

1 JAMES L. LOPES (No. 63678)
JEFFREY L. SCHAFER (No. 91404)
2 JANET A. NEXON (No. 104747)
HOWARD, RICE, NEMEROVSKI, CANADY,
3 FALK & RABKIN
A Professional Corporation
4 Three Embarcadero Center, 7th Floor
San Francisco, California 94111-4065
5 Telephone: 415/434-1600
Facsimile: 415/217-5910

50-275/523

6 Attorneys for Debtor and Debtor in Possession
7 PACIFIC GAS AND ELECTRIC COMPANY
8

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

12 In re

No. 01-30923 DM

13 PACIFIC GAS AND ELECTRIC
COMPANY, a California corporation,

Chapter 11

14 Debtor.
15

Date: May 25, 2001
Time: 1:30 p.m.
Place: 235 Pine St., 22nd Floor
San Francisco, California

16 Federal I.D. No. 94-0742640
17
18

19 MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF
20 MOTION FOR ORDER AUTHORIZING ASSUMPTION OF EXECUTORY
21 HYDROELECTRIC POWER PURCHASE CONTRACTS
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NEMEROVSKI
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1
2 INTRODUCTION

3 Pursuant to Section 365(a) of the Bankruptcy Code (11 U.S.C. §365(a)), Pacific Gas
4 and Electric Company, the debtor and debtor in possession in the above-captioned Chapter
5 11 case ("PG&E" or the "Debtor"), hereby moves this Court for an order authorizing
6 assumption of eight hydroelectric power purchase contracts and the ancillary agreements and
7 amendments thereto (collectively the "HPP Contracts"). Beginning in 1952, PG&E entered
8 into HPP Contracts with various California Irrigation Districts and Water Agencies to
9 purchase net electric output derived from the agencies' respective hydroelectric projects. As
10 there are material unperformed obligations under all eight agreements on the part of both
11 PG&E and the governmental agencies, the HPP Contracts PG&E is requesting to assume by
12 this motion are executory. PG&E therefore may assume these contracts with the approval of
13 this Court. See 11 U.S.C. §365(a).

14 The HPP Contracts include six major long-term agreements: (1) Tri-Dam Project
15 executed with the Oakdale and South San Joaquin Irrigation Districts in 1952; (2) South
16 Fork Project executed with the Oroville-Wyandotte Irrigation District in 1960; (3) Yuba-
17 Bear Project executed with the Nevada Irrigation District in 1963; (4) Middle Fork Project
18 executed with the Placer County Water Agency in 1963; (5) Merced River Development
19 Project executed with the Merced Irrigation District in 1964; and (6) Yuba River
20 Development Project executed with the Yuba County Water Agency in 1966. PG&E more
21 recently entered into two smaller-scale hydroelectric purchase contracts, both of which
22 involved adding new facilities onto existing projects: (1) Rollins Powerhouse Project
23 executed with the Nevada Irrigation District in 1978; and (2) Sly Creek Powerhouse Project
24 executed with the Oroville-Wyandotte Irrigation District in 1981. These eight HPP
25 Contracts are attached as Exhibits 1-8 to the Declaration of Randal S. Livingston
26 ("Livingston Decl.") filed concurrently herewith.¹

27 ¹PG&E has not attached to the Livingston Decl. the ancillary agreements and
28 amendments regarding matters contained in the contracts as they are extremely voluminous.
(continued . . .)

I.

GENERAL BACKGROUND

PG&E is an investor-owned utility providing electric and gas services to millions of California residents and businesses. Beginning approximately last summer, as a result of the partial deregulation of the power industry, PG&E was forced to pay dramatically increased wholesale prices for electricity. PG&E has, however, been prevented from passing these costs on to retail customers, resulting in a staggering financial shortfall. In the face of the deterioration in PG&E's financial condition, and with little progress having been made toward a resolution of the crisis, PG&E by early April 2001 determined that a Chapter 11 reorganization offered the best prospects for protecting the interests of its customers, creditors, employees, and shareholders alike. Accordingly, on April 6, 2001, PG&E filed a voluntary petition under Chapter 11 of the Bankruptcy Code. PG&E continues to manage and operate its business and property as a debtor in possession pursuant to Sections 1107 and 1108 of the United States Bankruptcy Code (11 U.S.C. §§ 1107-1108). No trustee has been appointed.

