Restructuring in the Rearview Mirror – a 10-Year Retrospective of California's Doomed Experiment with Electric Deregulation.
Courtroom 22 Coverage of the PG&E Bankruptcy

Montali Rejects State's Call for Adversary Proceeding, Sets Debate on Preemption

Judge Dennis Montali will not order Pacific Gas & Electric to commence an adversary proceeding against the state of California within the context of its Chapter 11 bankruptcy proceeding. Instead, the showdown over possible federal preemption of state laws will be taken up in a special hearing January 25. In the meantime, the state agencies will file their legal arguments against preemption by January 8.

The request for a forced adversary proceeding was made by the California Public Utilities Commission, the Attorney General's Office and various state agencies that contend PG&E's controversial plan of reorganization will violate a number of state laws, and therefore it must be rejected out of hand.

The matter is considered a "threshold issue" by the judge, who indicated that a ruling in favor of the CPUC's position would moot PG&E's proposed plan of reorganization and the associated disclosure process currently under way. "It's not appropriate to approve the disclosure statement without determining whether it can be approved," Montali reasoned during a December 4 status conference. "The big-ticket item is the fundamental confirmability of the plan."

State representatives want an adversary proceeding in order to segregate and challenge the core strategy of PG&E's reorganization proposal--to move key regulatory assets of generation, transmission and gas pipelines out of the distribution utility and into the parent corporation, where they would be subject to federal jurisdiction. PG&E would then recapitalize the assets to pay off an estimated $13 billion in debts.

Alan Kornberg, the outside attorney representing the CPUC, emphasized the importance of the jurisdictional matters. "This is an issue of a plan seeking to take apart 100 years of regulation of a public utility," Kornberg argued. "This is very significant relief. We and the other agencies are entitled to a complaint we can respond to."

PG&E's attorney Jim Lopes, in contrast, cast the state's motivation as trying to "delay and defeat this plan."

Also on the judge's mind is the possibility that the state and the CPUC would raise a "sovereign immunity" defense to thwart an adversary proceeding initiated by PG&E. Even though Kornberg suggested the CPUC might offer a limited waiver of its sovereign rights, Montali could not wrest a similar commitment from the attorney representing the California Department of Water Resources and a host of other state agencies. "This is not a unitary state. Each board has its own counsel," said Stephen Felderstein. "I cannot answer if each will assert sovereign immunity."

Nevertheless, each agency needs to know whether it will be affected by the plan and all of the state laws that could be superseded by PG&E's proposals, he asserted. "An adversary proceeding could accomplish that."

In a preliminary ruling from the bench, Montali said he would not order PG&E to launch an adversary proceeding as desired by California, but that does not prevent the state from initiating one.

The sovereignty issue is still shadowing the case, and it sets PG&E's Chapter 11 case apart from the bulk of bankruptcy proceedings. In one of the few appropriate precedents, Montali noted, the judge overseeing the reorganization of utility Public Service Company of New Hampshire determined that bankruptcy law can override state law, even though there was no specific application of the principle in that case.

What the judge tried to impress upon the state's attorneys was that he wants to address the legal issue separately from the practical matter of certifying a reorganization plan. As one PG&E Corp. representative put it, it is "the difference between can and should."

A determination that PG&E's plan can rely on federal law to supersede state laws or CPUC policies would later be put to a test of whether specific preemptions ought to be applied in all of the instances called for in PG&E's plan. However, a ruling that the state cannot be preempted would force a substantial revision to PG&E's proposals. Like many parties, Montali has found PG&E's disclosure incomplete as to the likely legal impacts. "How do I determine feasibility [of the plan] if I don't know what laws the debtor wants to preempt?" Montali asked.

The utility is already amending its plan and the associated disclosure statement to address a multitude of concerns raised by parties and to reflect its recent filing with federal agencies to effect parts of the plan. The bulk of the December 5 status conference was spent working out scheduling for sorting through the 71 objections received to the disclosure statement.

PG&E's attorney Lopes told the judge that the utility was prepared to submit a revised document by December 12 in advance of a hearing that had been set for the following week. The utility has been in contact with objectors to provide "more and better information" about a number of issues that were seen as deficient, including treatment of QF creditors, Lopes said. In an attempt to keep the utility's timetable for plan confirmation on track, Lopes pressed for a quick resolution of disclosure issues and a ruling on December 19 "that the plan is confirmable on its face."

Most parties grumbled at the swift pace, however, arguing to the judge that they will need more time to digest PG&E's changes to its statement, in addition to the 20,000-page filing made last week at the Federal Energy Regulatory Commission.

PG&E said it expected to finalize its list of executory contracts by February 1--before the formal plan of reorganization is circulated for creditor endorsement but after it had hoped to gain approval of the disclosure statement.

