

50-275/323

JAMES L. LOPES (No. 63678)  
WILLIAM J. LAFFERTY (No. 120814)  
GARY M. KAPLAN (No. 155530)  
CEIDE ZAPPARONI (No. 200708)  
HOWARD, RICE, NEMEROVSKI, CANADY,  
FALK & RABKIN  
A Professional Corporation  
Three Embarcadero Center, 7th Floor  
San Francisco, California 94111-4065  
Telephone: 415/434-1600  
Facsimile: 415/217-5910

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

UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF CALIFORNIA  
SAN FRANCISCO DIVISION

In re

PACIFIC GAS AND ELECTRIC  
COMPANY, a California corporation,

Debtor.

Federal I.D. No. 94-0742640

Case No. 01 30923 DM

Chapter 11 Case

Date: December 19, 2001

Time: 9:30 a.m.

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

HOWARD  
RICE  
NEMEROVSKI  
CANADY  
FALK  
& RABKIN  
A Professional Corporation

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF DEBTOR'S  
MOTION FOR (1) AUTHORITY TO COMPROMISE CLAIMS DUE ESTATE BY  
SEMPRA ENERGY TRADING CORPORATION AND SEMPRA ENERGY  
CORPORATION; (2) AUTHORITY TO ENTER INTO MASTER GAS AGREEMENT  
AND (3) APPROVAL OF PROVISIONS OF MASTER GAS AGREEMENT MODIFYING  
AUTOMATIC STAY

1001 Add: Kids Oge Mail Center

## TABLE OF CONTENTS

|  | Page |
|--|------|
| INTRODUCTION   | 1    |
| STATEMENT OF FACTS   | 2    |
| A. The Gas Agreements Between PG&E And SET.  | 2    |
| 1. The Master Gas Purchase and Sale Agreement and the DOE Orders.  | 2    |
| 2. The Gas Transmission Service Agreement.   | 3    |
| 3. The International Swap Dealers Association, Inc. ("ISDA") Agreement.  | 4    |
| B. SET's Electricity Claims.   | 4    |
| C. Disputes Between PG&E And SET Arising Out Of The Gas Agreements And The Electricity Claims.   | 4    |
| D. The Proposed Settlement Agreement With Sempra.  | 6    |
| ARGUMENT   | 8    |
| I. THE AGREEMENT IS FAIR AND EQUITABLE AND SHOULD BE AUTHORIZED PURSUANT TO BANKRUPTCY RULE 9019   | 8    |
| A. Bankruptcy Law Favors Compromises.  | 8    |
| B. The Agreement Compromises A Complex Series of Disputes Under Terms Beneficial To PG&E's Estate And Its Creditors Without The Expense and Diversion Of The Estate's Resources Attendant On Litigation. | 8    |
| 1. The Complexity and Novelty of the Disputed Issues Creates a Risk that PG&E Would Not Have Succeeded on the Merits.  | 8    |
| 2. The Continued Litigation Of The Complex Disputes Between Sempra And PG&E Would Entail Unnecessary Expense, Inconvenience, And Delay.  | 9    |
| 3. The Settlement Benefits PG&E's Estate And Creditors.  | 10   |
| II. PG&E SHOULD BE AUTHORIZED TO ENTER INTO THE PROPOSED NEW MASTER GAS AGREEMENT UNDER SECTION 363(B)(1) OF THE BANKRUPTCY CODE   | 11   |
| III. PG&E SHOULD BE AUTHORIZED TO INCUR POST-PETITION UNSECURED DEBT UNDER THE NMGA PURSUANT TO BANKRUPTCY CODE SECTION 364  | 12   |

