

PG&E CORP  
 Form 10-Q/A  
 June 30, 2003

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**UNITED STATES  
 SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C., 20549

**FORM 10-Q/A  
 Amendment No. 1**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES  
 EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2003

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
 EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

<b>Commission File Number</b>	<b>Exact Name of Registrant as specified in its charter</b>	<b>State or other Jurisdiction of Incorporation</b>	<b>IRS Employer Identification Number</b>
1-12609	PG&E Corporation	California	94-3234914
1-2348	Pacific Gas and Electric Company	California	94-0742640

**Pacific Gas and Electric Company**  
 77 Beale Street  
 P.O. Box 770000  
 San Francisco, California 94177

**PG&E Corporation**  
 One Market, Spear Tower Suite 2400  
 San Francisco, California 94105

(Address of principal executive offices)(Zip Code)

**Pacific Gas and Electric Company**  
 (415) 973-7000

**PG&E Corporation**  
 (415) 267-7000

Registrant's telephone number, including area code

Indicate by check mark whether the registrants (1) have filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the registrant was required to file such reports), and (2) have been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of latest practicable date.

Common Stock Outstanding, May 9, 2003:

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PG&E Corporation  
Pacific Gas and Electric Company

409,191,299 shares  
Wholly owned by PG&E Corporation

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## Explanatory Note

Subsequent to the issuance of PG&E Corporation's 1<sup>st</sup> quarter 2003 Consolidated Financial Statements, management discovered a misclassification of certain offsetting revenues and expenses within its continuing operations of PG&E National Energy Group (PG&E NEG). The reclassification resulted in a decrease in Operating Revenues from \$2,607 million to \$2,401 million and a similar decrease in Operating Expenses Cost of Commodity Sales and Fuel from \$364 million to \$158 million. This Amendment No. 1 to PG&E Corporation's and Pacific Gas and Electric Company's joint Form 10-Q for the quarter ended March 31, 2003, contains revised consolidated financial statements for PG&E Corporation for the quarter ended March 31, 2003. To reflect the revisions, this Amendment No. 1 hereby amends:

Part I, Item 1. Financial Statements. Corrections have been made to the Consolidated Statement of Operations for the three months ended March 31, 2003 and to Note 1 of the "Notes to the Consolidated Financial Statements."

Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. Corrections have been made to the sections entitled "Results of Operations" and "Consolidated Statements of Operations."

Part I, Item 3. Quantitative and Qualitative Disclosures About Market Risk. References are made to the "Management's Discussion and Analysis of Financial Condition and Results of Operations" filed as part of this amended Form 10-Q/A.

Part II, Item 6. Exhibits and Reports on Form 8-K (amended to file herewith, Exhibit 99.1, Certifications of the Chief Executive Officer and the Chief Financial Officer of PG&E Corporation required by Section 906 of the Sarbanes-Oxley Act of 2002, and Exhibit 99.2, Certifications of the Chief Executive Officer and the Chief Financial Officer of Pacific Gas and Electric Company required by Section 906 of the Sarbanes-Oxley Act of 2002.)

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## PART I. FINANCIAL INFORMATION

### ITEM 1: CONSOLIDATED FINANCIAL STATEMENTS

#### PG&E CORPORATION

#### CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share amounts)

Three months ended March 31,	
2003	2002
(as revised see Note 1)	
(Unaudited)	

Operating Revenues

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	<b>Three months ended March 31,</b>	
	<b>\$</b>	<b>\$</b>
Utility	2,067	2,453
Energy commodities and services	334	482
<b>Total operating revenues</b>	<b>2,401</b>	<b>2,935</b>
<b>Operating Expenses</b>		
Cost of electricity and natural gas for utility	1,027	149
Cost of energy commodities and services	158	306
Depreciation, amortization, and decommissioning	336	303
Operating and maintenance	774	860
Impairments, write-offs, and other charges	200	
Reorganization professional fees and expenses	35	16
<b>Total operating expenses</b>	<b>2,530</b>	<b>1,634</b>
<b>Operating Income (Loss)</b>	<b>(129)</b>	<b>1,301</b>
Reorganization interest income	10	22
Interest income	4	10
Interest expense	(375)	(334)
Other income (expense), net	3	20
<b>Income (Loss) Before Income Taxes</b>	<b>(487)</b>	<b>1,019</b>
Income tax provision (benefit)	(209)	396
<b>Income (Loss) From Continuing Operations</b>	<b>(278)</b>	<b>623</b>
<b>Discontinued Operations</b>		
Earnings (loss) from operations of USGenNE, Mountain View, and ET Canada (net of income tax expense (benefit) of \$(35) million in 2003 and \$5 million in 2002)	(65)	8
Net loss on disposal of USGenNE, Mountain View, and ET Canada (net of income tax (benefit) of \$(2) million in 2003)	(5)	
<b>Net Income (Loss) Before Cumulative Effect of Changes in Accounting Principles</b>	<b>(348)</b>	<b>631</b>
Cumulative effect of changes in accounting principles (net of income tax (benefit) of \$(4) million in 2003)	(6)	
<b>Net Income (Loss)</b>	<b>\$ (354)</b>	<b>\$ 631</b>
<b>Weighted Average Common Shares Outstanding, Basic</b>	<b>382</b>	<b>364</b>
<b>Earnings (Loss) Per Common Share from Continuing Operations, Basic</b>	<b>\$ (0.73)</b>	<b>\$ 1.71</b>
<b>Net Earnings (Loss) Per Common Share, Basic</b>	<b>\$ (0.93)</b>	<b>\$ 1.73</b>
<b>Earnings (Loss) Per Common Share from Continuing Operations, Diluted</b>	<b>\$ (0.73)</b>	<b>\$ 1.69</b>

<b>Net Earnings (Loss) Per Common Share, Diluted</b>	\$	(0.93)	\$	1.71
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See accompanying Notes to the Consolidated Financial Statements.

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**PG&E CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

(in millions)

	Balance at	
	March 31, 2003	December 31, 2002
	(Unaudited)	
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 4,568	\$ 3,895
Restricted cash	567	708
Accounts receivable:		
Customers (net of allowance for doubtful accounts of \$109 million in 2003 and \$113 million in 2002)	2,307	2,747
Regulatory balancing accounts	126	98
Price risk management	717	498
Inventories	240	347
Assets held for sale	266	707
Prepaid expenses and other	449	480
	<u>9,240</u>	<u>9,480</u>
Total current assets		
	<u>9,240</u>	<u>9,480</u>
<b>Property, Plant and Equipment</b>		
Utility	27,811	27,045
Non-utility:		
Electric generation	997	636
Gas transmission	1,779	1,761
Construction work in progress	1,315	1,560
Other	187	177
	<u>32,089</u>	<u>31,179</u>
<b>Total property, plant and equipment</b>	<u>32,089</u>	<u>31,179</u>
Accumulated depreciation and decommissioning	(13,223)	(14,251)
	<u>18,866</u>	<u>16,928</u>
<b>Net property, plant and equipment</b>	<u>18,866</u>	<u>16,928</u>
<b>Other Noncurrent Assets</b>		
Regulatory assets	1,984	2,053

	Balance at	
Nuclear decommissioning funds	1,314	1,335
Price risk management	264	398
Deferred income taxes	958	657
Assets held for sale	810	916
Other	1,857	1,929
<b>Total other noncurrent assets</b>	<b>7,187</b>	<b>7,288</b>
<b>TOTAL ASSETS</b>	<b>\$ 35,293</b>	<b>\$ 33,696</b>

See accompanying Notes to the Consolidated Financial Statements.

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**PG&E CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

(in millions)

	Balance at	
	March 31, 2003	December 31, 2002
	(Unaudited)	
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Liabilities Not Subject to Compromise</b>		
<b>Current Liabilities</b>		
Debt in default	\$ 4,373	\$ 4,230
Long-term debt, classified as current	601	298
Current portion of rate reduction bonds	290	290
Accounts payable:		
Trade creditors	1,327	1,273
Regulatory balancing accounts	337	360
Other	721	660
Interest payable	219	139
Income taxes payable		129
Price risk management	642	506
Liabilities of operations held for sale	353	699
Other	660	685
<b>Total current liabilities</b>	<b>9,523</b>	<b>9,269</b>
<b>Noncurrent Liabilities</b>		
Long-term debt	4,279	4,345
Rate reduction bonds	1,086	1,160

	Balance at	
	2003	2002
Asset retirement obligations	1,374	
Deferred income taxes	1,605	1,439
Deferred tax credits	139	144
Price risk management	259	305
Liabilities of operations held for sale	758	793
Other	3,286	2,963
<b>Total noncurrent liabilities</b>	<b>12,786</b>	<b>11,149</b>
<b>Liabilities Subject to Compromise</b>		
Financing debt	5,605	5,605
Trade creditors	3,611	3,580
<b>Total liabilities subject to compromise</b>	<b>9,216</b>	<b>9,185</b>
<b>Commitments and Contingencies (Notes 1, 2, 3, and 6)</b>		
<b>Preferred Stock of Subsidiaries</b>	480	480
<b>Common Stockholders' Equity</b>		
Common stock, no par value, authorized 800,000,000 shares, issued 408,610,591 common and 1,569,260 restricted shares in 2003 and 405,486,015 common shares in 2002	6,318	6,274
Common stock held by subsidiary, at cost, 23,815,500 shares	(690)	(690)
Unearned compensation	(21)	
Accumulated deficit	(2,233)	(1,878)
Accumulated other comprehensive loss	(86)	(93)
<b>Total common stockholders' equity</b>	<b>3,288</b>	<b>3,613</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 35,293</b>	<b>\$ 33,696</b>

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See accompanying Notes to the Consolidated Financial Statements.

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**PG&E CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in millions)

Three months ended March 31,	
2003	2002

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	<b>Three months ended March 31,</b>	
	<b>(Unaudited)</b>	
<b>Cash Flows From Operating Activities</b>		
Net income (loss)	\$ (354)	\$ 631
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, amortization, and decommissioning	336	320
Deferred income taxes and tax credits, net	(48)	(82)
Reversal of ISO accrual (Note 2)		(970)
Price risk management assets and liabilities, net	12	23
Other deferred charges and noncurrent liabilities	94	107
Loss on impairment or disposal of assets	200	
Loss from discontinued operations	7	
Cumulative effect of a change in accounting principle	10	
Net effect of changes in operating assets and liabilities:		
Restricted cash	141	5
Accounts receivable	433	428
Inventories	107	120
Accounts payable	177	344
Accrued taxes	(129)	479
Regulatory balancing accounts, net	(51)	125
Other working capital	93	(40)
Payments authorized by the Bankruptcy Court on amounts classified as liabilities subject to compromise (Note 2)	(39)	(248)
Assets and liabilities of operations held for sale, net	(20)	(41)
Other, net	(36)	(11)
<b>Net cash provided by operating activities</b>	<b>933</b>	<b>1,190</b>
<b>Cash Flows From Investing Activities</b>		
Capital expenditures	(472)	(711)
Proceeds from disposal of discontinued operations	102	
Other, net	30	(6)
<b>Net cash used by investing activities</b>	<b>(340)</b>	<b>(717)</b>
<b>Cash Flows From Financing Activities</b>		
Net borrowings under credit facilities		76
Long-term debt issued	152	190
Long-term debt matured, redeemed, or repurchased	(18)	(340)
Rate reduction bonds matured	(75)	(75)
Common stock issued	21	21
Other, net		(20)
<b>Net cash provided (used) by financing activities</b>	<b>80</b>	<b>(148)</b>
<b>Net change in cash and cash equivalents</b>	<b>673</b>	<b>325</b>
<b>Cash and cash equivalents at January 1</b>	<b>3,895</b>	<b>5,355</b>
<b>Cash and cash equivalents at March 31</b>	<b>\$ 4,568</b>	<b>\$ 5,680</b>

Three months ended  
March 31,

\_\_\_\_\_

\_\_\_\_\_

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**Supplemental disclosures of cash flow information**

Cash received for:		
Reorganization interest income	\$ 11	\$ 22
Cash paid for:		
Interest (net of amounts capitalized)	149	108
Income taxes paid (refunded), net	1	8
Reorganization professional fees and expenses	22	2

**Supplemental disclosures of noncash investing and financing activities**

Transfer of liabilities and other payables subject to compromise from operating assets and liabilities	47	75
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See accompanying Notes to the Consolidated Financial Statements.

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**PACIFIC GAS AND ELECTRIC COMPANY, A DEBTOR-IN-POSSESSION**
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(in millions)

	Three months ended March 31,	
	2003	2002
	(Unaudited)	
<b>Operating Revenues</b>		
Electric	\$ 1,237	\$ 1,778
Natural gas	830	675
	_____	_____
<b>Total operating revenues</b>	<b>2,067</b>	<b>2,453</b>
	_____	_____
<b>Operating Expenses</b>		
Cost of electricity	541	(166)
Cost of natural gas	486	315
Operating and maintenance	646	769
Depreciation, amortization, and decommissioning	310	271
Reorganization professional fees and expenses	35	16
	_____	_____
<b>Total operating expenses</b>	<b>2,018</b>	<b>1,205</b>
	_____	_____
<b>Operating Income</b>	<b>49</b>	<b>1,248</b>
Reorganization interest income	10	22



	<b>Three months ended March 31,</b>	
	<b>_____</b>	
Interest income	1	
Interest expense (non-contractual interest of \$30 million in 2003 and \$65 million in 2002)	(220)	(263)
Other income (expense), net	4	(5)
	<b>_____</b>	<b>_____</b>
<b>Income (Loss) Before Income Taxes</b>	<b>(156)</b>	<b>1,002</b>
Income tax provision (benefit)	(84)	406
	<b>_____</b>	<b>_____</b>
<b>Income (Loss) Before Cumulative Effect of Changes in Accounting Principles</b>	<b>(72)</b>	<b>596</b>
Cumulative effect of changes in accounting principles (net of income taxes of \$(1) million in 2003)	(1)	
	<b>_____</b>	<b>_____</b>
<b>Net Income (Loss)</b>	<b>(73)</b>	<b>596</b>
Preferred dividend requirement	6	6
	<b>_____</b>	<b>_____</b>
<b>Income Available for (Loss Allocated to) Common Stock</b>	<b>\$ (79)</b>	<b>\$ 590</b>
	<b>_____</b>	<b>_____</b>

See accompanying Notes to the Consolidated Financial Statements.

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**PACIFIC GAS AND ELECTRIC COMPANY, A DEBTOR-IN-POSSESSION**

**CONSOLIDATED BALANCE SHEETS**

(in millions)

	<b>Balance at</b>	
	<b>March 31, 2003</b>	<b>December 31, 2002</b>
	<b>_____</b>	<b>_____</b>
	<b>(Unaudited)</b>	
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 3,646	\$ 3,343
Restricted cash	191	150
Accounts receivable:		
Customers (net of allowance for doubtful accounts of \$63 million in 2003 and \$59 million in 2002)	1,511	1,900
Related parties	18	17
Regulatory balancing accounts	126	98
Inventories:		
Gas stored underground and fuel oil	82	154
Materials and supplies	122	121
Income taxes receivable	226	50
Prepaid expenses	66	110
Deferred income taxes		5
	<b>_____</b>	<b>_____</b>
<b>Total current assets</b>	<b>5,988</b>	<b>5,948</b>

	Balance at	
	_____	_____
<b>Property, Plant and Equipment</b>		
Electric	19,641	18,922
Gas	8,170	8,123
Construction work in progress	491	427
	_____	_____
<b>Total property, plant and equipment</b>	28,302	27,472
Accumulated depreciation and decommissioning	(12,485)	(13,515)
	_____	_____
<b>Net property, plant and equipment</b>	15,817	13,957
	_____	_____
<b>Other Noncurrent Assets</b>		
Regulatory assets	1,949	2,011
Nuclear decommissioning funds	1,314	1,335
Other	1,248	1,300
	_____	_____
<b>Total other noncurrent assets</b>	4,511	4,646
	_____	_____
<b>TOTAL ASSETS</b>	\$ 26,316	\$ 24,551
	_____	_____

See accompanying Notes to the Consolidated Financial Statements.

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**PACIFIC GAS AND ELECTRIC COMPANY, A DEBTOR-IN-POSSESSION**

**CONSOLIDATED BALANCE SHEETS**

(in millions)

	Balance at	
	_____	_____
	March 31, 2003	December 31, 2002
	_____	_____
	(Unaudited)	
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Liabilities Not Subject to Compromise</b>		
<b>Current Liabilities</b>		
Long-term debt, classified as current	\$ 591	\$ 281
Current portion of rate reduction bonds	290	290
Accounts payable:		
Trade creditors	468	380
Related parties	141	130
Regulatory balancing accounts	337	360
Other	388	374
Interest payable	189	126

	Balance at	
	_____	_____
Deferred income taxes	73	
Other	527	625
	_____	_____
<b>Total current liabilities</b>	3,004	2,566
	_____	_____
<b>Noncurrent Liabilities</b>		
Long-term debt	2,429	2,739
Rate reduction bonds	1,086	1,160
Regulatory liabilities	1,814	1,461
Asset retirement obligations	1,371	
Deferred income taxes	1,529	1,485
Deferred tax credits	139	144
Other	1,293	1,274
	_____	_____
<b>Total noncurrent liabilities</b>	9,661	8,263
	_____	_____
<b>Liabilities Subject to Compromise</b>		
Financing debt	5,605	5,605
Trade creditors	3,794	3,786
	_____	_____
<b>Total liabilities subject to compromise</b>	9,399	9,391
	_____	_____
<b>Commitments and Contingencies (Notes 1, 2, and 6)</b>		
	_____	_____
<b>Preferred Stock With Mandatory Redemption Provisions</b>		
6.30% and 6.57%, outstanding 5,500,000 shares, due 2002-2009	137	137
	_____	_____
<b>Stockholders' Equity</b>		
Preferred stock without mandatory redemption provisions		
Nonredeemable, 5% to 6%, outstanding 5,784,825 shares	145	145
Redeemable, 4.36% to 7.04%, outstanding 5,973,456 shares	149	149
Common stock, \$5 par value, authorized 800,000,000 shares, issued 321,314,760 shares	1,606	1,606
Common stock held by subsidiary, at cost, 19,481,213 shares	(475)	(475)
Additional paid-in capital	1,964	1,964
Reinvested earnings	726	805
	_____	_____
<b>Total stockholders' equity</b>	4,115	4,194
	_____	_____
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	\$ 26,316	\$ 24,551
	_____	_____

See accompanying Notes to the Consolidated Financial Statements.

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(in millions)

	Three months ended March 31,	
	2003	2002
(unaudited)		
<b>Cash Flows From Operating Activities</b>		
Net income (loss)	\$ (73)	\$ 596
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, amortization, and decommissioning	310	271
Deferred income taxes and tax credits, net	117	(113)
Other deferred charges and noncurrent liabilities	80	70
Reversal of ISO accrual (Note 2)		(970)
Cumulative effect of a change in accounting principle	2	
Net effect of changes in operating assets and liabilities:		
Restricted cash	(41)	5
Accounts receivable	381	208
Inventories	71	111
Income taxes receivable	(176)	
Accounts payable	122	453
Income taxes payable		519
Regulatory balancing accounts, net	(51)	125
Other working capital	24	95
Payments authorized by the Bankruptcy Court on amounts classified as liabilities subject to compromise (Note 2)	(39)	(225)
Other, net	7	14
<b>Net cash provided by operating activities</b>	<b>734</b>	<b>1,159</b>
<b>Cash Flows From Investing Activities</b>		
Capital expenditures	(371)	(353)
Proceeds from sale of assets	5	
Other, net	9	(7)
<b>Net cash used by investing activities</b>	<b>(357)</b>	<b>(360)</b>
<b>Cash Flows From Financing Activities</b>		
Long-term debt matured, redeemed, or repurchased		(333)
Rate reduction bonds matured	(75)	(75)
Other, net	1	
<b>Net cash used by financing activities</b>	<b>(74)</b>	<b>(408)</b>
<b>Net change in cash and cash equivalents</b>	<b>303</b>	<b>391</b>
<b>Cash and cash equivalents at January 1</b>	<b>3,343</b>	<b>4,341</b>
<b>Cash and cash equivalents at March 31</b>	<b>\$ 3,646</b>	<b>\$ 4,732</b>

Supplemental disclosures of cash flow information

	<b>Three months ended March 31,</b>	
Cash received for:		
Reorganization interest income	\$ 11	\$ 22
Cash paid for:		
Interest (net of amount capitalized)	116	65
Reorganization professional fees and expenses	22	2
<b>Supplemental disclosures of noncash investing and financing activities</b>		
Transfer of liabilities and other payables subject to compromise from operating assets and liabilities, net	47	75

See accompanying Notes to the Consolidated Financial Statements.

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1: GENERAL

#### Organization and Basis of Presentation

PG&E Corporation was incorporated in California in 1995 and became the holding company of Pacific Gas and Electric Company, a debtor-in-possession (the Utility), and its subsidiaries on January 1, 1997. The Utility, incorporated in California in 1905, is the predecessor of PG&E Corporation. The Utility delivers electric service to approximately 4.8 million customers and natural gas service to approximately 3.9 million customers in Northern and Central California. Both PG&E Corporation and the Utility are headquartered in San Francisco. As discussed further in Note 2, on April 6, 2001, the Utility filed a voluntary petition for relief under the provisions of Chapter 11 of the U.S. Bankruptcy Code (Bankruptcy Code) in the U.S. Bankruptcy Court for the Northern District of California (Bankruptcy Court). Pursuant to Chapter 11, the Utility retains control of its assets and is authorized to operate its business as a debtor-in-possession while being subject to the jurisdiction of the Bankruptcy Court.

PG&E Corporation's other significant subsidiary is PG&E National Energy Group, Inc. (PG&E NEG) and its subsidiaries, headquartered in Bethesda, Maryland. PG&E NEG was incorporated on December 18, 1998, as a wholly-owned subsidiary of PG&E Corporation. Shortly thereafter, PG&E Corporation contributed various subsidiaries to PG&E NEG. PG&E NEG's principal subsidiaries include:

PG&E Generating Company, LLC and its subsidiaries (collectively, PG&E Gen LLC);

PG&E Energy Trading Holdings Corporation and its subsidiaries (collectively, PG&E Energy Trading or PG&E ET); and

PG&E Gas Transmission Corporation and its subsidiaries (collectively, PG&E GTC), which includes PG&E Gas Transmission, Northwest Corporation and its subsidiaries (collectively, PG&E GTN), which includes North Baja Pipeline, LLC.

During February and March of 2003, certain lenders of PG&E Corporation exercised options to purchase 3 percent of the shares of PG&E NEG. No gain or loss was recognized by PG&E Corporation upon this transaction.

The Consolidated Financial Statements of PG&E Corporation and of the Utility have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets, and repayment of liabilities in the ordinary course of business. However, as a result of the bankruptcy of the Utility and current liquidity concerns at PG&E NEG and its subsidiaries, as further discussed below, such realization of assets and liquidation of liabilities are subject to uncertainty.

PG&E NEG currently is focused on power generation and natural gas transmission in the United States. As a result of the sustained downturn in the power industry, PG&E NEG and its affiliates have experienced a financial downturn, which caused the major credit rating agencies to downgrade PG&E NEG's and its affiliates' credit ratings in the second half of 2002 to below investment grade. PG&E NEG is

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currently in default under various recourse debt agreements and guaranteed equity commitments totaling approximately \$2.9 billion. In addition, other PG&E NEG subsidiaries are in default under various debt agreements totaling \$2.7 billion, but this debt is non-recourse to PG&E NEG.

PG&E NEG, its subsidiaries, and their lenders have been engaged in discussions to restructure PG&E NEG's and its subsidiaries' debt obligations and other commitments since October 2002. No agreement has been reached yet and there can be no assurance that an agreement will be reached. Any restructuring agreement that may be reached would be implemented through a reorganization proceeding under Chapter 11 of the Bankruptcy Code. Although PG&E NEG and its subsidiaries are continuing their efforts to maximize cash and reduce liabilities, such efforts are not expected to restore the financial condition of PG&E NEG and its subsidiaries. Absent a negotiated agreement, the lenders may exercise their default remedies or force PG&E NEG and certain of its subsidiaries into an involuntary proceeding under the Bankruptcy Code. Notwithstanding the status of current negotiations, PG&E NEG and certain of its subsidiaries also may elect to voluntarily seek protection under the Bankruptcy Code as early as the second quarter of 2003. Although PG&E Corporation continues to provide assistance to PG&E NEG, its subsidiaries and its lenders in their negotiations, management does not expect the outcome of any bankruptcy proceeding involving PG&E NEG or any of its subsidiaries to have a material adverse effect on the financial condition of PG&E Corporation or the Utility.

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This Quarterly Report on Form 10-Q/A is a combined report of PG&E Corporation and the Utility. Therefore, the Notes to the unaudited Consolidated Financial Statements apply to both PG&E Corporation and the Utility. PG&E Corporation's Consolidated Financial Statements include the accounts of PG&E Corporation, the Utility, PG&E NEG, and other wholly-owned and controlled subsidiaries. The Utility's Consolidated Financial Statements include its accounts and those of its wholly-owned and controlled subsidiaries.

