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7 PACIFIC GAS AND ELECTRIC COMPANY

8
9 UNITED STATES BANKRUPTCY COURT
10 NORTHERN DISTRICT OF CALIFORNIA
11 SAN FRANCISCO DIVISION

12 In re

13 PACIFIC GAS AND ELECTRIC
14 COMPANY, a California corporation,

15 Debtor.

16 Federal I.D. No. 94-0742640
17

Case No. 01-30923 DM

Chapter 11 Case

Date: February 26, 2004

Time: 1:30 p.m.

Place: 235 Pine Street, 22nd Floor
San Francisco, California

Judge: Hon. Dennis Montali

18
19 DECLARATION OF RAYMOND X. WELCH IN SUPPORT OF MOTION FOR
20 AUTHORITY TO ESTABLISH CASH-COLLATERALIZED LETTER OF CREDIT
PROGRAM AND FACILITY TO SECURE GAS PURCHASES, AND TO INCUR
21 SECURED DEBT RELATED THERETO
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BKRP01

1 I, Raymond X. Welch, declare:

2 1. I am the Portfolio Manager for the Gas Procurement Department of Pacific
3 Gas and Electric Company, the debtor and debtor in possession in the above-captioned
4 Chapter 11 case (the "Debtor" or "PG&E"). I make this Declaration in support of the
5 Debtor's Motion For Authority To Establish Cash-Collateralized Letter Of Credit Program
6 And Facility To Secure Gas Purchases, And To Incur Secured Debt Related Thereto (the
7 "Motion"). Except as otherwise stated herein, all capitalized words and terms used herein
8 have the same meanings ascribed to them in the Motion. I state the following from my own
9 knowledge (except as to any matters stated on information and belief, and as to such matters,
10 I am informed and believe they are true) and, if called upon as a witness, could and would
11 testify competently thereto.

12 Overview Of Requested Relief:

13 2. In order to facilitate the occurrence of the Effective Date of the confirmed
14 Plan in this case sometime approximately around the end of the first quarter of 2004, PG&E
15 seeks to terminate the GSSA so that the Gas Accounts pledged thereunder are available for
16 the financings contemplated to occur on the Effective Date. In order to terminate the GSSA
17 prior to the Effective Date and have the Existing Gas Suppliers' security interest in the Gas
18 Accounts terminated, PG&E will need to provide an alternative form of credit support for
19 the Existing Gas Suppliers for all amounts then owed under the GSSA, as well as for new
20 gas purchases that take place between the time the GSSA is terminated and the Effective
21 Date of the Plan. PG&E has determined that the issuance of irrevocable standby letters of
22 credit under the for the benefit of the Gas Suppliers is the most efficient and practicable
23 alternative form of credit support that will be acceptable to the Gas Suppliers. Thus, PG&E
24 is proposing to replace the GSSA Program with the Gas LC Program, such that the Gas
25 Suppliers will receive LCs as credit support for amounts owed them by PG&E, in lieu of the
26 Gas Accounts pledged under the GSSA.

27 3. I am informed and believe that this, in turn, requires PG&E to establish the
28 proposed Interim LC Facility with the LC Banks, so that LCs can be issued thereunder for

1 the benefit of Gas Suppliers until the Effective Date of the confirmed Plan, in the amounts
2 that are owed Existing Gas Suppliers under the GSSA at the time the GSSA is terminated,
3 plus the amount of PG&E's new gas purchases from Gas Suppliers between the time the Gas
4 LC Program is put in place and the Effective Date of the Plan. Once the Effective Date of
5 the Plan occurs, to the extent credit support is required for post-Effective Date gas
6 purchases, PG&E will post letters of credit issued under its new credit facility established
7 pursuant to Section 7.3 of the Plan.

