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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 NOTICE OF MOTION AND MOTION FOR AUTHORITY TO ESTABLISH CASH-  
20 COLLATERALIZED LETTER OF CREDIT PROGRAM AND FACILITY TO SECURE  
GAS PURCHASES, AND TO INCUR SECURED DEBT RELATED THERETO;  
21 MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

22 [SUPPORTING DECLARATIONS OF MICHAEL J. DONNELLY AND RAYMOND X.  
WELCH FILED SEPARATELY]  
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1 **NOTICE OF MOTION AND MOTION**

2 **PLEASE TAKE NOTICE** that on February 26, 2004 at 1:30 p.m., or as soon  
3 thereafter as the matter may be heard, in the Courtroom of the Honorable Dennis Montali,  
4 located at 235 Pine Street, 22nd Floor, San Francisco, California, Pacific Gas and Electric  
5 Company, the debtor and debtor in possession in the above-captioned Chapter 11 case  
6 (“PG&E” or the “Debtor”), will and hereby does move the Court for authority to establish a  
7 cash-collateralized letter of credit program and to enter into a cash-collateralized letter of  
8 credit facility for the purpose of providing credit support for the Debtor’s (i) gas purchases  
9 for its core customers in lieu of the existing pledge of certain gas-related accounts and assets,  
10 and (ii) purchase of gas transportation services on interstate gas transmission pipelines, and  
11 to incur secured debt related thereto (the “Motion”), all as more particularly described in the  
12 accompanying Memorandum of Points and Authorities, which is incorporated by reference  
13 herein. The Motion is based on this Notice of Motion and Motion, the accompanying  
14 Memorandum of Points and Authorities, the Declarations of Michael J. Donnelly and  
15 Raymond X. Welch filed concurrently herewith, the record of this case and any evidence or  
16 argument presented at or prior to the hearing on this Motion.

17 This Motion is made pursuant to Sections 363(b) and 364(d) of the United States  
18 Bankruptcy Code, 11 U.S.C. §§363(b) & 364(d).

19 **PLEASE TAKE FURTHER NOTICE** that pursuant to Rule 9014-1(c)(1) of the  
20 Bankruptcy Local Rules of the United States District Court for the Northern District of  
21 California, any written opposition to the Motion and the relief requested herein must be filed  
22 with the Bankruptcy Court and served upon appropriate parties (including counsel for  
23 PG&E, the Office of the United States Trustee and the Official Committee of Unsecured  
24 Creditors) at least 14 days prior to the scheduled hearing date. If there is no timely  
25 opposition to the requested relief, the Court may enter an order granting such relief by  
26 default and without further hearing.

1 MEMORANDUM OF POINTS AND AUTHORITIES<sup>1</sup>

2 I.

3 INTRODUCTION AND OVERVIEW

4 By this Motion, PG&E requests authority, pursuant to Sections 363(b)(1) and  
5 364(d)(1) of the Bankruptcy Code, to establish a cash-collateralized letter of credit program  
6 (as described more fully below, the "Gas LC Program") and a cash-collateralized letter of  
7 credit facility with one or more banks (as described more fully below) for the purpose of  
8 providing credit support and thereby facilitating PG&E's gas purchases for its core  
9 customers in the ordinary course of PG&E's business and gas transportation related thereto,  
10 and to incur secured debt in favor of the letter of credit issuing bank(s) in connection  
11 therewith, up to a maximum of \$400 million face amount of cash-collateralized letters of  
12 credit outstanding under such letter of credit facility at any one time. For the reasons  
13 explained herein, this proposed Gas LC Program and facility is a salutary equivalent and  
14 substitute for the existing Court-approved security device now in place to provide necessary  
15 credit support for PG&E's core gas purchases, and will facilitate PG&E's emergence from  
16 Chapter 11.

17 Commencing shortly before its Chapter 11 filing in April 2001 (and, with the  
18 approval of this Court shortly after the Chapter 11 filing, continuing through the present  
19 date), PG&E has made ongoing and substantial use of what it calls its "GSSA Program" to  
20 provide credit support for its gas purchases for core customers. In broad outline, under the  
21 GSSA Program, with the approval of the California Public Utilities Commission (the  
22 "Commission") and this Court at appropriate junctures, PG&E entered into a master Gas  
23 Supplier Security Agreement (the "GSSA") with a group of gas suppliers, pursuant to which  
24 PG&E granted a security interest in most of its gas customer accounts receivable and various  
25 gas-related assets (collectively, the "Gas Accounts"), to secure PG&E's payments for gas  
26

27 <sup>1</sup> The evidentiary basis and support for the facts set forth in this Motion are contained  
28 in the Michael J. Donnelly and Raymond X. Welch Declarations filed concurrently herewith.

1 purchases from the gas suppliers that are parties to the GSSA (such gas suppliers are  
2 hereinafter referred to as the "Existing Gas Suppliers," and the Existing Gas Suppliers,  
3 together with any additional gas suppliers that PG&E may elect to purchase from to procure  
4 efficient pricing and meet its core customers' needs, are hereinafter collectively referred to  
5 as the "Gas Suppliers").