TABLE OF CONTENTS

Page  
13

CONCLUSION

HOWARD  
RICE  
NEMENOVSKI  
CANADY  
BALK  
& RABKIN  

---

A Professional Corporation

## TABLE OF AUTHORITIES

| <u>Cases</u>  | <u>Page</u> |
|---|-------------|
| Arden v. Motel Partners, 176 F.3d 1226 (9th Cir. 1999)  | 8           |
| Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063 (2d Cir. 1983)                                 | 11          |
| In re Ames Dep't Stores, Inc., 115 B.R. 34 (Bankr. S.D.N.Y. 1990)   | 12          |
| In re Crouse Group, Inc., 71 B.R. 544 (Bankr. E.D. Pa. 1987)  | 12          |
| In re Simasko Prod. Co., 47 B.R. 444 (D. Colo. 1985)  | 12          |
| In re Tenney Vill. Co., Inc., 104 B.R. 562 (Bankr. D.N.H. 1989)   | 12          |
| Martin v. Kane (In re A & C Props.), 784 F.2d 1377 (9th Cir. 1986)  | 8, 10, 11   |
| Norris Square Civic Ass'n v. St. Mary Hosp. (In re St. Mary Hosp.), 86 B.R. 393, (Bankr. E.D. Pa. 1988)                         | 12          |
| Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.), 147 B.R. 650 (S.D.N.Y. 1992) | 11          |
| Protective Comm. for Indep. Stockholders of TMT Trailer Ferry Inc. v. Anderson, 390 U.S. 414 (1968)                             | 8           |
| Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)   | 11          |
| Stephens Indus., Inc. v. McClung, 789 F.2d 386 (6th Cir. 1986)  | 11          |
| Woodson v. Fireman's Fund Ins. Co., 839 F.2d 610 (9th Cir. 1988)  | 8           |

### Statutes

|            |    |
|------------|----|
| 11 U.S.C.  |    |
| §363(b)(1) | 11 |
| §364(b)    | 12 |
| §365(e)(1) | 7  |

### Other Authorities

|   |    |
|---|----|
| Lawrence P. King, 3 <u>Collier on Bankruptcy</u> (15th ed. rev. 1998) | 11 |
|---|----|

WD 111601/1-1419949/cec/954787/v3

## INTRODUCTION

Pacific Gas and Electric Company ("PG&E" or "Debtor"), the debtor and debtor in possession in the above-captioned Chapter 11 case, seeks the Court's authorization to enter into a settlement agreement compromising certain of its claims against Sempra Energy Trading Corporation ("SET") and Sempra Energy Corporation ("Sempra Corp.") (collectively "Sempra"). As part of the settlement between Sempra and PG&E, PG&E seeks approval to enter into a new form of Master Gas Agreement with SET, which includes provisions expressly modifying the automatic stay of Section 362(a) of the Bankruptcy Code.

PG&E and Sempra are parties to a number of complex agreements governing purchase, sale and other transactions in natural gas under which multiple disputes have arisen. On November 5, 2001, Sempra and PG&E entered into an agreement entitled "Settlement Agreement and General Release" (the "Agreement"). Subject to the approval of this court, the Agreement resolves all outstanding gas disputes between Sempra and PG&E and provides for a payment to PG&E of \$48.5 million.<sup>1</sup>

The Agreement meets the requirements for authorization under Bankruptcy Rule 9019. It provides for Sempra's payment to PG&E of \$48.5 million, payable upon the "effective date" as defined in the Agreement, that is, the date upon which this Court has entered a final and non-appealable Order authorizing the entry into the Agreement. The Agreement provides for this multi-million dollar payment to PG&E's estate without the expense, risk and delay that would result if PG&E were forced to litigate a complex series of disputes arising out of the numerous agreements with Sempra at issue. The Agreement is therefore in the best interests of PG&E's bankruptcy estate, satisfies the standard for the compromise of claims, and should be authorized by this Court.

---

<sup>1</sup>The Agreement reserves for another day the resolution of Sempra's claims against PG&E arising out of electricity provided by Sempra into the Independent System Operator ("ISO") and California Power Exchange ("PX") markets. Agreement ¶8; see discussion infra at 7.

1 Furthermore, the Agreement provides for PG&E and SET to enter into an New  
2 Master Gas Agreement (the "NMGA"), allowing for deliveries of gas to PG&E for the next  
3 12 months and containing provisions modifying the automatic stay in a limited way. See  
4 discussion *infra* at p. 7 n.6. As explained in further detail, *infra*, the NMGA is a reasonable  
5 agreement that is in the best interests of PG&E's Chapter 11 estate and creditors. The  
6 NMGA will help to ensure gas supply on reasonable terms for PG&E's residential and small  
7 business customers.