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II.

THE HYDROELECTRIC POWER PURCHASE CONTRACTS

The HPP Contracts PG&E requests to assume by this motion are similar in structure and genesis. Beginning in the early 1950's, governmental owners of water rights — Irrigation Districts and Water Agencies — agreed to develop hydroelectric projects and sell the net electric output derived from such projects to PG&E at fixed prices. Each of the six major HPP agreements specifies a contract term of 50 years. The smaller-scale HPP

(... continued)

PG&E intends, however, for these documents, which do not materially alter PG&E's obligations with respect to the contracts, to be included in this assumption motion. PG&E will make these documents available upon request.

1 Contracts expire coterminously with the major HPP projects to which they were added.
2 Livingston Decl. ¶6.

3 The agreements came about because the agencies were primarily interested in
4 developing the hydroelectric projects for purposes of water supply and were not engaged in
5 the electricity business. The agencies owned the water rights for the potential hydroelectric
6 projects but lacked the financial means by which to construct the projects that would allow
7 them to perfect these rights.² PG&E agreed to purchase the electrical output derived from
8 such projects on a long-term basis at a price sufficient for the agencies to pay the
9 construction, financing and operating costs of the facilities. *Id.* ¶2.

10 Under the six major HPP Contracts, PG&E makes two types of payments for the
11 project electricity: (1) semiannual payments ("construction payments") to provide the
12 agencies with a revenue stream for paying off revenue bonds issued to finance project
13 construction costs; and (2) monthly operating and maintenance payments ("O&M
14 payments") to pay for the day-to-day operating costs of the projects and for repairs and
15 betterments.³ The only significant difference among the agreements is that the Tri-Dam
16 Project Contract calls for PG&E to make O&M payments on a lump sum, semi-annual basis
17 indexed to PG&E's labor costs, whereas the other HPP Contracts call for dollar-for-dollar
18 reimbursement of actual O&M costs. *Id.* ¶7.

19 The HPP Contracts have proven to be extremely cost-effective for PG&E and are
20 valuable assets because the parties developed the financing and payment schedule based on

21
22 ²At the time, each of the projects was considered to be of marginal economic value and
23 could only have been built using tax exempt financing by governmental agencies which
24 would not have to pay property taxes. The lengthy terms of the contracts were needed to
25 generate the maximum amount of bond proceeds for project construction purposes, and 50
26 years was the maximum term for which revenue bonds could be issued. Livingston Decl. at
27 ¶6.

28 ³In addition to the construction and O&M payments, PG&E makes per kilowatt-hour
("kWh") energy payments to the agencies under the terms of the two smaller-scale HPP
Contracts. These payments — 0.4 cents/kWh for the Rollins Powerhouse Project and 0.7
cents/kWh for the Sly Creek Powerhouse Project — are included in the calculation of the
average cost of energy. These payment prices escalate based on changes in PG&E's short-
run-avoided cost prices paid to qualifying facilities. Livingston Decl. at ¶10.

1 the relatively low electric power values prevailing in the late 1950s and 1960s — 0.5 or 0.6
2 cents/kWh. Id. ¶9. The average energy costs under the HPP Contracts are therefore
3 substantially lower than power prices currently prevailing in the market. The current
4 average cost of energy under the HPP Contracts is approximately 1.15 cents/kWh based on
5 average annual energy production. Id. In comparison, the current market quotes for on-peak
6 power in the third quarter of 2001 is 38 cents/kWh.⁴ Id. ¶11.

7 PG&E's assumption of the HPP Contracts is critical for the continuation of all eight
8 hydroelectric projects. PG&E's construction and O&M payments under these contracts
9 represent the sole source of funds with which the project owners pay their bond amortization
10 and operating costs. Id. ¶8. Any suspension of the HPP Contracts could therefore force the
11 project owners to default on their revenue bond payments. Such consequences would
12 deprive California of badly needed low-cost electric energy because the combined generating
13 capacity of these hydroelectric projects is immense — 1048 megawatts, or approximately
14 half of the capacity produced by PG&E's Diablo Canyon Nuclear Power Plant. Id. ¶14.