6 While the GSSA Program has worked relatively smoothly to facilitate the  
7 uninterrupted flow of gas to PG&E's customers throughout the Chapter 11 case to date, it is  
8 now time for PG&E to prepare for its emergence from Chapter 11 and, in connection  
9 therewith, to replace the GSSA Program with the proposed Gas LC Program. More  
10 specifically, PG&E is now preparing for the implementation of the "Plan Of Reorganization  
11 Under Chapter 11 Of the Bankruptcy Code For Pacific Gas And Electric Company Proposed  
12 By Pacific Gas And Electric Company, PG&E Corporation And the Official Committee of  
13 Unsecured Creditors Dated July 31, 2003, As Modified" (the "Plan"), which was confirmed  
14 by Order of this Court dated December 22, 2003. Section 7.3 of the confirmed Plan  
15 provides that as of the Effective Date of the confirmed Plan, PG&E, as the Reorganized  
16 Debtor, shall establish one or more credit facilities for a wide range of purposes, including  
17 funding operating expenses, providing letters of credit or other forms of credit support, and,  
18 to the extent PG&E deems it appropriate, to perform its obligations under the Plan. Section  
19 7.3 also authorizes PG&E, as the Reorganized Debtor, to establish one or more customer  
20 accounts receivable securitization programs for the same purposes. Accordingly, consistent  
21 with the confirmed Plan, PG&E intends, as of the Effective Date, to have in place various  
22 financings, including, without limitation, (1) a conventional credit facility that allows for  
23 revolving credit borrowings and for the issuance of letters of credit under the facility, which  
24 may be secured by various assets of the company, and (2) one or more accounts receivable  
25 securitization programs, to be secured by gas and electric customer accounts.

26 However, in order for the transition to these new facilities provided for in the  
27 confirmed Plan to occur smoothly on or about the Effective Date, PG&E believes that it is  
28 appropriate from both a cost and efficiency standpoint to begin transition to the proposed

1 Gas LC Program in early March 2004, so that the process of obtaining and recording the  
2 termination of the Gas Suppliers' security interest in the Gas Accounts can be completed  
3 before the Effective Date of the Plan. This will ensure that the Gas Accounts are freed up to  
4 be pledged in connection with one or more of the facilities contemplated under the  
5 confirmed Plan as of the Effective Date. Because PG&E anticipates an Effective Date for  
6 the Plan at approximately the end of the first quarter of this year, and because of the  
7 somewhat arcane way the cycle of gas purchases and payments works as explained more  
8 fully below, PG&E believes that migration to the new Gas LC Program commencing in  
9 early March 2004, with the aim of having fully terminated the GSSA by the end of March  
10 2004, will facilitate the earliest possible Effective Date.

11 The last (and for purposes of this Motion, most important) piece of this  
12 introductory overview is that in order to terminate the GSSA prior to the Effective Date of  
13 the Plan and have the Existing Gas Suppliers' security interest in the Gas Accounts  
14 terminated, PG&E will need to provide an alternative form of credit support for the Existing  
15 Gas Suppliers for all amounts then owed under the GSSA, as well as for new gas purchases  
16 that take place between the time the GSSA is terminated and the Effective Date of the Plan.  
17 PG&E has determined that the issuance of irrevocable standby letters of credit ("LCs") for  
18 the benefit of the Gas Suppliers is the most efficient and practicable alternative form of  
19 credit support that will be acceptable to the Gas Suppliers. Thus, PG&E is proposing to  
20 replace the GSSA Program with the Gas LC Program, such that the Gas Suppliers will  
21 receive LCs as credit support for amounts owed them by PG&E, in lieu of the Gas Accounts  
22 pledged under the GSSA.

23 This, in turn, requires PG&E to establish an interim LC facility (the "Interim LC  
24 Facility") with one or more banks (the "LC Banks"), so that LCs can be issued thereunder  
25 for the benefit of Gas Suppliers until the Effective Date of the confirmed Plan, in the  
26 amounts that are owed Existing Gas Suppliers under the GSSA at the time the GSSA is  
27 terminated, plus the amount of PG&E's new gas purchases from Gas Suppliers between the  
28 time the Gas LC Program is put in place and the Effective Date of the Plan. Once the



1 Effective Date of the Plan occurs, to the extent credit support is required for post-Effective  
2 Date gas purchases, PG&E will post letters of credit issued under a new credit facility  
3 established pursuant to Section 7.3 of the Plan.

4 PG&E has determined that in light of its current credit rating (which will not be  
5 upgraded to investment grade until the Effective Date), it cannot establish the requisite  
6 Interim LC Facility without posting cash collateral with the LC Banks in an amount  
7 approximately equal to the face amount of the LCs issued under the facility. Based on  
8 PG&E's experience over the past several years, PG&E believes that it may need to cause up  
9 to \$400 million of LCs to be issued under the Interim LC Facility. PG&E by this Motion  
10 therefore seeks authority to establish the Interim LC Facility and pledge up to \$420 million  
11 in cash or cash equivalents to the LC Banks to secure PG&E's obligations to the LC Banks  
12 under the Interim LC Facility.<sup>2</sup> In connection with such Interim LC Facility, PG&E expects  
13 that, consistent with market standards, PG&E will be required to pay a small percentage fee  
14 for such facility, based on the maximum amount of the LCs issued thereunder, and may be  
15 required to reimburse certain expenses of the LC Banks, and also seeks approval therefor.

