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50-275/323

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: September 26, 2003 Time: 10:30 a.m. Place: 235 Pine Street, 22nd Floor San Francisco, California Judge: Hon. Dennis Montali

HOWARD RICE NEMEROVSKI CANADY FALK & RABKIN
A Professional Corporation

NOTICE OF MOTION AND MOTION FOR AUTHORITY TO ENTER INTO CERTAIN HEDGING TRANSACTIONS IN CONNECTION WITH FINANCING UNDER PROPOSED PLAN OF REORGANIZATION, AND TO INCUR SECURED DEBT RELATED THERETO; MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

[SUPPORTING DECLARATIONS OF MICHAEL J. DONNELLY, JOSEPH SAUVAGE AND WALTER S. HULSE FILED SEPARATELY]

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NOTICE OF MOTION AND MOTION

PLEASE TAKE NOTICE that on September 26, 2003 at 10:30 a.m., or as soon thereafter as the matter may be heard, in the Courtroom of the Honorable Dennis Montali, located at 235 Pine Street, 22nd Floor, San Francisco, California, Pacific Gas and Electric Company, the debtor and debtor in possession in the above-captioned Chapter 11 case ("PG&E" or the "Debtor"), will and hereby does move the Court for authority to enter into certain interest rate hedging transactions in connection with financing under the plan of reorganization for PG&E, to enter into and perform its obligations under related agreements, and to incur secured debt related thereto (the "Motion"). The Motion is based on this Notice of Motion and Motion, the accompanying Memorandum of Points and Authorities, the Declarations of Michael J. Donnelly ("Donnelly Declaration"), Joseph Sauvage ("Sauvage Declaration") and Walter S. Hulse ("Hulse Declaration") filed concurrently herewith, the record of this case and any evidence or argument presented at or prior to the hearing on this Motion.

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

MEMORANDUM OF POINTS AND AUTHORITIES[1]

I.

INTRODUCTION

By this Motion, PG&E requests authority, pursuant to Section 363(b)(1) and Section 364 of the Bankruptcy Code, to enter into certain interest rate hedging transactions in connection with financing under the reorganization plan for PG&E, and to incur secured debt related thereto. More specifically, and as explained in more detail below, PG&E seeks authorization to enter into interest-rate swaps, caps, collars, forward rate agreements, options and floors (collectively, the "Interest Rate Hedges") in connection with debt that PG&E contemplates issuing to implement a reorganization plan in this case, and the agreements with counterparties to the Interest Rate Hedges with respect thereto (collectively, the "Hedge Agreements"), subject to an aggregate liability limitation amount for all Interest Rate Hedges and Hedge Agreements as described below. Further, PG&E by this Motion seeks an order authorizing PG&E to incur secured obligations and post collateral to secure its obligations under certain Interest Rate Hedges and Hedge Agreements pursuant to Bankruptcy Code Section 364(d)(1), as described more specifically below.

Pursuant to this Motion, PG&E seeks authority to enter into Interest Rate Hedges and Hedge Agreements with maturity dates (in the case of Performance Interest Rate Hedges as defined below) or expiration dates (in the case of Straight Option Transactions as defined below) through June 30, 2004.[2] PG&E reserves the right to seek further authority with

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[1] The evidentiary basis and support for the facts set forth in this Motion are contained in the Donnelly Declaration filed concurrently herewith.

[2] PG&E anticipates a March 31, 2004 Effective Date for the currently pending Plan of Reorganization under Chapter 11 of the Bankruptcy Code for Pacific Gas and Electric Company Proposed By Pacific Gas and Electric Company, PG&E Corporation, and the Official Committee of Unsecured Creditors Dated July 31, 2003 (the "PG&E Plan"). (By its Order dated July 31, 2003, the Bankruptcy Court approved the Disclosure Statement with respect to the PG&E Plan and scheduled a confirmation hearing on the PG&E Plan to commence on November 3, 2003.) However, PG&E believes it is prudent to provide for some flexibility in the event this anticipated effective date of a plan of reorganization is delayed for any reason. PG&E believes that obtaining authorization to enter into Interest Rate Hedges with a settlement or exercise date of up to June 30, 2004 provides PG&E with adequate and reasonable flexibility, for the following reasons:

(continued . . .)

respect to any Interest Rate Hedges and Hedge Agreements as appropriate, including, without limitation, in the event that the PG&E Plan fails to be confirmed and become effective before the settlement dates of any Performance Interest Rate Hedges and corresponding Hedge Agreements entered into pursuant to this Motion, or in connection with an alternative reorganization plan for PG&E.[3]

The relief sought by this Motion reflects the fact that market interest rates are near historically low levels when viewed over the last 30 years. Securing the benefits of

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(... continued)

In the case of a Straight Option Transaction, the longer the period before the option expiration date the greater the cost of the option. The reason for this increased cost is that the longer exercise period increases the timeframe during which market movements can occur. As a result, the amount of risk protection provided by the option increases, since the probability that an option might be exercised increases, and the cost of obtaining such increased protection correspondingly increases. In short, a Straight Option (as defined below) with an expiration date of June 30, 2004 necessarily will cost more than a Straight Option with an expiration date of March 31, 2004.

