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12 PACIFIC GAS AND ELECTRIC COMPANY

13 UNITED STATES BANKRUPTCY COURT
14 NORTHERN DISTRICT OF CALIFORNIA
15 SAN FRANCISCO DIVISION

16 In re
17
18 PACIFIC GAS AND ELECTRIC
19 COMPANY, a California corporation,

20 Debtor.

21 Federal I.D. No. 94-0742640

Case No. 01 30923 DM

Chapter 11 Case

Date: September 29, 2003

Time: 1:30 p.m.

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

Judge: Hon. Dennis Montali

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MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF DEBTOR'S
MOTION FOR ORDER AUTHORIZING PACIFIC GAS AND ELECTRIC COMPANY
TO COMPROMISE CLAIMS AGAINST EL PASO NATURAL GAS COMPANY ET
ALIA AND TO ENTER INTO AGREEMENTS RESOLVING THE CLAIMS

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HOWARD
RICE
NEMEROVSKI
CANADY
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A Professional Corporation

1 Pacific Gas and Electric Company ("PG&E" or the "Debtor"), the debtor and
2 debtor in possession in the above-captioned Chapter 11 case, seeks the Court's authorization
3 to enter into certain agreements which resolve potential claims by PG&E and others
4 (collectively, the "Settling Claimants")¹ against El Paso Corporation, El Paso Natural Gas
5 Company and El Paso Merchant Energy, L.P. (collectively, "El Paso," and together with the
6 Settling Claimants, the "Parties") arising out of the California energy crisis in 2000 and
7 2001.

8 9 10 **FACTUAL BACKGROUND**

11 12 **I.**

13 **STATEMENT OF FACTS**

14 From June 2000 to June 2001, the prices paid by California citizens for natural
15 gas and electricity rose to unprecedented levels, creating a state-wide emergency (the
16 "California energy crisis"). Because gas is a key cost-input in most electric generation, spot
17 gas prices in the Topock, Arizona spot market (a key market for incremental supplies of gas
18 for delivery to California) affected open market prices for electric power during the
19 California energy crisis. As a result, California consumers paid at least \$8.3 billion more
20 than they expected to pay for natural gas supplies and the natural gas component of electrical

21
22 ¹In addition to PG&E, the Settling Claimants consist of: the Attorney General of the
23 State of California, the Governor of the State of California, the California Public Utilities
24 Commission, the California Department of Water Resources, the California Energy
25 Oversight Board, the Attorney General of the State of Washington, the Attorney General of
26 the State of Oregon, the Attorney General of the State of Nevada, Southern California
27 Edison Company, the City of Los Angeles, the City of Long Beach, and classes consisting of
28 all individuals and entities in California that purchased natural gas and/or electricity for use
and not for resale or generation of electricity for the purpose of resale, between September 1,
1996 and March 20, 2003, inclusive, represented by class representatives Continental Forge
Company, Andrew and Andrea Berg, Gerald J. Marcil, United Church Retirement Homes of
Long Beach, Inc., doing business as Plymouth West, Long Beach Brethren Manor, Robert
Lamond, Douglas and Valerie Welch, William Patrick Bower, Thomas L. French, Frank and
Kathleen Stella, John Clement Molony, SierraPine, Ltd., John and Jennifer Frazee, John
W.H.K. Phillip, and Cruz Bustamante.

1 energy supplies. PG&E and its ratepayers bore a substantial portion of these massive
2 overpayments. Declaration Of Joshua Bar-Lev In Support Of Debtor's Motion For Order
3 Authorizing Pacific Gas and Electric Company To Compromise Claims Against El Paso
4 Natural Gas Company Et Alia And To Enter Into Agreements Resolving The Claims ("Bar-
5 Lev Decl.") ¶3.

6 7 II.

8 SUMMARY AND STATUS OF THE CLAIMS

9 On April 4, 2000, the California Public Utilities Commission (the "CPUC") filed
10 a complaint against El Paso Natural Gas Company ("EPNG"), El Paso Merchant Energy-
11 Gas, L.P., and El Paso Merchant Energy Company at the Federal Energy Regulatory
12 Commission (the "FERC") (Docket No. RP00-241-000) alleging that firm contracts held by
13 El Paso Merchant Energy-Gas, L.P. and El Paso Merchant Energy Company for
14 transportation capacity on the EPNG system were obtained in violation of the FERC's
15 Standards of Conduct and raising issues regarding the exercise of market power (the "FERC
16 Natural Gas Proceeding"). Southern California Edison ("Edison") and PG&E, among
17 others, subsequently intervened in that proceeding. Id. ¶4.