16 PG&E emphasizes that the substitution of the proposed Interim LC Facility for  
17 the GSSA is a salutary exchange that in no way prejudices the estate or its unsecured  
18 creditors pending the Effective Date. This is for the simple reason that all of PG&E's  
19 obligations to the Existing Gas Suppliers under the GSSA have remained oversecured  
20 pursuant to the terms of the GSSA, and have always been paid and continue to be paid in full  
21 on time. Thus, by effectively substituting cash collateral for PG&E's outstanding  
22 obligations to the Existing Gas Suppliers under the Gas LC Program for the oversecured  
23 security interest in Gas Accounts under the GSSA Program, PG&E is actually freeing up

24 \_\_\_\_\_  
25 <sup>2</sup> Banks that require cash collateral as a condition of issuing letters of credit typically  
26 require a small cushion over the face amount of the issued letters of credit, to cover interest,  
27 fees and costs, to the extent applicable. Accordingly, PG&E needs discretion to post this  
28 slight cushion, which PG&E estimates would not exceed five percent of the face amount of  
the issued letters of credit and may be less. The \$420 million cash collateral limit sought by  
this Motion includes a maximum 5% cushion on \$400 million of maximum face amount of  
outstanding letters of credit.

1 estate assets, more closely matching the amount of security/credit support with the amount  
2 of the outstanding secured obligations. Further, the amounts PG&E owes the Gas Suppliers  
3 are a function solely of the gas purchases that PG&E makes, and thus are in no way driven  
4 or influenced by whether the credit support device is a security interest in Gas Accounts, on  
5 the one hand, or an LC, on the other.

6 As long as PG&E is establishing the Gas LC Program and Interim LC Facility for  
7 the principal purpose of replacing the GSSA Program, PG&E, as an ancillary matter, also  
8 believes it appropriate and prudent to be able to use the new program and facility to provide  
9 necessary credit support for related purchases of gas transportation services on interstate gas  
10 transmission pipelines. While in Chapter 11 PG&E has provided credit support for such gas  
11 transportation purchases by prepaying or depositing cash when necessary. Having the  
12 option of using LCs going forward until the Effective Date will have risk management  
13 benefits to PG&E and the estate. The estimated maximum need for gas transportation  
14 purchases outstanding at any one time is \$50 million, so PG&E by this Motion, as part of the  
15 proposed Gas LC Program, requests authority to use up to a maximum of \$50 million of the  
16 Interim LC Facility for the issuance of LCs to support the purchase of gas transportation  
17 services.<sup>3</sup>

18 Assuming the proposed Gas LC Program and Interim LC Facility are approved  
19 by the Court, they will be in place as a transitional mechanism for only a limited period of  
20 time. This is because pursuant to the terms of the confirmed Plan, it is a condition  
21 concurrent to the Effective Date that PG&E emerge on such date with an investment grade  
22

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23 <sup>3</sup> Thus, of the \$400 million maximum face amount of LCs that can be outstanding  
24 under the Interim LC Facility proposed by this 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 this 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 credit rating. Once so restored to investment grade status, PG&E not only expects demands  
2 for credit support to diminish, but PG&E expects that it will not be restricted to cash-  
3 collateralized LCs for LCs issued under one or more of its post-Effective Date credit  
4 facilities, but rather will have the ability under one or much of such facilities to issue LCs up  
5 to some material dollar amount that are unsecured or secured by non-cash assets. Thus, for  
6 any gas purchases made after the Effective Date that require credit support, PG&E will  
7 cause LCs to be issued under a new credit facility established pursuant to Section 7.3 of the  
8 Plan. And while PG&E also may seek to transfer to a post-Effective Date credit facility any  
9 LCs that may then be outstanding under the Interim LC Facility (thereby hastening the  
10 termination of the Interim LC Facility), even if that proves to be impractical, all such  
11 outstanding LCs issued under the Interim LC Facility prior to the Effective Date will mature  
12 within some reasonable period after the Effective Date based on their respective expiry  
13 dates. Thus, under all circumstances, the Interim LC Facility will phase out and be fully  
14 supplanted by a post-Effective Date LC facility within a limited period of time after the  
15 Effective Date.

16 Finally, PG&E notes that BNY Western Trust Company, in its capacity as the  
17 successor trustee (the "Indenture Trustee") under that certain Indenture dated December 1,  
18 1920 as amended to date (the "1920 Indenture"), presently has a lien on substantially all of  
19 PG&E's real and personal property assets, and therefore has an interest in the cash that  
20 PG&E proposes be pledged to secure its obligations to the LC Banks under the Interim LC  
21 Facility. However, as explained more fully below, the Indenture Trustee's interests are more  
22 than adequately protected, and the Indenture Trustee's interest is therefore not an  
23 impediment to granting the LC Banks a senior lien on the cash collateral to be pledged to  
24 them pursuant to Section 364(d)(1) of the Bankruptcy Code.