Notwithstanding this increased cost, PG&E believes it is good business judgment to purchase an option with an expiration date that allows for some slippage in the Effective Date of the PG&E Plan, because the price of the option is based in part on current interest rate parameters as of the option purchase date, and the premium for the longer period is therefore fixed and known at the time of purchase. If, on the other hand, PG&E were to purchase a Straight Option with an expiration date of March 31, 2004 and there were some slippage in the Effective Date of the PG&E Plan, PG&E at that time would have to purchase a new Straight Option with a new expiration date, the price of which is unknowable at the present time because the second option necessarily would be priced based on interest rate parameters at the time of such future purchase. This is not a presently quantifiable risk. Accordingly, if PG&E determines to purchase a Straight Option, PG&E believes that it generally makes better business sense to purchase a Straight Option with an expiration date allowing for some flexibility, with a cost that is fully determinable and known at the time of purchase.

In the case of Interest Rate Hedges that combine one or more of the non-option hedging devices with an option hedging device, the same reasoning applies. Because virtually any Interest Rate Hedges entered into by PG&E pursuant to this Motion beyond a Straight Option Transaction will involve a combination of one or more non-option hedging devices with an option hedging device, PG&E by this Motion seeks authority to enter into Interest Rate Hedges with a settlement date of up to June 30, 2004.

[3] On July 25, 2003, PG&E petitioned the California Public Utilities Commission (the "Commission") for authorization to hedge interest rates for fixed rate long-term debt anticipated as part of the financing to implement a confirmed plan of reorganization in PG&E's bankruptcy case, prior to confirmation of a reorganization plan. PG&E's July 25, 2003 petition to the Commission builds on the Commission's prior decision (D.02-11-030) and seeks to modify that decision to expand the types of hedges and plans of reorganization covered by the Commission's authorization for pre-confirmation hedging. PG&E's ability to engage in the Interest Rate Hedges will be contingent upon receipt of appropriate approval from the Commission.

these low rates for the debt contemplated to be issued by PG&E under its reorganization plan will enhance the efficiency of such plan and will be beneficial to the estate and interested parties. Authorizing PG&E to enter into the Interest Rate Hedges and Hedge Agreements while forward interest rates are relatively low will provide a tool to help protect against potential significant increases in interest rates that might occur before its reorganization plan is implemented, thereby mitigating against potentially higher borrowing costs that may prevail when debt is issued as anticipated under PG&E's reorganization plan. This is in the interests of PG&E, its creditors and ratepayers alike.

II.

FACTUAL BACKGROUND

A. General Background

PG&E filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on April 6, 2001. A trustee has not been appointed, and PG&E continues to function as a debtor in possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code.

B. PG&E's Reorganization Plan

PG&E will be required to issue and/or reinstate significant amounts of long-term debt as part of its implementation financing under virtually any reorganization plan that will resolve this Chapter 11 case. Under the PG&E Plan, such long-term debt is anticipated to aggregate $8.8 billion, although contingencies could increase the amount to approximately $10.5 billion. Of the $8.8 billion, approximately $7.7 billion is estimated to be new long-term debt, of which approximately $7.4 billion is anticipated to be fixed-rate, long-term debt.[4] Entering into agreements to preserve the benefits of the currently low market interest

[4] Similar amounts of debt would be required under each of the reorganization plans previously proposed by (i) PG&E and PG&E Corporation (the "Original PG&E Plan"), and (ii) the California Public Utilities Commission and the Official Committee of Unsecured Creditors (the "Commission Plan"). In view of the PG&E Plan, the Bankruptcy Court has stayed confirmation proceedings with respect to the Original PG&E Plan and the Commission Plan. PG&E anticipates that regardless of which reorganization plan is confirmed in this case, PG&E will be required to issue significant amounts of long-term debt to implement such plan.

rates is anticipated to provide long-lasting benefits to the estate and interested parties.[5] Because the window of opportunity to secure the benefits of current low forward interest rates is uncertain, PG&E seeks authorization to promptly enter into the Interest Rate Hedges and Hedge Agreements pursuant to this Motion.

C. Interest Rates and Risk

The attractiveness of current market interest rates is exemplified by the closing yields on 5-year and 10-year U.S. Treasury notes, which were 3.34% and 4.48% per annum, respectively, as of August 26, 2003. These U.S. Treasury note rates, which are illustrative of similar trends in other interest rate benchmarks, are at levels close to the lowest rates seen in decades. On August 26, 2003, the 30-year U.S. Treasury bond yield was 5.27% per annum, which again is among the lowest rates prevailing since the United States Treasury began issuing 30-year bonds on a regular basis.

As is typical with corporate long-term debt, the interest rate on PG&E's anticipated long-term debt issuances under its reorganization plan will be based on a combination of the yield on a comparable maturity U.S. Treasury note or bond, which reflects the time-value of money (referred to as the "risk-free" rate), and a credit spread, which reflects a premium for PG&E's credit risk. The financial markets offer various mechanisms for PG&E to hedge the U.S. Treasury yield portion of the interest rate on its future long-term debt. However, these markets do not offer instruments that would allow PG&E to hedge the credit-spread portion of the debt. Thus, PG&E could only hedge for the impact of changes on a component of the interest rates on PG&E debt to be issued in the future. Financial market instruments appropriate for that purpose would enable the Debtor to hedge rates related to U.S. Treasury yields for such a future date (which is referred to as

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[5]Generally speaking, PG&E's borrowing costs are recoverable in retail gas and electric rates (see Commission Decision 02-11-027, 2002 Cal. PUC LEXIS 718, at *11), so controlling those costs is in the interest of ratepayers. The Settlement Agreement that is the basis for the PG&E Plan expressly provides that the actual reasonable cost of PG&E's interest rate hedging activities with respect to the financing necessary for the PG&E Plan shall be reflected and recoverable in PG&E's retail gas and electric rates.

the "forward yield"), although it is not possible to lock in today's current yields (referred to as the "spot yield") for debt that will be issued in the future.

