expensive litigation, the ultimate result of which could be significantly worse for PG&E than the settlement proposed in the Consent Judgment. In addition, there is some degree of uncertainty as to whether PG&E would be forced to expend funds, in addition to funds expended in defending any litigation, to pay administrative priority claims of CRWQCB or to pay the costs of investigating and/or ameliorating the effects of the seawater discharges pursuant to an injunction. Thus, PG&E believes that it is in the best interest of the estate to agree to the Consent Judgment and to pay the amounts provided under the Consent Judgment.

Finally, PG&E notes that both of the competing reorganization plans proposed in this case provide for the payment in full of all pre-petition claims. Therefore, the early payment of the CRWQCB claim by virtue of the funding of the environmental projects would not have a material effect on other creditors or the estate.

C. Payment Of Potential Pre-Petition Claims Pursuant To Consent Judgment Should Be Authorized Pursuant To Section 105 Of The Bankruptcy Code And The Court's Inherent Equitable Powers.

As discussed above, the proposed settlement may be deemed to involve the payment of a pre-petition claim prior to the implementation of a confirmed plan of reorganization in this case. To the extent that Bankruptcy Rule 9109(a) would not authorize such a payment, Section 105(a) of the Bankruptcy Code may be relied on for such authority. Section 105(a) authorizes a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The purpose of Section 105 is "to assure the bankruptcy courts' power to take whatever action is appropriate or necessary in aide of the exercise of their jurisdiction." 2 Lawrence P. King, Collier on Bankruptcy §105.01 at 105-6 (15th ed. rev. 2000). For the reason stated above, the proposed settlement embodied in the Consent Judgment, including the prompt funding of $5 million for the environmental monitoring programs described above, is in the best interests of the Debtor and its estate. Accordingly, if for any reason this Court determines that the prompt funding of the $5,000,000 by PG&E called for pursuant to the Consent Judgment is not authorized pursuant to Bankruptcy Rule 9109(a), PG&E requests that the Court authorize such payment pursuant to the Court's authority and discretion under Section 105(a) of the Bankruptcy Code.

CONCLUSION

The Debtor has carefully considered the risks, complexity and expense associated with further litigation of the disputes between it and the CRWQCB. In the Debtor's sound business judgment, these factors tip the scale heavily in favor of approval of the proposed Consent Judgment as fair, reasonable and equitable and in the best interests of the estate and its constituencies. For these reasons, the Debtor respectfully requests that the Court grant its Motion and approve the Consent Judgment in the form attached as Exhibit 1 to the Nelson Declaration and the modification of the automatic stay, to the extent applicable, to allow the filing of the action and, simultaneously therewith, the Consent Judgment.

DATED: February 11, 2003.

Respectfully,

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A Professional Corporation

By: _____
JEFFREY L. SCHAFFER

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

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THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS HAS NO OBJECTION TO THE FOREGOING APPLICATION AND THE RELIEF REQUESTED THEREIN.

MILBANK, TWEED, HADLEY & McCLOY LLP

_____
Attorneys for OFFICIAL COMMITTEE OF UNSECURED CREDITORS

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CONCLUSION

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DATED: _____, 2003.

Respectfully,

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

By: _____
JEFFREY L. SCHAFFER

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

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