1 II.

2 RELEVANT FACTS

3 A. Background of GSSA

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

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

15 Based on PG&E's inability to secure and maintain a sufficient supply of gas for  
16 its core customers on an unsecured credit basis, the Commission, in response to an  
17 application of PG&E, issued its Decision 01-01-062 on January 31, 2001, granting PG&E  
18 authorization to pledge its Gas Accounts to Gas Suppliers for PG&E's purchases of gas for  
19 core customers. Pursuant to such Commission decision, on or about February 7, 2001,  
20 PG&E entered into the GSSA with a number of its then-existing Gas Suppliers. This  
21 allowed for the uninterrupted flow of gas purchases and deliveries, ensuring PG&E's timely  
22 payment of amounts owed to Gas Suppliers for core gas supplies delivered in January 2001  
23 and future months.

24 Given the importance of the GSSA to the provision of one of PG&E's essential  
25 utility services, immediately after PG&E filed its Chapter 11 petition in April 2001, PG&E,  
26 by an emergency motion dated April 6, 2001 (Docket No. 18 ) and a follow-on motion  
27 dated June 26, 2001 (Docket No. 1128) sought this Court's approval of the GSSA and the  
28 GSSA Program. This Court granted PG&E's request by interim and final orders dated April

1 9, 2001, May 10, 2001, and July 30, 2001 (docket nos. 49, 493 and 1686), respectively.

2 Although the Commission's initial authorization of the GSSA was time-limited,  
3 the Commission has extended the authorization each year without interruption in the GSSA.  
4 The most recent extension expires on the earlier of (i) May 1, 2004, (ii) PG&E's return to an  
5 investment grade credit rating, (iii) provision of letters of credit to the gas suppliers to secure  
6 PG&E's gas purchase obligations, and (iv) expiration of specified notice periods.<sup>4</sup> The  
7 Bankruptcy Court's authorization allowing PG&E to pledge its Gas Accounts to Gas  
8 Suppliers pursuant to the GSSA did not specify a termination date.

9 While cash prepayment of Gas Suppliers is a potential alternative means of  
10 procuring core gas requirements, the GSSA has been very important in minimizing PG&E's  
11 credit exposure to its counterparties in a gas market that has seen both significant reductions  
12 in the numbers of suppliers and concurrent deterioration in the credit ratings of those  
13 suppliers who have survived. Among PG&E's current core Gas Suppliers, a number have  
14 experienced credit rating downgrades and now present a credit risk in situations where  
15 PG&E is otherwise required to pay prior to the gas flowing. Thus, the ability to rely on the  
16 GSSA has been an important element in securing adequate core gas supplies, while at the  
17 same time minimizing PG&E's credit exposure to Gas Suppliers.

18  
19 <sup>4</sup> While the expiration of the Commission's current authorization on May 1, 2004  
20 would seem to provide PG&E with several more months of purchasing ability under the  
21 GSSA, in fact the current authorization to May 1, 2004 only allows PG&E to buy core gas  
22 under the GSSA until March 2004 as a practical matter. This is because of the three-month  
23 cycle of purchases, deliveries and payments, as described further in Part II.B below. For this  
24 reason, PG&E as a precautionary matter recently has filed a petition with the Commission  
25 for modification of its prior decisions respecting the GSSA, to extend the expiration date for  
26 the GSSA authorization from May 1, 2004 to August 1, 2004, which as a practical matter  
27 would allow gas purchases to be made under the GSSA until June 2004. Nonetheless, as  
28 explained more fully in the text of this Motion, 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 this 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 this 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           Accordingly, while PG&E wants to terminate the GSSA Program and the GSSA  
2 in early March in order to facilitate the financings contemplated to be in place on the  
3 Effective Date of the Plan, PG&E does not wish to replace the GSSA with cash prepayments  
4 for gas purchases because of the materially increased credit risk to PG&E and its estate that  
5 widespread cash prepayments would entail.<sup>5</sup> Rather, PG&E by this Motion seeks to replace  
6 the GSSA with LCs issued pursuant to the proposed Gas LC Program and Interim LC  
7 Facility, with the LCs serving the same credit-risk-management function as the GSSA  
8 arrangement.

9           **B. Security/Payment Mechanics Under GSSA**

10           Since its inception, the GSSA has provided security for at least three months of  
11 gas supply at any given time. The monthly cycle of buying, taking delivery and paying for  
12 core gas delivered for a given month spans at least three calendar months. This time span  
13 results because contracting, receipt and payment for baseload gas supplies occur in different  
14 months. For instance, much of the contracting activity for a specific month's gas supply  
15 occurs in the month prior to the actual deliveries, during a concentrated period known as  
16 "bid week." Thus, to obtain gas for April delivery, PG&E will contract for the gas in the  
17 March bid week. Gas suppliers, however, will not contract with PG&E in March bid week  
18 unless they are comfortable with the security PG&E can provide to support its payments for  
19 the April gas deliveries. Since normal payment for gas deliveries occurs around the 25<sup>th</sup> of  
20 the month after delivery has occurred, PG&E must provide the gas suppliers with security  
21 for April gas deliveries during the entire period from March bid week until the May payment  
22 date. Consequently, in a given month, the GSSA has provided security to suppliers for  
23 (i) the prior month's gas delivery, (ii) gas purchases being delivered within the month, and  
24

25           <sup>5</sup> 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 (iii) gas under contract for delivery in the next month.