PG&E Corporation and the Utility believe that the accompanying Consolidated Financial Statements reflect all adjustments that are necessary to present a fair statement of the consolidated financial position and results of operations for the interim periods. All material adjustments are of a normal recurring nature unless otherwise disclosed in this Form 10-Q/A. All significant intercompany transactions have been eliminated from the Consolidated Financial Statements.

This quarterly report should be read in conjunction with PG&E Corporation's and the Utility's Consolidated Financial Statements and Notes to the Consolidated Financial Statements included in their combined 2002 Annual Report on Form 10-K, as amended, and PG&E Corporation's and the Utility's other reports filed with the Securities and Exchange Commission (SEC).

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of revenues, expenses, assets and liabilities, and the disclosure of contingencies. As these estimates involve judgments on a wide range of factors, including future economic conditions that are difficult to predict, actual results could differ from these estimates.

PG&E Corporation's and the Utility's Consolidated Financial Statements have been prepared in accordance with the American Institute of Certified Public Accountants' Statement of Position (SOP) 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code," and on a going-concern basis, which contemplates continuity of operation, realization of assets, and liquidation of liabilities in the ordinary course of business. However, as a result of the Utility's Chapter 11 filing and PG&E NEG's current liquidity concerns, such realization of assets and liquidation of liabilities are subject to uncertainty. Under SOP 90-7, certain liabilities of the Utility existing prior to the Utility's Chapter 11 filing are classified as Liabilities Subject to Compromise on PG&E Corporation's and the Utility's Consolidated Balance Sheets. Additionally, professional fees and expenses directly related to the Chapter 11 proceeding and interest income on funds accumulated during the bankruptcy are reported separately as reorganization items. Finally, the extent to which the Utility's reported interest expense differs from its stated contractual interest is disclosed on the Utility's Consolidated Statements of Operations.

Certain amounts in the 2002 Consolidated Financial Statements have been reclassified to conform to the 2003 presentation. These reclassifications did not affect the consolidated net income reported by PG&E Corporation and the Utility for the periods presented.

### **Adoption of New Accounting Policies and Summary of Significant Accounting Policies**

The accounting principles used by PG&E Corporation and the Utility include those necessary for rate-regulated enterprises, which reflect the ratemaking policies of the California Public Utilities Commission (CPUC) and the Federal Energy Regulatory Commission (FERC). Except as disclosed below, PG&E Corporation and the Utility are following the same accounting principles discussed in their combined 2002 Annual Report on Form 10-K, as amended.

### ***Guarantor's Accounting and Disclosure Requirements for Guarantees***

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PG&E Corporation incorporated the clarified disclosure requirements from Financial Accounting Standards Board (FASB) Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45) into its December 31, 2002, disclosures of guarantees. Beginning January 1, 2003, PG&E Corporation applied the initial recognition and initial measurement provisions of FIN 45 to guarantees issued or modified after December 31, 2002.

FIN 45 elaborates on existing disclosure requirements for most guarantees. It also clarifies that at the time a company issues a guarantee, it must recognize an initial liability for the fair value of the obligation it assumes under that guarantee, including its ongoing obligation to stand ready to perform over the term of the guarantee in the event that specified triggering events or conditions occur. This information also must be disclosed in interim and annual financial statements.

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FIN 45 does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of the guarantee, noting that the offsetting entry would depend on the circumstances in which the guarantee was issued. There also is no prescribed approach included for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. It is noted that the liability typically would be reduced by a credit to earnings as the guarantor is released from risk under the guarantee. The adoption of this interpretation did not have a material impact on the Consolidated Financial Statements of PG&E Corporation or the Utility.

### *Accounting for Asset Retirement Obligations*

On January 1, 2003, PG&E Corporation adopted Statements of Financial Accounting Standards (SFAS) No. 143, "Accounting for Asset Retirement Obligations" (SFAS No. 143). SFAS No. 143 provides accounting requirements for costs associated with legal obligations to retire tangible long-lived assets. SFAS No. 143 requires that an asset retirement obligation be recorded at fair value in the period in which it is incurred, if a reasonable estimate of fair value can be made. In the same period, the associated asset retirement costs are capitalized as part of the carrying amount of the related long-lived asset. In each subsequent period, the liability is accreted to its present value and the capitalized cost is depreciated over the useful life of the long-lived asset. Rate-regulated entities may recognize regulatory assets or liabilities as a result of timing differences between the recognition of costs as recorded in accordance with this Statement and costs recovered through the ratemaking process.

The impacts of adopting SFAS No. 143 were as follows:

The Utility has identified its nuclear generation and certain fossil generation facilities as having asset retirement obligations as of January 1, 2003. No additional asset retirement obligations had been identified as of March 31, 2003. Through December 31, 2002, the Utility had recorded \$1.4 billion for its nuclear and fossil decommissioning obligations in accumulated depreciation and decommissioning in the Consolidated Balance Sheets.

Upon adoption of this Statement, the Utility reclassified the decommissioning liabilities recorded through December 31, 2002, as asset retirement obligations in the Consolidated Balance Sheets. To record the decommissioning liabilities at fair value as required by SFAS No. 143, the Utility then reduced the asset retirement obligations by \$53 million. The Utility increased its property, plant and equipment balance by \$332 million to reflect the fair value of the asset retirement costs as of the date the obligation was incurred, less accumulated depreciation from the date the obligation was incurred through December 31, 2002. Finally, the Utility recorded a regulatory liability of \$387 million to reflect the cumulative effect of adoption for its nuclear facilities. This regulatory liability represents timing differences between recognition of nuclear decommissioning obligations in accordance with GAAP and ratemaking purposes. The cumulative effect of the change in accounting principle for the Utility's fossil facilities as a result of adopting this Statement was a loss of \$1 million, after-tax.

If this Statement had been adopted on January 1, 2002, the pro forma effects on earnings of the accounting change for the three months ended March 31, 2002, would not have been material. The amounts recorded upon adoption of this Statement reflect the pro forma effects on the Consolidated Balance Sheets had this Statement been adopted on December 31, 2002.

The Utility has established trust funds that are legally restricted for purposes of settling its nuclear decommissioning obligations. As of March 31, 2003, the fair value of these trust funds was approximately \$1.3 billion.

The Utility may have potential asset retirement obligations under various land right documents associated with its transmission and distribution facilities. The majority of the Utility's land rights are perpetual. Any non-perpetual land rights generally are renewed continuously because the Utility intends to utilize these facilities indefinitely. Since the timing and extent of any potential asset retirements are unknown, the fair value of any obligations associated with these facilities cannot be reasonably estimated.

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The Utility collects estimated removal costs in rates through depreciation in accordance with regulatory treatment. These amounts do not represent SFAS No. 143 asset retirement obligations and will continue to be recorded within accumulated depreciation. As of March 31, 2003, the Utility estimated the removal costs recorded in accumulated depreciation were approximately \$1.7 billion.

PG&E NEG has identified its generating facilities as having asset retirement obligations as of January 1, 2003. Upon implementation of SFAS No. 143, PG&E NEG recorded \$2 million to its property, plant and equipment to reflect the fair value of the asset retirement costs as of the date the obligation was incurred, and recognized \$3 million for asset retirement obligations. The cumulative effect of the change in accounting principle as a result of adopting this Statement was a loss of

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\$3 million, after-tax, on PG&E Corporation Consolidated Statements of Operations. The impact to PG&E NEG of implementing SFAS No. 143 by its unconsolidated affiliates is immaterial.

If this Statement had been adopted on January 1, 2002, the pro forma effects on earnings of the accounting change for the three months ended March 31, 2002, would not have been material.

PG&E GTN may have potential asset retirement obligations under various land right documents associated with its gas transmission facilities. The majority of PG&E GTN's land rights are perpetual. Any non-perpetual land rights generally are renewed continuously because PG&E GTN intends to utilize these facilities indefinitely. Since the timing and extent of any potential asset retirements are unknown, the fair value of any obligations associated with these facilities cannot be reasonably estimated.

PG&E GTN collects estimated removal costs in rates through depreciation in accordance with regulatory treatment. These amounts do not represent SFAS No. 143 asset retirement obligations and will continue to be recorded within accumulated depreciation. PG&E GTN estimated the related removal costs accrued within accumulated depreciation were approximately \$11.5 million at March 31, 2003.

### ***Accounting for Costs Associated with Exit or Disposal Activities***

On January 1, 2003, PG&E Corporation adopted SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This Statement supersedes previous accounting guidance, principally Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity" (EITF 94-3). SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF 94-3, a liability for an exit cost is recognized at the commitment date of an exit plan. SFAS No. 146 also establishes that the liability initially should be measured and recorded at fair value. The adoption of this Statement did not have any current impact on the Consolidated Financial Statements of PG&E Corporation or the Utility.

### ***Change from Gross to Net Method of Reporting Revenues and Expenses on Trading Activities***

Effective at the quarter ended September 30, 2002, PG&E Corporation changed its method of reporting gains and losses associated with energy trading contracts from the gross method of presentation to the net method. PG&E Corporation believes that the net method provides a more accurate and consistent presentation of energy trading activities on the financial statements. Amounts to be presented under the net method include all gross margin elements related to energy trading activities.

Before implementation of the net method and the subsequent rescission of EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" (EITF 98-10), as noted below, PG&E Corporation had reported unrealized gains and losses on trading activities on a net basis in operating revenues. However, PG&E Corporation had reported realized gains and losses on a gross basis in operating income, as both operating revenues and costs of commodity sales and fuel. PG&E Corporation now is reporting realized gains and losses from trading activities on a net basis as operating revenues, and in accordance with the rescission of EITF 98-10, unrealized gains and losses on energy trading activities no longer are reported as these contracts are accounted for under the cost method.

Implementation of the net method has no net effect on gross margin, operating income, or net income. Accordingly, PG&E Corporation continues to report realized income from non-trading activities on a gross basis in operating revenues and operating expenses. Prior year financial statements have been reclassified to conform to the net method.



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The schedule below summarizes the amounts impacted by the change in methodology on PG&E Corporation's Consolidated Statements of Operations for the three months ended March 31, 2002:

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	<b>Prior Method of Presentation (Gross Method)</b>	<b>As Presented (Net Method)</b>
	<b>Three months ended March 31, 2002</b>	<b>Three months ended March 31, 2002</b>
	(in millions)	
Energy commodities and services(1)	\$ 2,114	\$ 498
Cost of commodities and services(2)	1,956	340
<b>Net Subtotal</b>	<b>\$ 158</b>	<b>\$ 158</b>

- (1) These amounts, as presented in the net method, differ from the financial statements due to the exclusion of equity earnings in affiliates and eliminations and other, which amounted to net charges of \$16 million at March 31, 2002.
- (2) These amounts, as presented in the net method, differ from the financial statements due to the exclusion of eliminations and other, which amounted to a benefit of \$34 million at March 31, 2002.

### ***Rescission of EITF 98-10***

In October 2002, the EITF rescinded EITF 98-10. Energy trading contracts that are derivatives in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities" (collectively, SFAS No. 133), will continue to be accounted for at fair value under SFAS No. 133. Contracts that previously were marked to market as trading activities under EITF 98-10 and that did not meet the definition of a derivative now are accounted for at cost, through a one-time adjustment recorded as a cumulative effect of a change in accounting principle. This requirement was effective as of January 1, 2003, and resulted in a \$2 million loss, net of tax, reflected on the PG&E Corporation's Consolidated Statements of Operations for the three months ended March 31, 2003. For PG&E Corporation, the majority of trading contracts are derivative instruments as defined in SFAS No. 133. The rescission of EITF 98-10 has no effect on the accounting for derivative instruments used for non-trading purposes, which continue to be accounted for in accordance with SFAS No. 133. The reporting requirements associated with the rescission of EITF 98-10 were applied prospectively for all EITF 98-10 energy trading contracts entered into after October 25, 2002, although the number of energy trading contracts subject to the prospective implementation was considered immaterial.

### ***Earnings (Loss) Per Share***

Basic earnings (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed by dividing net income (loss), adjusted for convertible note interest and amortization, by the weighted average number of common shares outstanding plus the assumed issuance of common shares for all dilutive securities.

The following is a reconciliation of PG&E Corporation's net income (loss) and weighted average common shares outstanding for calculating basic and diluted net income (loss) per share:

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	Three months ended March 31,	
	2003	2002
	(in millions, except per share amounts)	
Income (loss) from continuing operations	\$ (278)	\$ 623
Discontinued operations	(70)	8
<b>Net income (loss) before cumulative effect of a change in accounting principle</b>	<b>(348)</b>	<b>631</b>
Cumulative effect of a change in accounting principle	(6)	
<b>Net income (loss)</b>	<b>\$ (354)</b>	<b>\$ 631</b>

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<b>Weighted average common shares outstanding, basic</b>	382	364
Add: Employee stock options and PG&E Corporation shares held by grantor trusts		4
<b>Shares outstanding for diluted calculations</b>	<b>382</b>	<b>368</b>
<b>Earnings (Loss) Per Common Share, Basic</b>		
Income (loss) from continuing operations	\$ (0.73)	\$ 1.71
Discontinued operations	(0.18)	0.02
Cumulative effect of a change in accounting principle	(0.02)	
<b>Net earnings (loss)</b>	<b>\$ (0.93)</b>	<b>\$ 1.73</b>
<b>Earnings (Loss) Per Common Share, Diluted</b>		
Income (loss) from continuing operations	\$ (0.73)	\$ 1.69
Discontinued operations	(0.18)	0.02
Cumulative effect of a change in accounting principle	(0.02)	
<b>Net earnings (loss)</b>	<b>\$ (0.93)</b>	<b>\$ 1.71</b>

The diluted earnings per share for the three months ended March 31, 2003, excludes approximately one million incremental shares related to employee stock options and shares held by grantor trusts, five million incremental shares related to warrants, and 18 million incremental shares related to the 9.5 percent Convertible Subordinated Notes, and includes associated interest expense of \$4 million (net of income taxes of \$3 million) due to the anti-dilutive effect upon loss from continuing operations.

PG&E Corporation reflects the preferred dividends of subsidiaries as other expense for computation of both basic and diluted earnings per share.

**Stock-Based Compensation**

PG&E Corporation and the Utility account for stock-based compensation using the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," as allowed by SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure, an Amendment of FASB Statement No. 123." Under the intrinsic value method, PG&E Corporation and the Utility do not recognize any compensation expense for stock options, as the exercise price is equal to the fair market value of a share of PG&E Corporation common stock at the time the options are granted. Had compensation expense been recognized using the fair value-based method under SFAS No. 123, PG&E

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Corporation's pro forma consolidated earnings (loss) and earnings (loss) per share would have been as follows:

	<b>Three months ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(in millions, except per share amounts)</b>	
<b>Net income (loss):</b>		
As reported	\$ (354)	\$ 631
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(5)	(5)
	<b>\$ (359)</b>	<b>\$ 626</b>
<b>Basic earnings (loss) per share:</b>		
As reported	\$ (0.93)	\$ 1.73

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Pro forma	\$	(0.94)	\$	1.72
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**Diluted earnings (loss)  
per share:**

As reported	\$	(0.93)	\$	1.71
Pro forma	\$	(0.94)	\$	1.70

Had compensation expense been recognized using the fair value-based method under SFAS No. 123, the Utility's pro forma consolidated earnings (loss) would have been as follows:

	<b>Three months ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(in millions)</b>	
<b>Income available for (loss allocated to) common stock:</b>		
As reported	\$ (79)	\$ 590
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(2)	(2)
	<b>\$ (81)</b>	<b>\$ 588</b>

On January 2, 2003, PG&E Corporation awarded 1.6 million shares of restricted PG&E Corporation common stock to eligible employees of PG&E Corporation and its subsidiaries. The shares were granted with restrictions and are subject to forfeiture unless certain conditions are met.

The restricted shares were issued at the grant date and are held in an escrow account. The shares become available to the employees as the restrictions lapse. In general, the restrictions on 80 percent of the shares lapse automatically over a period of four years at the rate of 20 percent per year. Restrictions to the remaining 20 percent of the shares will lapse at a rate of 5 percent per year if PG&E Corporation is in the top quartile of its comparator group as measured by annual total shareholder return for each year ending immediately before each annual lapse date.

Total compensation expense resulting from the restricted stock issuance reflected on PG&E Corporation's Consolidated Statements of Operations for the three months ended March 31, 2003, was \$1.4 million, of which \$0.8 million was recognized by the Utility.

**Comprehensive Income**

PG&E Corporation's and the Utility's comprehensive income (loss) consists principally of changes in the market value of certain cash flow hedges under SFAS No. 133, as amended.

	PG&E Corporation		Utility	
	2003	2002	2003	2002
	(in millions)			
<b>Three months ended March 31</b>				
Net income available for (loss allocated to) common stock	\$ (354)	\$ 631	\$ (79)	\$ 590
Net gain (loss) in other comprehensive income (OCI) from current period hedging transactions and price changes in accordance with SFAS No. 133	(1)	(75)		
Net reclassification from OCI to earnings	5	5		
Foreign currency translation adjustment	3			
<b>Comprehensive income (loss)</b>	<b>\$ (347)</b>	<b>\$ 561</b>	<b>\$ (79)</b>	<b>\$ 590</b>

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The above changes to OCI are stated net of income taxes of \$48 million at March 31, 2003, and \$38 million at March 31, 2002.

**Income Taxes**

In 2003, PG&E Corporation increased its valuation allowance due to the continued uncertainty in realizing certain state deferred tax assets arising at PG&E NEG. During the first quarter of 2003, valuation allowances of \$10 million were recorded in continuing operations. Additional valuation allowances of \$7 million were recorded in discontinued operations, and \$5 million in accumulated other comprehensive loss.

In addition to the above reserves, PG&E NEG recorded valuation allowances due to continued uncertainty in realizing federal deferred tax assets. These valuation allowances were determined on a stand-alone basis. During the first quarter of 2003, valuation allowances of \$66 million were recorded in continuing operations. Additional valuation allowances of \$37 million were recorded in discontinued operations, \$3 million recorded in cumulative effect of changes in accounting principles, and \$48 million recorded in accumulated other comprehensive loss. These reserves were eliminated in consolidation, as PG&E Corporation believes that it is more likely than not that the federal deferred tax assets will be realized on a consolidated basis.

**Related Party Transactions**

In accordance with various agreements, the Utility and other subsidiaries provide and receive various services to and from their parent, PG&E Corporation. The Utility and PG&E Corporation exchange administrative and professional support services in support of operations. These services are priced either at the fully loaded cost (i.e., direct costs and allocation of overhead costs) or at the higher of fully loaded cost or fair market value, depending on the nature of the services provided. PG&E Corporation also allocates certain other corporate administrative and general costs to the Utility and other subsidiaries using a variety of factors, including the number of employees, operating expenses excluding fuel purchases, total assets, and other cost-causal methods. Additionally, the Utility purchases gas commodity and transmission services from, and sells reservation and other ancillary services to, PG&E NEG. These services are priced at either tariff rates or fair market value depending on the nature of the services provided. Intercompany transactions are eliminated in consolidation; therefore, no profit results from these transactions. The Utility's significant related party transactions were as follows:

Three months ended March 31,	
2003	2002
(in millions)	

**Three months ended  
March 31,**

<b>Utility proceeds from:</b>		
Administrative services provided to PG&E Corporation	\$ 2	\$ 1
Gas reservation services provided to PG&E ET	3	3
Trade deposit due from PG&E GTN	3	
<b>Utility payments for:</b>		
Administrative services received from PG&E Corporation	\$ 13	\$ 27
Interest accrued on pre-petition liability	2	
Administrative services received from PG&E NEG	1	
Gas commodity and transmission services received from PG&E ET	10	19
Transmission services received from PG&E GTN	15	12
Trade deposit due to PG&E ET	1	

#### **Accounting Pronouncements Issued But Not Yet Adopted**

##### *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

In April 2003, the FASB issued Statement No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" (SFAS No. 149). SFAS No. 149 amends and clarifies the accounting and reporting for derivative instruments, including certain derivatives embedded in other contracts, and for hedging activities under SFAS No. 133. The amendments in SFAS No. 149 require that contracts with comparable characteristics be accounted for similarly. The Statement clarifies under what circumstances a contract with an initial net investment meets the characteristics of a derivative according to SFAS

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No. 133 and when a derivative contains a financing component that warrants special reporting in the statement of cash flows. In addition, the Statement amends the definition of an underlying to conform it to language used in FIN No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", and amends certain other existing pronouncements. The provisions of the Statement that relate to SFAS No. 133 Implementation Issues that have been effective for periods that began prior to June 15, 2003, should continue to be applied in accordance with their respective effective dates.

The requirements of SFAS No. 149 are effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. PG&E Corporation is currently evaluating the impacts, if any, of SFAS No. 149 on its Consolidated Financial Statements.

##### *Consolidation of Variable Interest Entities*

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46), which expands upon existing accounting guidance addressing when a company should include in its financial statements the assets, liabilities, and activities of another entity or arrangement it is involved with. FIN 46 notes that many of what are now referred to as "variable interest entities" have commonly been referred to as special-purpose entities or off-balance sheet structures. However, the Interpretation's guidance is to be applied to not only these entities but to all entities and arrangements found within a company. FIN 46 provides some general guidance as to the definition of a variable interest entity. PG&E Corporation is currently evaluating all entities and arrangements it is involved with to determine if they meet the FIN 46 criteria as variable interest entities.

Until the issuance of FIN 46, a company generally included another entity in its Consolidated Financial Statements only if it controlled the entity through voting interests. FIN 46 changes that by requiring a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns, or both. A company that consolidates a variable interest entity is now referred to as the "primary beneficiary" of that entity.

FIN 46 requires disclosure of variable interest entities that the company is not required to consolidate but in which it has a significant variable interest.

The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. There were no new variable interest entities created by PG&E Corporation between February 1, 2003, and March 31, 2003. The consolidation requirements apply to variable interest entities created before January 31, 2003, in the first fiscal year or interim period beginning after June 15, 2003, so these

requirements would be applicable to PG&E Corporation in the third quarter of 2003. Certain new and expanded disclosure requirements must be applied to PG&E Corporation's March 31, 2003 disclosures if there is an assessment that it is reasonably possible that an enterprise will consolidate or disclose information about a variable interest entity when FIN 46 becomes effective. PG&E Corporation is currently evaluating the impacts of FIN 46's initial recognition, measurement, and disclosure provisions on its Consolidated Financial Statements.

### **2003 Revision**

Subsequent to the issuance of PG&E Corporation's quarter ended March 31, 2003 consolidated financial statements, management discovered a misclassification of certain offsetting revenues and expenses within continuing operations. As a result PG&E Corporation's quarter ended March 31, 2003 Consolidated Financial Statements have been revised to reflect the reclassification. The reclassification resulted in a decrease in quarter ended March 31, 2003 Operating Revenues Energy Commodities and Services from \$540 million to \$334 million, and a similar decrease in Operating Expenses Cost of Energy Commodities and Services from \$364 million to \$158 million. The reclassification did not result in a change in consolidated operating income or net income, the Consolidated Balance Sheets or the Consolidated Statements of Cash Flows.

### **NOTE 2: THE UTILITY CHAPTER 11 FILING**

#### **Electric Industry Restructuring**

In 1998, California implemented electric industry restructuring and established a market framework for electric generation in which generators and other electricity providers were permitted to charge market-based prices for electricity sold on the wholesale market. The restructuring of the electric industry was mandated by the California Legislature in Assembly Bill (AB) 1890. The mandate included a retail electricity rate freeze and a plan for recovery of generation-related costs that were expected to be uneconomic under the new market framework (transition costs). Additionally, the CPUC strongly encouraged the Utility to sell more than 50 percent of its fossil fuel-fired generation facilities and made it economically unattractive for the Utility to retain its remaining generation facilities. The new market framework called for the creation of the Power Exchange (PX) and the Independent System Operator (ISO). Before it ceased operation in January 2001, the PX established market-clearing prices for electricity. The ISO's role is to schedule delivery of electricity for all market participants and operate certain markets for electricity. Until December 15, 2000, the Utility was required to sell all of its owned and contracted generation to, and purchase all electricity for its retail customers from, the PX. Customers were given the choice of continuing to buy electricity from the Utility, or to buy electricity from independent power generators or retail electricity suppliers (customers who chose to buy from independent power generators or retail electricity suppliers are referred to as direct access customers). Most of the Utility's customers continued to buy electricity from the Utility.

For the seven-month period from June 2000 through December 2000, wholesale electric prices in California averaged \$0.18 per kilowatt-hour (kWh). During this period, the Utility's retail electric rates were frozen and provided only approximately \$0.05 per kWh to pay for the Utility's electricity costs.