Under most circumstances, forward U.S. Treasury yields are higher than current spot U.S. Treasury yields. As of August 26, 2003, the market's expectation of the yield of a 10-year U.S. Treasury note on March 31, 2004 was approximately 0.35% above the current spot yield, and for January 1, 2005, the market expectation of the yield was approximately 0.75% above the current spot yield. These expected rates could change dramatically if market rates and expectations of future U.S. Treasury rates change.

Although it would be difficult to project with any certainty the movement of U.S. Treasury yields in the next year, the current levels are among the lowest in decades. Since there is a general belief that interest rates normally increase in a growing or recovering economy, should the U.S. economy rebound from its current slump, interest rates are likely to increase further. Hedging interest rates at or near levels expected in the near term will partially reduce the exposure to higher debt costs faced by PG&E's estate and its constituents at the time that the long-term debt is anticipated to be issued.

D. Interest Rate Hedge Descriptions

PG&E proposes to minimize its exposure to potential future interest rate increases by using the Interest Rate Hedges to hedge, in part, its cost of long-term debt financing upon implementation of a confirmed reorganization plan. By this Motion, PG&E requests authority to enter into Hedge Agreements to engage in the following types of Interest Rate Hedges: interest rate swaps, caps, floors, collars, forward rate agreements and options, each of which is described below.

1. Interest Rate Swaps

An interest rate swap is an agreement between two parties in which one party agrees to pay the other party a certain fixed rate of interest, and the other party agrees to pay the first party a certain variable (or "floating") rate of interest, for a specified time period. PG&E would make or receive cash payments that reflect the difference between the fixed and floating rates for the applicable time period. For example, if PG&E agrees to pay the

fixed rate and receive the floating rate and interest rates increase beyond the fixed rate during the applicable time, then the counterparty would pay PG&E the difference between the floating and fixed rates. Conversely, if PG&E agrees to pay the fixed rate and receive the floating rate and interest rates decrease, then PG&E would pay the counterparty the difference. Interest rate swaps can also involve parties who both pay floating rates, but based on different indexes.

2. Interest Rate Caps, Floors and Collars

An interest-rate cap is a financial instrument that sets a maximum rate of interest on variable-rate obligations. An interest-rate floor sets a minimum rate of interest on variable-rate obligations. An interest rate collar is a financial instrument that sets both minimum and maximum rates of interest on variable-rate obligations.

3. Forward Rate Agreements

PG&E may choose to enter into forward contracts with respect to U.S. Treasury securities and/or interest rate swaps. A forward contract with respect to U.S. Treasury securities is an agreement between two parties to buy and sell a specific U.S. Treasury note or bond at a specified price on a forward basis (at the settlement date). On the settlement date, PG&E would either make or receive a cash payment that reflects the difference between the expectation of rates at the time of the agreement (the contractual rate), and the actual level of rates on the date of settlement (the market rate). If PG&E agrees to sell a specified U.S. Treasury security and the market price for the particular security is below the specified contractual price on the settlement date (i.e., market interest rates for Treasury notes have increased above the contractual rate), then the counterparty would pay PG&E the difference. Conversely, if PG&E agrees to sell a specified U.S. Treasury security and the applicable U.S. Treasury security market price on the settlement date is above the specified contractual price (i.e., market interest rates have decreased below the contractual rate), then PG&E would pay the counterparty the difference.

A forward interest rate swap is an agreement between two parties to enter into an interest rate swap at a later settlement date. As with a forward contract with respect to U.S.

Treasury securities, on the settlement date, the parties cash settle the difference between the contractual rate and the actual (market) interest rate, instead of actually entering into the interest rate swap. If the swap provided for PG&E to pay a fixed interest rate and receive a floating rate from the counterparty and the applicable market interest rate is above the fixed contractual rate, then the counterparty would pay PG&E the difference. On the other hand, if the applicable market interest rate is below the fixed contractual rate, then PG&E would pay the counterparty the difference.

In either of the forward rate agreements described above, a payment to PG&E would offset the higher interest expense resulting from an increase in the risk-free rate component of the long-term debt to be issued under its reorganization plan, and a payment by PG&E to the counterparty would be offset by the lower interest expense resulting from a decrease in the risk-free rate component of such long-term debt. The net result under either arrangement is management of the risk-free interest rate applicable to the portion of PG&E's anticipated debt issuance that is hedged.

4. **Option Contracts**

In general, an option contract is an agreement giving the purchaser the right, but not the obligation, to buy (call) or sell (put) an asset at a given price (referred to as the "strike price"). The option's strike price and maturity date are determined when the contract is entered into, and an "upfront premium" is established for payment from the purchaser to the seller.

PG&E may choose to purchase a floor or a cap, which may be in the form of a single put or call option or a series of put or call options on a specified financial instrument, such as a U.S. Treasury security or an interest rate swap. Used in this way, options may be thought of as analogous to an insurance policy, in that an upfront premium is paid in order to limit total payments. In the case of a put option, PG&E would be purchasing the right to sell the underlying asset to the counterparty at the strike price; therefore, if interest rates increase, thereby decreasing the price of the asset below the put option's strike price, PG&E would exercise the put option and receive from the counterparty a payment based on the

difference between the market price and the strike price. Conversely, if interest rates decrease, thereby increasing the market price of the asset above the strike price, PG&E would not exercise the put option and no payment would be exchanged. In such a case, PG&E would have paid the upfront premium but would receive no offsetting payment. Call options offer analogous protection against falling interest rates and rising asset prices. The purchase of only an option hedging device as described in this paragraph, whereby PG&E pays the purchase price upfront at the time of purchase and has no future payment obligations to the counterparty, is referred to in this Motion as a "Straight Option Transaction", and the product so purchased is referred to as a "Straight Option".