18 Since then, at least seven class action complaints have been filed against El Paso
19 and other defendants in California state courts, alleging that El Paso and others had
20 committed antitrust violations and engaged in unfair competition or unfair business practices
21 in the California gas and/or electric power markets (collectively, the "Class Actions"). The
22 Attorneys General of the States of California and Nevada, the cities of Long Beach and Los
23 Angeles, and various utility companies have filed complaints in state court and at the FERC
24 alleging violations of laws and regulations by El Paso and other power sellers with respect to
25 the California energy crisis. Id. ¶5.

26 In September 2001, the Attorney General of the State of California commenced
27 an investigation into the facts relating to El Paso's participation in the California gas and
28 electric power markets from 1998 to the present, which to date has resulted in the production

1 by El Paso of hundreds of thousands of pages of documents and numerous investigative
2 hearings. The Attorneys General of Washington and Oregon have also been investigating
3 the facts relating to El Paso's direct and indirect participation in the Oregon and Washington
4 electric power and gas markets from 1998 to the present. Id. ¶6.

5 In addition, the California Attorney General, PG&E and Edison have each filed
6 federal court actions in the United States District Court of the Central District of California
7 alleging that El Paso's manipulation of the California energy market during the energy crisis
8 violated federal and state anti-trust and unfair competition laws.² The complaints in these
9 now-consolidated actions are based, legally and factually, in large part, on investigation and
10 analysis undertaken by Edison, the CPUC and PG&E in the FERC Natural Gas Proceeding.
11 Id. ¶7 & Ex. A.

13 III.

14 THE SETTLEMENT TERMS

15 In order to resolve the many claims set forth above³ in a manner that would
16 provide prompt and effective relief to the people of the states of California, Nevada, Oregon
17 and Washington without the burden, expense and uncertainty of continued litigation, PG&E,
18 the other Settling Claimants and El Paso (collectively, the "Parties") negotiated a settlement
19 (the "Settlement"). Id. ¶8. The terms of the Settlement are set forth in the Master Settlement
20 Agreement (the "MSA"), executed on June 24, 2003 and attached as Exhibit B to the Bar-
21 Lev Declaration. Id. ¶9. The MSA resolves claims against El Paso in both state and federal
22 court, as well as at the FERC. Id.

23 To implement the payment of consideration under the MSA, the Settling
24 Claimants entered into an Allocation Agreement (the "AA"), attached as Exhibit C to the
25 Bar-Lev Declaration, and a Designated Representative Agreement (the "DRA"), attached as

26 ²PG&E's complaint against El Paso is attached to the Bar-Lev Declaration as Exhibit
27 A.

28 ³The claims and allegations of all of the Settling Parties are set forth in greater detail
in the Master Settlement Agreement. See Bar-Lev Decl. Ex. B Part 2.

1 Exhibit D to the Bar-Lev Declaration, and will soon enter into an Escrow Agreement (the
2 "EA"). Id. ¶10. The AA was entered into between the Settling Claimants and sets forth the
3 terms under which the settlement proceeds are to be allocated and administered. Id. ¶11.
4 The DRA, also entered into between the Settling Claimants, designates the Office of the
5 California Attorney General as the Designated Representative (the "DR") of the Settling
6 Claimants and governs how and when the DR is to act on behalf of the Settling Claimants.
7 Id. ¶12. The AA and the DRA were executed simultaneously with the MSA. Id. ¶13. The
8 EA will govern the escrow account in which the settlement funds will be held until disbursed
9 and is still being negotiated and drafted. Id. ¶14. PG&E expects the EA to be finalized and
10 the escrow account to be established by approximately September 2003. See id.

11 Because the MSA and AA address the manner of disposition of estate assets, the
12 terms of these agreements are discussed in greater detail below.

13
14 **A. The Master Settlement Agreement**

15 Under the terms of the MSA, El Paso has agreed to provide, inter alia, \$1.55
16 billion in settlement consideration, valued in nominal dollars,⁴ in three principal forms: (1)
17 up-front payments; (2) deferred payments; and (3) a contract concession. Specifically, El
18 Paso will make up-front payments to the Settling Claimants totaling approximately \$550
19 million; will make semiannual payments to the Settling Claimants over twenty years totaling
20 approximately \$875 million; and will reduce the price of power to the Settling Claimants by
21 \$125 million under a long-term power supply contract between El Paso and the California
22 Department of Water Resources (the "CDWR"). Id. ¶15.

23
24 **1. The Up-front Payments**

25 Under the MSA, the approximately \$550 million in up-front payments consists of
26 the following:

27
28 ⁴Nominal dollars are amounts that have not been adjusted to take into account the
effect of inflation.