## 8 9 STATEMENT OF FACTS

### 10 A. The Gas Agreements Between PG&E And SET.

11 In 1998 and 1999 PG&E and SET entered into a number of contracts governing  
12 transactions in natural gas between the two companies.<sup>2</sup>

#### 13 1. The Master Gas Purchase and Sale Agreement and the DOE Orders.

14 Effective January 1, 1998, the "core gas procurement" department of PG&E  
15 ("Core Procurement") and SET entered into the Master Gas Purchase and Sale Agreement  
16 (the "MGPSA"), which contains the general terms applicable to gas purchase, sale and  
17 exchange transactions between PG&E and SET. MGPSA at 1. Declaration of David  
18 Anderson filed herewith ("Anderson Decl.") Ex. 1 at Ex. 2. Core Procurement is  
19 responsible for acquiring the natural gas needed to serve PG&E's "core" customers,  
20 primarily residential and small business gas users. Anderson Decl. ¶3; Declaration of  
21 Raymond X. Welch filed herewith ("Welch Decl.") ¶1. SET and PG&E entered into a  
22 number of sales transactions under the MGPSA. Anderson Decl. ¶3.

23 On January 19, 2001 and January 23, 2001, the United States Secretary of Energy  
24

25 <sup>2</sup>Further details regarding the Gas Transmission Service Agreement and the  
26 transactions thereunder, the Master Gas Purchase and Sale Agreement, the ISDA, and a  
27 detailed recitation of the history of disputes between SET, Sempra Corp. and PG&E is set  
28 forth in the Declaration of Daniel F. Thomas of PG&E and the exhibits thereto, executed on  
June 22, 2001 and filed with this Court in support of PG&E's Opposition to SET's Motion  
for Relief from Stay filed July 5, 2001. A true and correct copy of the said Declaration is  
attached as Exhibit 1 to PG&E's Request for Judicial Notice, filed herewith ("RJN") Ex. 1.

1 issued Temporary Emergency Natural Gas Purchase and Sale Orders (collectively, the "DOE  
2 Orders") in order to "assure the continued availability of natural gas for high-priority  
3 (including electric generation) uses in the central and northern regions of California." Inter  
4 alia, the DOE Orders required SET to deliver natural gas to PG&E in accordance with pre-  
5 existing contractual arrangements, namely, consistent with the terms of the MGPSA.  
6 Anderson Decl. Ex. A at Ex. 5.

## 7                   2.    The Gas Transmission Service Agreement.

8                   Effective March 1, 1998, PG&E and SET entered into the Gas Transmission  
9 Service Agreement (the "GTSA"). Anderson Decl. Ex. A at Ex. 1. In the GTSA, PG&E  
10 agreed to make available to SET certain gas transmission (i.e., transportation) services.  
11 Anderson Decl. ¶6. It also agreed to make available to SET gas "lending" and "parking"  
12 services, whereby PG&E would provide loans of natural gas to SET from PG&E's system,  
13 to be paid back in kind within a specified term, which could run from one day to a number of  
14 months; or would permit SET to "park" natural gas by providing storage of gas on PG&E's  
15 system. Id. The GTSA provides the general terms applicable to PG&E's provision of gas  
16 transmission, parking and lending services. Id. The specific terms of individual transactions  
17 were separately specified in individual written confirmations (entitled "Exhibits")  
18 subsequently entered into by the parties under the GTSA. Id. In particular, the precise  
19 amounts of natural gas lent or parked, the duration of each separate lending or parking  
20 transaction, and the price agreed upon for each transaction were specified in the Exhibits  
21 completed by SET and PG&E on a per-transaction basis. Id.

22                   Parking and lending services are subject to the terms of the CPUC-approved tariff  
23 schedule entitled "G-BAL," which addresses the consequences of imbalances in the parties'  
24 gas lend or parking positions, i.e. any failure of PG&E's customers to return lent gas or  
25 remove parked gas from PG&E's system at the end of the transaction. Anderson Decl. ¶7;  
26 RJN Ex. 4 at E. G-BAL provides that in the event that a customer fails to return gas lent in  
27 accordance with an Exhibit, and agreement is not reached between PG&E and the customer  
28 within 30 days for return of the gas, the outstanding balance is subject to a mandatory cash-

1 out provision and certain imbalance and reimbursement charges accrue to PG&E. Anderson  
2 Decl. ¶7; RJN Ex. 1 at Ex. E.