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

15 The Interim LC facility that replaces the GSSA, then, will need to provide  
16 continuity in credit assurance for the Gas Suppliers, to accommodate PG&E's repeat month-  
17 to-month contracting and some multi-month contracts for core gas needed later in the year.<sup>6</sup>  
18 For this reason, in place of the GSSA, PG&E under the proposed Interim LC Facility will  
19 need to use LCs, with terms potentially extending through March 31, 2005, both for existing  
20 contracts and for new core gas purchase commitments that take place between the time the  
21 Gas LC Program is implemented pursuant to this Motion and the Effective Date. Once the  
22 Effective Date occurs, no additional LCs will be issued under the authorization requested in  
23 this Motion, but rather, if and to the extent LCs are required for core gas purchase  
24 commitments made after the Effective Date, they will be issued under a post-Effective Date

25 \_\_\_\_\_  
26 <sup>6</sup> 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.

1 credit facility.

2 **C. Rationale For Requested Maximum Amount Of Gas LC Program And**  
3 **Interim LC Facility To Replace GSSA**

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

17 Based on its experience respecting core gas purchases, PG&E estimates that the  
18 amount reasonably needed for this rolling three-month period will be approximately \$350 to  
19 \$400 million, depending on gas prices.<sup>7</sup> After taking into account the "cushion" that may be  
20 required by the LC Banks,<sup>8</sup> PG&E by this Motion therefore seeks to establish a Gas LC  
21 Program and to enter into an Interim LC Facility that permits PG&E to pledge cash  
22 collateral to the LC Banks of up to \$420 million to secure up to \$400 million face amount of  
23 LCs outstanding at any one time that are issued to Gas Suppliers as credit support for

24 \_\_\_\_\_  
25 <sup>7</sup> Since the GSSA Program was instituted, the aggregate amount of gas purchases  
26 secured by the GSSA during each rolling three-month period has ranged from a high of  
27 approximately \$600 million to a low of approximately \$30 million. These material swings  
28 are a function of seasonal demand factors, as well as pricing changes. The \$400 million  
authorization sought by this Motion represents PG&E's three-month estimate based on  
probability analysis and near-term forward demand and pricing estimates.

<sup>8</sup> See footnote 2, supra.



1 PG&E's core gas purchases.<sup>9</sup>

2 As already noted above, in addition to contracting with gas suppliers for core gas,  
3 PG&E also has rights to gas transportation services on interstate gas transmission pipelines,  
4 which PG&E utilizes to move gas purchased in the American southwest or in Canada to its  
5 core gas load in California. Under their tariffs and applicable law, the transmission pipelines  
6 have required PG&E to provide credit assurance adequate to cover up to three months of its  
7 obligations to them. PG&E has provided such credit assurance to the transmission pipelines  
8 either through pre-payment or cash deposits. At this point, PG&E estimates its requirements  
9 in connection with the purchase of gas transmission services at \$50 million. In order to  
10 reduce counter-party credit exposure, PG&E would prefer to provide LCs instead of pre-  
11 payment to certain transmission pipelines. Thus, as part of this Motion, the requested \$400  
12 million authorization for aggregate face amount of LCs outstanding (and the corresponding  
13 requested \$420 million authorization for use of cash collateral to secure such LCs) includes  
14 \$50 million of face amount authorization and \$52.5 million of corresponding cash collateral  
15 authorization to support the purchase of gas transportation services.<sup>10</sup>

16 **D. Substituting The Interim LC Facility For The GSSA Will Not Prejudice**  
17 **PG&E Or Its Estate, And On The Contrary Will Benefit PG&E, Its Estate**  
18 **And Its Creditors**

19 Assuming the proposed Gas LC Program and Interim LC Facility are approved as  
20 a substitute for the GSSA Program and GSSA, then once the LCs under the Interim LC  
21 Facility are issued to the Gas Suppliers in the respective amounts then outstanding and  
22 secured under the GSSA, the GSSA will terminate and the Gas Accounts will no longer be  
23 subject to the Gas Suppliers' security interest.<sup>11</sup> Based on experience, PG&E anticipates

24 <sup>9</sup> PG&E emphasizes that the \$400 million figure represents the maximum amount of  
25 LCs that can be outstanding at any time. Based on a variety of factors, PG&E may choose to  
26 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-money cycle in cash and providing an LC for the other two months).

27 <sup>10</sup> 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.

28 <sup>11</sup> While the actual mechanics of obtaining the termination of the Gas Suppliers'  
(continued . . .)