E. Combination, Notional Amount and Timing of Interest Rate Hedges

PG&E may choose to enter into combinations of the above-described Interest Rate Hedges. For example, PG&E may purchase a floor in combination with a forward rate agreement to limit to a defined dollar amount any potential settlement payment to the counterparty that would be required. In this scenario, if interest rates were to decrease, the floor would protect against the significant settlement payment that would otherwise be required as a result of a precipitous interest rate drop. The premium on the floor would either be paid upfront or embedded into the forward rate agreement by increasing its fixed contractual rate. Additionally, PG&E might utilize a combination of floors and caps to create a collar—a limitation on interest costs to a pre-defined range.

PG&E is seeking approval to transact up to $7.4 billion in notional amount of Interest Rate Hedges, although the notional amount of the actual Interest Rate Hedges may be less. This maximum $7.4 billion in notional amount would cover all or a substantial portion of the principal amount of long-term fixed rate debt anticipated to be issued by PG&E under its reorganization plan.

Other than a Straight Option Transaction, for all other types of Interest Rate Hedges a payment may be due from either party to the other upon the settlement/maturity date of the transactions (all such other types of Interest Rate Hedges being referred to in this

Motion as "Performance Interest Rate Hedges").[6] To maximize the benefits to PG&E from any Performance Interest Rate Hedges, the ending date should be selected with reference to the anticipated time of issuance of the implementation financing for PG&E's reorganization plan, but with some reasonable flexibility for slippage.[7] While the precise date of such financing implementation is uncertain, PG&E submits that the relatively low forward interest rates available today with respect to the approximate period when PG&E expects to implement financing under its reorganization plan, and the risk of increasing interest rates justify entering into any Performance Interest Rate Hedges and corresponding Hedge Agreements before the precise reorganization plan financing implementation date is determined.

If the implementation financing occurs prior to a Performance Interest Rate Hedge's settlement date, the Performance Interest Rate Hedge can be unwound early or sold. In the case of a forward rate agreement, the settlement amount would then be based upon the difference between the Performance Interest Rate Hedge's contractual interest rate and the then-effective forward rate as determined by the capital markets. For example, if the implementation financing occurred three months prior to the Performance Interest Rate Hedge's settlement date, then the settlement amount would be based on the difference between the contractual interest rate and the three-month forward interest rate at the time of the unwind.

As discussed above, PG&E seeks authority to enter into Interest Rate Hedges and

[6]It is critical to the definition of "Performance Interest Rate Hedges" in this Motion that a payment may be due from <u>either</u> party to the other upon the maturity or earlier termination of the hedge. Accordingly, a Straight Option Transaction, as defined in Part II.D.4. above, is <u>not</u> a Performance Interest Rate Hedge because although PG&E's counterparty to a Straight Option Transaction may have a payment obligation to PG&E upon the exercise of the option, PG&E would not have any potential payment obligation to the counterparty beyond the purchase price that is paid in full by PG&E "up front" at the time the Straight Option is purchased.

[7]See footnote 2 above for an explanation of the justification for permitting PG&E to enter into Interest Rate Hedges and Hedge Agreements with settlement (and, in the case of Straight Option Transactions, expiration) dates a modest period beyond the anticipated Effective Date of the PG&E Plan.

corresponding Hedge Agreements with settlement dates (in the case of Performance Interest Rate Hedges) and expirations dates (in the case of Straight Option Transactions) through June 30, 2004, while reserving all rights to seek additional authority with respect to the Interest Rate Hedges and corresponding Hedge Agreements, as appropriate. For example, if it becomes clear that the PG&E Plan is not likely to be confirmed and become effective by June 30, 2004, PG&E expects to seek authority to enter into one or more new Interest Rate Hedges and corresponding Hedge Agreements with a new settlement/maturity date (in the case of a Performance Interest Rate Hedge) or expiration date (in the case of a Straight Option Transaction), depending on market conditions at that time. Alternatively, if it is determined that it is appropriate to terminate a Performance Interest Rate Hedge, then such Performance Interest Rate Hedge could be unwound prior to its original maturity date.

F. <u>Sensitivity Analysis With Respect To The Interest Rate Hedges Based on Changes in Market Rates</u>

On the settlement date of a Performance Interest Rate Hedge, one party typically pays the other party a certain amount pursuant to the agreement based on the difference between the contract and market rates of interest. If the market interest rate fell below the Performance Interest Rate Hedge contract rate, PG&E would make an appropriate payment to the counterparty out of cash on hand and issue additional debt pursuant to its reorganization plan. The cost of this additional debt would be expected to be effectively offset by the lower interest rate on the long-term debt to be issued by PG&E pursuant to its reorganization plan. Conversely, if the market interest rate increased above an Interest Rate Hedge contract rate (including either a Performance Interest Rate Hedge or a Straight Option), the counterparty would make appropriate payment to PG&E, thereby increasing PG&E's cash on hand and presumably decreasing the amount of debt to be issued pursuant to the reorganization plan, which would be expected to reduce the overall interest expense on such debt issued at the then-applicable market rate.