3 **3. The International Swap Dealers Association, Inc. ("ISDA") Agreement.**

4 In July 1999, PG&E and Sempra entered into the International Swap Dealers  
5 Association Inc. Agreement (the "ISDA"). Anderson Decl. ¶8 & Ex. A at Ex. 4. The ISDA  
6 governs various swap or hedging transactions in financial instruments, which were intended  
7 to hedge the parties' risk in the natural gas markets. Generally speaking, upon events of  
8 defined default, the ISDA provides for a close-out of certain outstanding transactions  
9 between the parties and a setoff of amounts remaining outstanding between the parties  
10 arising out of such transactions.<sup>3</sup>

11 **B. SET's Electricity Claims.**

12 SET was a supplier of electricity into the Independent System Operator ("ISO")  
13 and the California Power Exchange ("PX") markets. Anderson Decl. ¶9. SET has claimed  
14 that (a) the ISO and the PX were PG&E's agents for the purchase of certain of the electricity  
15 provided to the ISO and PX, and (b) PG&E owes it approximately \$70 million for the supply  
16 of electricity into the ISO and PX markets. *Id.*

17 **C. Disputes Between PG&E And SET Arising Out Of The Gas Agreements  
18 And The Electricity Claims.**

19 Beginning in January 2001, disputes arose between PG&E and SET regarding  
20 their respective performance under the MGPSA (including with regard to the volumes and  
21 pricing of gas provided to PG&E under the DOE Orders), the GTSA, the ISDA (collectively  
22 the "Gas Agreements") and electricity supplied by SET into the ISO and PX markets.  
23 Anderson Decl. ¶10.

24 On January 18, 2001, SET purported to terminate all of the Gas Agreements with  
25 PG&E and net out the outstanding amounts thereunder. RJN Ex.1 at Ex. E. SET purported

26 <sup>3</sup>This is a very general description of the operations of the ISDA setoff provisions.  
27 As the court is aware, PG&E and Sempra vigorously disputed the precise interpretation and  
28 parameters of the ISDA setoff provisions. The Agreement does not articulate any consensus  
between the parties as to a definitive interpretation of the ISDA setoff provision, but merely  
renders it moot for the purpose of the disputes between PG&E and Sempra.



1 to exercise its setoff rights under the ISDA and MGPSA to setoff gas volumes (valued in  
2 dollars) it owed under the GTSA against amounts that SET claimed PG&E owed SET for  
3 electricity supplied to the ISO and PX. Anderson Decl. ¶11. As a result, SET claimed that it  
4 owed nothing to PG&E under all the Gas Agreements, and PG&E owed SET certain—  
5 unquantified—amounts. Id. & Ex. A at Ex. 6. As a further result of its claimed setoff,  
6 Sempra claimed it had no obligation to return net amounts of gas lent and owing to PG&E  
7 under the GTSA because it claimed that all the transactions set forth in the outstanding  
8 exhibits had been also terminated and setoff effective January 18, 2001. Id.

9 As of the date of Sempra's purported "termination" of its obligations to return gas  
10 to PG&E under the GTSA, there were approximately nine billion cubic feet of natural gas  
11 that SET asserted it would not return to PG&E, which PG&E was owed over the remainder  
12 of the year 2000. Anderson Decl. ¶12. As gas became due and was not delivered, PG&E  
13 was obliged to replace it at its own expense in order to ensure that service to customers and  
14 the integrity of PG&E system operations would be maintained. Id.

15 Furthermore, as SET failed to return gas under Exhibits that had become due,  
16 PG&E believes that significant imbalance charges were accruing under Schedule G-BAL at  
17 the rate of millions of dollars per week. Anderson Decl. ¶13; RJN Ex. 1 at Ex. E.

18 To partially address PG&E's claims and ensure that PG&E received certain of the  
19 outstanding gas deliveries, which it had not as yet replaced, on May 17, 2001, the parties  
20 entered into a stipulation providing that SET would deliver all the gas PG&E claimed  
21 Sempra was obliged to deliver from June 1, 2001 onwards (the "Stipulation"). Anderson  
22 Decl. ¶14 & Ex. A at Ex.6. The Stipulation was approved by this Court on May 29, 2001.  
23 Id. The Stipulation was entered into with a full reservation of rights on Sempra's part—if it  
24 was later determined that Sempra was correct in its assertion that its termination and setoff  
25 under the MGPSA and ISDA extinguished all its obligations to deliver this gas, PG&E  
26 would be liable to pay Sempra for all the post-June 1 gas delivered, together with interest.  
27 Stipulation at ¶3; Anderson Decl. Ex. A at Ex. 6.