15 The likelihood of project termination in the event PG&E is unable to assume the HPP
16 Contracts is not baseless conjecture. PG&E understands that certain of the project owners
17 have investigated the possibility of unilateral, early termination of the HPP Contracts if
18 PG&E defaults on its payments. Id. ¶8. While PG&E does not believe the HPP Contracts
19 provide for forfeiture, the owners could shut down or sell their hydroelectricity outside the
20 contracts until a payment dispute can be resolved.

21 22 III.

23 ARGUMENT

24 Bankruptcy Code Section 365 governs the treatment of executory contracts following
25 the filing of a bankruptcy petition: a "trustee [or debtor in possession], subject to the court's
26

27 ⁴This market price reflects the cost estimated for power delivered during the 16 peak
28 hours of weekdays and Saturdays.

1 approval, may assume or reject any executory contract or unexpired lease of the debtor.”
2 11 U.S.C. §365(a).⁵ By this Motion, PG&E asks the Court to enter an order pursuant to
3 Section 365(a) authorizing it to assume the HPP Contracts.

4
5 A. The Hydroelectric Power Purchase Contracts Are Executory Contracts.

6 The Bankruptcy Code, although addressing the treatment of executory contracts upon
7 the filing of a bankruptcy petition, does not define the term “executory contract.” The
8 federal courts have, however, construed the term in a common fashion. Based on the
9 legislative history, the Supreme Court has defined “executory contract” as a contract on
10 which “performance is due to some extent on both sides.” NLRB v. Bildisco & Bildisco,
11 465 U.S. 513, 522 n.6 (1984) (citation omitted). Similarly, the Ninth Circuit has held that
12 Section 365 refers to those contracts “in which the obligations of both parties ‘are so far
13 unperformed that the failure of either to complete performance would constitute a material
14 breach excusing the performance of the other.’” Elliott v. Four Seasons Properties (In re
15 Frontier Properties, Inc.), 979 F.2d 1358, 1364 (9th Cir. 1992) (quoting Pacific Express, Inc.
16 v. Teknikron Infoswitch Corp. (In re Pacific Express, Inc.), 780 F.2d 1482, 1487 (9th Cir.
17 1986) (citation omitted)); see Commercial Union Ins. Co. v. Texscan Corp. (In re Texscan
18 Corp.), 976 F.2d 1269, 1272 (9th Cir. 1992). While the determination of whether a contract
19 is executory for bankruptcy purposes is a matter of federal law, the issue of whether a
20 party’s failure to perform its remaining contract obligations constitutes a material breach is
21 one of state law. See 976 F.2d at 1272; Griffel v. Murphy (In re Wegner), 839 F.2d 533, 536
22 (9th Cir. 1988).

23 Under California law, any failure on PG&E’s part to continue making payments
24 consistent with the terms of the HPP Contracts will qualify as a material breach: “[T]he
25 several obligations of the parties constitute to each, reciprocally, the consideration of the

26
27 ⁵PG&E may assume executory contracts with the Court’s approval because the
28 Bankruptcy Code gives a debtor in possession the rights, powers, functions, and duties of a
trustee. See 11 U.S.C. §1107(a).

1 contract; and a failure to perform constitutes a failure of consideration either partial or
2 total” Bliss v. California Co-op. Producers, 30 Cal. 2d 240, 249 (1947) (citation
3 omitted). In considering this same contract principle under Arizona law, the Ninth Circuit
4 held that the duty to pay money on one side is a material obligation sufficient to render the
5 contract executory where corresponding material obligations exist on the other side. In re
6 Wegner, 839 F.2d at 537. In Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.), 625 F.2d
7 290, 292 (9th Cir. 1980), for example, the Ninth Circuit held a licensing agreement
8 executory where the debtor, Select-A-Seat, had entered into a worldwide exclusive licensing
9 agreement with Fenix Cattle Company. Under this agreement, Fenix received exclusive
10 rights to use and license Select-A-Seat’s software packages in all but five areas of the world
11 and, in turn, contracted to pay Select-A-Seat \$140,000 down plus five percent of its annual
12 net income from use of the licenses. In considering Fenix’s argument that the contract was
13 no longer executory because it had received license rights to the software upon payment of
14 the initial \$140,000 fee, the court considered germane that Fenix was also obligated to pay
15 Select-A-Seat five percent of its annual net return from use of the software: “If Fenix failed
16 to make these annual payments, that failure would constitute a material breach of the
17 contract Conversely, the agreement was executory from Select-A-Seat’s perspective.
18 Because of the exclusive nature of the license . . . Select-A-Seat was under a continuing
19 obligation not to sell its software packages to other parties.” *Id.*