PG&E's potential risk and liability with respect to any Performance Interest Rate Hedges and corresponding Hedge Agreements will necessarily be based on current forward

interest rates and volatility at the time that the Performance Interest Rate Hedge is commenced. Under recent market conditions, for a $1 billion forward contract on a 10-year interest rate swap (designed to hedge against changes in the interest rate of securities with a 10-year maturity) at a fixed contractual rate of 5.27%, a decline in the swap rate to 4.27% would result in PG&E paying approximately $80.7 million to the counterparty. Conversely, an increase of in the swap rate from 5.27% to 6.27% would result in the counterparty paying approximately $73.5 million to PG&E.

This would indicate that if PG&E were to enter into comparable hedging transactions with a notional amount aggregating approximately $7.4 billion (the maximum authority sought by this Motion), its potential liability would amount to close to $600 million for a decline in interest rates of 100 basis points.[8] However remote the possibility of such a decline in interest rates when rates are already near historic lows, PG&E would not be comfortable undertaking anywhere near this level of risk. Accordingly, PG&E intends to engage in transactions which would limit its potential liabilities under any and all Interest Rate Hedges to no more than $90 million in the aggregate, and PG&E by this Motion therefore seeks authority to enter into Interest Rate Hedges and Hedge Agreements in a notional amount of up to $7.4 billion outstanding at one time, provided that PG&E in so doing uses devices that limit its maximum liability to an aggregate of $90 million.[9] PG&E believes that this $90 million maximum liability amount provides PG&E with adequate authority to carry out a reasonable hedging program to carry out the objectives of this

[8]For technical reasons, the impact is not completely proportional to the change in rates. For example, a decline in interest rates of 50 basis points would result in a potential liability of approximately $290 million, and decline in interest rates of two hundred basis points would result in a potential liability of approximately $1.25 billion. In any event, the exact nature and structure of the Interest Rate Hedges that PG&E enters into may be different from the examples contained in this Motion.

[9] This maximum $90 million amount includes the aggregate of (a) the costs of the hedging devices that PG&E may utilize to limits its potential liability under the Interest Rate Hedges, (b) PG&E's potential liability to counterparties under the Interest Rate Hedges and corresponding Hedge Agreements resulting from changes in applicable interest rates, and (c) the purchase price for any Straight Options).

Motion.[10]

In addition to considering PG&E's maximum potential liability under the proposed Interest Rate Hedges, it is important to consider the potential impact of not entering into Interest Rate Hedges in the current favorable interest rate environment. If PG&E does not enter into any Interest Rate Hedges and PG&E issues the maximum potential $7.4 billion amount of fixed-rate debt anticipated under the PG&E Plan, each increase of 200 basis points in interest rates would increase PG&E's annual pre-tax interest expense by $148 million. Assuming (for illustration purposes only) that the maturities of all fixed-rate debt issued under the PG&E Plan were 10 years, such an unhedged 200-basis-points increase in interest rates would amount to additional interest expense to PG&E with a present value of approximately $1 billion. Under any reasoned analysis, PG&E believes that it is sound business judgment to use the available financial tools to hedge against this interest rate risk, particularly in view of the currently low market interest rates. This risk mitigation benefits the bankruptcy estate and interested parties alike.

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G. Counterparties for the Interest Rate Hedges and Hedge Agreements

Consistent with the Settlement Agreement that is the basis for the PG&E Plan (a copy of which is attached as Exhibit D to the PG&E Plan), PG&E has agreed to name UBS Securities LLC and Lehman Brothers Inc. as exclusive book runners, lead managers and hedging providers of all financings pursuant to the PG&E Plan with equal economics for 80 percent of the aggregate total fees and commissions payable on such financings.[11]

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[10]Using a $7.4 billion aggregate notional amount of comparable hedging transactions, an increase in interest rates of 100 basis points above a locked-in rate for a Performance Interest Rate Hedge or a strike rate in a Straight Option Transaction would result in the hedging counterparties having payment obligations to PG&E aggregating approximately $500 million. Because, theoretically, there is no limit to the amount that interest rates can increase, there is no upper limit to the hedging counterparties' potential obligations to PG&E. For this reason, and in order to the address and mitigate the risk of any counterparty not being able to perform its obligations upon the settlement of any interest rate hedge transaction, PG&E is requiring that, subject to negotiated uncollateralized thresholds, each hedging counterparty's potential obligations to PG&E under the Interest Rate Hedges be secured by collateral consisting of cash or relatively liquid securities.

[11] PG&E also has been directed by the Commission to work with UBS Securities LLC in Commission Decision 02-11-030 on implementation financing for PG&E's

(continued . . .)

Accordingly, PG&E anticipates that Lehman Brothers Special Financing Inc., together with Lehman Brothers Holdings Inc. as guarantor, or any affiliates thereof agreed to in writing by PG&E (collectively, "Lehman") and/or UBS AG or any affiliates thereof agreed to in writing by PG&E (collectively, "UBS") will be PG&E's counterparties with respect to 80 percent of the Interest Rate Hedges, provided that such Interest Rate Hedges and corresponding Hedge Agreements are on commercially reasonable terms and rates. PG&E under all circumstances may enter into Interest Rate Hedges and Hedge Agreements with any institutional counterparties for the remaining 20 percent of the hedging transactions.