SET sought to arbitrate all disputes with PG&E under the GTSA and in relation to its claimed electricity setoff; and on June 5, 2001, SET sought relief from stay from this Court in order to do so. RJN Ex. 2. By order dated July 28, 2001, this Court modified the automatic stay to allow Sempra to arbitrate its disputes under the GTSA, including its setoff defenses under the ISDA and MGPSA, so long as the arbitration did not "determine: (a) the amount of any net liability of PG&E to SET (after the application of SET's setoff claims) and (b) whether PG&E has any claims against SET pursuant to Section 553(b) of the Bankruptcy Code [regarding mutuality of setoff]." Anderson Decl. Ex. A at Ex. 7.

Furthermore, apart from disputes under the GTSA, disputes also arose between the parties in relation to amounts outstanding under SET's claimed termination of the ISDA and the claimed termination of the MGPSA. Anderson Decl. ¶15.

Thus, in summary, at the time of the Court's order on July 28, 2001, SET and PG&E were embroiled in disputes under the GTSA, the ISDA, the MGPSA (including the DOE Orders), and SET's electricity claims.<sup>4</sup> See Anderson Decl. ¶¶11, 13-15.

#### **D. The Proposed Settlement Agreement With Sempra.**

On November 5, 2001, PG&E entered into the Agreement with SET and Sempra Corp. which, subject to the Court's approval, settles all the outstanding disputes with SET under the Gas Agreements; provides that SET and PG&E will enter into an NMGA; and, importantly, reserves the electricity disputes between SET and PG&E for another day. Anderson Decl. ¶16. In broad terms, the Agreement provides that:

(i) all disputes between SET and PG&E in relation to the Gas Agreements (the GTSA, the MGPSA (including the DOE Orders), and the ISDA) are resolved with a one-

---

<sup>4</sup>In addition, a dispute arose between PG&E and Sempra Corp., as a guarantor of SET. On March 23, 2001, PG&E directed a letter to Sempra Corp. demanding that Sempra Corp., as guarantor under a guarantee dated June 9, 1999, provide prompt and complete payment and performance under the GTSA. RJN Ex. 1 at ¶18 & Ex. L. By letter dated March 26, 2001, Sempra Corp. refused to honor PG&E's demand, taking the position that "no amount is owing at this time from [SET] to PG&E, so no amount can be due under the Guarantee." RJN Ex. 1 ¶18 & Ex. M. As the terms of the Agreement resolves all gas disputes between SET and PG&E; consequently, the dispute on the guarantee between Sempra Corp. and PG&E is also resolved.

1 time payment by Sempra to PG&E of \$48.5 million payable upon the "effective date" of the  
2 Agreement, as defined. Agreement ¶7.<sup>5</sup>

3 (ii) Sempra and PG&E agree to defer resolution of Sempra's claims for electricity  
4 supplied to the ISO and PX, which Sempra claims was supplied to the ISO and PX as agents  
5 for PG&E. Agreement ¶8.

6 (iii) SET agrees to deliver the remainder of the post-June 1 gas as provided for in  
7 the Stipulation, without payment from PG&E, i.e., waiving any claim that PG&E is required  
8 to pay any amount on account of the post-June 1 gas. Agreement ¶3.

9 (iv) SET and PG&E agree, subject to this Court's approval, to enter into the  
10 proposed NMGA providing for SET to deliver natural gas to PG&E's Core Procurement  
11 department on substantially similar terms as those set forth in the MGPSA except that (1)  
12 PG&E is obliged to prepay for gas deliveries on a monthly basis and (2) SET agrees to  
13 provide a \$10 million line of credit to be utilized by PG&E in certain circumstances.

14 Agreement ¶6 & Ex. 9; Welch Decl. ¶7.

15 (v) As part of the proposed NMGA, and subject to this Court's approval, PG&E  
16 agrees to modify the automatic stay in the event of certain defined events of default on the  
17 part of PG&E.<sup>6</sup> Agreement ¶1.

18 <sup>5</sup>The "effective date" of the Agreement is the date upon which the Order of the  
19 Bankruptcy Court approving the Agreement and making consequent Orders becomes final  
and non-appealable. Agreement ¶1.