20 Under this framework provided by the Ninth Circuit, each of the HPP Contracts PG&E
21 seeks to assume by this Motion is executory. For each major HPP project, PG&E agreed to
22 purchase the net electric output at fixed prices for 50 years and the government agencies, in
23 turn, agreed to sell such output to PG&E for the duration of this period. The smaller-scale
24 HPP Contracts expire coterminously with the major HPP projects to which they were added.
25 The first major HPP Contract — the Tri-Dam Project — was executed by the parties in 1952
26 and, as amended, will not terminate until 2004. The last major HPP Contract to be executed
27 — the Yuba River Development Project — will not terminate until 2016. By their terms,
28 then, performance remains due under each HPP Contract.

1 B. PG&E's Assumption Of The Executory Contracts Is Based On Sound Business
2 Judgment.

3 The Bankruptcy Code does not provide courts with a standard to use in determining the
4 propriety of a debtor in possession's decision to assume or reject an executory contract.

5 3 L. King, Collier on Bankruptcy, ¶365.03[1], at 365-22 (15th ed. rev. 2000). The widely
6 accepted test among federal courts, however, is the business judgment standard. See
7 Bildisco, 465 U.S. at 523; Group of Institutional Investors v. Chicago, 318 U.S. 523, 550
8 (1943) ("[T]he question whether a lease should be rejected and if not on what terms it should
9 be assumed is one of business judgment."). Under this rule, courts accord great deference to
10 a debtor in possession's decision to assume an executory contract. See, e.g., Orion Pictures
11 Corp. v. Showtime Network, Inc. (In re Orion Pictures Corp.), 4 F.3d 1095, 1098 (2d Cir.
12 1993) ("At heart, a motion to assume should be considered a summary proceeding.");
13 Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers,
14 Inc.), 756 F.2d 1045, 1046 (4th Cir. 1985) ("Lubrizol") ("[T]he bankrupt's decision . . . is to
15 be accorded the deference mandated by the sound business judgment rule as generally
16 applied by courts to discretionary actions or decisions of corporate directors."); In re III
17 Enterprises, Inc., 163 B.R. 453, 469 (Bankr. E.D. Pa. 1994) ("We will not substitute our own
18 business judgment for that of the Debtor . . . unless 'the decision is so unreasonable that it
19 could not be based on sound business judgment, but only on bad faith or whim.'") (citations
20 omitted); Summit Land Co. v. Allen (In re Summit Land Co.), 13 B.R. 310, 315 (Bankr. D.
21 Utah 1981) ("[C]ourt approval under Section 365(a), if required, except in extraordinary
22 situations, should be granted as a matter of course. To begin, this rule places responsibility
23 for administering the estate with the trustee, not the court.").

24 Ninth Circuit courts, in accordance with the widely accepted standard, have adopted
25 the business judgment rule for reviewing Section 365(a) motions: "We believe the 'business
26 judgment' rule is the standard which controls the court's right to disapprove the [debtor in
27 possession's] decision to reject an executory contract. . . . Virtually all recent Bankruptcy
28 Court decisions follow this rule." Robertson v. Pierce (In re Chi-Feng Huang), 23 B.R. 798,