The frozen rates were designed to allow the Utility to recover its authorized costs and, to the extent the frozen rates generated revenues in excess of the Utility's authorized costs, recover its transition costs. During the California energy crisis, frozen rates were insufficient to cover the Utility's electricity procurement and other costs. Since the Utility no longer could conclude that its under-collected purchased power and remaining transition costs were probable of recovery, the Utility charged \$6.9 billion to expense for these costs at December 31, 2000. The Utility's inability to recover procurement costs from customers ultimately resulted in billions of dollars in defaulted debt and unpaid bills, and caused the Utility to file a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court on April 6, 2001.

In January 2001, the CPUC increased electric rates by \$0.01 per kWh, and in March 2001 by another \$0.03 per kWh, and restricted use of these surcharge revenues to "ongoing procurement costs" and "future power purchases."

In May 2001, the CPUC authorized the Utility to collect an additional \$0.005 per kWh in revenues for 12 months to make up for the time lag between March 2001, when the CPUC authorized the \$0.03 surcharge, and June 2001, when the Utility began collecting the \$0.03 surcharge. Although the collection of this "half-cent" surcharge originally was scheduled to end on May 31, 2002, the CPUC issued a resolution ordering the Utility to continue collecting the half-cent surcharge until further consideration by the CPUC and to record the surcharge revenues in a balancing account.

In November 2002, the CPUC approved a decision modifying the restrictions on the use of revenues generated by the surcharges to permit the revenues to be used for the purpose of securing or restoring the Utility's reasonable financial health, as determined by the CPUC. The CPUC

will determine in other proceedings how the surcharge revenues can be used, whether there is any cost or other basis to support specific surcharge levels, and whether the resulting rates are just and reasonable. After the CPUC determines when the AB 1890 rate freeze ended, the CPUC will determine the extent and disposition of the Utility's under-collected costs, if any, remaining at the end of the rate freeze. If the CPUC determines that the Utility recovered revenues in excess of its transition costs or in excess of other permitted uses, the CPUC may require the Utility to refund such excess revenues.

In December 2002, the CPUC issued a decision authorizing the Utility to record amounts related to the \$0.01 and \$0.03 surcharge revenues as an offset to unrecovered transition costs.

Based on the November and December 2002 CPUC decisions discussed above and an agreement between the CPUC and another California investor-owned utility, Southern California Edison (SCE), in which SCE was allowed to use its half-cent surcharge to offset its California Department of Water Resources (DWR) revenue requirement, the Utility believes it can continue to recognize revenues related to the \$0.01, \$0.03, and half-cent surcharges after the statutory end of the rate freeze, which was March 31, 2002. As such, the Utility has not recorded a regulatory liability for these surcharge revenues, or any portion thereof, in its financial statements. If the CPUC requires the Utility to refund any of these revenues in the future, the Utility's earnings could be materially affected.

### Recovery of Transition Costs

During 2001, the price of wholesale electricity stabilized. In 2001 and 2002, as a result of the wholesale electricity price stabilization and the CPUC-authorized surcharges, the Utility's total generation-related electric revenues were greater than its generation-related costs, resulting in the partial recovery of previously written-off under-collected purchased power and transition costs. As of December 31, 2000, the Utility had accumulated a total of approximately \$4.1 billion (after-tax) in unrecovered purchased power and generation-related transition costs. This amount was charged to earnings at that time because the Utility could no longer conclude that such costs were probable of collection through regulated rates. Generation-related costs in excess of generation-related revenues continue to be expensed as they are incurred. As of March 31, 2003, the outstanding balance of the Utility's unrecovered purchased power and transition costs amounted to \$2.4 billion (after-tax) compared to a balance of \$2.2 billion (after-tax) at December 31, 2002. The increase in the unrecovered balance from December 31, 2002, to March 31, 2003, was due to first quarter 2003 generation-related costs in excess of generation-related revenues. Typically, electric revenues are lower in the winter because of lower consumption and lower winter rates.

The recovery of these remaining under-collected purchased power costs and transition costs will depend on a number of factors, including the ultimate outcome of the Utility's bankruptcy and future regulatory and judicial proceedings, including the outcome of the Utility's filed rate doctrine litigation. (The filed rate doctrine litigation refers to a lawsuit filed in November 2000 in the U.S. District Court for the Northern District of California by the Utility against the CPUC)

Commissioners, asking the court to declare that the federally approved wholesale electricity costs that the Utility has incurred to serve its customers are recoverable in retail rates under the federal filed rate doctrine.)

Under AB 1890, the rate freeze was scheduled to end on the earlier of March 31, 2002, or the date that the Utility recovered all of its generation-related transition costs as determined by the CPUC. However, in January 2002, the CPUC issued a decision finding that new California legislation, AB 6X, had materially affected the implementation of AB 1890. The CPUC scheduled further proceedings to address the impact of AB 6X on the AB 1890 rate freeze for the Utility and to determine the extent and disposition of the Utility's remaining unrecovered transition costs. In its November 2002 decision regarding the surcharge revenues discussed above, the CPUC reiterated that it had yet to decide when the rate freeze ended and the disposition of any under-collected costs remaining at the end of the rate freeze.

During the third quarter of 2002, and again during the first quarter of 2003, the CPUC represented that, since utilities now are required under state law (AB 6X) to retain their generating assets and the CPUC has regained its traditional rate authority over those assets, costs associated with those assets may be recovered by the utilities in the traditional way under cost-based regulation. Based on these CPUC decisions and representations, the Utility believes it can continue to record revenues collected under its existing overall retail rates, subsequent to the statutory end of the rate freeze.

However, the CPUC's proceedings to consider the impact of AB 6X on the AB 1890 rate freeze and the disposition of the Utility's unrecovered transition costs are still pending. The California Supreme Court currently is considering the authority of the CPUC to enter into a settlement with SCE, which allows SCE to recover under-collected procurement and transition costs in light of the provisions of AB 1890. Oral argument has been set before the California Supreme Court in this case on May 27, 2003. Either in response to judicial decisions such as this one, or on its own initiative, it is possible that at some future date the CPUC may change its interpretation of law or otherwise seek to change the Utility's overall retail electric rates retroactively. The Utility has not provided reserves for potential refunds of any of these revenues as of

March 31, 2003. If the CPUC requires the Utility to refund any of these revenues in the future, the Utility's earnings could be materially affected.

### **Electricity Purchases**

In January 2001, as wholesale electric prices continued to exceed retail rates, the major credit rating agencies lowered their ratings for the Utility and PG&E Corporation to non-investment grade levels. Consequently, the Utility lost access to its bank facilities and capital markets, and no longer could continue buying electricity to deliver to its customers. As a result, in the first quarter of 2001, the California Legislature and the Governor of California authorized the DWR to purchase electricity for the Utility's customers and to issue revenue bonds to finance electricity purchases (governed by AB 1X). Initially, the DWR indicated that it intended to buy electricity only at "reasonable prices" to meet the Utility's net open position, leaving the ISO to purchase the remainder in order to avoid blackouts. The Utility accrued approximately \$1 billion for ISO billings for the period January 17, 2001, through April 6, 2001. However, in 2001 and 2002, the FERC issued a series of orders directing the ISO to buy electricity only on behalf of creditworthy entities. The Utility currently acts as a billing and collection agent for electricity provided to its customers by the DWR. As such, revenues associated with these activities are passed through to the DWR and are not included in the Utility's results of operations.

In February 2002, the CPUC approved a decision, which was further modified in March 2002, that set the statewide DWR revenue requirement for 2001 and 2002. The DWR revenue requirement decision allows the DWR to collect amounts from ratepayers to provide the revenues needed by the DWR to procure electricity for the customers of the Utility and the other California investor-owned utilities (IOUs).

The DWR's revenue requirement included the procurement charges previously billed by the ISO and accrued by the Utility. As such, because of certain 2001 and 2002 FERC orders and the February and March 2002 CPUC decisions, in the first quarter of 2002 the Utility reversed the excess of the ISO accrual (for the period from January 17, 2001, through April 6, 2001) over the amount of the additional DWR revenue requirement applicable to 2001, for a net reduction of accrued purchased power costs of approximately \$595 million (pre-tax).

In October 2002, the DWR filed a proposed amendment to the CPUC's May 16, 2002, servicing order requesting both prospective and retrospective changes to the calculation that determines the amount of revenue the Utility is required to pass through to the DWR. Under its statutory authority, the DWR may request the CPUC to order utilities to implement such amendments, and the CPUC has approved such amendments in the past without significant change. In December 2002, the CPUC issued an operating order requiring the Utility to perform the operational, dispatch, and administrative functions for the DWR's allocated contracts beginning on January 1, 2003. The operating order, which applies prospectively, includes the DWR's proposed method of calculating the amount of revenues that the Utility must pass through to the DWR but does not change the servicing order relating to the same calculation. In March 2003, the DWR submitted a letter to the CPUC reaffirming its position and quantifying the amount of revenues that the DWR has requested the CPUC to order the Utility to

pass through to the DWR. As a result, the Utility has accrued an additional \$96 million (pre-tax) liability for pass-through revenues for electricity previously provided by the DWR to the Utility's customers. In total as of March 31, 2003, the Utility has accrued an additional \$539 million (pre-tax) liability for pass-through revenues to the DWR based on the DWR's October 2002 proposed amendment, the CPUC's December 2002 operating order, and the March 2003 letter from the DWR. Of this amount, \$369 million (pre-tax) had been accrued at December 31, 2002.

In April 2003, the Utility and the DWR entered into an operating agreement, which has been approved by the CPUC. Effective in April 2003, the operating agreement supersedes the operating order. The operating agreement provides that the Utility will begin passing through revenues to the DWR consistent with the DWR's October 2002 and March 2003 requests for amendments to the servicing order, but subject to the outcome of the CPUC's consideration of the DWR's requests. In addition, if the CPUC grants the DWR's request for changes to the servicing order, the Utility would be required to make additional cash payments to the DWR consistent with its accrual of pass-through revenues to the DWR for the periods prior to the effective date of the operating agreement.

In October 2002, the Utility filed a lawsuit in a California court asking the court to find that the DWR's revenue requirements had not been demonstrated to be "just and reasonable" (as required by AB 1X) and lawful. The Utility asked the court to order the DWR's revenue requirement determination to be withdrawn as invalid, and that the DWR be precluded from imposing its revenue requirements on the Utility and its customers until it has complied with the law. The lawsuit is scheduled to be considered by the court during the third or fourth quarter of 2003.

### **Senate Bill 1976**

Under AB 1X, the DWR is prohibited from entering into new agreements to purchase electricity to meet the net open position of the IOUs after December 31, 2002. In September 2002, the Governor signed California Senate Bill (SB) 1976 into law. As required by SB 1976, each



California IOU submitted an electricity procurement plan to meet the residual net open position associated with that utility's customer demand.

A central feature of the SB 1976 regulatory framework is its direction to the CPUC to create new electric procurement balancing accounts to track and allow recovery of the differences between recorded revenues and costs incurred under an approved procurement plan. The CPUC must review the revenues and costs associated with the Utility's electric procurement plan at least semi-annually and adjust rates or order refunds, as appropriate, to properly amortize the balancing accounts. The CPUC must establish a schedule for amortizing the over-collections or under-collections in the electric procurement balancing accounts so that the aggregate over-collections or under-collections reflected in the accounts do not exceed 5 percent of the IOUs' actual recorded generation revenues for the prior calendar year, excluding revenues collected on behalf of the DWR. Mandatory semi-annual review and adjustment of the balancing accounts will continue until January 1, 2006, after which time the CPUC will conduct electric procurement balancing account reviews and adjust retail ratemaking amortization schedules for the balancing accounts as the CPUC deems appropriate and in a manner consistent with the requirements of SB 1976 for timely recovery of electricity procurement costs. Additionally, in a December 2002 interim opinion, the CPUC established a maximum annual procurement disallowance for administration of all contracts and least-cost dispatch of resources equal to twice the Utility's annual administrative costs of managing procurement activities, including the administration and dispatch of electricity associated with DWR allocated contracts.

In December 2002, the CPUC issued an interim opinion adopting the Utility's electricity procurement plan for 2003. On January 1, 2003, the Utility resumed the function of procuring electricity to meet the portion of its customers' needs that is not covered by the combination of the allocation of electricity from existing DWR contracts and the Utility's own electric resources and contracts. To meet this requirement, the Utility entered into contracts for fuel supply, capacity, and transmission rights that limit exposure to potentially high congestion charges. These one-year term contracts did not have a material impact on the Utility's commitments previously disclosed in its 2002 Annual Report on Form 10-K, as amended.

The Utility filed its long-term procurement plan (long-term plan), which covers the next 20 years, with the CPUC on April 15, 2003. The Utility's long-term plan states that certain important policy issues, including the restoration of the Utility's financial health and investment grade credit rating, should be resolved before the CPUC can adopt a credible long-term plan for the Utility. The long-term plan indicates that a fundamental requirement for restoring the Utility's credit rating is the provision of procurement cost recovery by the CPUC. The Utility also mentions other conditions that the CPUC should consider implementing before adopting its long-term plan, including providing comprehensive guidelines that give the Utility the flexibility to react quickly to changing market conditions and determining which customers the Utility will serve and under what price. In this latter condition, the Utility notes that it will continue to be exposed to unrecovered costs unless the CPUC requires customer classes to pay the full amount of costs incurred on their behalf. While the long-term plan states that there is no immediate need for the Utility to construct or make long-term commitments to new resources, it notes that the Utility's role in future generation development will be directly impacted by its credit rating.

### *Allocation of DWR Electricity to Customers of the IOUs*

Since 2001, the Utility and the other California IOUs have acted as the billing and collection agents for the DWR's sales of its electricity to retail customers. In September 2002, the CPUC issued a decision allocating the electricity provided under existing DWR contracts to the customers of the IOUs. This decision required the Utility, along with the other IOUs, to begin performing all the day-to-day scheduling, dispatch, and administrative functions associated with the DWR contracts allocated to the IOUs' respective portfolios by January 1, 2003.

Although the DWR retains legal and financial responsibility for these contracts, the DWR has stated publicly that it intends to transfer full legal title of, and responsibility for, the DWR electricity contracts to the IOUs as soon as possible. However, SB 1976 does not contemplate a transfer of title of the DWR contracts to the IOUs. In addition, the operating agreement approved by the CPUC in April 2003 (implementing the Utility's operational and scheduling responsibility with respect to the DWR allocated contracts) specifies that the DWR will retain legal and financial responsibility for the contracts. The Utility's proposed plan of reorganization prohibits the Utility from accepting, directly or indirectly, assignment of legal or financial responsibility for the DWR contracts. Either the State of California (State) or the CPUC may seek to provide the DWR with authority to effect such a transfer of legal title in the future. The Utility has informed the CPUC, the DWR, and the State that the Utility would vigorously oppose any attempt to transfer the DWR allocated contracts to the Utility without the Utility's consent.

### **Chapter 11 Filing**

On April 6, 2001, the Utility filed for relief under Chapter 11 of the Bankruptcy Code, causing the Utility to become subject to the jurisdiction of the Bankruptcy Court. Throughout the Chapter 11 proceeding, the Utility has maintained control over its assets and has been authorized to operate its business as a debtor-in-possession. Subsidiaries of the Utility, including PG&E Funding, LLC (which holds rate reduction bonds) and PG&E Holdings, LLC (which holds stock of the Utility), are not included in the Utility's Chapter 11 filing. PG&E Corporation, the Utility's parent, and PG&E NEG have not filed for Chapter 11 and are not included in the Utility's Chapter 11 filing. PG&E Corporation, however, is a co-proponent of the Utility's proposed plan of reorganization (Plan) described below.

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In connection with the Utility's Chapter 11 filing, various parties filed claims with the Bankruptcy Court totaling approximately \$50.1 billion through March 31, 2003. Of these claims, approximately \$26.5 billion have been disallowed or withdrawn. Of the remaining \$23.6 billion of filed claims, pursuant to the Plan and alternative plan (discussed below), claims asserted in the amount of approximately \$5.5 billion are expected to pass through the bankruptcy proceeding and be determined in the appropriate court or other tribunal during the bankruptcy proceeding or after it concludes.

The Utility has objected to approximately \$1 billion of the remaining \$23.6 billion of filed claims. These objections are pending in the Bankruptcy Court. The Utility intends to object to approximately \$4.4 billion of the remaining \$23.6 billion of filed claims. These objections relate primarily to generator claims. Generator claims could be reduced significantly based on the FEREC's March 26, 2003, decision finding that electricity suppliers significantly overcharged California buyers, including IOUs, from October 2, 2000, to June 20, 2001. The Utility has recorded its estimate of all valid claims at March 31, 2003, as \$9.4 billion of Liabilities Subject to Compromise and \$3.0 billion of Long-Term Debt. The Utility has paid certain claims authorized by the Bankruptcy Court, as discussed below, and reduced the amount of outstanding claims accordingly. In addition, since its Chapter 11 filing, the Utility has accrued interest on all claims it considers valid. This additional interest accrual is not included in the original \$50.1 billion of claims filed.

In addition to other parties, the City of Palo Alto and the Northern California Power Agency (NCPA) filed an objection to the Plan and the CPUC's alternative proposed plan of reorganization. The objection asserts that, by virtue of the Utility's termination of a wholesale electric transmission contract between the NCPA and the Utility, NCPA members, including Palo Alto, will now be required to obtain transmission service through the California ISO and will be subject to substantial ISO charges. Palo Alto and the NCPA further assert that the Utility's motivation for terminating the NCPA transmission contract was anticompetitive and violated federal antitrust laws. They claim that damages associated with these increased ISO congestion charges could exceed \$1 billion (which Palo Alto and the NCPA have indicated they would seek to treble under federal antitrust law). In January 2003, the Bankruptcy Court held an estimation hearing to determine what value to put on a possible future damages award that Palo Alto and the NCPA might receive, should they file, pursue, and establish liability on their antitrust claim. The Utility believes that Palo Alto's and the NCPA's claims are without merit.

The Bankruptcy Court has authorized certain payments and actions necessary for the Utility to continue its normal business operations while operating as a debtor-in-possession. For example, the Utility is authorized to pay employee wages and benefits,

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amounts payable to certain qualified facilities (QFs), interest on certain secured and unsecured debt, environmental remediation expenses, and expenditures related to property, plant and equipment. In addition, the Utility is authorized to refund certain customer deposits, use certain bank accounts and cash collateral, and assume responsibility for various hydroelectric contracts. The Utility also has received permission from the Bankruptcy Court to make payments on (1) pre- and post-petition interest on certain claims, (2) pre-petition trade payables to the majority of QFs and to certain other vendors, and (3) pre-petition secured debt that has matured.

As specified in the Plan described below, the Utility has agreed to pay pre- and post-petition interest on Liabilities Subject to Compromise at the rates set forth below, plus additional interest on certain claims as discussed below.

	<b>Amount Owed</b>	<b>Agreed Upon Interest Rate</b>	
	<b>(in millions)</b>	<b>(per annum)</b>	
Commercial Paper Claims	\$ 873	7.466%	
Floating Rate Notes	1,240	7.583%	(Implied yield of 7.690%)
Senior Notes	680	9.625%	
Medium-Term Notes	287	5.810% to 8.450%	
Revolving Line of Credit Claims	938	8.000%	
Majority of QFs	75	5.000%	
Other Claims	5,306	Various	
	<b>\$ 9,399</b>		
Liabilities Subject to Compromise at March 31, 2003			

Since the Plan did not become effective on or before February 15, 2003, the interest rates for Commercial Paper Claims, Floating Rate Notes, Senior Notes, Medium-Term Notes, and Revolving Line of Credit Claims have been increased by 37.5 basis points above the rates presented above, for periods on and after February 15, 2003. If the Plan does not become effective on or before September 15, 2003, the interest

rates for these claims on and after such date will be increased by an additional 37.5 basis points. Finally, if the effective date does not occur on or before March 15, 2004, the interest rates for these claims on and after such date will be increased by an additional 37.5 basis points. For other claims, the Utility has recorded interest at the contractual or FERC-tariffed interest rate. When those rates do not apply, the Utility has recorded interest at the federal judgment rate.

### ***Proposed Plan of Reorganization***

The Utility and PG&E Corporation jointly have proposed a plan of reorganization, referred to as the Plan, which would allow the Utility to restructure its businesses and refinance the restructured businesses. The Plan is designed to align the Utility's existing businesses under the regulators that best match the business functions. Retail assets (natural gas and electricity distribution) would remain under the retail regulator, the CPUC. The wholesale assets (electric transmission, interstate natural gas transportation, and electric generation) would be placed under wholesale regulators, the FERC and the Nuclear Regulatory Commission (NRC). After this realignment, the retail-focused business would be a natural gas and electricity distribution company (Reorganized Utility), representing approximately 70 percent of the book value of the Utility's current assets.

In contemplation of the Plan becoming effective, the Utility has created three new limited liability companies, the LLCs, which currently are owned by the Utility's wholly-owned subsidiary, Newco Energy Corporation (Newco). On the effective date of the Plan, the Utility would transfer substantially all the assets and liabilities primarily related to the Utility's electricity generation business to Electric Generation LLC (Gen), the assets and liabilities primarily related to the Utility's electricity transmission business to ETrans LLC (ETrans), and the assets and liabilities primarily related to the Utility's natural gas transportation and storage business to GTrans LLC (GTrans).

The Plan proposes that on the effective date of the Plan, the Utility would distribute to PG&E Corporation all of the outstanding common stock of Newco. Each of ETrans, GTrans, and Gen would continue to be an indirect wholly-owned subsidiary of PG&E Corporation. Finally, on the effective date of the Plan or as promptly thereafter as practicable, PG&E Corporation would distribute all the shares of the Utility's common stock that it then holds to its existing shareholders in a spin-off transaction. After the spin-off, the Reorganized Utility would be an independent publicly held company. The common stock of the Reorganized Utility generally would be freely tradable by the recipients. The Reorganized Utility

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would retain the name "Pacific Gas and Electric Company," and apply to list its common stock on the New York Stock Exchange.

Although the Reorganized Utility would be legally separated from the LLCs, the Reorganized Utility would have significant operating relationships with the LLCs covering a range of functions and services after the effective date of the Plan.

During 2002, the Utility undertook several initiatives to prepare for separation under the Plan. The Utility has spent approximately \$43 million in 2002 and approximately \$15 million in 2003 on these initiatives. Of this amount, approximately \$4 million has been capitalized to Property, Plant and Equipment in the Consolidated Balance Sheets.

The Plan proposes to satisfy allowed claims with cash, long-term notes issued by the LLCs, or a combination of cash and such notes. Each of ETrans, GTrans, and Gen would issue long-term notes to the Reorganized Utility and the Reorganized Utility then would transfer the notes to certain holders of allowed claims. In addition, each of the Reorganized Utility, ETrans, GTrans, and Gen would issue "new money" notes in registered public offerings. These notes would be secured if necessary to obtain investment-grade credit ratings as required by the Plan. The LLCs then would transfer the proceeds of the sale of the new money notes, less working capital reserves, to the Utility for payment of allowed claims.

PG&E Corporation has agreed to contribute up to \$700 million in cash to the Utility's capital from the issuance of equity or from other available sources, to the extent necessary to satisfy the cash obligations of the Utility in respect of allowed claims and required deposits into escrow for disputed claims, or to obtain investment-grade ratings for the debt to be issued by the Reorganized Utility and the LLCs. If PG&E Corporation is required to issue equity, PG&E Corporation's amended and restated credit agreement dated October 18, 2002 (Credit Agreement) will require mandatory prepayment of outstanding loans in an amount equal to the net cash proceeds from the issuance or sale of equity by PG&E Corporation. In addition, PG&E Corporation generally is prohibited by the terms of the Credit Agreement from making investments in the Utility, except as specifically permitted by the terms of the loans or as required by applicable law or the conditions adopted by the CPUC with respect to holding companies. To the extent lender consent is required, PG&E Corporation intends to negotiate with its lenders. Absent any required lender consent, PG&E Corporation intends to seek to refinance its indebtedness.

If the Plan is confirmed by the Bankruptcy Court, the Plan requires that certain conditions must be satisfied or waived before the Plan can become effective, including, among other conditions:

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All actions, documents, and agreements necessary to implement the Plan shall have been effected or executed;

PG&E Corporation and the Utility shall have received all authorizations, consents, regulatory approvals, rulings, letters, no-action letters, opinions, or documents that are determined by PG&E Corporation and the Utility to be necessary to implement the Plan;

Standard & Poor's (S&P) and Moody's Investors Services (Moody's) shall have established investment-grade credit ratings for each of the securities to be issued by the Reorganized Utility, ETrans, GTrans, and Gen of not less than BBB- and Baa3, respectively;

The Plan shall not have been modified in a material way since the confirmation date; and

The registration statements pursuant to which the new securities will be issued shall have been declared effective by the SEC. The Reorganized Utility shall have consummated the sale of its new securities to be sold under the Plan, and the new securities of each of ETrans, GTrans, and Gen shall have been priced and the trade date with respect to each shall have occurred.