8 4. The substitution of the proposed Interim LC Facility for the GSSA is a
9 beneficial exchange that should in no way harm PG&E's creditors pending the Effective
10 Date. This is for the simple reason that all of PG&E's obligations to the Existing Gas
11 Suppliers under the GSSA have remained oversecured pursuant to the terms of the GSSA,
12 and have always been paid and continue to be paid in full and on time. Thus, by effectively
13 substituting cash collateral for PG&E's outstanding obligations to the Existing Gas Suppliers
14 under the Gas LC Program for the oversecured security interest in Gas Accounts under the
15 GSSA Program, PG&E is actually freeing up estate assets, and more closely matching the
16 amount of security/credit support with the amount of the outstanding secured obligations.
17 Further, the amounts PG&E owes the Gas Suppliers are a function solely of the gas
18 purchases that PG&E makes, and thus are in no way driven or influenced by whether the
19 credit support device is a security interest in Gas Accounts, on the one hand, or an LC, on
20 the other.

21 5. As long as PG&E is establishing the Gas LC Program and Interim LC Facility
22 for the principal purpose of replacing the GSSA Program, PG&E, as an ancillary matter, also
23 believes it appropriate and prudent to be able to use the new program and facility to provide
24 necessary credit support for related purchases of gas transportation services on interstate gas
25 transmission pipelines. While in Chapter 11 PG&E has provided credit support for such gas
26 transportation purchases by prepaying or depositing cash when necessary. Having the
27 option of using LCs going forward until the Effective Date will have risk management
28 benefits to PG&E and the estate. The estimated maximum need for gas transportation

1 purchases outstanding at any one time is \$50 million, so PG&E by the Motion, as part of the
2 proposed Gas LC Program, requests authority to use up to a maximum of \$50 million of the
3 Interim LC Facility for the issuance of LCs to support the purchase of gas transportation
4 services.¹

5 Background of GSSA:

6 6. PG&E provides gas service to approximately 3.9 million "core" residential
7 and small business customers ("core customers") by purchasing approximately 1 billion
8 cubic feet of gas each day from gas suppliers, most of whom are located outside of
9 California. Without such purchases, PG&E cannot provide sufficient gas for heating and
10 other essential uses for its core customers.

11 7. In the months prior to February 2001, due to PG&E's deteriorating credit
12 situation resulting from the California energy crisis and fears that PG&E would be unable or
13 unwilling to pay for gas supplies on a timely basis, gas suppliers refused to sell gas to PG&E
14 on an unsecured credit basis, even under existing gas supply contracts. Gas suppliers instead
15 insisted on either prepayment or other form of payment assurance as a condition to
16 continuing to sell gas to PG&E.

17 8. Based on PG&E's inability to secure and maintain a sufficient supply of gas
18 for its core customers on an unsecured credit basis, the California Public Utilities
19 Commission, in response to an application of PG&E, authorized PG&E to pledge its Gas
20 Accounts to Gas Suppliers for PG&E's purchases of gas for core customers. Pursuant to
21 such Commission decision, on or about February 7, 2001, PG&E entered into the GSSA
22

23 ¹ Thus, of the \$400 million maximum face amount of LCs that can be outstanding
24 under the Interim LC Facility proposed by the Motion, up to \$50 million of LCs outstanding
25 at any one time could be used to support the purchase of gas transportation services. But
26 such \$50 million "sublimit" for gas transportation services is not intended or proposed to be
27 exclusively for gas transportation services, but rather can be used for core gas purchases to
28 the extent not used for the purchase of gas transportation services. For example, under the
Gas LC Program and Interim LC Facility proposed by the Motion, if PG&E had caused \$25
million of LCs to be issued and outstanding to support the purchase of gas transportation
services, PG&E could cause up to \$375 million to be issued and outstanding to support the
purchase of core gas supplies.

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1 with a number of its then-existing Gas Suppliers. This allowed for the uninterrupted flow of
2 gas purchases and deliveries, ensuring PG&E's timely payment of amounts owed to Gas
3 Suppliers for core gas supplies delivered in January 2001 and future months.