800 (B.A.P. 9th Cir. 1982) (citations omitted); see Upland/Euclid, Ltd. v. Grace Restaurant Co. (In re Upland/Euclid, Ltd.), 56 B.R. 250, 251 n.1 (B.A.P. 9th Cir. 1985) ("Whether a lease should be rejected is a matter for the debtor's business judgment."); Turbowind, Inc. v. Post Street Mgmt., Inc. (In re Turbowind, Inc.), 42 B.R. 579, 585 (Bankr. S.D. Cal. 1984) ("The debtor has met its burden under the liberal 'business judgment' standard."). Under the rule as generally formulated and applied in corporate litigation, courts defer to decisions of corporate directors regarding matters entrusted to their business judgment except upon a finding of bad faith or gross abuse of business discretion. See Lubrizol, 756 F.2d at 1047; Lewis v. Anderson, 615 F.2d 778, 782 (9th Cir. 1979). Transposed to the bankruptcy context, the business judgment rule as applied to PG&E's decision to assume the HPP Contracts because of perceived business advantage requires that the Court approve this Motion unless PG&E has made such decision in bad faith or is grossly abusing its business discretion. See Lubrizol, 756 F.2d at 1046-47; In re GP Express Airlines, Inc., 200 B.R. 222, 230 (Bankr. D. Neb. 1996) ("Absent a showing of bad faith or abuse of debtor's discretion, however, debtor's exercise of business judgment in deciding whether to assume a lease will generally not be disturbed.").

PG&E's assumption of the HPP Contracts is based on a sound business decision and is necessary for a successful reorganization. Most significantly, the cost of power PG&E purchases under the HPP Contracts is substantially lower than the power prices currently prevailing in the market. The lower cost is a result of the hydroelectric projects having been financed with tax exempt revenue bonds and PG&E paying the Irrigation Districts and Water Agencies at cost for the hydroelectricity. The current average cost of energy under the HPP Contracts is approximately 1.15 cents/kWh based on average annual energy production. In comparison, the current market quotes for on-peak power in the third quarter of 2001 is 38 cents/kWh. Livingston Decl. ¶11. As the hydroelectricity purchased under the HPP Contracts is significantly more affordable than that currently available on the market, the HPP Contracts represent valuable company assets. In addition to benefiting PG&E, moreover, the low cost of the hydroelectricity flows straight to consumers.

Also, the HPP projects provide significant ancillary services under the terms of the HPP Contracts for which PG&E does not make further payments. The electricity transmission system, to function, requires that the generation of power match consumer demand. To address the fluctuation and ensure calibration, the system relies on various ancillary services known as "regulation," "spinning reserve," "non-spinning reserve," and "blackstart." The regulation service, for instance, reacts when demand exceeds generation by sending out a command to reserve generators to increase the supply. The spinning, non-spinning and blackstart systems are also methods by which to expeditiously regulate power supplies to match instantaneous fluctuations in demand for electricity. Under the HPP Contracts, PG&E has available these ancillary services at no additional cost and may use these capabilities to meet the needs of its retail load or, if the services exceed the need, sell them on the market to the ISO and credit back the revenue to retail customers. *Id.* ¶12. These ancillary services are thus valuable assets — for their financial value as well as their role in inspiring consumer confidence — and PG&E's decision to assume the HPP Contracts is based on sound business judgment.

The majority of the HPP projects, including the Tri-Dam Project, Yuba-Bear Project, Merced River Development Project, Yuba River Development Project, and Rollins Powerhouse Project, are, moreover, hydraulically interconnected with PG&E-owned projects. In other words, water passes back and forth between a HPP project powerhouse and a PG&E powerhouse. *Id.* ¶13 Under the HPP Contracts, PG&E dispatches both projects and the operations are highly coordinated to maximize the use of water resources for generating power. If the Court does not authorize PG&E to assume the HPP Contracts, the project owners may sell the hydropower to others with different load characteristics and the new customers' generation needs will likely be at variance with that of PG&E's. Such a convoluted operation could result in reducing the amount of power PG&E is able to generate as well as undermine the effective use of water resources in general. By assuming the HPP Contracts, PG&E intends to preempt this potential havoc and stabilize its business.

1 In sum, PG&E's decision to assume the eight HPP Contracts is based on sound
2 business judgment. Most significantly, the cost of power PG&E purchases under the HPP
3 Contracts is substantially lower than the power prices currently prevailing in the market and
4 such cost-effectiveness surely makes business sense. In addition to the low cost of
5 hydroelectricity, the HPP Contracts provide PG&E with ancillary services which it can then
6 make available on the market for the ISO to purchase. The HPP project operations as
7 presently configured are, moreover, highly coordinated and interconnected with PG&E-
8 owned projects. In light of these factors, business judgment compels the assumption of the
9 HPP Contracts.