1 that the amount of LCs to be issued (and, accordingly, the amount of cash collateral that will  
2 need to be posted as security with the LC Banks) will be substantially less than the Gas  
3 Accounts pledged under the GSSA because the obligations owing to the Gas Purchasers  
4 have at all times been oversecured via the GSSA. Thus, there is no prejudice to the estate in  
5 substituting LCs issued under the Interim LC Facility for the Gas Accounts under the GSSA.

6 More important, the substitution of the Gas LC Program for the GSSA Program  
7 commencing in early March 2004 should allow PG&E to transition fully to the Gas LC  
8 Program and make a full and clean break from the lien under the GSSA by around the end of  
9 the first quarter of 2004, thereby maximizing the amount of its Gas Accounts that can be  
10 included in PG&E's contemplated accounts receivable securitization program put in place  
11 on the Effective Date of the Plan as one of the financing devices contemplated in Section 7.3  
12 of the Plan. This is beneficial to PG&E, its estate and its creditors because the accounts  
13 receivable financing contemplated under Section 7.3 of the Plan will help PG&E access  
14 commercial paper markets for working capital, commencing on the date the Plan goes  
15 effective and continuing thereafter. This helps PG&E achieve an Effective Date by  
16 approximately the end of the first quarter of 2004, and, because creditors with allowed  
17 claims are paid on the Effective Date, this is in the interests of PG&E, its estate and creditors

18 ( . . . continued)

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 alike.

2 **E. Terms of Proposed Interim LC Facility**

3 As already indicated, PG&E, based on its due diligence, believes and represents  
4 that prior to the Effective Date of the Plan, it cannot obtain a letter of credit facility without  
5 securing such facility with cash collateral in an amount at all times approximately equal to  
6 the outstanding face amount of LCs issued under any such facility. Because PG&E will be  
7 required to post cash collateral to secure its obligations under any such facility, there will be  
8 little or no credit risk to the LC Banks that provide such facility. Thus, assuming a cash-  
9 collateralized letter of credit facility, and based on its due diligence to date, PG&E  
10 anticipates that the pricing and other terms of such facility will be on relatively standard and  
11 commercially reasonable terms, with PG&E being required to execute a reimbursement  
12 agreement and related documentation pertaining to the facility, to pay a small percentage fee  
13 based on the amount of the LCs issued under the facility, and also potentially to reimburse  
14 certain expenses of the LC Banks.

15 Accordingly, by this Motion PG&E seeks authority (i) to establish an Interim LC  
16 Facility with one or more LC Banks of PG&E's choice, on commercially reasonable terms  
17 for such a facility that is fully cash collateralized, to be used for the gas procurement purpose  
18 specified in this Motion, (ii) to enter into a reimbursement agreement in favor of the LC  
19 Banks pertaining to the Interim LC Facility and other documentation customary for a facility  
20 of this nature, (iii) to pledge cash or cash equivalents to the LC Banks who provide such  
21 facility (or their designated agent, subject to PG&E's satisfaction with any such agent's  
22 reputation and creditworthiness) in an amount equal to the outstanding face amount of the  
23 LCs issued under the Interim LC Facility (plus a small cushion as described in footnote 2  
24 above), which pledged cash or cash equivalents shall secure PG&E's reimbursement and  
25 other obligations to the LC Banks under the documentation pertaining to the Interim LC  
26 Facility, and (iv) to pay such commercially reasonable fees and expenses of the LC Banks as  
27 PG&E agrees to in the documentation for the Interim LC Facility.

1 **F. Lien Of Indenture Trustee Under 1920 Indenture**

2 As already noted, until the Effective Date of the Plan, the Indenture Trustee has a  
3 lien on substantially all of PG&E's real and personal property under the 1920 Indenture.  
4 Such lien is the subject of that certain "Stipulation (I) Authorizing and Restricting Use of  
5 Cash Collateral Pursuant to 11 U.S.C. §363 and Bankruptcy Rule 4001 and (II) Granting  
6 Adequate Protection Pursuant to 11 U.S.C. §§361 and 363" entered into between PG&E and  
7 the Indenture Trustee on May 9, 2001, as amended to date (the "Cash Collateral  
8 Stipulation") and approved by the Bankruptcy Court by its Order thereon dated the same  
9 date and by subsequent Orders approving the amendments to the Cash Collateral Stipulation.

10 PG&E has had discussions with the Indenture Trustee concerning this Motion  
11 and the use of cash collateral that it entails in order to provide security to LC Banks under  
12 the Interim LC Facility pursuant to Bankruptcy Code Section 364(d). The Indenture Trustee  
13 has indicated that it has no objection to PG&E's filing of the Motion, but at the same time,  
14 pending its further consideration of the relief requested, the Indenture Trustee has reserved  
15 the right to object to the use of cash collateral and to require that PG&E carry its burden of  
16 establishing that the Indenture Trustee's interests are adequately protected.