If one or more of the conditions have not been satisfied or waived, the confirmation order would be vacated and the Utility's obligations with respect to claims and equity interests would remain unchanged.

In connection with the Plan, PG&E Corporation and the Utility contend that bankruptcy law expressly preempts state law in connection with the implementation of a plan of reorganization. The Bankruptcy Court rejected this contention. PG&E Corporation and the Utility appealed this decision to the U.S. District Court for the Northern District of California (District Court). The District Court reversed the Bankruptcy Court's ruling and remanded the case back to the Bankruptcy Court for further proceedings, ruling that the Bankruptcy Code expressly preempts "nonbankruptcy laws that would otherwise apply to bar, among other things, transactions necessary to implement the reorganization plan." The District Court entered judgment on September 19, 2002, and the CPUC and several other parties thereafter initiated an appeal to the U.S. Court of Appeals for the Ninth Circuit. The Ninth Circuit has scheduled arguments to be heard on May 14, 2003.

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On February 27, 2003, the California counties of Alameda, Fresno, San Luis Obispo, Sonoma, and the City and County of San Francisco (collectively, the Counties) filed a motion for summary judgment denying confirmation of the Plan, arguing that the Plan is not feasible because it purports to transfer to Gen, or a subsidiary of Gen, the Utility's beneficial interests in the Nuclear Facilities Qualified CPUC Decommissioning Master Trust Agreement (Trust). The Counties contend that the contemplated transfer is unlawful because the Utility's interests in the Trust do not constitute property of the Utility's estate. The Counties also argue that prior CPUC approval of the transfer is necessary but the Utility has not requested such approval. The Utility vigorously contests the Counties' allegations.

### ***The CPUC/OCC's Alternative Plan of Reorganization***

The CPUC and the Official Committee of Unsecured Creditors (OCC) jointly have proposed an alternative plan of reorganization (CPUC/OCC plan) for the Utility that does not call for realignment of the Utility's existing businesses. The alternative plan instead provides for the continued regulation of all of the Utility's current operations by the CPUC. The alternative plan proposes to satisfy all allowed creditor claims in full either through reinstatement or payment in cash, using a combination of cash on hand and the proceeds from the issuance of \$7.3 billion of new senior secured debt and the issuance of \$1.5 billion of new unsecured debt and preferred securities. The alternative plan also proposes to establish a \$1.75 billion regulatory asset, which would be included in the Utility's rate base and would be amortized over ten years.

The CPUC/OCC plan also provides that it would not become effective until the Utility and the CPUC enter into a "reorganization agreement" under which the CPUC promises to establish retail electric rates on an ongoing basis sufficient to facilitate achieving and maintaining investment grade credit ratings for portions of the Utility's securities and to recover in rates (1) the interest and dividends payable on, and the amortization and redemption of, the securities to be issued under the alternative plan, and (2) certain recoverable costs (defined as the amounts the Utility is authorized by the CPUC to recover in retail electric rates in accordance with historical practice for all of its prudently incurred costs, including capital investment in property, plant and equipment, a return of capital, and a return on capital and equity to be determined by the CPUC from time to time in accordance with its past practices).

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PG&E Corporation and the Utility believe the alternative plan is not credible or confirmable. PG&E Corporation and the Utility do not believe the alternative plan would restore the Utility or its debt securities to investment-grade status if the alternative plan is to become effective. Additionally, PG&E Corporation and the Utility believe the alternative plan would violate applicable federal and state law.

### **Confirmation Hearings**

The trial on confirmation of the alternative plan began on November 18, 2002. The trial on the Plan began on December 16, 2002, with objections common to both plans slated for trial during the Plan trial. On March 4, 2003, the Bankruptcy Court ordered the Utility, the CPUC, and other parties involved in the confirmation trial to participate in settlement negotiations. On March 11, 2003, the Bankruptcy Court then issued an order staying nearly all the proceedings in the confirmation trial until May 12, 2003. On April 23, 2003, the Bankruptcy Court extended this stay for an additional 30 days. A status conference is scheduled for June 16, 2003.

The Utility is unable to predict which plan, if any, the Bankruptcy Court will confirm. If either plan is confirmed, implementation of the confirmed plan may be delayed due to appeals, CPUC actions or proceedings, or other regulatory hearings that could be required in connection with the regulatory approvals necessary to implement that plan, and other events. The uncertainty regarding the outcome of the bankruptcy proceeding and the related uncertainty around the plan of reorganization that is ultimately adopted and implemented will have a significant impact on the Utility's future liquidity and results of operations. The Utility is unable at this time to predict the outcome of its bankruptcy case or the effect of the reorganization process on the claims of the Utility's creditors or the interests of the Utility's preferred shareholders. However, the Utility believes, based on information presently available to it, that cash and cash equivalents on hand at March 31, 2003, of \$3.6 billion and cash available from operations will provide sufficient liquidity to allow it to continue as a going concern through 2003.

### **NOTE 3: PG&E NEG LIQUIDITY AND FINANCIAL MATTERS**

#### **Credit Ratings**

Prior to July 31, 2002, most of the various debt instruments of PG&E NEG and its subsidiaries carried investment-grade credit ratings as assigned by S&P and Moody's, two major credit rating agencies. Since July 31, 2002, PG&E NEG's rated entities have been downgraded several times. The result of these downgrades has left all of PG&E NEG consolidated rated entities and debt instruments at below investment-grade.

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The downgrade of PG&E NEG's credit ratings impacted various guarantees and financial arrangements that require PG&E NEG to maintain certain credit ratings from S&P and/or Moody's. Because of the downgrades, PG&E NEG's counterparties have demanded PG&E NEG to provide additional security for performance in the form of cash, letters of credit, acceptable replacement guarantees, or advanced funding of obligations. Other counterparties continue to have the right to make such demands. If PG&E NEG fails to provide this additional collateral within defined cure periods, PG&E NEG may be in default under contractual terms. In addition to agreements containing ratings triggers, other agreements allow counterparties to seek additional security for performance whenever such counterparty becomes concerned about PG&E NEG's or its subsidiaries' creditworthiness. PG&E NEG's credit downgrades constrained its access to additional capital and triggered increases in cost of indebtedness under many of its outstanding debt arrangements.

The credit downgrades also impacted PG&E NEG's and its subsidiaries' ability to service their financial obligations by putting constraints on the ability to move cash from one subsidiary to another or to PG&E NEG itself. PG&E NEG's subsidiaries now must independently determine, in light of each company's financial situation, whether any proposed dividend, distribution, or intercompany loan is permitted and is in such subsidiary's interest.

The effects of the credit downgrades on PG&E NEG's debt facilities and other contractual arrangements are described below. Amounts required to be paid under debt agreements and other significant contractual commitments also are described below.

#### **Debt Restructuring**

PG&E NEG is currently in default under various debt agreements and guaranteed equity commitments totaling approximately \$2.9 billion. In addition, other PG&E NEG subsidiaries are in default under various debt agreements totaling approximately \$2.7 billion, but this debt is non-recourse to PG&E NEG. On November 14, 2002, PG&E NEG defaulted on the repayment of the \$431 million 364-day tranche of its corporate revolving credit facility (Corporate Revolver). Loans and letters of credit outstanding as of March 31, 2003, under the two-year tranche of the Corporate Revolver were \$258 million, consisting of \$185 million of letters of credit and \$73 million of loans. The default under the Corporate Revolver also constitutes a cross-default as of March 31, 2003, under (1) PG&E NEG Senior Unsecured Notes (\$1 billion outstanding), (2) its guarantee of a turbine revolving credit agreement (\$205 million outstanding), and (3) various equity commitment guarantees totaling \$960 million. In addition, on November 15, 2002, PG&E NEG failed to pay a \$52 million interest payment due under PG&E NEG

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Senior Unsecured Notes. PG&E NEG currently does not have sufficient cash to meet its financial obligations and has ceased making payments on its debt and equity commitments.

PG&E NEG, its subsidiaries, and their lenders have been engaged in discussions to restructure PG&E NEG's and its subsidiaries' debt obligations and other commitments since October 2002. No agreement has been reached yet and there can be no assurance that an agreement will be reached. Any restructuring agreement that may be reached would be implemented through a reorganization proceeding under Chapter 11 of the Bankruptcy Code. Although PG&E NEG and its subsidiaries are continuing their efforts to maximize cash and reduce liabilities, such efforts are not expected to restore the financial condition of PG&E NEG and its subsidiaries. Absent a negotiated agreement, the lenders may exercise their default remedies or force PG&E NEG and certain of its subsidiaries into an involuntary proceeding under the Bankruptcy Code. Notwithstanding the status of current negotiations, PG&E NEG and certain of its subsidiaries also may elect to voluntarily seek protection under the Bankruptcy Code as early as the second quarter of 2003. Although PG&E Corporation continues to provide assistance to PG&E NEG, its subsidiaries and its lenders in their negotiations, management does not expect the outcome of any bankruptcy proceeding involving PG&E NEG or any of its subsidiaries to have a material adverse effect on the financial condition of PG&E Corporation or the Utility.

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### Debt in Default and Long-Term Debt

The schedule below summarizes PG&E NEG's and its subsidiaries' outstanding debt in default and long-term debt as of March 31, 2003, and December 31, 2002:

Description	Maturity	Interest Rates	Outstanding Balance At	
			March 31, 2003	December 31, 2002
(in millions)				
<b>Debt in Default</b>				
PG&E NEG, Inc. Senior Unsecured Notes	2011	10.375%	\$ 1,000	\$ 1,000
PG&E NEG, Inc. Credit Facility-Tranche B (364-day)	11/14/02	Prime plus credit spread	431	431
PG&E NEG, Inc. Credit Facility-Tranche A (2-year facility with a \$258 million maximum commitment)	8/23/03	Prime plus credit spread	73	42
Turbine and Equipment Facility	12/31/03	Prime plus credit spread	205	205
GenHoldings Construction Facility Tranche A	12/5/03	LIBOR plus credit spread	194	118
GenHoldings Construction Facility Tranche B	12/5/03	LIBOR plus credit spread	1,068	1,068
GenHoldings Swap Termination			50	50
Lake Road Construction Facility Tranche A	12/11/02	Prime plus credit spread	227	227
Lake Road Construction Facility Tranche B	12/11/02	Prime plus credit spread	219	219
Lake Road Construction Facility Tranche C		Prime plus credit spread		
Lake Road Working Capital Facility	12/9/03	Prime plus credit spread	27	23
Lake Road Swap Termination	12/11/02		61	61
La Paloma Construction Facility Tranche A	12/11/02	Prime plus credit spread	374	367
La Paloma Construction Facility Tranche B	12/11/02	Prime plus credit spread	296	291
La Paloma Construction Facility Tranche C	12/11/02	Prime plus credit spread	21	20
La Paloma Working Capital Facility	12/9/03		46	29
La Paloma Swap Termination	12/11/02		81	79
Subtotal			\$ 4,373	\$ 4,230
<b>Long-term debt</b>				
PG&E GTN Senior Unsecured Notes	2005	7.10%	\$ 250	\$ 250
PG&E GTN Senior Unsecured Debentures	2025	7.80%	150	150
PG&E GTN Senior Unsecured Notes	2012	6.62%	100	100
PG&E GTN Medium-Term Notes	2003	6.96%	6	6
PG&E GTN Credit Facility	5/2/05	LIBOR plus credit spread	40	58
USGenNE Credit Facility	9/1/03	LIBOR plus credit spread	75	75
Plains End Construction Facility	9/6/06	LIBOR plus credit spread	65	56
Other Debt Related to Attala	Various	Principally LIBOR plus credit spread	237	

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			<b>Outstanding Balance At</b>	
Mortgage Loan Payable	2010	CP rate + 6.07%	7	7
Other	Various	Various	20	20
<b>Subtotal</b>			<b>\$ 950</b>	<b>\$ 722</b>
<b>Total Debt in Default and Long-term Debt</b>			<b>\$ 5,323</b>	<b>\$ 4,952</b>
<b>Amounts Classified as:</b>				
Debt in Default			\$ 4,373	\$ 4,230
Long-term Debt, Classified as Current			10	17
Long-term Debt			865	630
Amount Related to Liabilities of Operations Held for Sale, Classified as Current			75	75
<b>Total Debt in Default and Long-term Debt</b>			<b>\$ 5,323</b>	<b>\$ 4,952</b>

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**Accrued Interest**

For the period ended March 31, 2003, accrued interest was recorded on the following debt instruments:

	<b>PG&amp;E NEG</b>
	<b>(in millions)</b>
PG&E NEG Senior Unsecured Notes	\$ 91
PG&E NEG Inc. Credit Facility	17
Turbine and Equipment Facility	7
Lake Road Facilities	16
La Paloma Facilities	4
PG&E GTN Facilities	11
<b>Total</b>	<b>\$ 146</b>

**GenHoldings Construction Facility**

In December 2001, PG&E NEG entered into a \$1.075 billion 5-year non-recourse credit facility for a portfolio of generating projects held by GenHoldings I, LLC (GenHoldings), a wholly-owned indirect subsidiary of PG&E NEG. The credit facility, which increased to \$1.5 billion on April 5, 2002, is secured by the Millennium, Harquahala, Covert, and Athens projects. The facility was intended to be used to reimburse PG&E NEG and lenders for a portion of the construction costs already incurred on these projects and to fund a portion of the balance of the construction costs through completion.

GenHoldings has defaulted under its credit agreement by failing to make equity contributions to fund construction draws for the Athens, Harquahala, and Covert projects. In November and December 2002, GenHoldings' lenders executed waivers and amendments to the credit agreement under which they agreed to continue to waive GenHoldings' equity default until March 31, 2003 and increased loan commitments to cover such shortfall.

In connection with the lenders' waiver of various defaults and additional funding commitments, PG&E NEG has agreed to cooperate with any reasonable proposal by the lenders regarding disposition of the equity in or assets of any or all of the PG&E NEG subsidiaries holding the Athens, Covert, Harquahala, and Millennium projects.

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As of March 21, 2003, the lenders executed a waiver letter extending to June 30, 2003, the waiver of GenHoldings' equity default. In addition, the waiver letter also waives other existing defaults in order to permit the continued availability of loan facilities to fund construction and operation of the projects until such time as a transfer of the projects to the GenHoldings lenders may be completed. An event of default will occur if such transfer is not accomplished by June 30, 2003. A default would trigger lender remedies, including the right to foreclose on the Millennium, Harquahala, Athens, and Covert projects.

Under the waiver, PG&E NEG has re-affirmed its guarantee of GenHoldings' remaining obligation to make equity contributions to these projects of approximately \$355 million. Neither PG&E NEG nor GenHoldings currently expects to have sufficient funds to make this payment. The requirement to pay \$355 million will remain an obligation of PG&E NEG that would survive the transfer of the projects.

### ***Lake Road and La Paloma Construction Facilities***

In September 1999 and March 2000, Lake Road Generating Company, LP (Lake Road) and La Paloma Generating Company, LLC (La Paloma) entered into Participation Agreements to finance the construction of the two plants. In November 2002, Lake Road and La Paloma defaulted on their obligations to pay interest and swap payments. In addition, as a result of PG&E NEG's downgrade to below investment grade by both S&P and Moody's, PG&E NEG, as guarantor of certain debt obligations of Lake Road and La Paloma, became required to make equity contributions to Lake Road and La Paloma of \$230 million and \$375 million respectively. The lenders have accelerated all debt existing prior to December 11, 2002, including the guaranteed portion of the debt and made a payment under the PG&E NEG guarantee. Neither PG&E NEG, Lake Road nor La Paloma has sufficient funds to make these payments.

As of December 4, 2002, PG&E NEG and certain subsidiaries entered into various agreements with the respective lenders for each of the Lake Road and La Paloma generating projects providing for (1) funding of construction costs required to complete the La Paloma facility, and (2) additional working capital facilities to enable each subsidiary to timely pay for its fuel requirements and to provide its own collateral to support natural gas pipeline capacity reservations and independent

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transmission system operator requirements, as well as for general working capital purposes. Lenders extending new credit under these agreements have received liens on the projects that are senior to the existing lenders' liens. These agreements provide, among other things, that the failure to transfer right, title and interest in, to and under the Lake Road and La Paloma projects to the respective lenders by June 9, 2003 will constitute a default under the agreements. The failure to transfer the facilities would entitle the lenders to accelerate the new indebtedness and exercise other remedies. The requirement to pay \$230 million and \$375 million for Lake Road and La Paloma, respectively, will remain an obligation of PG&E NEG that would survive the transfer of the projects.

### **Impairments, Write-offs, and Other Charges**

#### ***Consolidation and Impairment of Attala Generating Company LLC***

On May 7, 2002, Attala Generating Company LLC (Attala Generating), an indirect wholly-owned subsidiary of PG&E NEG, completed a \$340 million sale and leaseback transaction whereby it sold and leased back a 526-megawatt (MW) generation facility (Facility) in Mississippi to two third-party special-purpose entities (SPEs). These entities funded the acquisition of their undivided interests in the Facility through proceeds from the issuance of debt and equity. The SPEs funded \$103 million, or approximately 30 percent of the total fair value of the Facility on the transaction date, from the issuance of equity. The related transaction was accounted for as a lease because the owners of the SPEs had made an initial substantive residual equity capital investment that was intended to be at risk during the entire term of the lease.

During January 2003, the SPEs distributed cash to their equity holders, which resulted in the SPEs no longer meeting the substantive equity at risk criteria, under current accounting requirements. PG&E NEG now consolidates the assets and liabilities of the SPEs.

The consolidation of the SPEs resulted in an increase in assets of \$62 million, representing the estimated fair value of the Facility and related inventories, and debt of \$237 million, representing the bonds issued to finance the sale-leaseback transaction. As the liabilities of the SPEs exceed their assets, a pre-tax charge to earnings of \$175 million was recorded in the first quarter of 2003.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46). See Note 1, "General Adoption of New Accounting Policies," for a more complete description of FIN 46. PG&E NEG currently is evaluating the impacts of FIN 46's initial recognition, measurement, and disclosure provisions on its Consolidated Financial Statements when these requirements become effective by the beginning of the third quarter of 2003.

PG&E NEG believes that, upon the adoption of FIN 46, it will not be required to continue to consolidate the SPEs associated with the sale-leaseback of the Facility since it has neither an equity investment nor a significant variable interest in the SPEs. Depending on the method



of adopting FIN 46 by PG&E NEG, either the difference between the book values of the SPEs' assets and liabilities will be recognized through earnings, or first quarter 2003 financial statements will be restated to eliminate the impact of initially consolidating the SPEs. Future earnings may also be impacted by the accrual of any probable payments under the Attala guarantee arrangement disclosed in Note 6 of the Notes to the Consolidated Financial Statements.

### ***Shaw Settlement Charges***

In connection with the terms of a proposed settlement of all pending disputes among Shaw Group Inc. (Shaw), Harquahala Generating Company, LLC (Harquahala), Covert Generating Company, LLC (Covert) and PG&E NEG, PG&E NEG has recognized a pre-tax charge of approximately \$32 million for anticipated legal settlement costs.

Harquahala generating facility, owned by Harquahala, is a 1,092-MW plant in Tonopah, Arizona, with about 88 percent of the construction complete. Covert generating facility, owned by Covert, is a 1,170-MW plant in Covert, Michigan, with about 84 percent of construction complete. The equity in Covert and Harquahala is owned by GenHoldings. On August 13, 2001, Harquahala and Covert entered into engineering procurement and construction contracts (EPCs) with Shaw to design, procure materials and equipment for, and construct these generating facilities.

During November and December 2002, Harquahala commenced arbitration against Shaw seeking a declaration that it was not obligated to withhold payments from a certain third party connected with the construction of the facility. Subsequently, Shaw commenced arbitration against Covert and Harquahala to recover the value of certain change order requests. In addition, Shaw filed a lawsuit against Harquahala, Covert, PG&E NEG, and NEG Construction Finance Company, LLC (CFC), alleging that it had not received adequate assurance of payment from PG&E NEG.

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Under the terms of the proposed settlement, PG&E NEG will pay approximately \$32 million to Shaw, the EPC contracts will be increased in the aggregate by \$65 million (the balance funded by the lenders), the completion deadlines will be extended, the cost-sharing agreements and related guarantees will be terminated, and PG&E NEG's completion guarantees to the lenders will be released. The parties are now negotiating definitive agreements.

### ***Mantua Creek Project***

The Mantua Creek project is a nominal 897 MW combined cycle merchant power plant located in the Township of West Depford, New Jersey. Due to liquidity concerns, PG&E NEG could no longer provide equity contributions to the project and beginning in the fourth quarter of 2002, began to suspend or terminate contracts with vendors. At December 31, 2002, PG&E NEG wrote off capitalized development and construction costs of \$257 million and established an additional accrual of \$22 million for charges and associated termination costs. For the period ending March 31, 2003, various termination cost accruals were adjusted as settlements occurred resulting in an approximate \$8 million reduction in impairment expense.

## **NOTE 4: DISCONTINUED OPERATIONS AND ASSETS HELD FOR SALE**

### **USGen New England**

In September 1998, USGen New England, Inc. (USGenNE) acquired the non-nuclear generating assets of the New England Electric System (NEES) for approximately \$1.8 billion. These assets included:

2,344 MW of coal- and oil-fired power plants in Massachusetts;

1,166 MW of hydroelectric facilities in New Hampshire, Vermont, and Massachusetts;

495 MW of gas-fired power plants in Rhode Island;

Above-market power purchase agreements with support payments provided by NEES for the first nine years;

Gas pipeline transportation contracts; and

Transition wholesale load contracts known as Standard Offer Agreements.

Consistent with its previously announced strategy to dispose of certain merchant assets, in December 2002 the Board of Directors of PG&E Corporation approved management's plans for the proposed sale of USGenNE. Under the provisions of SFAS No. 144, the equity of USGenNE has been accounted for as an asset held for sale at December 31, 2002. This requires that the asset be recorded at the lower of fair value, less costs to sell, or book value. Based on the current estimated fair value (based on the estimated proceeds) of a sale of USGenNE, PG&E NEG recorded a pre-tax loss of \$1.1 billion in the fourth quarter of 2002. PG&E NEG recorded an additional pre-tax loss on disposal of \$23 million in the first quarter of 2003. It was anticipated that the arrangements for the disposition of the USGenNE assets would be made during 2003. However, as a result of required regulatory approval by the FERC, it is anticipated that any disposals will not be consummated until 2004. The operating results from USGenNE are being reported as discontinued operations in the PG&E Corporation Consolidated Statements of Operations for the three months ended March 31, 2003, and 2002. Also under the provisions of SFAS No. 144, no depreciation has been recorded on the restated assets.

### Mountain View

On September 17 and 28, 2001, PG&E NEG purchased Mountain View Power Partners, LLC and Mountain View Power Partners II, LLC, respectively (collectively referred to as Mountain View), from SeaWest Wind Power, Inc. These companies own 44- and 22-MW wind energy projects, respectively, near Palm Springs, California (SeaWest). PG&E NEG contracted with SeaWest for the operation and maintenance of the wind units. Total consideration for these two companies was \$92 million. The two companies were merged on October 1, 2002. The power is sold to the DWR under a 10-year contract.

In December 2002, the Board of Directors of PG&E Corporation approved the sale of Mountain View. On December 18, 2002, a subsidiary of PG&E NEG entered into an agreement to sell Mountain View to Centennial Power, Inc. The sale occurred on January 3, 2003. PG&E NEG received \$102 million in proceeds for the sale of Mountain View, resulting in a \$19 million pre-tax gain.

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Under the provisions of SFAS No. 144, Mountain View is accounted for as an asset held for sale at March 31, 2003, and December 31, 2002. The operating results from Mountain View are being reported as discontinued operations in the PG&E Corporation Consolidated Statements of Operations for the three months ended March 31, 2003, and 2002.

### ET Canada

On March 18, 2003, PG&E Energy Trading-Gas Corporation (ET-Gas), a subsidiary of PG&E NEG, completed the sale of 100 percent of the stock of PG&E Energy Trading, Canada Corporation (ET Canada) to Seminole Canada Gas Company, a Nova Scotia unlimited liability company (Seminole). Seminole transferred approximately \$86 million at closing to ET-Gas and several of its affiliates, representing the purchase price and the return of collateral posted by ET-Gas and ET Canada to support ET Canada's energy trading transactions, plus interest. Most of the proceeds were used to repay principal and interest on an outstanding loan of \$76 million to another affiliate.

Seminole also has agreed within 30 days after the closing to replace certain letters of credit issued to support ET Canada's energy trading transactions and to obtain the release of ET-Gas and its affiliates, including PG&E GTN and PG&E NEG from obligations under guarantees issued for the same reasons. Seminole has indemnified ET-Gas for any liability under the letters of credit or the guarantees. As previously disclosed, in the fourth quarter of 2002, PG&E NEG recorded a \$25 million pre-tax loss on the anticipated disposition of ET Canada. In the first quarter of 2003, an additional \$3 million pre-tax loss on disposal was recorded.