(1) El Paso will deposit into escrow a payment in the amount of \$78,590,071 upon the later of the execution of the MSA or the Escrow Effective Date⁵ (id. ¶16(a) & Ex. B ¶4.1(e)(i));

(2) El Paso will deposit into escrow a payment in the amount of \$243,229,464 by December 22, 2003 (id. ¶16(b));

(3) El Paso Corporation will sell 26,371,308 shares of its common stock (worth approximately \$227,000,000 when the MSA was executed) at the direction of the Settling Claimants after a shelf registration statement authorizing issuance of the shares becomes effective.⁶ The proceeds of that stock sale will be deposited into escrow (id. ¶16(c) & Ex. B ¶4.1(j)); and

(4) El Paso will deposit into escrow prior to the Effective Date⁷ a payment in the amount of \$2 million, from a bonus pool for El Paso officers. Id. ¶16(d) & Ex. B ¶4.1(b).

2. The Deferred Payments

Beginning on the later of the Effective Date or July 1, 2004, El Paso will begin making deferred payments totaling approximately \$875 million in forty semi-annual installments over a period of twenty years (the "Deferred Payments"). Id. ¶17 & Ex. B ¶4.1(d)(i). El Paso may prepay its deferred payment obligation, in full or in part, before or after the Effective Date. Id. ¶17 & Ex. B ¶4.1(d)(ii)(A). If El Paso regains an investment grade credit rating for a period of six months or longer, the remaining payments are accelerated so that the obligation is paid off within fifteen instead of twenty years. Id. ¶17 &

⁵The Escrow Effective Date is the date on which all Parties (or their designated representatives) and an acceptable escrow agent execute an escrow agreement.

⁶It should be noted that the value of this component of the up-front payments may be significantly affected by the value of El Paso common stock when it is registered and sold.

⁷The Effective Date is defined as the date when all conditions precedent have been satisfied, including, inter alia, entry of a judgment by the San Diego Superior Court approving the class action settlement, approval of the settlement by the FERC and dismissal of various FERC proceedings against El Paso, the approval by the Bankruptcy Court of the settlement as to PG&E, and entry of a stipulated judgment in federal district court encompassing the structural relief agreed to by the parties. Bar-Lev Decl. Ex. B ¶¶3.1, 3.2.

1 Ex. B ¶4.1(d)(i)(B). Under a twenty-year amortization schedule, each semiannual payment
2 will be in the amount of \$21,890,651. Id. ¶17 & Ex. B ¶4.1(d)(i). If the amortization
3 schedule is accelerated to fifteen years, the amount of each payment will increase, although
4 the precise amount of the increase will depend on when the acceleration takes place. See id.
5 ¶17 & Ex. B ¶4.1(d)(i)(B). The amortization schedule will not revert to twenty years if El
6 Paso thereafter becomes non-investment grade. See id.

7 El Paso will secure the Deferred Payments with oil and gas reserves with a value
8 equal to 130% (a coverage ratio of 1.3 to 1) of the net present value of the outstanding
9 Deferred Payments, measured as of the close of each calendar quarter. Id. ¶18 & Ex. B
10 ¶8.3(a)(ii). El Paso will deliver letters of credit or other collateral acceptable to the Settling
11 Claimants and to any applicable rating agency (if the obligations have been monetized). Id.
12 ¶18 & Ex. B ¶8.3.

13
14 **3. The Contract Concession to CDWR**

15 As of the Effective Date, El Paso will amend the Master Power Purchase and Sale
16 Agreement dated as of February 9, 2001, between El Paso Merchant LP and CDWR to
17 reduce the price of the contract by \$125,000,000 over the remaining two and half years of
18 the term of the contract. Id. ¶19 & Ex. B ¶4.1(g). Under the AA, CDWR has committed to
19 use all consideration allocated to it (including this contract concession) to reduce its annual
20 revenue requirement. Id. ¶19 & Ex. C ¶4(c)(ii).

21
22 **4. Structural Remedies**

23 El Paso agrees to certain "structural remedies" to prevent any future manipulation
24 of the California gas market, including guarantees to make physically available the capacity
25 to deliver 3,290 MMcf/day of gas to California and clarification of the procedure whereby
26 northern California shippers may recall Block II capacity in order to serve customers in
27 PG&E's service area, as set forth in the settlement approved by the FERC in Docket No.
28

1 RP95-363-000 on April 16, 1997 (the "1996 Settlement").⁸ Id. ¶20 & Ex. B ¶3.5, Appendix
2 1.69. With the exception of issues that are within the exclusive jurisdiction of the FERC, the
3 structural remedies are to be enforced in Federal District Court through a special master. Id.
4 ¶20 & Ex. B, Appendix 3.4.