17 **III.**

18 **PG&E SHOULD BE AUTHORIZED TO SUBSTITUTE THE  
19 GAS LC PROGRAM FOR THE GSSA PROGRAM AND TO  
20 ENTER INTO THE INTERIM LC FACILITY PURSUANT TO  
21 BANKRUPTCY CODE SECTION 363(b)(1)**

22 PG&E submits that because purchasing gas for its core customers is a vital utility  
23 function and is part of the ordinary course of PG&E's business, the proposed substitution of  
24 the GSSA Program and GSSA with the Gas LC Program and the Interim LC Facility is an  
25 ordinary-course-of-business decision that does not, in and of itself, require any approval  
26 under Bankruptcy Code Section 363.<sup>12</sup> Nonetheless, because of the magnitude of its gas

27 <sup>12</sup>PG&E of course recognizes that its proposed incurrence of secured debt under the  
28 proposed Interim LC Facility requires Court approval pursuant to Bankruptcy Code Section  
364(d), which is separately dealt with in Part IV below.

1 purchases and therefore the proposed Gas LC Program, PG&E is seeking authorization  
2 under Section 363(b).

3 In determining whether to authorize the use, sale or lease of property of the estate  
4 outside of the ordinary course of business under Bankruptcy Code Section 363(b)(1), courts  
5 require a debtor to show that a sound business purpose justifies such actions, applying  
6 essentially the same "business judgment" test that is used in determining whether to approve  
7 the assumption or rejection of an executory contract. See, e.g., Stephens Indus., Inc. v.  
8 McClung, 789 F.2d 386, 389-90 (6th Cir. 1986); Comm. of Equity Sec. Holders v. Lionel  
9 Corp. (In re Lionel Corp.), 722 F.2d 1063, 1070-71 (2d Cir. 1983); 3 Lawrence P. King,  
10 Collier on Bankruptcy ¶363.02[1][g] (15th ed. rev. 1998).

11 The burden of establishing a valid business purpose for the use of property of the  
12 estate outside the ordinary course of business falls upon the debtor. See In re Lionel Corp.,  
13 722 F.2d at 10-71. Once the debtor has articulated a rational business justification, however,  
14 a presumption attaches that the decision was made on an informed basis, in good faith and in  
15 the honest belief that the action was in the best interest of the debtor. See, e.g., Official  
16 Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.),  
17 147 B.R. 650, 656 (S.D.N.Y. 1992) (citing Smith v. Van Gorkom, 488 A.2d 858, 872 (Del.  
18 1985)).

19 Sound business justifications support PG&E's decision to terminate the GSSA  
20 Program and the GSSA, and to replace it with the proposed Gas LC Program and Interim LC  
21 Facility. As discussed at length above, authorizing PG&E to supplant the GSSA with the  
22 Interim LC Facility not only does not cause any prejudice to the estate or its creditors, but on  
23 the contrary has the net effect of freeing up assets for the benefit of the estate and its  
24 creditors. Further, it assists PG&E in managing the credit risk that arises from prepaying  
25 suppliers rather than using credit support devices such as the proposed Gas LC Program.  
26 Finally, PG&E's substitution of the GSSA with the proposed Interim LC Facility is  
27 appropriate planning for the Effective Date because it facilitates the simultaneous financings  
28 contemplated to be in place on the Effective Date. In short, the proposed termination of the

1 GSSA and substituting in its place the Interim LC Facility is highly beneficial to the estate  
2 and its creditors, and there accordingly is ample business justification for it.  
3  
4

5 IV.

6 **PG&E SHOULD BE AUTHORIZED TO INCUR SECURED**  
7 **DEBT PURSUANT TO BANKRUPTCY CODE SECTION 364**

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

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

11 (A) the trustee is unable to obtain such credit otherwise; and

12 (B) there is adequate protection of the interest of the holder of the lien  
on the property of the estate on which such senior or equal lien is  
13 proposed to be granted." (11 U.S.C. §364(d)(1))

14 Thus, the statutory prerequisites for obtaining credit on a senior secured basis is  
15 that the debtor be unable to obtain such credit otherwise, and that there be adequate  
16 protection for the existing lienholder. This test is clearly satisfied in this case.

17 First, as discussed above, PG&E has determined that, in light of its current sub-  
18 investment grade status, any banks that are likely to be acceptable to the Gas Suppliers as  
19 LC issuers will require, as a condition of establishing an Interim LC Facility for PG&E, that  
20 PG&E post cash collateral in which the LC Banks have a senior perfected interest in order to  
21 secure PG&E's reimbursement and related obligations to the LC Banks providing the  
22 Interim LC Facility. Thus, PG&E, prior to the Effective Date, is unable to obtain a letter of  
23 credit facility under which it can issue LCs to Gas Suppliers as a substitute for the Gas  
24 Accounts under the GSSA unless PG&E incurs obligations on a senior secured basis to the  
25 LC Banks, as described above.