4 9. Given the importance of the GSSA to the provision of one of PG&E's
5 essential utility services, immediately after PG&E filed its Chapter 11 petition in April 2001,
6 PG&E, by an emergency motion dated April 6, 2001, sought the Bankruptcy Court's
7 approval of the GSSA and the GSSA Program. The Bankruptcy Court granted PG&E's
8 request:

9 10. Although the Commission's initial authorization of the GSSA was time-
10 limited, the Commission has extended the authorization each year without interruption in the
11 GSSA. The most recent extension expires on the earlier of (i) May 1, 2004, (ii) PG&E's
12 return to an investment grade credit rating, (iii) provision of letters of credit to the gas
13 suppliers to secure PG&E's gas purchase obligations, and (iv) expiration of specified notice
14 periods.² The Bankruptcy Court's authorization allowing PG&E to pledge its Gas Accounts
15 to Gas Suppliers pursuant to the GSSA did not specify a termination date.

16 11. While cash prepayment of Gas Suppliers is a potential alternative means of
17 procuring core gas requirements, the GSSA has been very important in minimizing PG&E's
18 credit exposure to its counterparties in a gas market that has seen both significant reductions
19

20 ² While the expiration of the Commission's current authorization on May 1, 2004
21 would seem to provide PG&E with several more months of purchasing ability under the
22 GSSA, in fact the current authorization to May 1, 2004 only allows PG&E to buy core gas
23 under the GSSA until March 2004 as a practical matter. This is because of the three-month
24 cycle of purchases, deliveries and payments, as described further in paragraphs 13-15 below.
25 For this reason, PG&E as a precautionary matter recently has filed a petition with the
26 Commission for modification of its prior decisions respecting the GSSA, to extend the
27 expiration date for the GSSA authorization from May 1, 2004 to August 1, 2004, which as a
28 practical matter would allow gas purchases to be made under the GSSA until June 2004.
Nonetheless, PG&E far prefers, for both administrative and cost-efficiency reasons, to start
transition to the Gas LC Program and Interim LC Facility in March 2004, with the aim of
fully terminating and replacing the GSSA with LCs issued pursuant to the Interim LC
Facility by the end of the first quarter of 2004. Accordingly, there is no inconsistency in
PG&E's filing of the Motion, on the one hand, and its filing of such petition with the
Commission, on the other, as the latter is simply a responsible back-up measure in the event
the Motion is not granted or, even if it is granted, the proposed Interim LC Facility cannot be
finalized and put in place as quickly as PG&E anticipates.

1 in the numbers of suppliers and concurrent deterioration in the credit ratings of those
2 suppliers who have survived. Among PG&E's current core Gas Suppliers, a number have
3 experienced credit rating downgrades and now present a credit risk in situations where
4 PG&E is otherwise required to pay prior to the gas flowing. Thus, the ability to rely on the
5 GSSA has been an important element in securing adequate core gas supplies, while at the
6 same time minimizing PG&E's credit exposure to Gas Suppliers.

7 12. Although PG&E wants to terminate the GSSA Program and the GSSA in
8 early March in order to facilitate the financings contemplated to be in place on the Effective
9 Date of the Plan, PG&E does not wish to replace the GSSA with cash prepayments for gas
10 purchases because of the materially increased credit risk to PG&E and its estate that
11 widespread cash prepayments would entail.³ Rather, PG&E by the Motion seeks to replace
12 the GSSA with LCs issued pursuant to the proposed Gas LC Program and Interim LC
13 Facility, with the LCs serving the same credit-risk-management function as the GSSA
14 arrangement.