5
6 **5. Release of Claims By PG&E and El Paso**

7 Pursuant to the MSA, PG&E agrees to release all claims against El Paso related
8 to, inter alia, the exercise of market power; manipulation or misreporting of gas or electric
9 power prices; and reduction of the supply of natural gas, electric power or gas pipeline
10 capacity for the period September 1, 1996 through March 20, 2003. Id. ¶21 & Ex. B ¶5.2.
11 In return, El Paso agrees to release all claims against PG&E related to, inter alia, the price or
12 supply of natural gas, electric power or gas pipeline capacity for the period through March
13 20, 2003, including El Paso's bankruptcy claim against PG&E for approximately \$57.5
14 million, the amount PG&E allegedly owes for sales of power to PG&E through the
15 California Independent System Operator and the California Power Exchange (Claim No.
16 0008837). Id. ¶21 & Ex. B ¶¶5.3, 5.4. The release does not cover claims asserted by PG&E
17 against other parties in various regulatory proceedings, such as the FERC Refund
18 Proceeding and the 390 QF Proceeding at the CPUC, where PG&E is seeking refunds of
19 excessive energy payments made to Qualifying Facilities ("QFs") during the energy crisis
20 (including El Paso owned/controlled QFs). Id. ¶22 & Ex. B ¶5.5(c).

21
22 **B. The Allocation Agreement**

23 In addition to the settlement with El Paso, the Settling Claimants also agreed on
24 the allocation of and administration of the settlement proceeds. Id. ¶23 & Ex. C. The key
25 elements of the AA, which was entered into between the Settling Claimants, are as follows:

26
27 ⁸The parties to the 1996 Settlement divided EPNG's 1.614 Epf/day of turnback
28 capacity into three blocks (Blocks I, II and III) for the term of that settlement. Block II
contains 614 MMcf/day of capacity and consists of primary point deliveries to Topock for
PG&E and others.

1 (1) The consideration is being divided pro rata based on calculation of the
2 "damages" suffered by each party.⁹ Id. ¶23 & Ex. C ¶4. The percentages can only be
3 estimated at this time because, depending on the final allocation of consideration to
4 municipal claimants (which is subject to a claims procedure), the allocation percentages of
5 the other Settling Claimants may change to some extent. Id. ¶23 & Ex. C ¶4(d).

6 (2) PG&E will receive approximately 6% (currently estimated at \$81 million) of
7 the total consideration for damages incurred as a result of core gas purchases and
8 approximately 16% (currently estimated at \$217 million) of the total consideration for
9 damages as a result of electricity purchases (collectively, the "Settlement Amount). Id. ¶24
10 & Ex. C ¶4.

11 (3) In a rulemaking proceeding initiated pursuant to a recent Order Instituting
12 Rulemaking ("OIR"), the CPUC will determine how the El Paso settlement proceeds paid to
13 PG&E should be allocated among various classes of customers and will designate the refund
14 and accounting mechanisms for PG&E's portion of the proceeds. Id. ¶25 & Ex. C ¶4(b).

15 Further, the CDWR is allocated approximately 33% (approximately \$461
16 million) for damages as a result of electricity purchases, which include the reduced price of
17 its contracts with El Paso. Id. ¶26 & Ex. C ¶4(c). All consideration received by the CDWR
18 shall be used to reduce the CDWR's revenue requirement, and the allocation of such
19 reduction among utilities shall be determined by the CPUC. Id.

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25 ⁹Such pro rata sharing percentages apply to the up-front and deferred consideration
26 received from El Paso. The consideration reflects prior deduction of certain fixed amounts,
27 including (1) fixed allocations for the settlement shares of the states of Washington, Oregon
28 and Nevada, and for the consideration going to certain other non-class claimants; (2)
attorneys' fees for the attorneys representing the plaintiff classes and for the attorneys
representing the Office of the California Attorney General, the CPUC, PG&E, Edison, and
the City of Los Angeles; and (3) the \$125 million CDWR contract concession. Bar-Lev
Decl. Ex. C ¶¶3, 4, 6.

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ARGUMENT

I.