The following table reflects the combined operating results of USGenNE, Mountain View, and ET Canada for the three months ended March 31, 2003, and 2002:

Three months ended March 31,	
2003	2002

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	Three months ended March 31,	
	(in millions)	
<b>Operating Revenues</b>	\$ 122	\$ 216
<b>Operating Expenses</b>		
Cost of commodity sales and fuel	172	131
Operations, maintenance, and management	52	63
Depreciation and amortization		17
	<u>224</u>	<u>211</u>
<b>Total operating expense</b>	\$ 224	\$ 211
	<u>(102)</u>	<u>5</u>
<b>Operating Income (Loss)</b>	(102)	5
Interest income	7	10
Interest expense	(1)	
Other expense, net	(4)	(2)
	<u>(100)</u>	<u>13</u>
<b>Income (Loss) Before Income Taxes</b>	\$ (100)	\$ 13
Income tax expense (benefit)	(35)	5
	<u>(65)</u>	<u>8</u>
<b>Earnings (Loss) from Assets classified as Discontinued Operations</b>	\$ (65)	\$ 8

The following table reflects the components of assets and liabilities held for sale of USGenNE at March 31, 2003, and the combined components of assets and liabilities held for sale of USGenNE, Mountain View, and ET Canada at December 31, 2002:

	Balance At	
	March 31, 2003	December 31, 2002
	(in millions)	
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 52	\$ 32
Accounts receivable trade	157	300
Inventory	53	82
Price risk management	2	196

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Prepaid expenses, deposits and other	2	97
	<u>266</u>	<u>707</u>
<b>Total current assets held for sale</b>		
<b>Property, Plant and Equipment</b>		
Total property, plant and equipment(1)	718	799
Accumulated depreciation	(279)	(285)
	<u>439</u>	<u>514</u>
<b>Net property, plant and equipment</b>		

<b>Other Noncurrent Assets</b>		
Long-term receivables(2)	303	319
Intangible assets, net of accumulated amortization of \$37 million and \$37 million	20	20
Price risk management	7	30
Other	41	33
<b>Total noncurrent assets held for sale</b>	<b>810</b>	<b>916</b>
<b>TOTAL ASSETS HELD FOR SALE</b>	<b>\$ 1,076</b>	<b>\$ 1,623</b>
<b>LIABILITIES</b>		
<b>Current Liabilities</b>		
Long-term debt, classified as current	\$ 75	\$ 75
Accounts payable and Accrued expenses	31	207
Price risk management	161	331
Out-of-market contractual obligations(3)	86	86
<b>Total current liabilities of operations held for sale</b>	<b>353</b>	<b>699</b>
<b>Noncurrent Liabilities</b>		
Price risk management	241	272
Out-of-market contractual obligations(3)	501	501
Other noncurrent liabilities and deferred credit	16	20
<b>Total noncurrent liabilities held for sale</b>	<b>758</b>	<b>793</b>
<b>TOTAL LIABILITIES HELD FOR SALE</b>	<b>1,111</b>	<b>1,492</b>
<b>NET ASSETS (LIABILITIES) HELD FOR SALE</b>	<b>\$ (35)</b>	<b>\$ 131</b>

(1) Includes impairment charges made against property, plant and equipment.

(2) USGenNE receives payments from a wholly-owned subsidiary of NEES, related to the assumption of power supply agreements, which are payable monthly through January 2008. The long-term receivables are valued at the present value of the scheduled payments using a discount rate that reflects NEES' credit rating on the date of acquisition.

(3) Commitments contained in the underlying Power Purchase Agreements (PPAs) by USGenNE, gas commodity and transportation agreements (collectively, the Gas Agreements), and Standard Offer Agreements acquired by USGenNE in September 1998 were recorded at fair value, based on management's estimate of either or both the gas commodity and gas transportation markets and electric markets over the life of the underlying contracts, discounted at a rate commensurate with the risks associated with such contracts. Standard Offer Agreements reflect a commitment to supply electric capacity and energy necessary for certain affiliates to meet their obligations to supply fixed-rate service. PPAs and Gas Agreements are amortized on a straight-line basis over their specific lives. The Standard Offer Agreements are amortized using an accelerated method, since the decline in value is greater in earlier years due to increasing contract pricing terms designed to reduce demand for supply service over time.

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Included in the assets and liabilities held for sale summary above, are certain amounts paid to USGenNE related to the assumption of power supply agreements and certain purchase obligations assumed by USGenNE from the acquisition that occurred in 1998.

### NOTE 5: PRICE RISK MANAGEMENT

PG&E NEG is in the process of reducing and unwinding its trading positions. Additionally, asset hedge positions associated with the merchant plants will either remain with the assets or be terminated. PG&E NEG has significantly reduced its energy

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trading operations in an ongoing effort to raise cash and reduce debt. PG&E NEG's objective is to limit its asset trading and risk management activities to only what is necessary for energy management services to facilitate the transition of PG&E NEG's merchant generation facilities through their sale, transfer, or abandonment process. PG&E NEG will then further reduce and transition to retain only limited capabilities to ensure fuel procurement and power logistics for PG&E NEG's retained independent power plant operations.

#### Non-Trading Activities

At March 31, 2003, PG&E Corporation had cash flow hedges of varying durations associated with commodity price risk, interest rate risk, and foreign currency risk, the longest of which extend through December 2011, March 2014, and December 2004, respectively.

The amount of commodity hedges included in Accumulated Other Comprehensive Income or Loss (OCI), net of tax, at March 31, 2003, was a loss of \$36 million. The amount of interest rate hedges included in OCI, net of tax, at March 31, 2003, was a loss of \$49 million. The amount of foreign currency hedges included in OCI, net of tax, at March 31, 2003, was a loss of \$1 million.

PG&E Corporation's net derivative losses included in OCI at March 31, 2003, were \$86 million, of which approximately \$45 million is expected to be reclassified into earnings within the next 12 months based on the contractual terms of the contracts or the termination of the hedge position. The actual amounts reclassified from OCI to earnings will differ as a result of market price changes. The Utility did not have any cash flow hedges at March 31, 2003, or at March 31, 2002. PG&E Corporation's ineffective portion of changes in amounts of cash flow hedges was immaterial for the three months ended March 31, 2003, and March 31, 2002.

The schedule below summarizes the activities affecting Accumulated Other Comprehensive Income (Loss), net of tax, from derivative instruments:

	Three months ended March 31, 2003		Three months ended March 31, 2002	
	PG&E Corporation	Utility	PG&E Corporation	Utility
	(in millions)			
Derivative gains (losses) included in accumulated other comprehensive income (loss) at beginning of period	\$ (90)	\$	\$ 36	\$
Net gain (loss) from current period hedging transactions and price changes	(1)		(75)	
Net reclassification to earnings	5		5	
	(86)	(86)	(34)	(34)
Derivative gains (losses) included in accumulated other comprehensive income at end of period			(5)	(2)
Foreign currency translation adjustment			(1)	
Other			(40)	(2)
Accumulated other comprehensive income (loss) at end of period	\$ (86)	\$ (86)	\$ (40)	\$ (2)

Normally, most non-trading activity earnings are recognized on an accrual basis as revenues are earned and as expenses are incurred. For example, the effective portion of contracts accounted for as cash flow hedges have no mark-to-market effect on earnings; these contracts are presented on a mark-to-market basis on the balance sheet in price risk management (PRM) assets and liabilities and OCI. Other non-trading contracts are exempt from the SFAS No. 133 fair value requirements under the normal purchases and sales exception and thus have no

mark-to-market effect on earnings.

Cash flow hedge accounting was discontinued for commodity cash flow hedges on January 1, 2003. Accordingly, such non-trading activities affect PG&E NEG's earnings on a mark-to-market basis. PG&E NEG recognizes the prospective change in fair value relating to commodity hedges and the ineffective portion of the changes in the fair value of all cash flow hedges in earnings. PG&E NEG also has certain derivative contracts that, while they are meant for non-trading purposes, do not qualify for cash flow hedge accounting or for the normal purchases and sales exception to SFAS No. 133. These derivatives are reported in earnings on a mark-to-market basis. These contracts primarily consist of those derivative commodity

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contracts for which normal purchases and sales treatment was disallowed upon PG&E NEG's implementation of Derivative Implementation Group (DIG) C15 and C16 effective April 1, 2002.

PG&E NEG's pre-tax earnings for the period ended March 31, 2003, include gains of \$50 million related to commodity hedges, previously deferred in OCI, after it became probable that the forecasted transactions will not occur.

### Trading Activities

Unrealized gains and losses from trading activities, including the reversal of unrealized gains and losses previously recognized on contracts that go to settlement or delivery, are presented on a net basis in operating revenues. Realized gains and losses from trading activities also are presented on a net basis in operating revenues, beginning in the third quarter of 2002, as more fully described in Note 1 of the Notes to the Consolidated Financial Statements.

Gains and losses on trading contracts affect PG&E Corporation's gross margin in the accompanying PG&E Corporation Consolidated Statements of Operations on an unrealized, mark-to-market basis as the fair value of the forward positions on these contracts fluctuate. Settlement or delivery on a contract generally does not result in incremental net income recognition because the profit or loss on a contract is recognized in income on an unrealized, mark-to-market basis during the periods before settlement occurs.

Gains and losses on trading contracts affect PG&E Corporation's cash flow when these contracts are settled. Net realized gains reported in the table below primarily reflect the net effect of contracts that have been settled in cash. Net realized gains also include certain non-cash items, including amortization of option premiums that were paid or received in cash in earlier periods, but are considered realized when the related options are exercised or expire.

PG&E Corporation's net gains (loss) on trading activities are as follows:

	<b>Three months ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(in millions)</b>	
<b>Trading activities:</b>		
Unrealized gains (loss), net	\$ 8	\$ (3)
Realized gains (loss), net	(33)	45
Total	\$ (25)	\$ 42

### Price Risk Management Assets and Liabilities

PRM assets and liabilities on the accompanying PG&E Corporation Consolidated Balance Sheets reflect the aggregation of the fair values of outstanding contracts. These fair values are calculated on a mark-to-market basis for contracts that will be settled in future periods. PRM assets and liabilities at March 31, 2003, include amounts for trading and non-trading activities, as described below:

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	PRM Assets		PRM Liabilities		Net Assets (Liabilities)
	Current	Noncurrent	Current	Noncurrent	
	(in millions)				
<b>Trading activities</b>	\$ 688	\$ 202	\$ (632)	\$ (247)	\$ 11
<b>Non-trading activities</b>	29	62	(10)	(12)	69
<b>Total consolidated PRM assets and liabilities</b>	<b>\$ 717</b>	<b>\$ 264</b>	<b>\$ (642)</b>	<b>\$ (259)</b>	<b>\$ 80</b>

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Non-trading activities include certain long-term contracts that are not included in PG&E Corporation's trading portfolio but, due to certain pricing provisions and volumetric variability, are unable to receive hedge accounting treatment or the normal purchases and sales exception, as outlined by interpretations of SFAS No. 133. PG&E Corporation has certain other non-trading derivative commodity contracts for the physical delivery of purchases and sales quantities transacted in the normal course of business. These other non-trading activities include contracts that are exempt from SFAS No. 133 fair value requirements under the normal purchases and sales exemption, as described previously. Although the fair value of these other non-trading contracts is not required to be presented on the balance sheet, revenues and expenses generally are recognized in income using the same timing and basis as are used for the non-trading activities accounted for as cash flow hedges. Hence, revenues are recognized as earned and expenses are recognized as incurred.

#### Credit Risk

Credit risk is the risk of loss that PG&E Corporation and the Utility would incur if counterparties failed to perform their contractual obligations (these obligations are reflected as Accounts Receivable - Customers, net; notes receivable included in Other Noncurrent Assets - Other; Price Risk Management (PRM) assets; and Assets Held For Sale on the Consolidated Balance Sheets of PG&E Corporation and the Utility, as applicable). PG&E Corporation and the Utility conduct business primarily with customers or vendors, referred to as counterparties, in the energy industry. These counterparties include other investor-owned utilities, municipal utilities, energy trading companies, financial institutions, and oil and gas production companies located in the United States and Canada. This concentration of counterparties may impact PG&E Corporation's and the Utility's overall exposure to credit risk because their counterparties may be similarly affected by economic or regulatory changes, or other changes in conditions.

PG&E Corporation and the Utility manage their credit risk in accordance with the PG&E Corporation Risk Management Policy. This establishes processes for assigning credit limits to counterparties before entering into agreements with significant exposure to PG&E Corporation and the Utility. These processes include an evaluation of a potential counterparty's financial condition, net worth, credit rating, and other credit criteria as deemed appropriate, and are performed at least annually.

Credit exposure is calculated daily, and in the event that exposure exceeds the established limits, PG&E Corporation and the Utility take immediate action to reduce the exposure, or obtain additional collateral, or both. Further, PG&E Corporation and the Utility rely heavily on master agreements that require the counterparty to post security, referred to as credit collateral, in the form of cash, letters of credit, corporate guarantees of acceptable credit quality, or eligible securities if current net receivables and replacement cost exposure exceed contractually specified limits.

PG&E Corporation and the Utility calculate gross credit exposure for each counterparty as the current mark-to-market value of the contract (that is, the amount that would be lost if the counterparty defaulted today) plus or minus any outstanding net receivables or payables, prior to the application of the counterparty's credit collateral.

During the three months ended March 31, 2003, PG&E Corporation's credit risk decreased primarily due to contract terminations with PG&E NEG counterparties. During the three months ended March 31, 2003, the Utility's credit risk increased due primarily to an increase in commodity prices and to downgrades of some counterparties' credit ratings to levels below investment grade. The downgrades increase the Utility's credit risk because any collateral provided by these counterparties in the form of corporate guarantees or eligible securities may be of lesser or no value. Therefore, in the event these counterparties failed to perform under their contracts, the Utility may face a greater potential maximum loss. In contrast, the Utility does not face any additional risk if counterparties' credit collateral is in the form of cash or letters of credit, as this collateral is not affected by a credit rating downgrade.

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During the three months ended March 31, 2003, PG&E Corporation and the Utility recognized no losses due to the contract defaults or bankruptcies of counterparties.

At March 31, 2003, PG&E Corporation had no single counterparty that represented greater than 10 percent of PG&E Corporation's net credit exposure. At March 31, 2003, the Utility had one investment-grade counterparty that represented 17 percent of the Utility's net credit exposure.

The schedule below summarizes PG&E Corporation's and the Utility's credit risk exposure to counterparties that are in a net asset position, with the exception of exchange-traded futures (the exchange provides for contract settlement on a daily basis), as well as PG&E Corporation's and the Utility's credit risk exposure to counterparties with a greater than 10 percent net credit exposure, at March 31, 2003, and December 31, 2002:

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	<u>Gross Credit Exposure Before Credit Collateral(1)</u>	<u>Credit Collateral(2)</u>	<u>Net Credit Exposure(2)</u>	<u>Number of Counterparties &gt;10 percent</u>	<u>Net Exposure of Counterparties &gt;10 percent</u>
	(in millions)				
<b>At March 31, 2003</b>					
PG&E Corporation	\$ 789	\$ 198	\$ 591	\$	\$
Utility(3)	306	116	190	1	32
<b>At December 31, 2002</b>					
PG&E Corporation	\$ 1,165	\$ 195	\$ 970	\$	\$
Utility(3)	288	113	175	2	55

- (1) Gross credit exposure equals mark-to-market value, notes receivable, and net (payables) receivables where netting is allowed. Gross and net credit exposure amounts reported above do not include adjustments for time value, liquidity, model, or credit reserves.
- (2) Net credit exposure is the gross credit exposure minus credit collateral (cash deposits and letters of credit).
- (3) The Utility's gross credit exposure includes wholesale activity only. Retail activity and payables incurred prior to the Utility's bankruptcy filing are not included. Retail activity at the Utility consists of the accounts receivable from the sale of gas and electricity to millions of residential and small commercial customers.

The schedule below summarizes the credit quality of PG&E Corporation's and the Utility's net credit risk exposure to counterparties at March 31, 2003, and December 31, 2002.

<u>Credit Quality(1)</u>	<u>Net Credit Exposure(2)</u>	<u>Percentage of Net Credit Exposure</u>
	(in millions)	
<b>At March 31, 2003</b>		
<b>PG&amp;E Corporation</b>		
Investment-grade(3)(4)	\$ 380	64%
Noninvestment-grade	119	20%
Not rated(4)	92	16%
<b>Total</b>	<b>\$ 591</b>	<b>100%</b>



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Credit Quality(1)	Net Credit Exposure(2)	Percentage of Net Credit Exposure
<b>Utility</b>		
Investment-grade(3)(4)	\$ 110	58%
Noninvestment-grade	80	42%
Not rated(4)		
<b>Total</b>	<b>\$ 190</b>	<b>100%</b>

**At December 31, 2002**

**PG&E Corporation**

Investment-grade(3)(4)	\$ 700	72%
Noninvestment-grade	205	21%
Not rated(4)	65	7%
<b>Total</b>	<b>\$ 970</b>	<b>100%</b>

**Utility**

Investment-grade(3)(4)	\$ 111	63%
Noninvestment-grade	64	37%
Not rated(4)		

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<b>Total</b>	<b>\$ 175</b>	<b>100%</b>
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- (1) Credit ratings are determined by using publicly available credit ratings of the counterparty. If the counterparty provides a guarantee by a higher rated entity (e.g., its parent), the rating determination is based on the rating of its guarantor.
- (2) Net credit exposure is the gross credit exposure minus credit collateral (cash deposits and letters of credit).
- (3) Investment-grade is determined using publicly available information, i.e., rated at least Baa3 by Moody's Investors Services and BBB- by Standard & Poor's.
- (4) Most counterparties with no ratings are governmental authorities which are not rated but which PG&E Corporation has assessed as equivalent to investment-grade based upon an internal credit rating of credit quality, and are designated as "investment-grade" above. Other counterparties with no rating, and designated as "not rated" above, are subject to an internal assessment of their credit quality and a credit rating designation.

PG&E Corporation has regional concentrations of credit exposure to counterparties that conduct business primarily throughout North America. The Utility has a regional concentration of credit risk associated with its receivables from residential and small commercial customers in Northern California. However, the risk of material loss due to nonperformance from these customers is not considered likely. Reserves for uncollectible accounts receivable are provided for the potential loss from nonpayment by these customers based on historical experience. At March 31, 2003, the Utility had a net regional concentration of credit exposure totaling \$190 million to counterparties that conduct business primarily throughout North America.

**NOTE 6: COMMITMENTS AND CONTINGENCIES**

PG&E Corporation has substantial financial commitments and contingencies in connection with agreements entered into supporting the Utility's and PG&E NEG's operating, construction, and development activities. These commitments and contingencies are discussed more fully in the PG&E Corporation and Utility combined 2002 Annual Report on Form 10-K, as amended. The following summarizes PG&E Corporation's, the Utility's, and PG&E NEG's contingencies and cancelled, new, and significantly modified commitments since the combined 2002 Annual Report on Form 10-K, as amended, was filed.

### **Utility**

The Utility has significant gain and loss contingencies related to California electric industry restructuring and its Chapter 11 filing. See Note 2 for a discussion of these matters.

### ***Nuclear Insurance***

The Utility has several types of nuclear insurance for its Diablo Canyon Power Plant (DCPP) and Humboldt Bay Power Plant (HBPP). The Utility has insurance coverage for property damages and business interruption losses as a member of Nuclear Electric Insurance Limited (NEIL). NEIL is a mutual insurer owned by utilities with nuclear facilities. Under this insurance, if any nuclear generating facility insured by NEIL suffers severe losses, the NEIL Board of Directors could require the Utility to pay additional premiums of up to \$32 million to cover property damages and business interruption for DCPP and up to \$1.4 million to cover property damages for HBPP.

Under federal law, the Price-Anderson Act (Act), public liability claims from a nuclear incident are limited to \$9.5 billion. As required by the Act, the Utility has purchased the maximum available public liability insurance of \$300 million for DCPP. The balance of the \$9.5 billion of liability protection is covered by a loss-sharing program (secondary financial protection) among utilities owning nuclear reactors. Under the Act, secondary financial protection is required for all reactors of 100 MW or higher. If a nuclear incident results in costs in excess of \$300 million, then the Utility may be responsible for up to \$88 million per reactor, with payments in each year limited to a maximum of \$10 million per incident until the Utility has fully paid its share of the liability. Since the Utility has two nuclear reactors of over 100 MW, the Utility may be assessed up to \$176 million per incident, with payments in each year limited to a maximum of \$20 million per incident. In February 2003, a provision extending the Price-Anderson Act through the end of 2003 was adopted by the United States Congress. No other material terms of the Price-Anderson Act changed as a result of the provision.

Additionally, the Utility has purchased \$53.3 million of private liability insurance for HBPP and has a \$500 million indemnification from the NRC for public liability arising from nuclear incidents covering liabilities in excess of the \$53.3 million of private liability insurance for HBPP.

### ***Workers' Compensation Security***

The Utility is self-insured for workers' compensation. The Utility must deposit collateral with the State Department of Industrial Relations (DIR) to maintain its status as a self-insurer for workers' compensation claims made against the Utility. Acceptable forms of collateral include surety bonds, letters of credit, cash, or securities. The Utility currently provides collateral in the form of approximately \$365 million in surety bonds.

In February 2001, several surety companies provided cancellation notices because of the Utility's financial situation. The DIR has not agreed to release the canceling sureties from their obligations for claims occurring prior to the cancellation and has continued to apply the cancelled bond amounts, totaling \$185 million, towards the \$365 million amount of collateral. The Utility was able to supplement the difference through three additional active surety bonds totaling \$180 million. At March 31, 2003, the cancelled bonds have not impacted the Utility's self-insured status under California law. PG&E Corporation has guaranteed the Utility's reimbursement obligation associated with these surety bonds and the Utility's underlying obligation to pay workers' compensation claims.

### ***Balancing Account Reserves***

In 2002, the CPUC ordered the Utility to create certain electric balancing accounts to track specific electric-related amounts, primarily including revenue shortfalls from baseline allowance increases and costs related to the self-generation incentive program, for which the CPUC has not yet determined a specific recovery method. In the decisions ordering the creation of these balancing accounts, the CPUC indicated that the recovery method of these amounts would be determined in the future. Because the Utility cannot conclude that the amounts in these balancing accounts are considered probable of recovery in future rates, the Utility has reserved these balances by recording a charge against earnings. As of March 31, 2003, the reserve for these balances was approximately \$190 million.

## PG&amp;E NEG

*Letters of Credit*

In addition to the outstanding balances under the credit facilities described in Note 3, PG&E NEG has commitments available under facilities to issue letters of credit. The following table lists the various letter of credit facilities that have the capacity to issue letters of credit:

Borrower	Maturity	Letter of Credit Capacity	Letter of Credit Outstanding March 31, 2003
(in millions)			
PG&E NEG	8/03	\$ 185	\$ 185
USGenNE	8/03	25	13
PG&E Gen	12/04	7	7
PG&E ET	9/03	19	19
PG&E ET	11/03	35	33

*Tolling Agreements*

PG&E ET entered into tolling agreements with several counterparties under which it, at its discretion, supplies the fuel to the power plants and then sells the plant's output in the competitive market. Payments to counterparties are reduced if the plants do not achieve agreed-upon levels of performance. The face amount of PG&E NEG's and its subsidiaries' guarantees relating to PG&E ET's tolling agreements is approximately \$600 million. The tolling agreements are with: (1) Liberty Electric Power, L.P. (Liberty) guaranteed by both PG&E NEG and PG&E GTN for an aggregate amount of up to \$150 million, (2) DTE-Georgetown, LLC (DTE) guaranteed by PG&E GTN for up to \$24 million, (3) Calpine Energy Services, L.P. (Calpine) for which no guarantee is in place, (4) Southaven Power, LLC (Southaven) guaranteed by PG&E NEG for up to \$175 million, and (5) Caledonia Generating, LLC (Caledonia) guaranteed by PG&E NEG for up to \$250 million.

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**Liberty** Liberty has provided notice to PG&E ET that the ratings downgrade of PG&E NEG constituted a material adverse change under the tolling agreement, requiring PG&E ET to replace the guarantee and post security in the amount of \$150 million. PG&E ET has not posted such security. Under the terms of the guarantees, Liberty has the right to terminate the agreement and seek recovery of a termination payment for a maximum amount of up to \$150 million. Liberty first must proceed against PG&E NEG's guarantee, and can demand payment under PG&E GTN's guarantee only if (1) PG&E NEG is in bankruptcy, or (2) Liberty has made a payment demand on PG&E NEG which remains unpaid five business days after the payment demand is made. In addition, PG&E ET has provided notices to Liberty of several breaches of the tolling agreement by Liberty and has advised Liberty that, unless cured, these breaches would constitute a default under the agreement. If these defaults remain uncured, PG&E ET has the right to terminate the agreement and seek recovery of a termination payment.