15 Security/Payment Mechanics Under GSSA

16 13. Since its inception, the GSSA has provided security for at least three months
17 of gas supply at any given time. The monthly cycle of buying, taking delivery and paying
18 for core gas delivered for a given month spans at least three calendar months. This time span
19 results because contracting, receipt and payment for baseload gas supplies occur in different
20 months. For instance, much of the contracting activity for a specific month's gas supply
21 occurs in the month prior to the actual deliveries, during a concentrated period known as
22 "bid week." Thus, to obtain gas for April delivery, PG&E will contract for the gas in the
23 March bid week. Gas suppliers, however, will not contract with PG&E in March bid week
24

25 ³ In some instances, where it makes sense to PG&E, PG&E has prepaid for core gas
26 or escrowed payments for the benefit of a Gas Supplier rather than utilizing the GSSA, and
27 likely will continue to do so on a limited basis. But in the current environment where core
28 gas suppliers will not extend unsecured credit to PG&E, PG&E considers it prudent to
manage its risk exposure by providing alternative credit enhancement devices acceptable to
the Gas Suppliers, such as the GSSA or LCs.

1 unless they are comfortable with the security PG&E can provide to support its payments for
2 the April gas deliveries. Since normal payment for gas deliveries occurs around the 25th of
3 the month after delivery has occurred, PG&E must provide the gas suppliers with security
4 for April gas deliveries during the entire period from March bid week until the May payment
5 date. Consequently, in a given month, the GSSA has provided security to suppliers for
6 (i) the prior month's gas delivery, (ii) gas purchases being delivered within the month, and
7 (iii) gas under contract for delivery in the next month.

8 14. The dollar amount of the collateral needed for core gas purchases is
9 primarily based on this three-month gas contracting, delivery and payment cycle, because
10 that cycle determines the amount of PG&E's payment obligation for past and near-term gas
11 deliveries. In some instances, however, PG&E contracts several months in advance for core
12 gas to be delivered later in the year. An example of this situation would be multi-month
13 contracts executed in spring that also include some gas supply needed to meet higher core
14 needs in the upcoming winter. At present, a gas supplier may not enter into a multi-month
15 contract unless PG&E provides credit assurance that extends for the term of the multi-month
16 commitment. In addition, many of PG&E's month-to-month gas purchases have been with
17 the same suppliers who are parties to multi-month contracts with PG&E. So PG&E has
18 needed to maintain ongoing credit assurance with that important pool of suppliers willing to
19 do business with PG&E. Under the GSSA, the term of the PG&E's credit assurance has not
20 been an issue because the GSSA has continued in effect since February 2001 without
21 interruption.

22 15. The Interim LC facility that replaces the GSSA, then, will need to provide
23 continuity in credit assurance for the Gas Suppliers, to accommodate PG&E's repeat month-
24 to-month contracting and some multi-month contracts for core gas needed later in the year.⁴

25 _____
26 ⁴ As of January 23, 2004, PG&E has several multi-month contracts for core gas
27 supplies, with the longest one ending in October 2004. At this point in the year, PG&E
28 would normally begin initial contracting activity to begin acquiring core gas supply for the
2004-2005 winter. Early planning and procurement for winter is especially important in an
environment of volatile gas prices and supply, such as North America currently faces.

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1 For this reason, in place of the GSSA, PG&E under the proposed Interim LC Facility will
2 need to use LCs, with terms potentially extending through March 31, 2005, both for existing
3 contracts and for new core gas purchase commitments that take place between the time the
4 Gas LC Program is implemented pursuant to the Motion and the Effective Date. I am
5 informed and believe that once the Effective Date occurs, additional LCs will not be issued
6 under the authorization requested in the Motion, but rather, if and to the extent necessary,
7 will be issued under a post-Effective Date credit facility.