**THE SETTLEMENT IS FAIR AND EQUITABLE AND IN THE BEST INTERESTS
OF THE ESTATE.**

“The law favors compromise and not litigation for its own sake . . .” Martin v. Kane (In re A & C Properties), 784 F.2d 1377, 1381 (9th Cir. 1986). Bankruptcy courts have great latitude in approving compromise agreements that are “fair and equitable.” Woodson v. Fireman’s Fund Ins. Co. (In re Woodson), 839 F.2d 610, 620 (9th Cir. 1988). In determining whether a compromise is “in the best interest of the bankrupt estate” (A & C Properties, 784 F.2d at 1382), courts 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; and (d) the paramount interest of the creditors and a proper deference to their reasonable views in the premises.” (Id. at 1381)

PG&E respectfully submits that these A & C Properties factors weigh in favor of the Settlement, as demonstrated below.

A. The Probability of Success is Uncertain.

In a case of this type, the outcome is always uncertain, and the probability of success is difficult to weigh. El Paso has denied all wrongdoing and disputes the amount of damages suffered by PG&E and the other Settling Claimants. If PG&E's federal action were to proceed through trial, there is a reasonable risk that the factfinder would award PG&E damages that would be lower than the Settlement Amount. Bar-Lev Decl. ¶27.

B. The Settlement Amount Is Not Expected To Be Difficult To Collect From the El Paso Entities.

The pursuit of PG&E's claims against El Paso in the federal action and elsewhere

(to the extent necessary) would require lengthy and expensive litigation, and the judgment would likely be subject to appeal. Consequently, a considerable amount of time would pass before El Paso would be required, if at all, to compensate PG&E for its alleged damages. The Settlement minimizes this delay and uncertainty by preventing further appeals and disputes and by providing for guaranteed up-front and deferred payments by El Paso to PG&E and the other Settling Claimants. Id. ¶28.

Under the terms of the MSA, El Paso shall deposit the settlement proceeds into an escrow account for payment to the Settling Claimants. Id. ¶16 & Ex. B ¶4.1(b), (e), (j). El Paso will also secure the Deferred Payments with oil and gas reserves with a value equal to 130% of the net present value of the Deferred Payments, measured as of the close of each calendar quarter. Id. ¶18 & Ex. B ¶8.3(a)(ii). El Paso will also deliver letters of credit or other collateral acceptable to the Settling Claimants and to any applicable rating agency. Id. ¶18 & Ex. B ¶8.3. In the event of default, the Settling Claimants may, upon prior notice to El Paso, accelerate the Deferred Payments, making the entire discounted amount immediately due and payable. Id. ¶29 & Ex. B ¶9.1. As such, PG&E expects collection of the Settlement Amount to be without difficulty. See id.

C. The Case is Complex And Continued Litigation Would Entail Unnecessary Expense, Inconvenience and Delay.

The Settlement is monumental in scope and complexity; it resolves the complex and various claims against El Paso of over twenty parties who previously differed in their willingness to settle. If the Settlement were not approved, each of the Settling Claimants would presumably continue litigating its particular claims at great expense and inconvenience to both the parties involved and the courts. Id. ¶30.

PG&E's litigation against El Paso raises many complex and challenging issues, including El Paso's expected challenge of PG&E's damages. These complex issues would presumably require extensive expert analysis and testimony and result in protracted and costly litigation. Based on the foregoing considerations, PG&E believes that the Settlement

1 eliminates such unnecessary expense, inconvenience and delay and is thus favorable to the
2 Debtor. See id. ¶31.

3
4 **D. The Settlement Benefits the Creditors.**

5 The Settlement fully resolves PG&E's claims against El Paso without the
6 expense, risk and delay inherent in PG&E's civil action against El Paso. Id. ¶32. Avoidance
7 of unnecessary litigation will benefit PG&E's creditors by minimizing costs and delay and
8 allowing PG&E's personnel to focus on more critical functions. Id. The Settlement Amount
9 will avoid the risk of a lower net recovery for the estate if PG&E were to pursue its civil
10 action against El Paso through trial. Id. ¶33. Moreover, El Paso has agreed to withdraw its
11 bankruptcy claim against PG&E, thereby eliminating the need to expend further estate
12 resources in separate litigation concerning the value of this claim. See id. ¶21. The
13 Settlement not only preserves estate assets, but also provides the estate with funds which
14 will assist the Debtor in implementing its plan of reorganization. Id. ¶33.

15 **CONCLUSION**

16
17 Based on all of the factors discussed above, PG&E respectfully submits that the
18 Settlement is fair and equitable and in the best interests of the estate. Accordingly, PG&E
19 respectfully requests that this Court grant the Motion and enter an order authorizing PG&E
20 to compromise its claims against El Paso and to enter into any agreements necessary to
21 resolve such claims, including the MSA, AA, DRA and EA.

22 DATED: September 8, 2003.

23 Respectfully,

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

26 By: 
27 WILLIAM J. LAFFERTY

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