**DTE-Georgetown** By letter dated October 14, 2002, DTE provided notice to PG&E ET that the downgrade of PG&E GTN constituted a material adverse change under the tolling agreement between PG&E ET and DTE and that PG&E ET was required to post replacement security within ten days. By letter dated October 23, 2002, PG&E ET advised DTE that because there had not been a material adverse change with respect to PG&E GTN within the meaning of the tolling agreement, PG&E ET was not required to post replacement security. If PG&E ET was required to post replacement security and it failed to do so, DTE would have the right to terminate the tolling agreement and seek recovery of a termination payment.

**Calpine** The tolling agreement states that on or before October 15, 2002, Calpine was to have issued a full notice to proceed under its construction contract to its engineering, procurement, and construction contractor for the Otay Mesa facility. On October 16, 2002, PG&E ET asked Calpine to confirm that it had issued this full notice to proceed and Calpine was not able to do so to the satisfaction of PG&E ET. Consequently, PG&E ET advised Calpine by letter dated October 30, 2002, that it was terminating the tolling agreement effective November 29, 2002. Calpine has indicated that this termination was improper and constituted a default under the agreement, but has not taken any further action.

**Southaven and Caledonia Tolling Agreements** PG&E ET signed a tolling agreement with Southaven dated as of June 1, 2000, under which PG&E ET is required to provide credit support as defined in the tolling agreement. PG&E ET satisfied this obligation by providing an investment-grade guarantee from PG&E NEG as defined in the tolling agreement. The amount of the guarantee now does not exceed \$175 million. By letter dated August 31, 2002, Southaven advised PG&E ET that it believed an event of default under the tolling agreement had taken place with respect to this obligation because PG&E NEG was no longer investment-grade as defined in the tolling agreement, and because PG&E ET had failed to provide, within 30 days from the downgrade, substitute credit support that met the requirements of the tolling agreement. Southaven has the right to terminate the agreement and seek a termination payment. In addition, PG&E ET provided Southaven with a notice of

default respecting Southaven's performance under the tolling agreement and concerning the inability of the facility to inject its output into the local grid. Southaven has not cured this default and on February 4, 2003, PG&E ET provided a notice of termination.

In addition, PG&E ET signed a tolling agreement with Caledonia dated as of September 20, 2000, under which PG&E ET is required to provide credit support, as defined in the tolling agreement. PG&E ET satisfied this obligation by providing a guarantee from PG&E NEG that was investment-grade, as defined in the tolling agreement. The amount of the guarantee does not exceed \$250 million. By letter dated August 31, 2002, Caledonia advised PG&E ET that it believed an event of default under the tolling agreement had taken place with respect to this obligation because PG&E NEG was no longer investment-grade, as defined in the tolling agreement, and because PG&E ET had failed to provide, within 30 days from the downgrade, substitute credit support that met the requirements of the tolling agreement. Caledonia has the right to terminate the tolling agreement and seek a termination payment. In addition, PG&E ET provided Caledonia with a notice of default respecting Caledonia's performance under the tolling agreement and concerning the inability of the facility to inject its output into the local grid. Caledonia has not cured this default and on February 4, 2003, PG&E ET provided a notice of termination.

On February 7, 2003, Southaven and Caledonia filed emergency petitions to compel arbitration or, in the alternative, for a temporary restraining order and preliminary injunction with the Circuit Court of Montgomery County, Maryland (Court). On March 3, 2003, the Court issued an order ruling that PG&E ET must continue to perform under the agreements. PG&E ET appealed this decision to an intermediate Maryland appellate court. However, on April 8, 2003, the highest appellate court in Maryland issued, on its own motion, an order taking jurisdiction of the appeal.

PG&E ET is not able to predict whether the counterparties will seek to terminate the agreements or whether the Court will grant the requested relief. Accordingly, it is not able to predict whether or the extent to which these proceedings will have a material adverse effect on PG&E NEG's financial condition or results of operations.

Under each tolling agreement, determination of the termination payment is based on a formula that takes into account a number of factors, including market conditions such as the price of power and the price of fuel. In the event of a dispute over the amount of any termination payment that the parties are unable to resolve by negotiation, the tolling agreement provides

for mandatory arbitration. The dispute resolution process could take as long as six months to more than a year to complete. To the extent that PG&E ET did not pay these damages, the counterparties could seek payment under the guarantees for an aggregate amount not to exceed \$600 million. PG&E NEG is unable to predict whether counterparties will seek to terminate their tolling agreements. PG&E NEG currently does not expect to be able to pay any termination payments that may become due.

#### ***Guarantees***

PG&E NEG and certain subsidiaries have provided guarantees as of March 31, 2003, to approximately 188 counterparties in support of PG&E ET's energy trading and non-trading activities related to PG&E NEG's merchant energy portfolio in the face amount of \$2.2 billion. Typically, the overall exposure under these guarantees is only a fraction of the face value of these guarantees, since not all counterparty credit limits are fully used at any time. As of March 31, 2003, PG&E NEG and its rated subsidiaries' aggregate exposure under these guarantees was approximately \$150 million. The amount of such exposure varies daily depending on changes in market prices and net changes in position. In light of the downgrades, some counterparties have sought and others may seek replacement security to collateralize the exposure guaranteed by PG&E NEG and its subsidiaries. PG&E GTN and PG&E ET have terminated the arrangements pursuant to which PG&E GTN provided guarantees on behalf of PG&E ET such that PG&E GTN will provide no new guarantees on behalf of PG&E ET.

At March 31, 2003, PG&E ET's estimated exposure not covered by a guarantee (excluding exposure under tolling agreements) is approximately \$96 million.

To date, PG&E ET has met those replacement security requirements properly demanded by counterparties and has not defaulted under any of its master trading agreements, although one counterparty has alleged a default. No demands have been made upon the guarantors of PG&E ET's obligations under these trading agreements. In the past, PG&E ET has been able to negotiate acceptable arrangements and reduce its overall exposure to counterparties when PG&E ET or its counterparties have faced similar situations. There can be no assurance that PG&E ET can continue to negotiate acceptable arrangements in the current circumstances. PG&E NEG cannot quantify with any certainty the actual future calls on PG&E ET's liquidity. PG&E NEG's and its subsidiaries' ability to meet these calls on their liquidity will vary with market price volatility, uncertainty with respect to PG&E NEG's financial condition, and the degree of liquidity in the energy markets. The actual calls for collateral will depend largely upon the ability to enter into forbearance agreements and pre- and early-pay arrangements with counterparties, the continued performance of PG&E NEG companies under the underlying agreements with counterparties, whether counterparties have the right to demand such collateral, the execution of master netting agreements and offsetting transactions, changes in the amount of exposure, and the

counterparties' other commercial considerations.

### ***Other Guarantees***

PG&E NEG has provided guarantees related to other obligations by PG&E NEG companies to counterparties for goods or services. PG&E NEG does not believe that it has significant exposure under these guarantees. The most significant of these guarantees relates to performance under certain construction contracts. In the event PG&E NEG is unable to provide any additional or replacement security that may be required as a result of rating downgrades, the counterparty providing the goods or services could suspend performance or terminate the underlying agreement and seek recovery of damages. These guarantees represent guarantees of subsidiary obligations for transactions entered into in the ordinary course of business. Some of the guarantees relate to the construction or development of PG&E NEG's power plants and pipelines. These guarantees are described below.

PG&E NEG has issued guarantees to construction financing lenders for the performance of the contractors building the Harquahala and Covert generating projects for up to \$555 million.

PG&E NEG has issued \$100 million of guarantees to the construction contractor of the Harquahala and Covert projects to cover certain separate cost-sharing arrangements.

PG&E NEG has provided a \$300 million guarantee to support a tolling agreement that a wholly-owned subsidiary, Attala Energy Company, LLC, has entered into with another wholly-owned subsidiary, Attala Generating Company, LLC.

The balance of the guarantees are for commitments undertaken by PG&E NEG or its subsidiaries in the ordinary course of business for services such as facility and equipment leases, ash disposal rights, and surety bonds.

### **PG&E Corporation**

As further discussed above, PG&E Corporation has guaranteed the Utility's reimbursement obligation associated with certain surety bonds and the Utility's obligation to pay workers' compensation claims.

### **Environmental Matters**

#### ***Utility***

The Utility may be required to pay for environmental remediation at sites where it has been, or may be, a potentially responsible party under the Comprehensive Environmental Response Compensation and Liability Act and similar state environmental laws. These sites include former manufactured gas plant sites, power plant sites, and sites used by the Utility for the storage, recycling, or disposal of potentially hazardous materials. Under federal and California laws, the Utility may be responsible for remediation of hazardous substances even if the Utility did not deposit those substances on the site.

The Utility records an environmental remediation liability when site assessments indicate remediation is probable and a range of likely clean-up costs can be reasonably estimated. The Utility reviews its remediation liability on a quarterly basis for each site that may be exposed to remediation responsibilities. The liability is an estimate of costs for site investigations, remediation, operations and maintenance, monitoring, and site closure using (1) current technology, (2) enacted laws and regulations, (3) experience gained at similar sites, and (4) the probable level of involvement and financial condition of other potentially responsible parties. Unless there is a better estimate within this range of possible costs, the Utility records the lower end of this range.

The Utility had an undiscounted environmental remediation liability of \$286 million at March 31, 2003, and \$331 million at December 31, 2002. During the first quarter, the liability was reduced by \$45 million primarily due to a reassessment of the estimated cost of remediation. The \$286 million accrued at March 31, 2003, includes (1) \$103 million related to the pre-closing remediation liability associated with divested generation facilities, and (2) \$183 million related to remediation costs for those generation facilities that the Utility still owns, manufactured gas plant sites, gas gathering sites, and compressor stations. Of the \$286 million environmental remediation liability, the Utility has recovered \$153 million through rates charged to its customers, and expects to recover approximately \$96 million of the balance in future rates. The Utility also is recovering its costs from insurance carriers and from other third parties whenever it is possible.

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The cost of the hazardous substance remediation ultimately undertaken by the Utility is difficult to estimate. A change in the estimate may occur in the near term due to uncertainty concerning the Utility's responsibility, the complexity of environmental laws and regulations, and the selection of compliance alternatives. The Utility estimates the upper limit of the range using assumptions least favorable to the Utility, which is based upon a range of reasonably possible outcomes. The Utility's future costs could increase to as much as \$396 million if (1) the other potentially responsible parties are not financially able to contribute to these costs, (2) the extent of contamination or necessary remediation is greater than anticipated, or (3) the Utility is found to be responsible for clean-up costs at additional sites.

On June 28, 2001, the Bankruptcy Court authorized the Utility to continue its hazardous waste remediation program and to expend (1) up to \$22 million in hazardous substance remediation programs and procedures in each calendar year in which the Chapter 11 case is pending, and (2) any additional amounts in emergency situations involving post-petition releases or threatened releases of hazardous substances subject to the Bankruptcy Court's specific approval.

The California Attorney General, on behalf of various state environmental agencies, filed claims in the Utility's bankruptcy proceeding for environmental remediation at numerous sites totaling approximately \$770 million. For most if not all of these sites, the Utility is in the process of remediation in cooperation with the relevant agencies and other parties responsible for contributing to the clean-up in the normal course of business. Since the Utility's proposed plan of reorganization provides that the Utility intends to respond to these types of claims in the regular course of business, and since the Utility has not argued that the bankruptcy proceeding relieves the Utility of its obligations to respond to valid environmental remediation orders, the Utility believes the claims seeking specific cash recoveries are invalid.

### ***PG&E NEG***

In May 2000, USGenNE, an indirect subsidiary of PG&E NEG, received an Information Request from the U.S. Environmental Protection Agency (EPA), pursuant to Section 114 of the Federal Clean Air Act (CAA). The Information

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Request asked USGenNE to provide certain information relative to the compliance of its Brayton Point and Salem Harbor plants with the CAA. No enforcement action has been brought by the EPA to date. USGenNE has had preliminary discussions with the EPA to explore a potential settlement of this matter. Management believes that it is not possible to predict at this point whether any such settlement will occur or, in the absence of a settlement, the likelihood of whether the EPA will bring an enforcement action.

As a result of the EPA Information Request and environmental regulatory initiatives by the Commonwealth of Massachusetts, USGenNE is exploring ways to achieve significant reductions of sulfur dioxide and nitrogen oxide emissions. Additional requirements for the control of mercury and carbon dioxide emissions also will be forthcoming as part of these regulatory initiatives. Management believes that USGenNE would meet these requirements through installation of controls at the Brayton Point and Salem Harbor plants and estimates that capital expenditures on these environmental projects could approximate \$376 million over the next four years. These estimates are currently under review and it is possible that actual expenditures may be higher. Based on an emission control plan filed for Brayton Point under the regulations implementing these initiatives, the Massachusetts Department of Environmental Protection (DEP) ruled that Brayton Point is required to meet the newer, more stringent emission limitations for sulfur dioxide and nitrogen oxide by 2006. In April 2002, USGenNE filed with the DEP a revised plan for Salem Harbor that it believes meets the DEP requirements for the 2006 compliance date. However, on June 7, 2002, the DEP ruled that Salem Harbor must satisfy these limitations by 2004. USGenNE has since filed a number of appeals challenging this decision and unless and until the decision is reversed, the compliance date for Salem Harbor remains October 2004. USGenNE and the DEP recently have agreed to enter into negotiations concerning Salem Harbor's compliance schedule with the DEP regulation, in an attempt to develop a schedule that USGenNE could meet, assuming that financing and all other necessary approvals are in place. USGenNE will not be able to operate Salem Harbor unless it is in compliance with these emission limitations. PG&E NEG believes that it is impossible to meet the October 2004 deadline. Therefore, it may not be able to operate the facility after that deadline. USGenNE and the DEP recently have agreed to enter into negotiations concerning a Salem Harbor compliance schedule with the DEP regulation on a schedule that USGenNE could meet, assuming that financing and all other necessary approvals are in place.

Various aspects of the DEP's regulations allow for public participation in the process through which the DEP determines whether the 2004 or 2006 deadline applies and approves the specific activities that USGenNE will undertake to meet the new regulations. A number of local environmental groups are now participants in this process.

The EPA is required under the CAA to establish new regulations for controlling hazardous air pollutants from combustion turbines and reciprocating internal combustion engines. Although the EPA has yet to propose the regulations, the CAA required that they be promulgated by November 2000. Another provision in the CAA requires companies to submit case-by-case Maximum Achievable Control Technology (MACT) determinations for individual plants if the EPA fails to finalize regulations within 18 months past the deadline. The EPA has extended this deadline through previous rulemakings. In late 2002, the EPA proposed a rule that would require the case-by-case MACT applications to be submitted by October 30, 2003, if the EPA has not promulgated a MACT rule as of that date. The EPA intends to finalize the MACT regulations

before this date, thus eliminating the need for the plant-specific permits. PG&E NEG will not be able to accurately quantify the economic impact of the future regulations until more details are available through the rulemaking process.

PG&E NEG's existing power plants are subject to federal and state water quality standards with respect to discharge constituents and thermal effluents. Three of the fossil-fueled plants owned and operated by USGenNE (Salem Harbor, Manchester Street, and Brayton Point) are operating pursuant to National Pollutant Discharge Elimination System (NPDES) permits that have expired. For the facilities whose NPDES permits have expired, permit renewal applications are pending, and all three facilities are continuing to operate under existing terms and conditions until new permits are issued. On July 22, 2002, the EPA and the DEP issued a draft NPDES permit for Brayton Point that, among other things, substantially limits the discharge of heat by Brayton Point into Mount Hope Bay. Based on its initial review of the draft permit, USGenNE believes that the draft permit is excessively stringent. It is estimated that USGenNE's cost to comply with the new permit conditions could be as much as \$248 million through 2006, but this is a preliminary estimate. There are various administrative and judicial proceedings that must be completed before the draft NPDES permit for Brayton Point becomes final, and these proceedings are not expected to be completed during 2003. In addition, the EPA, as well as local environmental groups, previously expressed concern that the metal vanadium is not addressed at Brayton Point or Salem Harbor under the terms of the old NPDES permits. Based upon the lack of an identified control technology, USGenNE believes it is unlikely that the EPA will require that vanadium be addressed pursuant to a NPDES permit. However, if the EPA does insist on including vanadium in the NPDES permit, USGenNE may have to spend a significant amount to comply with such a provision. In addition, it is possible that the new permits for Salem Harbor and Manchester Street also may contain more stringent limitations than prior permits and that the cost to comply with the new permit conditions could be greater than the current estimate of \$4 million. Lastly, the issuance of any final NPDES permits may be affected by the EPA's proposed regulations under Section 316(b) of the Clean Water Act.

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On March 27, 2002, the Rhode Island Attorney General notified USGenNE of his belief that Brayton Point "is in violation of applicable statutory and regulatory provisions governing its operations," including "protections accorded by common law" respecting discharges from the facility into Mount Hope Bay. He stated that he intends to seek judicial relief "to abate these environmental law violations and to recover damages" within the next 30 days. PG&E NEG believes that Brayton Point is in full compliance with all applicable permits, laws, and regulations. The complaint has not yet been filed or served. In early May 2002, the Rhode Island Attorney General stated that he did not plan to file the action until the EPA issues a draft Clean Water Act NPDES permit for Brayton Point. The EPA issued this draft permit on July 22, 2002, and the Rhode Island Attorney General has since stated he has no intention of pursuing this matter until he reviews USGenNE's response to the draft permit which was submitted on October 4, 2002. Management is unable to predict whether he will pursue this matter and, if he does, the extent to which it will have a material adverse effect on PG&E NEG's financial condition or results of operations.

On April 9, 2002, the EPA proposed regulations under Section 316(b) of the Clean Water Act for cooling water intake structures. The regulations would affect existing power generation facilities using over 50 million gallons per day typically including some form of "once-through" cooling. Brayton Point, Salem Harbor, and Manchester Street are among an estimated 539 plants nationwide that would be affected by this rulemaking. The proposed rule calls for a set of performance standards that vary with the type of water body and that are intended to reduce impacts to aquatic organisms. The final regulations are scheduled to be promulgated in February 2004. The extent to which they may require additional capital investment will depend on the timing of the NPDES permit proceedings for the affected facilities.

During April 2000, an environmental group served USGenNE and other PG&E NEG subsidiaries with a notice of its intent to file a citizen's suit under the Resource Conservation Recovery Act. In September 2000, PG&E NEG signed a series of agreements with the DEP and the environmental group to resolve these matters that require PG&E NEG to alter its existing wastewater treatment facilities at its Brayton Point and Salem Harbor generating facilities. PG&E NEG began the activities during 2000 and is expected to complete them in 2003. PG&E NEG incurred expenditures related to these agreements of \$5.4 million in 2000, \$2.6 million in 2001, and \$4.7 million in 2002. In addition to the costs previously incurred, PG&E NEG maintains a reserve in the amount of \$6 million relating to its estimate of the remaining expenditures to fulfill its obligations under these agreements. PG&E NEG has deferred costs associated with capital expenditures and has set up a receivable account for amounts it believes are probable of recovery from insurance proceeds.

PG&E NEG believes that it may be required to spend up to approximately \$636 million, excluding insurance proceeds, through 2008 for environmental compliance to continue operating these facilities. This amount may change, however, and the timing of any necessary capital expenditures could be accelerated in the event of a change in environmental regulations or the commencement of any enforcement proceeding against PG&E NEG. PG&E NEG has not made any commitments to spend these amounts. In the event PG&E NEG does not spend or is unable to spend because of liquidity constraints amounts needed in order to comply with these requirements, PG&E NEG may not be able to continue to operate one or all of these facilities.

Global climate change is a significant environmental issue that is likely to require sustained global action and investment over many decades. PG&E NEG has been engaged on the climate change issue for several years and is working with others on developing appropriate public policy responses to this challenge. PG&E NEG continuously assesses the financial and operational implications of this issue; however, the outcome and timing of these initiatives are uncertain.

PG&E NEG emits varying quantities of six greenhouse gases, including carbon dioxide and methane, in the course of its operations. Depending on the ultimate regulatory regime put into place for greenhouse gases, PG&E NEG's operations, cash flows, and financial condition could be adversely affected. Given the uncertainty of the regulatory regime, it is not possible to predict the extent to which climate change regulation will have a material adverse effect on PG&E NEG's financial condition or results of operations.

## Legal Matters

In the normal course of business, PG&E Corporation, the Utility, and PG&E NEG are named as parties in a number of claims and lawsuits. The most significant of these are discussed below. The Utility's Chapter 11 bankruptcy filing on April 6, 2001, discussed in Note 2 of the Notes to the Consolidated Financial Statements, automatically stayed the litigation described below against the Utility, except as otherwise noted.

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### *Chromium Litigation*

There are 15 civil suits pending against the Utility in several California state courts. One of these suits also names PG&E Corporation as a defendant. One additional civil suit, *Kearney v. Pacific Gas and Electric Company*, was filed against the Utility and PG&E Corporation after the Utility's bankruptcy filing and was dismissed without prejudice while the plaintiffs sought the right to file and pursue late claims in the Bankruptcy Court. In the *Kearney* case, the Bankruptcy Court ruled that the six adult plaintiffs could not file untimely bankruptcy claims against the Utility. The court also ruled that the 24 minor plaintiffs could file untimely bankruptcy claims against the Utility. The suits allege personal injuries, wrongful death, and loss of consortium and seek compensatory and punitive damages based on claims arising from alleged exposure to chromium in the vicinity of the Utility's gas compressor stations at Hinkley and Kettleman, California, and the area of California near Topock, Arizona. Currently, there are approximately 1,200 plaintiffs in the chromium litigation cases.

The Utility is responding to the suits in which it has been served and is asserting affirmative defenses. The Utility will pursue appropriate legal defenses, including statute of limitations, exclusivity of workers' compensation laws, and factual defenses, including lack of exposure to chromium and the inability of chromium to cause certain of the illnesses alleged.

Approximately 1,260 individuals have filed proofs of claims with the Bankruptcy Court (most are plaintiffs in the 15 cases) alleging that exposure to chromium in soil, air, or water at or near the Utility's compressor stations at Hinkley and Kettleman, California, and the area of California near Topock, Arizona, caused personal injuries, wrongful death, or related damages. Approximately 1,035 of these claimants have filed proofs of claims requesting an approximate aggregate amount of \$580 million and approximately another 225 claimants have filed claims for an "unknown amount." On November 14, 2001, the Utility filed objections to these claims and requested the Bankruptcy Court to transfer the chromium claims to the federal District Court. On January 8, 2002, the Bankruptcy Court denied the Utility's request to transfer the chromium claims and granted certain claimants' motion for relief from stay so that the state court lawsuits pending before the Utility filed its bankruptcy petition can proceed. Orders granting relief from stay have been entered.

As of April 6, 2001, the Utility had filed 13 summary judgment motions challenging the claims of the trial test plaintiffs and had completed discovery of plaintiffs' experts. Plaintiffs' discovery of the Utility's experts was underway. Plaintiffs currently are completing discovery of the Utility's experts and of related issues, and four of the 13 summary judgment motions are scheduled for hearing in 2003. At a status conference on March 17, 2003, the Los Angeles Superior Court scheduled a trial of eighteen test cases to commence in March 2004.

The Utility has recorded a reserve in its financial statements in the amount of \$160 million for these matters. PG&E Corporation and the Utility believe that, after taking into account the reserves recorded at March 31, 2003, the ultimate outcome of this matter will not have a material adverse impact on PG&E Corporation's or the Utility's financial condition or future results of operations.

### *Natural Gas Royalties Litigation*

This litigation involves the consolidation of approximately 77 False Claims Act cases filed in various federal district courts by Jack J. Grynberg (called a relator in the parlance of the False Claims Act) on behalf of the United States of America, against more than 330 defendants, including the Utility and PG&E GTN. The cases were consolidated for pretrial purposes in the District of Wyoming. The current case grows out of prior litigation brought by the same relator in 1995 that was dismissed in 1998.

Under procedures established by the False Claims Act, the United States, acting through the Department of Justice (DOJ), is given an opportunity to investigate the allegations and to intervene in the case and take over its prosecution if it chooses to do so. In April 1999, the U.S. DOJ declined to intervene in any of the cases.



The complaints allege that the various defendants (most of which are pipeline companies or their affiliates) incorrectly measured the volume and heat content of natural gas produced from federal or Indian leases. As a result, it is alleged that the defendants underpaid, or caused others to underpay, the royalties that were due to the United States for the production of natural gas from those leases. The complaints do not seek a specific dollar amount or quantify the royalties claim. The complaints seek unspecified treble damages, civil penalties, and expenses associated with the litigation.

The relator has filed a claim in the Utility's bankruptcy case for \$2.5 billion, \$2 billion of which is based upon the plaintiff's calculation of penalties sought against the Utility.

PG&E Corporation and the Utility believe the allegations to be without merit and intend to present a vigorous defense. PG&E Corporation and the Utility believe that the ultimate outcome of the litigation will not have a material adverse effect on their financial condition or results of operations.