To the extent that PG&E enters into Interest Rate Hedges and Hedge Agreements with Lehman and/or UBS, PG&E notes that affiliates of such parties (i.e., Lehman Brothers Inc. and UBS Securities LLC) are acting as the financial advisor and capital markets arranger to PG&E and the Commission, respectively. PG&E also notes that it anticipates that the function of "Calculation Agent" under any Interest Rate Hedge and Hedge Agreement that PG&E enters into — i.e., the agent that performs certain settlement calculations under a Hedge Agreement, except if a defined "Event of Default" or "Termination Event" occurs, in which case the calculations are performed by the non-defaulting party (in the case of Event of Default) or the non-affected party (in the case of certain Termination Events) under the applicable Hedge Agreement — may be performed by one of the parties to the Hedge Agreement or an independent third party. These matters are still under discussion and have not been finally determined. Thus, it is possible that under certain circumstances Lehman, UBS, or other counterparties may act as the Calculation Agent under one or more Hedge Agreements pertaining to one or more Interest Rate Hedges, and in such role would be responsible for the calculation of certain settlement amounts with respect to those Interest Rate Hedges. In any event, each counterparty acting as a Calculation Agent is obligated to perform its calculations in good faith and in a commercially reasonable manner.

(. . . continued)
emergence from Chapter 11.

PG&E has been advised by Lehman Brothers Inc. that, consistent with what the financial markets would require for financial institutions to enter into these types of complex finance-related agreements with a Chapter 11 debtor, the Hedge Agreements pertaining to one or more Interest Rate Hedges will require the Bankruptcy Court to have entered a final order (in form and substance satisfactory to the institutional counterparty):

(1) Authorizing PG&E to enter into the Interest Rate Hedges and the corresponding Hedge Agreements, and, with respect to any Performance Interest Rate Hedge and corresponding Hedge Agreements, to incur secured debt pursuant to Bankruptcy Code Section 364(d);

(2) Finding that the counterparty to each Hedge Agreement pertaining to a Performance Interest Rate Hedge is extending credit to PG&E in good faith within the meaning of Bankruptcy Code Section 364(e);[12] and

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[12] Because PG&E anticipates entering into 80% of the Interest Rate Hedges and corresponding Hedge Agreements with Lehman and UBS, the evidentiary basis for the good faith of Lehman and UBS as prospective hedge counterparties are contained in the Sauvage and Hulse Declarations, respectively, and PG&E by this Motion seeks a good faith determination respecting Lehman and UBS pursuant to Section 364(e). Further, as discussed above, PG&E also may enter into Interest Rate Hedges and Hedge Agreements with other institutional counterparties (each an "other institutional counterparty"). PG&E understands that any such other institutional counterparty, like Lehman and UBS, will require a "good faith" determination pursuant to Bankruptcy Code Section 364(e) as a condition to entering into any Performance Interest Rate Hedge and corresponding Hedge Agreement with PG&E. Because all such other institutional counterparties have not yet been selected, to facilitate such other institutional counterparties entering into Hedge Agreements with PG&E consistent with this Motion, PG&E by this Motion also seeks the Court's approval of a streamlined procedure for such proposed other institutional counterparties to seek a good faith determination pursuant to Bankruptcy Code Section 364(e), as follows: Any proposed other institutional counterparty with whom PG&E intends to enter into a Performance Interest Rate Hedge and corresponding Hedge Agreement pursuant to this Motion would file and serve on counsel for each of the Debtor, the Official Committee of Unsecured Creditors, the Commission and the United States Trustee (collectively, the "Served Parties") a declaration establishing such proposed other institutional counterparty's good faith, discussing the types of matters addressed in the Sauvage and Hulse Declarations; the Service Parties would have until five calendar days after service of such declaration to file with the Court and serve upon the Served Parties any opposition to a good faith determination with respect to such proposed other institutional counterparty; if no timely opposition is submitted by one of the Served Parties, the Court (in its discretion) may enter an order determining the good faith of such proposed other institutional counterparty without further proceedings. In the event that any of the Served Parties files and serves on objection, the Court, in its discretion, may do either of the following: (1) overrule the objection and issue its order determining the good faith of the proposed other institutional counterparty, or (2) advise the (continued . . .)

(3) Authorizing the counterparty to each Hedge Agreement to exercise its rights and remedies under the Hedge Agreement(s) with such counterparty, notwithstanding the automatic stay provisions of Bankruptcy Code Section 362.[13]

H. Secured Debt Requirements Related to the Interest Rate Hedges

As a matter of prudent business practice, and consistent with PG&E's risk management policies and practices with respect to hedge counterparties, PG&E expects to require its counterparties to post collateral to secure their potential payment obligations to PG&E with respect to certain Interest Rate Hedges based on market movements adverse to the counterparty's position, which obligations, as indicated in footnote 10 above, may be quite substantial in view of the magnitude of the contemplated transactions. PG&E believes and represents that if PG&E so requires its hedge counterparties to post collateral, the counterparties will require PG&E to post collateral to secure PG&E's potential payment obligations to the counterparty with respect to Performance Interest Rate Hedges based on market movements adverse to PG&E's position.

For example, in the situation where the market interest rate rises above the rate used in a Performance Interest Rate Hedge, the counterparty may need to post collateral in an amount that represents all or a portion of the payment to PG&E that would be due if the hedge were to cash settle on the exposure measurement date. Conversely, in the situation

(. . . continued)
Served Parties that it is declining to further consider or to determine the good faith of the proposed other institutional counterparty without a noticed hearing. Notwithstanding the foregoing, in addition to the Declarations on behalf of UBS and UBS Securities LLC and Lehman and Lehman Brothers Inc filed and served herewith, PG&E prior to the hearing on the Motion may file and serve good faith declarations of one or more proposed other institutional counterparties who are identified after the Motion is filed but prior to the hearing on the Motion, and PG&E will request at the hearing on the Motion that the Court include in its Order granting the Motion good faith determinations pursuant to Bankruptcy Code Section 364(e) with respect to such proposed other institutional counterparties.