Montali appeared to see the contract concerns as a lesser issue compared to the universe of creditors' need for a swift resolution of the case. The supplemental information "is just part of the mosaic that constitutes disclosure," he said. Still, he provided another four weeks of time to work through objections.

In an effort to weed out objections to the disclosure statement, Montali told PG&E to hold direct meetings with all parties that filed objections.

During a January 14 hearing, PG&E will review the disposition of objections, and parties will have an opportunity to air any lingering complaints about the adequacy of disclosure. Montali warned that it might be a long and arduous hearing. "We will go all day to handle residual objections," he said while offering a glimmer of optimism. "Sometimes they all go away and sometimes the only objector left is me," the judge quipped **[Arthur O'Donnell].**

PG&E Lists CPUC Preemption Possibilities

In a revised disclosure package released December 19, Pacific Gas & Electric identified about three dozen sections of the Public Utilities Code and a few specific decisions from the California Public Utilities Commission that could conflict with its plan to transfer regulatory assets to federal jurisdiction. The utility will ask Judge Dennis Montali to declare that bankruptcy laws allow preemption of those state laws, although it is certain that the CPUC and other state agencies will argue against that outcome during a January 25 hearing.

According to PG&E, however, the vast majority of state laws and CPUC rules will remain in effect. Though it mentioned the potential for conflict with some state Corporation Code statutes, the utility said that the vast body of regulation over its operations will remain intact.

PG&E "will retain more than 14,000 existing permits, licenses and franchises necessary for its business and continue to operate under their existing terms and conditions," stated the filing. Other changes in the plan were mostly nonsubstantive, but provided more information about creditors' payment priorities.

The core of the plan involves transfer of generation, gas pipelines and electric transmission to new business units regulated by the Federal Energy Regulatory Commission, but PG&E stated that 70 percent of its asset base will remain under California jurisdiction. PG&E said the new business entities "will step into the shoes" of the utility to take on existing responsibilities related to nuclear safety, health and safety, air and water quality, timber harvesting and other functions. The transfer of permits is largely "ministerial" and is unlikely to interfere with the plan of reorganization, PG&E claimed.

With respect to jurisdiction over assets, the utility claims a broad exemption under Section 1123(a) of the Bankruptcy Code that "preempts state regulation from interfering with the implementation and consummation of the plan."

While the CPUC has challenged the strategy as a "regulatory jailbreak" that violates state laws and policies, Judge Montali recently noted that preempting state law is a different matter than violating it. At this point, Montali is grappling with the principle of preemption; at the time of plan confirmation he will determine whether specific laws or rules will be supplanted in order to confirm PG&E's proposed plan.

The PUC sections specified by PG&E run from the general to the highly specific. For example, Section 701 gives the CPUC broad authority to "supervise and regulate every public utility in the state and may do all things . . . necessary and convenient in the exercise of such power." Subsequent provisions, including Sections 816-830, could limit the utility's ability to issue bonds without CPUC approval, a restriction that directly affects

PG&E's plan to leverage its asset base to pay off creditors by issuing as much as $10 billion in new long-term bonds and securing short-term debt.

With particular reference to asset transfers, Sections 377 and 851 hold that the utility cannot dispose of generation assets without CPUC approval prior to January 1, 2006.

"The commission shall ensure that public utility generation assets remain dedicated to service for the benefit of California ratepayers," states the law.

The CPUC has recently attempted to affirm its jurisdiction over electric transmission, adding an ordering paragraph to a recent decision on the northeast San Jose transmission project that would retain state control over the project and its costs, despite PG&E's claim of federal jurisdiction [D01-12-017].

PG&E also cited an October 26, 1994, commission resolution that prohibited PG&E from transferring its pipeline system to federal jurisdiction [Res. L-244]. At the time, PG&E was proceeding with a major expansion of its Canada-to-California pipeline system, and the commission feared the utility would try to move its entire system to federal jurisdiction.

Among other code sections and CPUC orders that PG&E is trying to preempt are those related to affiliate transactions, power purchases, assignment of permits, issuance of common stock, an entire body of regulations pertaining to gains on sale of regulatory assets and the various conditions attached to the approval of the PG&E Corp. holding company [D96-11-017 and D99-04-068].

PG&E did not specifically mention decisions related to incentive pricing for the Diablo Canyon nuclear plants, although energy prices would be set by a power sales agreement outside of CPUC control under PG&E's plan.

The CPUC has called PG&E's plan "deeply flawed on many levels" and claims it represents "a disguised rate increase." The agency will challenge application of the Chapter 11 proceeding "as a legislative device to displace entire regulatory schemes," the CPUC told the court last month. "PG&E is not acting in good faith by attempting to use the plan process to deregulate itself by shifting significant estate assets beyond state regulation."

Also this week, PG&E asked the court to extend its period of exclusivity over plan formulation until June 30, 2002 **[Arthur O'Donnell].**

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