10
11 C. PG&E Will Cure All Arrearages And Provide Adequate Assurance Of Future
12 Performance In Compliance With 11 U.S.C. Section 365(b).

13 Section 365(b)(1) provides that the debtor in possession may not assume an executory
14 contract unless it provides adequate assurance that it will cure any defaults, that it will
15 compensate the other party for any pecuniary loss resulting from the default, and that the
16 contract will be performed in the future. 11 U.S.C. §365(b)(1)(A)-(C). See also General
17 Motors Corp. v. Worthington (In re Claremont Acquisition Corp., Inc.), 113 F.3d 1029, 1033
18 (9th Cir. 1997) ("In general, a debtor must cure all defaults, both monetary and
19 nonmonetary, prior to the assumption and assignment of an executory contract."). In
20 compliance with Section 365(b)(1), and upon entry of the Court's order authorizing
21 assumption of the HPP Contracts, PG&E will cure all arrearages. Such arrearages do not
22 exceed the amount of one month's worth of O&M payments on each contract. Prior to filing
23 the Chapter 11 petition, PG&E was timely in making its semiannual construction payments
24 and monthly O&M payments according to the terms of each HPP Contract. Livingston
25 Decl. ¶15. As a consequence of filing the petition, however, PG&E was unable to issue the
26 first O&M payments which fell due after the Petition Date but which covered a portion of
27 the pre-petition period. These payments represent an aggregate amount of approximately
28 \$1.62 million in arrearages, ranging from approximately \$6,147 due under the Rollins

1 Powerhouse Project Contract to approximately \$469,522 due under the Middle Fork Project
2 Contract. *Id.* ¶16. PG&E has more than adequate cash reserves to cure these arrearages.

3 In addition, and as required under §365(b), PG&E has sufficient revenue to provide
4 adequate assurance of future performance under the HPP Contracts. PG&E estimates that
5 the combined average construction payments due under the HPP Contracts from April 20,
6 2001 until 2004 will be approximately \$27.4 million per annum and the estimated combined
7 average O&M payments due under the HPP Contracts for this same time period will be
8 approximately \$27.8 million per annum. Beginning in 2004 and unless any HPP Contract is
9 renewed, moreover, the combined average payment PG&E will owe under the HPP
10 Contracts will decrease even after accounting for inflation and changing project operating
11 and maintenance needs as the HPP Contracts will begin to conclude. PG&E's revenue, on
12 the other hand, based on its rate setting and collection structure, has averaged approximately
13 \$22.2 billion per annum from 1998 to 2000. The payments due under the HPP Contracts
14 therefore represent only a small amount of PG&E's projected revenue. *Id.* ¶¶17-19. By this
15 Motion, PG&E is providing assurance that it is prepared to make the requisite payments out
16 of its rate revenues — PG&E has built the payment costs under the HPP Contracts into its
17 rate setting process — and there is no reason to believe it will be unable to do so.

18 Further on the adequate assurance front, the project owners are in a particularly good
19 position in the hypothetical (and definitely unlikely) event that PG&E were to default on its
20 payments under the HPP Contracts. First, because the HPP Contracts are based on power
21 values dramatically below market rates, any court-approved liquidation of the HPP Contracts
22 would produce a substantial premium providing a more than sufficient fund to compensate
23 the project owners for any damages and make them whole. Second, if PG&E breached the
24 HPP Contracts post-assumption and the Court decided to allow the project owners to
25 terminate such contracts, the project owners themselves presumably would be able to resell
26 the subject hydroelectricity for substantially higher prices than those on which the HPP
27 Contracts are based. The project owners would therefore not only suffer no damages but, on
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1 the contrary, would reap a substantial windfall benefit. There should, therefore, be no
2 question that PG&E is providing sufficient adequate assurance of future performance.

3
4 IV.

5 CONCLUSION

6 For the foregoing reasons and pursuant to 11 U.S.C. Section 365, PG&E respectfully
7 requests that the Court enter an order authorizing PG&E to assume the HPP Contracts.
8

9 DATED: April 25, 2001

10 Respectfully,

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

By: 

JEFFREY L. SCHAFER

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

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