26 Further, the interest of the only existing potential lienholder—the Indenture  
27 Trustee—is fully secured and adequately protected by a substantial equity cushion, as has  
28 been repeatedly demonstrated in previous motions filed by PG&E in this case. As set forth

1 in the Debtor's Operating Report filed with this Court on December 30, 2003 (Docket No.  
2 14322), as of November 30, 2003, the Debtor's total reported assets exceeded \$27 billion  
3 (including cash on hand of approximately \$4 billion), while the Debtor's outstanding  
4 obligations under the 1920 Indenture, which are secured by substantially all of the Debtor's  
5 assets until the Effective Date, aggregate approximately \$3 billion. Further, PG&E, by a  
6 separate motion filed January 26, 2004 that is scheduled to be heard at the same time as this  
7 Motion, has sought authority to pay timely \$310 million in principal amount of the bonds  
8 issued and outstanding pursuant to the 1920 Indenture that mature on March 1, 2004, which,  
9 assuming such other motion is granted, will reduce the outstanding obligations under the  
10 1920 Indenture to approximately \$2.7 billion.

11 The existence of an "equity cushion" or a "value cushion"—the value of the  
12 collateral in excess of the amount of the secured claim at issue—"is the classic form of  
13 protection for a secured debt," and it is well settled that "the existence of an equity cushion,  
14 standing alone, can provide adequate protection." Pistole v. Mellor (In re Mellor), 734 F.2d  
15 1396, 1400 (9th Cir. 1984). Accord, Travelers Ins. Co. v. Plaza Family P'ship (In re Plaza  
16 Family P'ship), 95 B.R. 166, 171 (E.D. Cal. 1989). In In re Mellor, the Ninth Circuit Court  
17 of Appeals held that a creditor's 20% value cushion constituted adequate protection as a  
18 matter of law, and reversed the lower court's finding to the contrary as "clearly erroneous."  
19 In re Mellor, 734 F.2d at 1401. The Court of Appeals also made clear that a cushion of less  
20 than 20% could constitute adequate protection, and cited with approval authorities holding  
21 that value cushions of 10% to 20% constituted adequate protection. Id. Here, by stark  
22 contrast, the Indenture Trust has an equity cushion of in excess of 800%. Thus, the  
23 Indenture Trustee's interest here is adequately protected by a substantial equity cushion,  
24 which will remain equal to many times the value of the Indenture Trustee's lien interest after  
25 giving affect to the maximum amount of collateral that PG&E seeks to grant a senior lien on  
26 pursuant to this Motion.

27 In addition, as already noted above, at the same time PG&E posts cash collateral  
28 in favor of the Banks of up to an aggregate amount of \$420 million for LCs issued under the

1 Interim LC Facility, the Gas Accounts will be freed from the lien under the GSSA, restoring  
2 the Indenture Trustee to whatever senior position on the Gas Accounts it had prior to PG&E  
3 entering into the GSSA. This creation of equivalent value constitutes further adequate  
4 protection for the Indenture Trustee.

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

19 Based on the foregoing, PG&E submits that the Court should authorize PG&E,  
20 pursuant to Bankruptcy Code Section 364(d), to incur post-petition secured debt in favor of  
21 the LC Banks up to an aggregate of \$400 million outstanding at any one time under the  
22 proposed Interim LC Facility, and to grant a senior lien in favor of such LC Banks (or their  
23 designated agent acceptable to PG&E) in cash or cash equivalents of PG&E up to an  
24 aggregate of \$420 million at any one time.

### 25 CONCLUSION

26 For all of the foregoing reasons, PG&E respectfully requests that the Court make  
27 and enter its Order as follows:

- 28 1. Granting the Motion;



1           2. Authorizing PG&E to terminate the GSSA Program and the GSSA as soon  
2 as practicable, with the aim of fully terminating the GSSA by late March 2004;

3           3. Authorizing PG&E to establish the Gas LC Program, to enter into the  
4 Interim LC Facility on terms commercially reasonable to PG&E (including a reimbursement  
5 agreement and any other documentation customary for a facility of this nature) and perform  
6 its obligations thereunder, and to cause LCs to be issued under the Interim LC Facility in  
7 connection with the LC Gas Program described in this Motion, provided that in all events,  
8 the aggregate limit of the Interim LC Facility (and the face amount of LCs issued  
9 thereunder) shall not exceed \$400 million outstanding at any one time;

10           4. Authorizing PG&E to post collateral and grant a senior lien on collateral  
11 consisting of cash or cash equivalents, up to a maximum aggregate amount of \$420 million  
12 outstanding at any one time, in favor of the LC Banks to secure PG&E's obligations under  
13 the Interim LC Facility, pursuant to Bankruptcy Code Section 364(d)(1), all as more  
14 particularly described above;

15           5. Authorizing PG&E to pay such commercially reasonable fees and expenses  
16 of the LC Banks in connection with the Interim LC Facility as PG&E agrees to in the  
17 documentation for the Interim LC Facility; and

18           6. Granting such other and further relief as may be just and appropriate.

19  
20 DATED: January 29, 2004

21           Respectfully,

22           HOWARD, RICE, NEMEROVSKI, CANADY,  
23           FALK & RABKIN  
24           A Professional Corporation

25           By:   
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27           Attorneys for Debtor and Debtor in Possession  
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