8 Rationale For Requested Maximum Amount Of Gas LC Program And Interim LC Facility
9 To Replace GSSA

10 16. Based on the foregoing, ending the GSSA Program by terminating the
11 GSSA, and replacing it with LCs issued pursuant to the proposed Gas LC Program and
12 Interim LC Facility, will require PG&E to post LCs in a sufficient dollar amount to cover
13 approximately three months of core gas purchases. Thus, for example, for those Gas
14 Suppliers whose security interest in Gas Accounts is replaced by LCs under the new Interim
15 LC Facility during the transition month of March 2004, LCs will be needed to cover not only
16 the not-yet-due amount for already-contracted-for February and March core gas deliveries,
17 but also contracting activity in March bid week for April gas deliveries. Accordingly, the
18 LCs would need to cover the three-month period of February through April 2004. As
19 payment for February gas deliveries is made, March gas deliveries are completed, and April
20 bid week contracting for May gas deliveries occurs, the three-month period would roll
21 forward by a month, and this cycle of LC issuances under the Interim LC Facility would
22 continue until the Effective Date of the Plan.

23 17. Based on its experience respecting core gas purchases, PG&E estimates that
24 the amount reasonably needed for this rolling three-month period will be approximately
25 \$350 to \$400 million, depending on gas prices.⁵ After taking into account the "cushion"

26 ⁵ Since the GSSA Program was instituted, the aggregate amount of gas purchases
27 secured by the GSSA during each rolling three-month period has ranged from a high of
28 approximately \$600 million to a low of approximately \$30 million. These material swings
are a function of seasonal demand factors, as well as pricing changes. The \$400 million

(continued . . .)

1 that may be required by the LC Banks (which is explained in the Declaration of Michael J.
2 Donnelly filed concurrently herewith), PG&E by the Motion therefore seeks to establish a
3 Gas LC Program and to enter into an Interim LC Facility that permits PG&E to pledge cash
4 collateral to the LC Banks of up to \$420 million to secure up to \$400 million face amount of
5 LCs outstanding at any one time that are issued to Gas Suppliers as credit support for
6 PG&E's core gas purchases.⁶

7 18. As already noted above, in addition to contracting with gas suppliers for core
8 gas, PG&E also has rights to gas transportation services on interstate gas transmission
9 pipelines, which PG&E utilizes to move gas purchased in the American southwest or in
10 Canada to its core gas load in Northern and Central California. Under their approved tariffs
11 and applicable law, the transmission pipelines have required PG&E to provide credit
12 assurance adequate to cover up to three months of its obligations to them. PG&E has
13 provided the required credit assurance to the transmission pipelines either through pre-
14 payment or cash deposits. At this point, PG&E estimates its collateral requirements in
15 connection with the purchase of gas transmission services at approximately \$50 million. In
16 order to reduce counterparty credit exposure, PG&E would prefer to provide LCs instead of
17 prepayment to certain transmission pipelines. The \$420 million maximum cash collateral
18 authorization sought in the Motion includes an estimated \$52.5 million that is the maximum
19 PG&E would anticipate using for cash-collateralized LCs to support the purchase of gas
20 transportation services as part of the Gas LC Program.⁷

21 19. Assuming the proposed Gas LC Program and Interim LC Facility are
22

23 (. . . continued)

24 authorization sought by the Motion represents PG&E's three-month estimate based on
25 probability analysis and near-term forward demand and pricing estimates.

26 ⁶ PGE emphasizes that the \$400 million figure represents the maximum amount of
27 LCs that can be outstanding at any time. Based on a variety of factors, PG&E may choose to
28 use a combination of cash and LC issuances to transition from the present secured balances
under the GSSA to the new Gas LC Program (for example, by paying one month of the
three-month cycle in cash and providing an LC for the other two months).

⁷ This \$52.5 million includes the \$50 million sublimit for the purchase of gas
transportation services, plus the up-to-5% "cushion" described in footnote 2, supra.

1 approved as a substitute for the GSSA Program and GSSA, then once the LCs under the
2 Interim LC Facility are issued to the Gas Suppliers in the respective amounts then
3 outstanding and secured under the GSSA, the GSSA will terminate and the Gas Accounts
4 will no longer be subject to the Gas Suppliers' security interest.⁸ Based on experience,
5 PG&E anticipates that the amount of LCs actually issued (and, accordingly, the amount of
6 cash collateral that will need to be posted as security with the LC Banks) will be
7 substantially less than the amount of Gas Accounts that would have been pledged under the
8 GSSA because the obligations owing to the Gas Purchasers have at all times been
9 oversecured via the GSSA. Thus, there should be no harm to the estate in substituting LCs
10 issued under the Interim LC Facility for the Gas Accounts under the GSSA.