[13] As will be provided in the Hedge Agreements pertaining to any Performance Interest Rate Hedges, time is of the essence in respect of any payment or collateral-posting obligations due from PG&E or any applicable counterparty. Accordingly, each of PG&E and any applicable counterparty shall be entitled to demand and receive prompt payment of collateral calls and termination payments in accordance with the provisions of the Hedge Agreements pertaining to Performance Interest Rate Hedges.

where the forward interest rate curve drops below the forward rate used in a Performance Interest Rate Hedge, PG&E may be required to post collateral that represents the payment to the counterparty that would be required if the hedge were to cash settle on the exposure measurement date.

As part of this Motion, PG&E seeks authorization to enter into Performance Interest Rate Hedges and corresponding Hedge Agreements with collateral-posting requirements, granting liens on collateral in favor of the counterparties, and obtaining liens on collateral from the counterparties (and, with respect to Straight Option Transactions, obtaining liens on collateral from the counterparties), as follows: PG&E would be required to post collateral from time to time to the extent of PG&E's potential payment obligations as a result of changes in applicable market interest rate parameters in any Performance Interest Rate Hedges, and would be entitled to the return of collateral from time to time to the extent that PG&E potential payment obligations dropped below the amount of collateral then posted as a result of changes in applicable market interest parameters.

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Lehman, UBS or any other counterparty under any Interest Rate Hedge and corresponding Hedge Agreement would each have an uncollateralized exposure threshold (the "Counterparty Collateral Threshold"), as follows[14]: if a counterparty or a guarantor of such counterparty's obligations under the Hedge Agreement(s) with such counterparty (a "Guarantor") has a long-term senior unsecured debt rating (a "Rating") of at least "AAA" from Standard & Poor's ("S&P") <u>and</u> "Aaa" from Moody's Investor's Service Inc. ("Moody's"), the Counterparty Collateral Threshold for such counterparty shall be $60 million; if a counterparty or its Guarantor has a Rating of (or, after entering into a Hedge

[14]Because PG&E has no potential future payment obligations under a Straight Option Transaction, there is no basis or need for PG&E to seek to incur secured debt or secured obligations under Section 364 in connection with a Straight Option Transaction. However, because the counterparty to a Straight Option Transaction does have payment obligations to PG&E if interest rates rise above the ceiling specified in the option, the counterparty to a Straight Option Transaction will be required to post collateral in favor of PG&E (subject to such counterparty's Counterparty Collateral Threshold) if interest rates rise sufficiently before the expiration or exercise of the option.

Agreement with PG&E, such counterparty's or such Guarantor's Rating is reduced to) anywhere from "AA+" through "AA-" from S&P and anywhere from "Aa1" through "Aa3" from Moody's, then the Counterparty Collateral Threshold for such counterparty shall be $40 million; if a counterparty or its Guarantor has a Rating of (or, after entering into a Hedge Agreement with PG&E, such counterparty's or such Guarantor's Rating is reduced to) anywhere from "A+" through "A-" from S&P and anywhere from "A1" through "A3" from Moody's, then the Counterparty Collateral Threshold for such counterparty shall be $20 million; and if a counterparty and its Guarantor has a Rating of (or, after entering into a Hedge Agreement with PG&E, such counterparty's or such Guarantor's Rating is reduced to) below "A-" from S&P or below "A3" from Moody's, the Counterparty Collateral Threshold for such counterparty shall be zero.[15]

Based on PG&E's maximum obligations under the Interest Rate Hedges as discussed in Part II.F. above, PG&E by this Motion seeks authority to utilize up to $90 million in cash or cash equivalents for purposes of posting collateral with counterparties in connection with the Performance Interest Rate Hedges and corresponding Hedge Agreements.[16] PG&E expects to fund such collateral-posting requirements under the Hedge Agreements pertaining to Performance Interest Rate Hedges from its cash and cash equivalents on hand. Because the counterparty would have a senior lien on such collateral posted under any such Hedge Agreements, the obligations under such Hedge Agreements would constitute senior secured debt within the meaning of Bankruptcy Code Section 364(d) to the extent of the value of the collateral posted pursuant to such Hedge Agreements.

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[15]PG&E as a Chapter 11 debtor does not have a credit rating that would support any collateral threshold for PG&E under this collateral threshold matrix. PG&E therefore has a collateral threshold of zero and, as set forth above, must secure its potential payment obligations under the Performance Interest Rate Hedges and corresponding Hedge Agreements it enters into pursuant to this Motion.

[16]Such collateral posting obligation will include an "independent amount" that will be based upon assessment of risk and volatility with respect to anyPerformance Interest Rate Hedge and PG&E's ability to fulfill its potential payment obligations on such hedge in the event of a termination or default event with respect to PG&E. Consistent with the $90 million aggregate liability limitation, in no event can the total amount of collateral posted, including the "independent amount," exceed $90 million.

I. <u>Lien Of Indenture Trustee Under 1920 Indenture</u>

BNY Western Trust Company has a lien on substantially all of PG&E's real and personal property in its capacity as the successor trustee (the "Indenture Trustee") under that certain Indenture dated December 1, 1920 as amended to date (the "1920 Indenture"), which is the subject of that certain "Stipulation (I) Authorizing and Restricting Use of Cash Collateral Pursuant to 11 U.S.C. §363 and Bankruptcy Rule 4001 and (II) Granting Adequate Protection Pursuant to 11 U.S.C. §§361 and 363" entered into between PG&E and the Trustee on May 9, 2001, as amended to date (the "Cash Collateral Stipulation") and approved by the Bankruptcy Court by its Order thereon dated the same date and by subsequent Orders approving the amendments to the Cash Collateral Stipulation.