20 <sup>6</sup>The proposed NMGA includes provisions modifying the automatic stay as follows:  
21 if PG&E's bankruptcy case is converted to a case under Chapter 7 of the Bankruptcy Code  
22 or a Trustee is appointed in PG&E's pending bankruptcy case, SET may deem such event to  
23 be a default under the NMGA, and in the event of such a default the automatic stay  
24 provisions of the Bankruptcy Code are permanently vacated solely for the purposes of (i)  
25 permitting SET to immediately close out, liquidate and terminate, exercise its right of setoff,  
26 and exercise its other remedies under the NMGA, without the need to obtain further  
27 approval of this Court; and (ii) providing that SET's rights to close out, liquidate and  
28 terminate and to exercise its right of setoff and other rights under the NMGA shall not be  
stayed, avoided, or otherwise limited by order of the Bankruptcy Court. This is limited and  
appropriate relief in the circumstances. Furthermore, such prospective relief from stay  
merely gives SET what it is arguably entitled to in any event. Section 556 of the Code  
which deals with forward contracts, of which the New Master Gas Agreement would be an  
example, provides that the non-debtor counter-party to such a contract may liquidate the  
contract notwithstanding the provisions of section 362(a), in the event of a default of the type  
specified in section 365(e)(1) (financial condition or insolvency). See 11 U.S.C. §365(e)(1)  
& 556; Agreement at Ex. 9.

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

**ARGUMENT**

**I. THE AGREEMENT IS FAIR AND EQUITABLE AND SHOULD BE AUTHORIZED PURSUANT TO BANKRUPTCY RULE 9019**

**A. Bankruptcy Law Favors Compromises.**

Bankruptcy law favors compromises which are considered “a normal part of the process of reorganization.” Protective Comm. for Indep. Stockholders of TMT Trailer Ferry Inc. v. Anderson, 390 U.S. 414, 424 (1968). The Bankruptcy Court accordingly has great latitude in approving compromise agreements. See Martin v. Kane (In re A & C Props.), 784 F.2d 1377, 1380-81 (9th Cir. 1986). The Court’s discretion is not, however, unlimited. See Arden v. Motel Partners, 176 F.3d 1226, 1228 (9th Cir. 1999). The Court may approve a compromise only if its “fair and equitable.” Protective Comm. for Indep. Stockholders of TMT Trailer Ferry Inc., 390 U.S. at 424. In evaluating any proposed compromise, the Court must consider the following factors:

“(a) The probability of success in the litigation; (b) the difficulties, if any, to be encountered in the matter of collection; (c) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; (d) the paramount interest of the creditors and a proper deference to their reasonable views in the premises.” (Woodson v. Fireman’s Fund Ins. Co., 839 F.2d 610, 620 (9th Cir. 1988) (quoting In re A&C Properties, 784 F.2d 1377, 1381 (9th Cir. 1986)).

Courts weigh these factors to determine whether the compromise is in the best interests of the estate. See A & C Props., 784 F.2d at 1382 (court must “weigh certain factors to determine whether the compromise is in the best interest of the bankrupt estate”).

**B. The Agreement Compromises A Complex Series of Disputes Under Terms Beneficial To PG&E’s Estate And Its Creditors Without The Expense and Diversion Of The Estate’s Resources Attendant On Litigation.**

Each of the A&C Properties factors weighs in favor of authorization of the Agreement.

**1. The Complexity and Novelty of the Disputed Issues Creates a Risk that PG&E Would Not Have Succeeded on the Merits.**

The Agreement provides for Sempra to defer resolution of its electricity claims, and settles all of the gas claims between the parties. Agreement ¶8; Anderson Decl. ¶17.

1 Thus, Sempra waives any claim that its electricity setoff claims wipe out its liability to return  
2 any gas under the GTSA after its purported termination on January 18, 2001. The benefit to  
3 the estate of this resolution is substantial. Dealing with Sempra's claimed electricity setoffs  
4 would have added a significant layer of factual, legal, and regulatory complexity and  
5 uncertainty to the arbitration of the parties' disputes. Id.