#### ***Federal Securities Lawsuit***

On April 16, 2001, a complaint was filed against PG&E Corporation and the Utility in the U.S. District Court for the Central District of California. The Utility subsequently was dismissed, due to its Chapter 11 bankruptcy filing. By order entered on or about May 31, 2001, the case was transferred to the U.S. District Court for the Northern District of California (District Court). On August 9, 2001, the plaintiff filed a first amended complaint in the District Court. An executive officer of PG&E Corporation also has been named as a defendant. The first amended complaint, purportedly brought on behalf of all persons who purchased PG&E Corporation common stock or certain shares of the Utility's preferred stock between July 20, 2000, and April 9, 2001, claimed that the defendants caused PG&E Corporation's Consolidated Financial Statements for the second and third quarters of 2000 to be materially misleading in violation of federal securities laws as a result of recording as a deferred cost and capitalizing as a regulatory asset the under-collections that resulted when escalating wholesale energy prices caused the Utility to pay far more to purchase electricity than it was permitted to collect from customers. On January 14, 2002, the District Court granted the defendants' motion to dismiss the plaintiffs' first amended complaint, finding that the complaint failed to state a claim in light of the public disclosures by PG&E Corporation, the Utility, and others regarding the under-collections, the risk that they might not be recoverable, the financial consequences of non-recovery, and other information from which analysts and investors could assess for themselves the probability of recovery.

On February 4, 2002, the plaintiffs filed a second amended complaint that, in addition to containing many of the same allegations as were in the first amended complaint, contains many of the same allegations that appear in the California Attorney General's complaint discussed below. The plaintiffs sought an unspecified amount of compensatory damages, plus costs and attorneys' fees. On March 11, 2002, the defendants filed a motion to dismiss the second amended complaint. After a hearing held on June 24, 2002, the District Court issued an order on June 25, 2002, granting the defendants' motion to dismiss the second amended complaint. The dismissal is with prejudice, prohibiting the plaintiffs from filing a further complaint. On November 15, 2002, the plaintiffs filed an appeal in the United States Court of Appeals for the Ninth Circuit, advancing substantially the same arguments that the District Court had rejected previously. The defendants filed their answer to the appeal on January 2, 2003, and expect that oral argument regarding the appeal will be heard in 2003.

PG&E Corporation believes the allegations to be without merit and intends to present a vigorous defense. PG&E Corporation believes that the ultimate outcome of the litigation will not have a material adverse effect on its financial condition or results of operations.

#### ***Order Instituting Investigation (OII) into Holding Company Activities and Related Litigation***

On April 3, 2001, the CPUC issued an OII into whether the California IOUs, including the Utility, have complied with past CPUC decisions, rules, or orders authorizing their holding company formations and/or governing affiliate transactions, as well as applicable statutes. The order states that the CPUC will investigate (1) the utilities' transfer of money to their holding companies since deregulation of the electric industry commenced, including during times when their utility subsidiaries were experiencing financial difficulties, (2) the failure of the holding companies to financially assist the utilities when needed, (3) the transfer by the holding companies of assets to unregulated subsidiaries, and (4) the holding companies' action to "ringfence" their unregulated subsidiaries. The CPUC also will determine whether additional rules, conditions, or changes are needed to adequately protect ratepayers and the public from dangers of abuse stemming from the holding company structure. The CPUC will investigate whether it should modify, change, or add conditions to the holding company decisions, make further changes to the holding company structure, alter the standards under which the CPUC determines whether to authorize the formation of holding companies, otherwise modify the decisions, or recommend statutory changes to the California Legislature. As a result of the investigation, the CPUC may impose remedies, prospective rules, or conditions, as appropriate.

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On January 9, 2002, the CPUC issued an interim decision and order interpreting the "first priority condition" adopted in the CPUC's holding company decision. This condition requires that the capital requirements of the Utility, as determined to be necessary and prudent to meet the Utility's obligation to serve or to operate the Utility in a prudent and efficient manner, be given first priority by the board of directors of the holding company. In the interim order, the CPUC stated, "the first priority condition does not preclude the requirement that the holding company infuse all types of capital into their respective utility subsidiaries where necessary to fulfill the Utility's obligation to serve." The three major California investor-owned energy utilities and their parent holding companies had opposed the broader interpretation, first contained in a proposed decision released for comment on December 26, 2001, as being inconsistent with the prior 15 years' understanding of that condition as applying more narrowly to a priority on capital needed for investment purposes. The CPUC also interpreted the first priority

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condition as prohibiting a holding company from (1) acquiring assets of its utility subsidiary for inadequate consideration, and (2) acquiring assets of its utility subsidiary at any price, if such acquisition would impair the utility's ability to fulfill its obligation to serve or to operate in a prudent and efficient manner. The utilities' applications for rehearing were denied on July 17, 2002.

In a related decision, the CPUC denied the motions filed by the California utility holding companies to dismiss the holding companies from the pending investigation on the basis that the CPUC lacks jurisdiction over the holding companies. However, in the interim decision interpreting the first priority condition discussed above, the CPUC separately dismissed PG&E Corporation (but no other utility holding company) as a respondent to the proceeding. In its written decision adopted on January 9, 2002, the CPUC stated that PG&E Corporation was being dismissed so that an appropriate legal forum could decide expeditiously whether adoption of the Utility's proposed Plan of Reorganization would violate the first priority condition. The utilities' applications for rehearing were denied on July 17, 2002.

The holding companies have filed petitions for review of both the CPUC's capital requirements and jurisdiction decisions in several state appellate courts, and the utilities also have filed petitions for review of the capital requirements decision with the California appellate courts. The CPUC moved to consolidate all proceedings in the San Francisco state appellate court and requested that the court extend the deadline by which the CPUC must file its responses to the petitions for review until after the consolidation occurred. The CPUC's request for consolidation was granted and all of the petitions are now before the First Appellate District in San Francisco, California.

On January 10, 2002, the California Attorney General filed a complaint in the San Francisco Superior Court against PG&E Corporation and its directors, as well as against directors of the Utility, alleging that PG&E Corporation violated various conditions established by the CPUC in decisions approving the holding company formation, among other allegations. The Attorney General also alleged that the December 2000 and January and February 2001 ringfencing transactions by which PG&E Corporation subsidiaries complied with credit rating agency criteria to establish independent credit ratings violated the holding company conditions.

Among other allegations, the Attorney General alleged that, through the Utility's bankruptcy proceedings, PG&E Corporation and the Utility engaged in unlawful, unfair, and fraudulent business practices in alleged violation of California Business and Professions Code Section 17200 by seeking to implement the transactions contemplated in the proposed Plan of Reorganization filed in the Utility's bankruptcy proceeding. The complaint also seeks restitution of assets allegedly wrongfully transferred to PG&E Corporation from the Utility. In February 2002, PG&E Corporation filed a notice of removal in the Bankruptcy Court to transfer the Attorney General's complaint to the Bankruptcy Court, as well as a motion to dismiss the lawsuit, or in the alternative, to stay the suit with the Bankruptcy Court. Subsequently, the Attorney General filed a motion to remand the action to state court. In June 2002, the Bankruptcy Court held that federal law preempted the Attorney General's allegations concerning PG&E Corporation's participation in the Utility's bankruptcy proceedings. The Bankruptcy Court directed the Attorney General to file an amended complaint omitting these allegations and remanded the amended complaint to the San Francisco Superior Court. Both parties have appealed the Bankruptcy Court's remand order. The appeal and cross-appeal are pending in the District Court.

On August 9, 2002, the Attorney General filed its amended complaint in the San Francisco Superior Court, omitting the allegations concerning PG&E Corporation's participation in the Utility's bankruptcy proceedings. PG&E Corporation and the directors named in the complaint have filed a motion to strike certain allegations of the amended complaint. In February 2003, the court denied the motions to strike on the grounds that they were premature, and stated that it would defer making a judgment on the merits of the defendants' arguments until the factual context of the case is more fully developed. A status conference has been scheduled for June 4, 2003.

The California Attorney General's case has been coordinated by the San Francisco Superior Court with the cases filed by the City and County of San Francisco and Cynthia Behr, both discussed below.

On February 11, 2002, a complaint entitled *City and County of San Francisco; People of the State of California v. PG&E Corporation, and Does 1-150*, was filed in San Francisco Superior Court. The complaint contains some of the same allegations contained in the Attorney General's complaint, including allegations of unfair competition. In addition, the complaint alleges causes of action for conversion, claiming that PG&E

Corporation "took at least \$5.2 billion from the Utility," and for unjust enrichment. The City seeks injunctive relief, the appointment of a receiver, payment to ratepayers, disgorgement, the imposition of a constructive trust, civil penalties, and costs of suit.

After removing the city's action to the Bankruptcy Court in February 2002, PG&E Corporation filed a motion to dismiss the complaint. Subsequently, the City filed a motion to remand the action to state court. In June 2002, the Bankruptcy Court issued an Amended Order on Motion to Remand stating that the Bankruptcy Court retained jurisdiction over the causes of

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action for conversion and unjust enrichment, finding that these claims belong solely to the Utility and cannot be asserted by the City and County, but remanding the Section 17200 cause of action to state court. Both parties have appealed the Bankruptcy Court's remand order. The appeal and cross-appeal are pending in the District Court.

Following remand, PG&E Corporation brought a motion to strike. In February 2003, the court denied the motion to strike on the grounds that it was premature, and stated that it would defer making a judgment on the merits of the defendants' arguments until the factual context of the case is more fully developed. A status conference has been scheduled for June 4, 2003.

PG&E Corporation also moved to coordinate this case with the Section 17200 case brought by Cynthia Behr, which is discussed below. That motion was granted. Subsequently, the court coordinated the California Attorney General's case with the *City and County of San Francisco* and *Behr* cases.

In addition, a third case, entitled *Cynthia Behr v. PG&E Corporation, et al.*, was filed on February 14, 2002, by a private plaintiff (who also has filed a claim in bankruptcy) in Santa Clara Superior Court also alleging a violation of California Business and Professions Code Section 17200. The Behr complaint also names the directors of PG&E Corporation and the Utility as defendants. The allegations of the complaint are similar to the allegations contained in the Attorney General's complaint but also include allegations of conspiracy, fraudulent transfer, and violation of the California bulk sales laws. The plaintiff requests the same remedies as the Attorney General's case and in addition requests damages, attachment, and restraints upon the transfer of defendants' property. In March 2002, PG&E Corporation filed a notice of removal in the Bankruptcy Court to transfer the complaint to the Bankruptcy Court. Subsequently, the plaintiff filed a motion to remand the action to state court. In its June 2002 ruling mentioned above as to the Attorney General's and the City's cases, the Bankruptcy Court retained jurisdiction over Behr's fraudulent transfer claim and bulk sales claim, finding them to belong to the Utility's estate. The Bankruptcy Court remanded Behr's Section 17200 claim to the Santa Clara Superior Court. Both parties have appealed the Bankruptcy Court's remand order. The appeal and cross-appeal are pending in the District Court.

Following remand, PG&E Corporation moved to have the *Behr* case coordinated with the City's case described above. That motion was granted, and the *Behr* case now is proceeding in San Francisco Superior Court. The *Behr* case also has been coordinated with the California Attorney General's case discussed above.

In September 2002, the defendants asked the San Francisco Superior Court to dismiss Behr's complaint. In April 2003, the court denied the request as to Behr's Section 17200 claim, but granted the request with respect to Behr's civil conspiracy cause of action. A status conference has been scheduled for June 4, 2003.

PG&E Corporation and the Utility believe that they have complied with applicable statutes, CPUC decisions, rules, and orders. Neither the Utility nor PG&E Corporation, however, can predict what the outcome of the CPUC's investigation will be or whether the outcome will have a material adverse effect on their results of operations or financial condition. PG&E Corporation believes that the allegations of the complaints are without merit and will vigorously respond to and defend the litigation. PG&E Corporation cannot predict whether the outcome of the litigation will have a material adverse effect on its results of operations or financial condition.

#### ***William Ahern, et al. v. Pacific Gas and Electric Company***

On February 27, 2002, a group of 25 ratepayers filed a complaint against the Utility at the CPUC demanding an immediate reduction of approximately \$0.035 kWh in allegedly excessive electric rates and a refund of alleged recent over-collections in electric revenue since June 1, 2001. The complaint claims that electric rate surcharges adopted in the first quarter of 2001 due to the high cost of wholesale power (surcharges that increased the average electric rate by \$0.04 per kWh) became excessive later in 2001. The only alleged over-collection amount calculated in the complaint is approximately \$400 million during the last quarter of 2001. On April 2, 2002, the Utility filed an answer, arguing that the complaint should be denied and dismissed immediately as an impermissible collateral action and on the basis that the alleged facts, even if assumed to be true, do not establish that currently authorized electric rates are not reasonable. On May 10, 2002, the Utility filed a motion to dismiss the complaint. The CPUC has not yet issued a decision. However, in November 2002, the CPUC issued a decision jointly in this

complaint case and in the rate stabilization proceedings modifying the restrictions on use of revenues generated by the surcharges to permit the revenues to be used for the purpose of securing or restoring the Utility's reasonable financial health, as determined by the CPUC. After the CPUC determines when the AB 1890 rate freeze ended, the CPUC will determine the extent and disposition of the Utility's under-collected costs, if any, remaining at the end of the rate freeze. If the CPUC determines that the Utility recovered revenues in excess of its transition costs or in excess of other permitted uses, the CPUC may require the Utility to refund such excess revenues. If the CPUC requires the Utility to refund any of these revenues in the future, the Utility's earnings could be materially affected.

### ***Mitsubishi Litigation***

Mitsubishi Power Systems, Inc. (MPS) has alleged a default under its contract for the sale and purchase of gas turbines and other equipment for failure to pay \$14 million. PG&E NEG's subsidiary has disputed this default notice because the payments were not due until January and July 2003. MPS terminated the contract for this alleged default on November 21, 2002. Although PG&E NEG does not agree that MPS had the right to do so, neither PG&E NEG nor any of its affiliates intended to challenge the termination. On January 31, 2003, PG&E NEG paid \$4.5 million of the \$14 million.

On May 7, 2003, Mitsubishi Heavy Industries, Inc. (MHI) filed suit in the United States District Court for the District of Maryland against PG&E NEG, PG&E National Energy Group, LLC (NEG LLC), and PG&E National Energy Group Construction Company, LLC (Construction). The defendants have not yet been served. In its complaint, MHI alleges damages totaling approximately \$300 million under the turbine purchase agreement and related contracts. MHI's claims arise from a dispute between the parties to a turbine purchase agreement regarding payments allegedly past due from Construction in respect of reservation fees (\$9.5 million) and gas generator equipment manufacture (\$30 million). MPS also requested that PG&E NEG cash collateralize its \$75 million guarantee issued in connection with the turbine purchase agreement. PG&E NEG and Construction have maintained (and will maintain in defense of MHI's claims) that no amounts were or are due.

PG&E Corporation cannot predict whether the outcome of the litigation will have a material adverse effect on its results of operations or financial condition.

### ***Recorded Liability for Legal Matters***

In accordance with SFAS No. 5 "Accounting for Contingencies," PG&E Corporation makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed quarterly and adjusted to reflect the impacts of negotiations, settlements and payments, rulings, advice of legal counsel, and other information and events pertaining to a particular case.

The provision for legal matters is included in PG&E Corporation's and the Utility's Other Noncurrent Liabilities in the Consolidated Balance Sheets and totaled \$200 million at March 31, 2003, and \$202 million at December 31, 2002.

### **NOTE 7: SEGMENT INFORMATION**

PG&E Corporation has identified three reportable operating segments based on similarities in the following characteristics:

Economic characteristics;

Products and services;

Types of customers;

Methods of distribution;

Regulatory environment; and

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How information is reported to and used by PG&E Corporation's chief operating decision makers.

The Utility is one reportable operating segment and the other two are part of PG&E NEG. These three reportable operating segments provide different products and services and are subject to different forms of regulation or jurisdictions.

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Segment information for the three months ended March 31, 2003, and 2002, was as follows:

PG&E National Energy Group							
Utility	Total PG&E NEG	Integrated Energy & Marketing Activities	Interstate Pipeline Operations	PG&E NEG Eliminations	PG&E Corporation, Eliminations and Other(1)	Total	
(in millions)							
<b>Three months ended March 31, 2003</b>							
Operating revenues (as revised)	\$ 2,064	\$ 337	\$ 306	\$ 49	\$ (18)	\$	\$ 2,401
Intersegment revenues(2)	3	22	7	15		(25)	
<b>Total operating revenues</b>	<b>2,067</b>	<b>359</b>	<b>313</b>	<b>64</b>	<b>(18)</b>	<b>(25)</b>	<b>2,401</b>
Income (Loss) from continuing operations(3)	(78)	(254)	(150)	16	(120)	54	(278)
Net income (loss)(4)	(79)	(369)	(217)	16	(168)	94	(354)
<b>Three months ended March 31, 2002(5)</b>							
Operating revenues(6)	2,450	485	442	47	(4)		2,935
Intersegment revenues(2)	3	31	19	12		(34)	
<b>Total operating revenues</b>	<b>2,453</b>	<b>516</b>	<b>461</b>	<b>59</b>	<b>(4)</b>	<b>(34)</b>	<b>2,935</b>
Income (Loss) from continuing operations(3)	590	29	18	18	(7)	4	623
Net income (loss)(4)	590	37	26	18	(7)	4	631
<b>Total assets at March 31, 2003(7)</b>	<b>\$ 26,316</b>	<b>\$ 7,613</b>	<b>\$ 7,254</b>	<b>\$ 1,350</b>	<b>\$ (991)</b>	<b>\$ 1,364</b>	<b>\$ 35,293</b>
<b>Total assets at March 31, 2002(7)</b>	<b>\$ 25,279</b>	<b>\$ 10,669</b>	<b>\$ 9,212</b>	<b>\$ 1,290</b>	<b>\$ 167</b>	<b>\$ 350</b>	<b>\$ 36,298</b>

- (1) Includes PG&E Corporation, PG&E Ventures LLC, and elimination entries. For the three months ended March 31, 2003, PG&E Corporation eliminated \$106 million of deferred tax asset valuation reserves recorded at PG&E NEG. PG&E Corporation believes it is more likely than not that it will be able to realize these deferred tax assets on a consolidated basis.
- (2) Intersegment electric and gas revenues are recorded at market prices, except for the Utility, which uses rates set by the CPUC, and PG&E NEG's Interstate Pipeline Operations, which uses rates set by the FERC.
- (3) Corresponds to Utility's Income Available for (Loss Allocated to) Common Stock excluding Cumulative Effect of Changes in Accounting Principles.
- (4) Corresponds to Utility's Income Available for (Loss Allocated to) Common Stock.
- (5)

Prior period amounts have been restated to reflect the reclassification of USGenNE, Mountain View, and ET Canada operating results to discontinued operations.

- (6) Operating revenues and operating expenses reflect the adoption of a new accounting policy in the third quarter of 2002 implementing a retroactive change from gross to net method of reporting revenues and expenses on trading activities. The amounts for trading activities for this period have been reclassified to conform with the new net presentation.
- (7) PG&E Corporation's assets exclude its investment in subsidiaries.

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## ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### OVERVIEW

PG&E Corporation is an energy-based holding company headquartered in San Francisco, California, that conducts its business through two principal subsidiaries: Pacific Gas and Electric Company (the Utility), an operating public utility engaged primarily in the business of providing electricity, natural gas distribution, and transmission services throughout most of Northern and Central California, and PG&E National Energy Group, Inc. (PG&E NEG), a company currently engaged in power generation and natural gas transmission.

The Utility filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code (Bankruptcy Code) in the U. S. Bankruptcy Court for the Northern District of California (Bankruptcy Court) on April 6, 2001. Pursuant to Chapter 11, the Utility retains control of its assets and is authorized to operate its business as a debtor-in-possession while being subject to the jurisdiction of the Bankruptcy Court. The factors causing the Utility to take this action are discussed in this Management's Discussion and Analysis (MD&A) of Financial Condition and Results of Operations and in Note 2 of the Notes to the Consolidated Financial Statements.

PG&E NEG and its principal subsidiaries include:

PG&E Generating Company, LLC and its subsidiaries (collectively, PG&E Gen LLC);

PG&E Energy Trading Holdings Corporation and its subsidiaries (collectively, PG&E Energy Trading or PG&E ET); and

PG&E Gas Transmission Corporation and its subsidiaries (collectively, PG&E GTC), which includes PG&E Gas Transmission, Northwest Corporation and its subsidiaries (collectively, PG&E GTN), which includes North Baja Pipeline, LLC.

As a result of the sustained downturn in the power industry, PG&E NEG and its affiliates have experienced a financial downturn, which caused the major credit rating agencies to downgrade PG&E NEG's and its affiliates' credit ratings to below investment grade. PG&E NEG is currently in default under various recourse debt agreements and guaranteed equity commitments totaling approximately \$2.9 billion. In addition, other PG&E NEG subsidiaries are in default under various debt agreements totaling \$2.7 billion, but this debt is non-recourse to PG&E NEG. At March 31, 2003, PG&E NEG had total liabilities in excess of total assets of approximately \$1.4 billion dollars.

PG&E NEG, its subsidiaries, and their lenders have been engaged in discussions to restructure PG&E NEG's and its subsidiaries' debt obligations and other commitments since October 2002. No agreement has been reached yet and there can be no assurance that an agreement will be reached. Any restructuring agreement that may be reached would be implemented through a reorganization proceeding under Chapter 11 of the Bankruptcy Code. Although PG&E NEG and its subsidiaries are continuing their efforts to maximize cash and reduce liabilities, such efforts are not expected to restore the financial condition of PG&E NEG and its subsidiaries. Absent a negotiated agreement, the lenders may exercise their default remedies or force PG&E NEG and certain of its subsidiaries into an involuntary proceeding under the Bankruptcy Code. Notwithstanding the status of current negotiations, PG&E NEG and certain of its subsidiaries also may elect to voluntarily seek protection under the Bankruptcy Code as early as the second quarter of 2003. Although PG&E Corporation continues to provide assistance to PG&E NEG, its subsidiaries and its lenders in their negotiations, management does not expect the outcome of any bankruptcy proceeding involving PG&E NEG

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or any of its subsidiaries to have a material adverse effect on the financial condition of PG&E Corporation or the Utility.

The factors affecting PG&E NEG's business and causing these defaults as well as the principal actions being taken by PG&E NEG are discussed later in this MD&A and in Note 3 of the Notes to the Consolidated Financial Statements.

The Consolidated Financial Statements of PG&E Corporation and of the Utility have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets, and repayment of liabilities in the ordinary course of business. However, as a result of the bankruptcy of the Utility and current liquidity concerns at PG&E NEG and its subsidiaries, as further discussed below, such realization of assets and liquidation of liabilities are subject to uncertainty.

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During the fourth quarter of 2002, PG&E NEG and certain subsidiaries agreed to sell or sold certain assets, abandoned other assets, and significantly reduced energy trading operations. As a result, PG&E NEG incurred significant charges in the fourth quarter of 2002. As a result, PG&E NEG expects to incur substantial charges to earnings in 2003 as it continues to restructure its operations.

PG&E Corporation has identified three reportable operating segments:

Utility;

Integrated Energy and Marketing, or the Generation Business; and

Interstate Pipeline Operations, or the Pipeline Business.

These segments were determined based on similarities in the following characteristics:

Economic;

Products and services;

Types of customers;

Methods of distribution;

Regulatory environment; and

How information is reported to and used by PG&E Corporation's chief operating decision makers.

These three reportable operating segments provide different products and services and are subject to different forms of regulations or jurisdictions. Financial information about each reportable operating segment is provided in this MD&A and in Note 7 of the Notes to the Consolidated Financial Statements.

This MD&A explains the general financial condition and the results of operations of PG&E Corporation and its subsidiaries, including:

Factors that affect each business;

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A comparison of revenues and expenses and why they changed between periods;

The sources and uses of cash between periods; and

How all of this along with related commitments and contingencies affects overall financial condition.

This is a combined Quarterly Report on Form 10-Q/A of PG&E Corporation and the Utility and includes separate Consolidated Financial Statements for each of these two entities. The Consolidated Financial Statements of PG&E Corporation reflect the accounts of PG&E Corporation, the Utility, PG&E NEG, and other wholly-owned and controlled subsidiaries. The Consolidated Financial Statements of the Utility reflect the accounts of the Utility and its wholly-owned and controlled subsidiaries. This combined MD&A should be read in conjunction with the Consolidated Financial Statements and Notes to the Consolidated Financial Statements included herein. Further, this Quarterly Report should be read in conjunction with PG&E Corporation's and the Utility's Consolidated Financial Statements and Notes to the Consolidated Financial Statements included in their combined 2002 Annual Report on Form 10-K, as amended. As discussed in Note 1 to the Notes to the Consolidated Financial Statements, PG&E Corporation's 2003 Consolidated Statement of Operations has been revised. This management's discussion and analysis gives effect to the revisions.