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

III.

PG&E SHOULD BE AUTHORIZED TO ENTER INTO THE INTEREST RATE HEDGES PURSUANT TO BANKRUPTCY CODE SECTION 363(b)(1)

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

(15th ed. rev. 1998).

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

Sound business justifications support PG&E's decision to enter into the Interest Rate Hedges, as it deems appropriate, subject to the maximum $90 million limit. As discussed above, authorizing PG&E to enter into Interest Rate Hedges (particularly while forward interest rates are relatively low) will provide a tool to help protect PG&E from potential increases in interest rates that might occur before its reorganization plan is implemented, thereby mitigating against potentially higher borrowing costs that may prevail when new debt is issued under PG&E's reorganization plan. This will accordingly benefit the bankruptcy estate and interested parties.

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IV.

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

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

> "The Court, after notice and a hearing, may authorize the obtaining of 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—
>
> (A) the trustee is unable to obtain such credit otherwise; and
>
> (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 proposed to be granted." (11 U.S.C. §364(d)(1))

Thus, the only statutory prerequisites for obtaining credit on a senior secured basis is that the debtor be unable to obtain such credit otherwise, and that there be adequate

protection for the existing lienholder. This test is clearly satisfied in this case.

First, as discussed above, as a matter of prudent business practices, and consistent with PG&E's risk management policies concerning the obligations of its hedge counterparties, PG&E expects to require its counterparties to post collateral to secure at least a portion of their potential payment obligations to PG&E (subject to the Counterparty Collateral Threshold as described in Part II.H above) with respect to certain Interest Rate Hedges based on market movements adverse to the counterparty's position, and the counterparties in turn will demand and require PG&E to post collateral to secure its potential payment obligations to the counterparty with respect to Performance Interest Rate Hedges based on market movements adverse to PG&E's position. Thus, PG&E is effectively unable to engage in Performance Interest Rate Hedges unless it provides credit on a senior secured basis to its counterparties as described in Part II.H above.

Further, the interest of the only existing potential lienholder—the Indenture Trustee—is fully secured and adequately protected by a substantial equity cushion, as has been repeatedly demonstrated in previous motions filed by PG&E in this case. As set forth in the Debtor's Operating Report filed with this Court (Docket No. 13037), as of May 31, 2003, the Debtor's total reported assets exceeded $26 billion (including cash on hand of approximately $3.5 billion), while the Debtor's outstanding obligations under the mortgage bond indenture, which are secured by substantially all of the Debtor's assets, aggregate approximately $3 billion.

The existence of an "equity cushion" or a "value cushion"—the value of the collateral in excess of the amount of the secured claim at issue—"is the classic form of protection for a secured debt," and it is well settled that "the existence of an equity cushion, standing alone, can provide adequate protection." In re Mellor, 734 F.2d 1396, 1400 (9th Cir. 1984). Accord, Travelers Ins. Co. v. Plaza Family P'ship (In re Plaza Family P'ship), 95 B.R. 166, 171 (E.D. Cal. 1989). In In re Mellor, the Ninth Circuit Court of Appeals held that a creditor's 20% value cushion constituted adequate protection as a matter of law, and reversed the lower court's finding to the contrary as "clearly erroneous." Pistole v. Mellor

(In re Mellor), 734 F.2d at 1401. The Court of Appeals also made clear that a cushion of less than 20% could constitute adequate protection, and cited with approval authorities holding that value cushions of 10% to 20% constituted adequate protection. Id. Here, by stark contrast, the Indenture Trust has an equity cushion of in excess of 700%. Thus, the Indenture Trustee's interest here is adequately protected by a substantial equity cushion, which will remain equal to many times the value of the Indenture Trustee's lien interest after giving affect to the maximum amount of collateral that PG&E seeks to grant a senior lien on pursuant to this Motion.

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 secured 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 Village 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).

Based on the foregoing, PG&E submits that the Court should authorize PG&E to incur post-petition secured debt of up to an aggregate of $90 million outstanding at any one time in favor of the counterparties to Performance Interest Rate Hedges and the corresponding Hedge Agreements under Section 364(d), and to grant a senior lien in favor of such counterparties in cash or cash-equivalents of PG&E up to an aggregate of $90 million at any one time.

CONCLUSION

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

1. Granting the Motion;

2. Authorizing PG&E to enter into and perform its obligations under the Interest Rate Hedges and the Hedge Agreements as described above, provided that the aggregate maximum amount of all of PG&E's liabilities thereunder does not exceed $90 million;

3. Authorizing PG&E to post collateral and grant a senior lien on collateral consisting of cash or cash equivalents, up to a maximum aggregate amount of $90 million outstanding at any one time, in favor of the applicable hedge counterparties to secure PG&E's obligations under Hedge Agreements pertaining to Performance Interest Rate Hedges pursuant to Bankruptcy Code Section 364(d)(1), as more particularly described above;

4. Determining that each of Lehman, UBS, and any other institutional counterparty who has submitted a satisfactory declaration as described in footnote 12 above, upon entering into one or more Hedge Agreements with PG&E pertaining to one or more Performance Interest Rate Hedges pursuant to this Motion, is extending credit to PG&E in good faith within the meaning of Bankruptcy Code Section 364(e); and

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

DATED: August 29, 2003

Respectfully,

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