6 The meaning and scope of the setoff language in the ISDA was vigorously  
7 disputed by the parties and certainly would have been vigorously litigated. Anderson Decl.  
8 ¶18. PG&E's interpretation of the ISDA and of applicable bankruptcy law precluded setoff  
9 of SET's electricity claims against the amounts outstanding to PG&E under the Gas  
10 Agreements. Id. While PG&E believes that its arguments may have prevailed, the language  
11 of the ISDA provision is by no means clear, and the interpretation of the ISDA provision in  
12 this factual context is a matter of first impression. Id. Therefore, there is a real risk of a  
13 determination adverse to PG&E. Furthermore, the consequences of an adverse decision are  
14 significant. If SET were permitted to setoff its electricity claims, PG&E would receive no  
15 payment at all for (1) the millions of cubic feet of gas owed by SET; (2) reimbursement for  
16 the gas replacement costs that had been borne by PG&E; or (3) the imbalance charges that  
17 PG&E could otherwise claim had accrued under Schedule G-BAL. Anderson Decl. ¶19.  
18 Furthermore, had the arbitration panel permitted Sempra's claimed electricity setoffs, then  
19 PG&E would have been obliged to pay for the deliveries of gas received after January 18,  
20 together with interest, pursuant to the Stipulation. See Id., Ex. A at Ex. 6. It is estimated  
21 that PG&E would have been "out-of-pocket" by approximately \$45 million had this  
22 occurred. See Id. ¶19. In the Agreement, conversely, PG&E's receipt of the post-June 1 gas  
23 will continue in accordance with the Stipulation, and PG&E will owe no amount in relation  
24 to those deliveries. Agreement ¶3.

25 **2. The Continued Litigation Of The Complex Disputes Between Sempra**  
26 **And PG&E Would Entail Unnecessary Expense, Inconvenience, And**  
27 **Delay.**

28 The Agreement settles most of the outstanding claims between the parties without  
protracted litigation, which was anticipated to include an arbitration of certain claims and

1 further subsequent bankruptcy court involvement to deal with setoff issues. See Anderson  
2 Decl. ¶17; RJN Ex. 1 at F. Thus, the Agreement avoids the costs and delay of the arbitration  
3 of PG&E's claims under the GTSA and Sempra's setoff claims under the ISDA and MGPSA  
4 and on account of its electricity deliveries. The litigation expenses and delay in arbitrating  
5 these claims would have been significant. Anderson Decl. ¶17. The arbitration itself would  
6 have been a lengthy procedure, probably including discovery and detailed briefing.  
7 Furthermore, due to the fact that the Bankruptcy Court's Order somewhat limited the  
8 arbitrator's authority to deal with certain setoff issues, there was the potential for protracted  
9 skirmishing both before the arbitrator and the Bankruptcy Court concerning the parameters  
10 of the arbitrator's authority and whether or not the arbitrator had acted within such  
11 parameters. Obviously, this effort is avoided and funds which otherwise would have been  
12 used in litigating this issue can be put to other uses. This factor militates in favor of prompt  
13 settlement.

### 14 **3. The Settlement Benefits PG&E's Estate And Creditors.**

15 The Agreement compromises the parties' numerous disputes regarding  
16 transactions in natural gas in a way that (1) avoids the risks and expense attendant upon the  
17 undoubtedly protracted litigation of a series of factually and legally complex agreements in  
18 more than one forum, (2) provides for the immediate payment of a large sum of money  
19 outstanding to the estate, and (3) assists in the security of gas supply for core customers in  
20 the short and medium term by providing for continued deliveries of the post-June 1 gas and  
21 the entry by SET into a further agreement by SET to supply core gas for next year. Thus,  
22 the Agreement benefits PG&E's estate and creditors in a number of ways. Avoidance of the  
23 expense and diversion of resources attendant on unnecessary litigation will benefit PG&E's  
24 creditors. The Agreement will add \$48.5 million to the estate at a time when PG&E is  
25 attempting to work towards a reorganization of its affairs. See Agreement ¶7. Furthermore,  
26 PG&E and its counsel have determined that the Agreement is in the best interests of both  
27 PG&E and its creditors. See Anderson Decl. ¶21. "The bankruptcy judge may give weight  
28

1 to the opinions of the trustee, the parties and their attorneys.” A & C Props., 784 F.2d at  
2 1384.