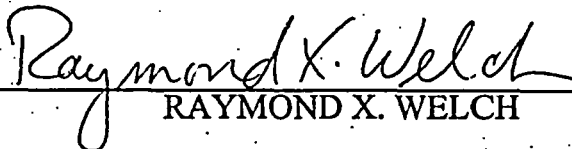
11 20. PG&E believes that because purchasing gas for its core customers is a vital
12 utility function and is part of the ordinary course of PG&E's business, the proposed
13 substitution of the GSSA Program and GSSA with the Gas LC Program and the Interim LC
14 Facility is an ordinary-course-of-business decision. Nonetheless, because of the magnitude
15 of its gas purchases and therefore the proposed Gas LC Program, and the cash collateral
16 required under the proposed Interim LC Facility, PG&E is seeking authorization by the
17

18 ⁸ While the actual mechanics of obtaining the termination of the Gas Suppliers'
19 security interest under the GSSA are still being worked out, PG&E is relatively confident
20 that if it can start issuing LCs under the proposed Interim LC Facility in early March 2004,
21 PG&E will be able to fully terminate the GSSA and free up the Gas Accounts thereunder by
22 around March 31, 2004 so that they are available for financings on the Effective Date. The
23 mechanics for obtaining and recording the termination of the security interest perfected in
24 favor of the Existing Gas Suppliers' agent under the GSSA is somewhat technical. Suffice it
25 to say, if PG&E can use most of the month of March for issuing LCs under the new Interim
26 LC Facility to obtain, on a supplier-by-supplier basis, acknowledgments of termination of
27 the GSSA by the Existing Gas Suppliers, PG&E believes it will have the requisite
28 acknowledgments in hand by around late March 2004 to cause the agent under the GSSA to
terminate of record the security interest in Gas Accounts under the GSSA, which PG&E
considers to be the point in time that the GSSA is fully terminated. PG&E notes that as the
Gas Accounts are so freed from the Gas Suppliers' security interest under the GSSA, the Gas
Accounts, pending the Effective Date of the Plan, remain subject to the lien of the Indenture
Trustee under the 1920 Mortgage, to the extent the Indenture Trustee already has a lien on
the Gas Accounts. However, pursuant to the terms of the Plan, as of the Effective Date of
the Plan the Gas Accounts will no longer be subject to any lien or security interest of the
Indenture Trustee and will therefore be available as of the Effective Date for the financings
contemplated under Section 7.3 of the Plan.

1 Motion.

2 21. Sound business justifications support PG&E's decision to terminate the
3 GSSA Program and the GSSA, and to replace them with the proposed Gas LC Program and
4 Interim LC Facility. As indicated above, authorizing PG&E to supplant the GSSA with the
5 Interim LC Facility not only does not cause any prejudice to the estate or its creditors, but on
6 the contrary has the net effect of freeing up assets for the benefit of the estate and its
7 creditors. Further, it assists PG&E in managing the credit risk that arises from prepaying
8 suppliers rather than using credit support devices such as the proposed Gas LC Program.
9 Finally, PG&E's substitution of the GSSA with the proposed Interim LC Facility is
10 appropriate planning for the Effective Date because it facilitates the simultaneous financings
11 contemplated to be in place on the Effective Date. In short, the proposed termination of the
12 GSSA and substituting in its place the Interim LC Facility is highly beneficial to the estate
13 and its creditors, and there accordingly is ample business justification for it.

14 I declare under penalty of perjury that the foregoing is true and correct, and that
15 this declaration was executed on January 29, 2004 at San Francisco, California.

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17 
18 RAYMOND X. WELCH

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