3 **II. PG&E SHOULD BE AUTHORIZED TO ENTER INTO THE PROPOSED NEW**  
4 **MASTER GAS AGREEMENT UNDER SECTION 363(B)(1) OF THE**  
5 **BANKRUPTCY CODE**

6 PG&E should be authorized to enter into the proposed NMGA pursuant to  
7 Section 363(b)(1) of the Bankruptcy Code.<sup>7</sup>

8 In determining whether to authorize a transaction under Section 363(b)(1), courts  
9 require a debtor to show that a sound business purpose justifies such actions, applying the  
10 “business judgment” test. See e.g., Stephens Indus., Inc. v. McClung, 789 F.2d 386, 389-90  
11 (6th Cir. 1986); Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722  
12 F.2d 1063, 1071 (2d Cir. 1983); see also 3 Lawrence P. King, Collier on Bankruptcy  
13 §363.02[1][g] (15th ed. rev. 1998).

14 The burden of establishing a valid business purpose for a transaction outside the  
15 ordinary course of business falls upon the debtor. See In re Lionel Corp., 722 F.2d at 1063.  
16 Once the debtor has articulated a rational business justification, however, a presumption  
17 attaches that the decision was made on an informed basis, in good faith and in the honest  
18 belief that the action was in the best interest of the debtor. See e.g., Official Comm. of  
19 Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.), 147 B.R. 650,  
20 656 (S.D.N.Y. 1992) (citing Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)).

21 Here, sound business justifications exist for PG&E’s entry into the proposed  
22 NMGA. The terms of the NMGA are commercially reasonable, including the payment  
23 terms. See Welch Decl. ¶6. Furthermore, the NMGA provides for Sempra’s supply of gas  
24 to Core Procurement for 12 months (6% of Core Procurement’s entire gas requirements for  
25 the year), thus assuring certainty of supply for a part of PG&E’s core gas needs. Welch

26 <sup>7</sup>It is arguable that entering into the proposed NMGA is within the ordinary course of  
27 PG&E’s business—the purchase and sale of gas to meet its core requirements—  
28 notwithstanding the requirement that PG&E prepay for the gas on a monthly basis.  
However, notwithstanding this, the proposed NMGA meets the standard for approval under  
Section 363(b)(1), as discussed above.

Decl. ¶8. The NMGA is thus beneficial in that it assists in ensuring a reliable supply of core gas at a fair and reasonable price for PG&E customers over the winter months. Id.

### III. PG&E SHOULD BE AUTHORIZED TO INCUR POST-PETITION UNSECURED DEBT UNDER THE NMGA PURSUANT TO BANKRUPTCY CODE SECTION 364

PG&E should also be authorized to enter into the NMGA pursuant to Bankruptcy Code section 364(b).

Bankruptcy Code Section 364(b) provides, in pertinent part, as follows:

“The Court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or incur unsecured debt other than under subsection (a) of this section<sup>8</sup>, allowable under section 503(b)(1) of this title as an administrative expense.” (11 U.S.C. §364(b))

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

In this case, the proposed NMGA provides for a \$10 million line of credit for the

---

<sup>8</sup>Subsection (a) of Section 364 authorizes the trustee to obtain unsecured credit and incur unsecured debt in the ordinary course of business. 11 U.S.C. § 364 (a).



1 provision of "swing gas," which refers to incidental gas purchases used, for example, to  
2 cover sudden upswings in demand. Welch Decl. ¶7; Agreement Ex. 9. This is required in  
3 order that PG&E have the flexibility to respond to unexpected surges in demand for gas, for  
4 example, the occurrence of an unseasonable cold snap. Such financing is clearly in the best  
5 interests of the estate and is not detrimental to parties in interest in this case. The NMGA  
6 does not contain terms that are primarily designed to benefit Sempra at the expense of the  
7 estate or to prevent motions by parties in interest from being decided on their merits.  
8 Accordingly, the Court should authorize PG&E to incur post-petition unsecured debt to  
9 Sempra under Section 364(b), as discussed above.


### 10 CONCLUSION

11 For all of the foregoing reasons, PG&E respectfully requests that this Court grant  
12 the Motion and enter its Order (1) authorizing PG&E to compromise its claims against  
13 Sempra in the terms of the Agreement and the Proposed Order filed herewith; (2)  
14 authorizing PG&E to enter into the NMGA and (3) approving of the provisions in the  
15 NMGA that grant prospective relief from stay to SET as provided for discussed in the  
16 Agreement.

17 DATED: November 19, 2001.

18 Respectfully,

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

21 By:   
22 CEIDE ZAPPARONI

23 Attorneys for Debtor and Debtor in Possession  
24 PACIFIC GAS AND ELECTRIC COMPANY  
25  
26  
27  
28