### Forward-Looking Statements and Risk Factors

This combined Quarterly Report on Form 10-Q/A, including this MD&A, contains forward-looking statements that are necessarily subject to various risks and uncertainties. These statements are based on current expectations and assumptions which management believes are reasonable and on information currently available to management. These forward-looking statements

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are identified by words such as "estimates," "expects," "anticipates," "plans," "believes," "could," "should," "would," "may," and other similar expressions. Actual results could differ materially from those contemplated by the forward-looking statements.

Although PG&E Corporation and the Utility are not able to predict all the factors that may affect future results, some of the factors that could cause future results to differ materially from those expressed or implied by the forward-looking statements, or from historical results, include:

*Recovery of Under-Collected Power Procurement and Transition Costs Previously Written Off.* The extent to which the Utility is able to recover its under-collected power procurement and transition costs previously written off depends on many factors, including:

What costs the California Public Utilities Commission (CPUC) determines are eligible for recovery as transition costs;

When the Utility's rate freeze ended, as determined by the CPUC;

Sales volatility and the level of direct access customers (i.e., those customers who choose an alternative energy provider);

Changes in the California Department of Water Resources' (DWR) revenue requirements required to be remitted to the DWR from existing retail rates;

Changes in the Utility's authorized revenue requirements;

Future regulatory or judicial decisions that determine whether the Utility is allowed under state law to recover under-collected power procurement and transition costs from its customers after the end of the rate freeze; and

The outcome of the Utility's claims against the CPUC Commissioners for recovery of under-collected power procurement and transition costs based on the federal filed rate doctrine.



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*Refundability of Amounts Previously Collected.* Whether the Utility is required to refund to ratepayers amounts previously collected depends on many factors, including:

Whether the CPUC determines that certain transition or procurement costs recovered in revenues collected by the Utility were not eligible transition costs or otherwise reduces the amount of revenues authorized to recover such transition or procurement costs;

Whether the CPUC makes retroactive changes in the allocation of the DWR's revenue requirements required to be remitted to the DWR from existing retail rates;

Whether the CPUC ultimately determines that certain past power procurement costs incurred by the Utility were not reasonably incurred and should be disallowed; and

The purposes for which the CPUC ultimately determines that surcharges approved by the CPUC in January, March, and May 2001 may be used.

*Outcome of the Utility's Bankruptcy Case.* The pace and outcome of the Utility's bankruptcy case will be affected by:

Whether the Bankruptcy Court confirms the Utility's proposed plan of reorganization (Plan), the alternative plan sponsored by the CPUC and the Official Committee of Unsecured Creditors (CPUC/OCC Plan), or some other plan of reorganization;

Whether regulatory and governmental approvals required to implement a confirmed plan are obtained and the timing of such approvals;

Whether there are any delays in implementation of a plan due to litigation, including the prosecution of any appeals related to regulatory, governmental, or Bankruptcy Court orders; and

Future equity or debt market conditions, future interest rates, future credit ratings, and other factors that may affect the ability to implement either plan or affect the terms, amount, and value of the securities proposed to be issued under either plan.

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*Operating Environment.* The amount of operating income and cash flows the Utility may record may be influenced by the following:

Future regulatory actions regarding the Utility's procurement of power for its retail customers;

The terms and conditions of the Utility's long-term generation procurement plan as approved by the CPUC;

The extent to which the Utility is able to timely recover in full its costs of service, including its procurement costs;

Future sales levels, which can be affected by general economic and financial market conditions, changes in interest rates, weather, conservation efforts, and the level of direct access customers;

The extent to which the Utility is required to purchase power to meet its customers' needs that is not supplied by Utility-owned generation or other contractual arrangements;

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The demand for and pricing of natural gas transportation and storage services, which may be affected by weather, overall gas-fired generation, and price spreads between various natural gas delivery points;

Changes in the Utility's authorized revenue requirements; and

Acts of terrorism, storms, earthquakes, accidents, mechanical breakdowns, or other events or perils that result in power outages or damages to the Utility's assets or operations, to the extent not covered by insurance.

*Legislative and Regulatory Environment.* PG&E Corporation's and the Utility's business may be impacted by:

Changes that may be made to California's electric industry restructuring legislation and to other applicable regulations, including for example, legislation that would repeal major portions of the electric industry restructuring law or that would extend the CPUC's jurisdiction to regulate certain activities of the parent companies of the California investor-owned electric and gas utilities (IOUs);

Legislative or regulatory changes affecting the electric and natural gas industries in the United States; and

Heightened regulatory and enforcement agency focus on the merchant energy business including investigations into "wash" or "round-trip" trading, specific trading strategies and other industry issues, with the potential for changes in industry regulations and in the treatment of PG&E NEG by state and federal agencies.

*Regulatory Proceedings and Investigations.* PG&E Corporation's and the Utility's business may be affected by:

The outcome of the Utility's various regulatory proceedings pending at the CPUC and at the Federal Energy Regulatory Commission (FERC); and

The outcome of the CPUC's pending investigation into whether IOUs have complied with past CPUC decisions, rules or orders authorizing their holding company formations and/or governing affiliate transactions, as well as applicable statutes.

*Pending Legal Proceedings.* PG&E Corporation's and the Utility's future results of operations and financial conditions may be affected by the outcomes of:

The lawsuits filed by the California Attorney General and the City and County of San Francisco against PG&E Corporation alleging unfair or fraudulent business acts or practices based on alleged violations of conditions established in the CPUC's holding company decisions;

The outcome of the California Attorney General's petition requesting revocation of PG&E Corporation's exemption from the Public Utility Holding Company Act of 1935; and

Other pending litigation.

*Competition.* PG&E Corporation's and the Utility's future results of operations and financial conditions may be affected by:

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The threat of municipalization, which may result in stranded Utility investment, loss of customer growth, and additional barriers to cost recovery;

Changes in the level of direct access customer cost responsibility and other surcharges related to direct access, and competition from other service providers to the extent restrictions on direct access are removed;

The development of alternative energy technologies;

The ability to compete for gas transmission services into Southern California and with alternative storage providers throughout California; and

The growth of distributed generation or self-generation.

*Environmental and Nuclear Matters.* PG&E Corporation's and the Utility's future results of operations and financial conditions may be affected by:

The effect of compliance with existing and future environmental laws, regulations, and policies, the cost of which could be significant;

Whether the Utility is able to fully recover in rates the costs of complying with existing and future environmental laws, regulations, and policies, the cost of which could be significant; and

Whether the Utility incurs costs in connection with its nuclear facilities that exceed the Utility's insurance coverage and other amounts set aside for decommissioning and other potential liabilities.

*Accounting and Risk Management.* PG&E Corporation's and the Utility's future results of operations and financial conditions may be affected by:

New accounting pronouncements;

Changes in critical accounting estimates;

Volatility in income resulting from mark-to-market accounting and changes in mark-to-market methodologies;

The extent to which the assumptions underlying critical accounting estimates, mark-to-market accounting, and risk management programs are not realized; and

The volatility of commodity fuel and electricity prices, and the effectiveness of risk management policies and procedures designed to address volatility.

*Potential Bankruptcy Filing.* The timing and manner in which bankruptcy proceedings involving PG&E NEG and certain of its subsidiaries commence will be affected by:

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The outcome of negotiations between PG&E NEG, its subsidiaries, and their lenders, as well as with representatives of the holders of PG&E NEG's Senior Notes, to restructure PG&E NEG's and its subsidiaries' indebtedness and commitments;

The inability of PG&E NEG, its merchant asset and other subsidiaries, including USGen New England, Inc. (USGenNE), to maintain sufficient liquidity necessary to meet their commodity and other obligations; and

The inability of USGenNE to comply with future environmental regulations and the impact such non-compliance would have on USGenNE's ability to operate its generating projects, particularly the Salem Harbor and Brayton Point power plants.

*Efforts to Restructure Operations.* PG&E NEG's future results of operations and financial condition will be affected by the success of its efforts to restructure its operations, including:

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The extent to which PG&E NEG incurs further charges to earnings as a result of the abandonment, sale, or transfer of assets, or termination of contractual commitments, whether such transactions occur in connection with the restructuring of PG&E NEG's indebtedness or otherwise;

Any potential charges to income that would result from the reduction and potential discontinuance of PG&E NEG's energy trading and marketing operations, including tolling transactions; and

The impact of lay-offs and loss of personnel at PG&E NEG.

*Current Conditions in the Energy Markets and the Economy.* PG&E Corporation's future results of operations and financial condition will be affected by changes in the energy markets, changes in the general economy, wars, embargoes, financial markets, interest rates, other industry participant failures, the markets' perception of energy merchants and other factors.

*Actions of PG&E NEG Counterparties.* PG&E Corporation's future results of operations and financial condition may be affected by:

The extent to which counterparties demand additional collateral in connection with PG&E ET's trading and non-trading activities and the ability of PG&E NEG and its subsidiaries to meet the liquidity calls that may be made; and

The extent to which counterparties seek to terminate tolling agreements and the amount of any termination damages they may seek to recover from PG&E NEG as guarantor.

As the ultimate impact of these and other factors is uncertain, these and other factors may cause future earnings to differ materially from historical results or outcomes currently sought or expected.

### **Market Conditions and Business Environment**

During 2002, adverse changes in the electric power and gas utility industry and energy markets affected PG&E Corporation, the Utility, and PG&E NEG's business, including:

Contractions and instability of wholesale electricity and energy commodity markets;

Significant decline in generation margins (spark spreads) caused by excess supply and reduced demand in most regions of the United States;

Loss of confidence in energy companies due to increased scrutiny by regulators, elected officials, and investors as a result of a string of financial reporting scandals;

Heightened scrutiny by credit rating agencies prompted by these market changes and scandals which resulted in lower credit ratings for many market participants; and

Resulting significant financial distress and liquidity problems among market participants leading to numerous financial restructurings and less market participation.

## LIQUIDITY AND FINANCIAL RESOURCES

### Utility

In 1998, the State of California implemented electric industry restructuring and established a framework allowing generators and other electricity providers to charge market-based prices for electricity sold on the wholesale market. The implementing legislation also established a retail electricity rate freeze and a plan for recovery of generation-related costs that were expected to be uneconomic under the new market framework. State regulatory action further strongly encouraged the Utility to sell a majority of its fossil fuel-fired generation facilities and made it economically unattractive to retain its remaining generation facilities. The resulting sales of generation facilities and the inability to enter into long-term purchased power contracts in turn made the Utility more dependent on spot purchases from the newly deregulated wholesale electricity market. Beginning in June 2000, wholesale prices for electricity began to increase. Prices moderated somewhat in the fall before increasing to unprecedented levels in November 2000 and later months. Since the Utility's retail rates were frozen, it financed the higher costs of wholesale electricity by issuing debt and drawing on its credit facilities.

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In the beginning of 2001, the major credit rating agencies lowered their ratings for the Utility and PG&E Corporation to non-investment grade levels. Consequently, the Utility lost access to its bank facilities and capital markets, and could no longer continue buying electricity to deliver to its customers. As a result of the Utility's lack of creditworthiness and similar conditions at the other California IOUs, in January 2001 the California Legislature and the Governor of California authorized the DWR to begin purchasing electricity for the State of California. Until January 2003, the DWR purchased the electricity needed to cover the Utility's net open position (the amount of electricity needed by retail electric customers that cannot be met by utility-owned generation and electricity under contract to the Utility).

The Utility's inability to recover its electric procurement costs from customers ultimately resulted in billions of dollars in defaulted debt and unpaid bills and caused the Utility to file a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court on April 6, 2001.

While in bankruptcy, the Utility is not allowed to pay liabilities incurred before it filed for bankruptcy without permission from the Bankruptcy Court. Additionally,

While in bankruptcy, the Utility does not have access to external funding from capital markets.

The Utility is in default under its credit facilities, commercial paper, floating rate notes, senior notes, pollution control loan agreements, and medium-term notes, as a result of its failure to pay certain of its obligations. However, the event of default under each security has been stayed in accordance with the bankruptcy proceedings.

The Utility has been making capital investments (investments in property, plant and equipment) out of its cash on hand under the supervision of the Bankruptcy Court. The Utility anticipates that it will be able to continue making such necessary capital investments in the future, subject to Bankruptcy Court approval.

Since filing for bankruptcy, the Utility has received permission from the Bankruptcy Court to make payments on (1) pre- and post-petition interest on certain claims, (2) pre-petition amounts payable to qualifying facilities (QFs) and certain other vendors, and (3) matured pre-petition secured debt.

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Since filing for bankruptcy, the Utility has been accruing interest on its pre-petition liabilities at the required rates included in the Utility's proposed plan of reorganization. As a result, the payment of such interest did not have a material adverse impact on its financial condition or results of operations.

The Utility will continue to accrue interest on its pre-petition liabilities at the required rates in 2003. However, due to the uncertainty of the ultimate outcome of the bankruptcy proceedings, the Utility is not able to estimate the amount of interest that will be paid in 2003 and beyond.

The Utility and PG&E Corporation have jointly filed a proposed plan of reorganization (Plan) that, if approved, would enable the Utility to emerge from bankruptcy. In November 2002, the Bankruptcy Court began the confirmation trial to determine which plan, if any, the Bankruptcy Court will confirm. On March 4, 2003, the Bankruptcy Court ordered the Utility, the CPUC, and other parties involved in the confirmation trial to participate in settlement negotiations. On March 11, 2003, the Bankruptcy Court then issued an order staying nearly all the proceedings in the confirmation trial until May 12, 2003. On April 23, 2003, the Bankruptcy Court extended this stay for an additional 30 days. A status conference is scheduled for June 16, 2003. PG&E Corporation and the Utility are not able to predict the ultimate outcome of the Utility's bankruptcy proceedings, including which plan, if any, the Bankruptcy Court may confirm.

Both the Plan and the alternative plan propose issuing new debt as part of the reorganization. PG&E Corporation and the Utility have incurred, and will continue to incur throughout the reorganization process, legal, accounting, trustee, and other fees associated with the proposed debt issuance. In addition, PG&E Corporation and the Utility have incurred and will continue to incur consulting fees for assistance with the implementation of either plan. Though a small amount of the costs directly related to the proposed debt issuance have been capitalized, the majority of the reorganization costs have been expensed and are included in Reorganization Professional Fees and Expenses in PG&E Corporation's and the Utility's Consolidated Statements of Operations.

Although the Utility still relies on electricity supplied by DWR contracts to service a significant portion of its total load, on January 1, 2003, the Utility and other California IOUs resumed procuring electricity to meet their customers' residual net open

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position under California Senate Bill (SB) 1976. In order to enter into short-term purchase contracts needed to cover its residual net open position, the Utility has posted collateral with the ISO and several other counterparties.

For further discussion of the California energy crisis, the Utility's voluntary petition for relief under the Bankruptcy Code, the status of the Chapter 11 confirmation hearings and the provisions of SB 1976, see Note 2 of the Notes to the Consolidated Financial Statements.

### **PG&E NEG**

PG&E NEG currently is focused on power generation and natural gas transmission in the United States. As a result of the sustained downturn in the power industry, PG&E NEG and its affiliates have experienced a financial downturn, which caused the major credit rating agencies to downgrade PG&E NEG's and its affiliates' credit ratings to below investment grade. PG&E NEG is currently in default under various recourse debt agreements and guaranteed equity commitments totaling approximately \$2.9 billion. In addition, other PG&E NEG subsidiaries are in default under various debt agreements totaling \$2.7 billion, but this debt is non-recourse to PG&E NEG.

PG&E NEG, its subsidiaries, and their lenders have been engaged in discussions to restructure PG&E NEG's and its subsidiaries' debt obligations and other commitments since October 2002. No agreement has been reached yet and there can be no assurance that an agreement will be reached. Any restructuring agreement that may be reached would be implemented through a reorganization proceeding under Chapter 11 of the Bankruptcy Code. Although PG&E NEG and its subsidiaries are continuing their efforts to maximize cash and reduce liabilities, such efforts are not expected to restore the financial condition of PG&E NEG and its subsidiaries. Absent a negotiated agreement, the lenders may exercise their default remedies or force PG&E NEG and certain of its subsidiaries into an involuntary proceeding under the Bankruptcy Code. Notwithstanding the status of current negotiations, PG&E NEG and certain of its subsidiaries also may elect to voluntarily seek protection under the Bankruptcy Code by the end of the second quarter of 2003. Although PG&E Corporation continues to provide assistance to PG&E NEG, its subsidiaries and its lenders in their negotiations, management does not expect the outcome of any bankruptcy proceeding involving PG&E NEG or any of its subsidiaries to have a material adverse effect on the financial condition of PG&E Corporation or the Utility. The factors affecting PG&E NEG's business causing these defaults and the principal actions being taken by PG&E NEG are discussed later in this MD&A and in Note 3 of the Notes to the Consolidated Financial Statements.

PG&E NEG, and its subsidiaries are restructuring their operations to increase cash, reduce financial obligations, dispose of merchant plant facilities, and decrease energy trading operations. PG&E NEG's objective is to limit its asset trading and risk management activities to only what is necessary for energy management services to facilitate the transition of PG&E NEG's merchant generation facilities through their sale, transfer or abandonment. PG&E NEG will then further reduce and transition to retain only limited capabilities to ensure fuel procurement and

power logistics for PG&E NEG's retained independent power plant operations.

## COMMITMENTS AND CAPITAL EXPENDITURES

PG&E Corporation has substantial financial commitments in connection with agreements entered into supporting the Utility's and PG&E NEG's operating, construction, and development activities.

### Utility

The Utility's contractual commitments include natural gas supply and transportation agreements, purchase power agreements (including agreements with QFs, irrigation districts and water agencies, bilateral power purchase contracts, and renewable energy contracts), nuclear fuel agreements, operating leases, and other commitments.

The Utility's commitments under financing arrangements include obligations to repay first and refunding mortgage bonds, senior notes, medium-term notes, pollution control loan agreements, Deferrable Interest Subordinated Debentures, lines of credit, letters of credit, floating rate notes, and commercial paper.

PG&E Funding LLC, a wholly-owned subsidiary of the Utility, is also obligated to make scheduled principal payments on its rate reduction bonds.

The Utility's contractual commitments and obligations are discussed in PG&E Corporation's 2002 Annual Report with updates to such disclosures included in Note 6 of the Notes to the Consolidated Financial Statements.

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## PG&E NEG

### Guarantees

PG&E NEG's and its subsidiaries' guarantees fall into four broad categories:

Equity commitments;

PG&E ET's energy trading and non-trading activities related to PG&E NEG's merchant energy portfolio, excluding tolling agreements;

Tolling agreements; and

Other guarantees.

PG&E NEG is currently in default under various debt agreements and guaranteed equity commitments totaling approximately \$2.9 billion. In addition, other PG&E NEG subsidiaries are in default under various debt agreements totaling approximately \$2.7 billion, but this debt is non-recourse to PG&E NEG. On November 14, 2002, PG&E NEG defaulted on the repayment of the \$431 million 364-day tranche of its corporate revolving credit facility (Corporate Revolver). Loans and letters of credit outstanding as of March 31, 2003, under the two-year tranche of the Corporate Revolver was \$258 million, \$185 million of letters of credit and \$73 million of loans. The default under the Corporate Revolver also constitutes a cross-default as of March 31, 2003, under (1) PG&E NEG's Senior Notes (\$1 billion outstanding), (2) its guarantee of a turbine revolving credit agreement (\$205 million outstanding), and (3) its equity commitment guarantees for the GenHoldings I, LLC (GenHoldings) credit facility (\$355 million outstanding), the La Paloma credit facility (\$375 million outstanding) and the Lake Road credit facility (\$230 million outstanding). In addition, on November 15, 2002, PG&E NEG failed to pay a \$52 million interest payment due under the Senior Notes. PG&E NEG currently does not have sufficient cash to meet its financial obligations and has ceased making payments on its debt and equity commitments.

### Equity Commitments

***GenHoldings Projects***

GenHoldings, an indirect subsidiary of PG&E NEG, is obligated under its credit facility to make equity contributions to fund construction of the Harquahala, Covert, and Athens generating projects. This credit facility is secured by these projects in addition to the Millennium generating facility. GenHoldings defaulted under its credit agreement in October 2002, by failing to make equity contributions to fund construction draws for the Athens, Harquahala, and Covert generating projects. Although PG&E NEG has guaranteed GenHoldings' obligations to make equity contributions of up to \$355 million, PG&E NEG notified the GenHoldings' lenders that it would not make further equity contributions on behalf of GenHoldings. In November and December 2002, the lenders executed waivers and amendments to the credit agreement under which they agreed to continue to waive, until March 31, 2003, the default caused by GenHoldings' failure to make equity contributions.

In connection with the lenders' waiver of various defaults and additional funding commitments, PG&E NEG has agreed to cooperate with any reasonable proposal by the lenders regarding disposition of the equity in or assets of any or all of the PG&E NEG subsidiaries holding the Athens, Covert, Harquahala, and Millennium projects.

As of March 21, 2003, the lenders executed a waiver letter extending to June 30, 2003, the waiver of GenHoldings' equity default. In addition, the waiver letter also waives other existing defaults in order to permit the continued availability of loan facilities to fund construction and operation of the projects until such time as a transfer of the projects to the GenHoldings lenders may be completed. An event of default will occur if such transfer is not accomplished by such deadline. Such a default would trigger lender remedies, including the right to foreclose on Millennium, Harquahala, Athens, and Covert.

Under the waiver, PG&E NEG has re-affirmed its guarantee of GenHoldings' remaining obligation to make equity contributions to these projects of approximately \$355 million. Neither PG&E NEG nor GenHoldings currently expects to have sufficient funds to make this payment. The requirement to pay \$355 million will remain an obligation of PG&E NEG that would survive the transfer of the projects.

***Lake Road and La Paloma Projects***

In September 1999 and March 2000, Lake Road Generating Company, LP (Lake Road) and La Paloma Generating Company, LLC (La Paloma) entered into Participation Agreements to finance the construction of the two plants. In November 2002,

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Lake Road and La Paloma defaulted on their obligations to pay interest and swap payments. In addition, as a result of PG&E NEG's downgrade to below investment grade by both S&P and Moody's, PG&E NEG, as guarantor of certain debt obligations of Lake Road and La Paloma, became required to make equity contributions to Lake Road and La Paloma of \$230 million and \$375 million respectively. The lenders have accelerated all debt existing prior to December 11, 2002, including the guaranteed portion of the debt and made a payment under the PG&E NEG guarantee. Neither PG&E NEG, Lake Road nor La Paloma has sufficient funds to make these payments.

As of December 4, 2002, PG&E NEG and certain subsidiaries entered into various agreements with the respective lenders for each of the Lake Road and La Paloma generating projects providing for (1) funding of construction costs required to complete the La Paloma facility, and (2) additional working capital facilities to enable each subsidiary to timely pay for its fuel requirements and to provide its own collateral to support natural gas pipeline capacity reservations and independent transmission system operator requirements, as well as for general working capital purposes. Lenders extending new credit under these agreements have received liens on the projects that are senior to the existing lenders' liens. These agreements provide, among other things, that the failure to transfer right, title and interest in, to and under the Lake Road and La Paloma projects to the respective lenders by June 9, 2003 will constitute a default under the agreements. The failure to transfer the facilities would entitle the lenders to accelerate the new indebtedness and exercise other remedies. The requirement to pay \$230 million and \$375 million for Lake Road and La Paloma, respectively, will remain an obligation of PG&E NEG that would survive the transfer of the projects.

**Activities Related to Merchant Portfolio Operations**

PG&E NEG and certain subsidiaries have provided guarantees as of January 31, 2003, to approximately 188 counterparties in support of PG&E ET's energy trading and non-trading activities related to PG&E NEG's merchant energy portfolio in the face amount of \$2.2 billion. Typically, the overall exposure under these guarantees is only a fraction of the face value of these guarantees, since not all counterparty credit limits are fully used at any time. As of March 31, 2003, PG&E NEG and its subsidiaries' aggregate exposure under these guarantees was approximately \$150 million. The amount of such exposure varies daily depending on changes in market prices and net changes in position. In light of the downgrades, some counterparties have sought and others may seek replacement security to collateralize the exposure guaranteed by PG&E NEG and its subsidiaries. PG&E GTN and PG&E ET have terminated the arrangements pursuant to which PG&E GTN provided guarantees on behalf of PG&E ET such that PG&E GTN will provide no new guarantees on behalf of PG&E ET.



At March 31, 2003, PG&E ET's estimated exposure not covered by a guarantee (excluding exposure under tolling agreements) is approximately \$96 million.

To date, PG&E ET has met those replacement security requirements properly demanded by counterparties and has not defaulted under any of its master trading agreements although one counterparty has alleged a default. No demands have been made upon the guarantors of PG&E ET's obligations under these trading agreements. In the past, PG&E ET has been able to negotiate acceptable arrangements and reduce its overall exposure to counterparties when PG&E ET or its counterparties have faced similar situations. There can be no assurance that PG&E ET can continue to negotiate acceptable arrangements in the current circumstances. PG&E NEG cannot quantify with any certainty the actual future calls on PG&E ET's liquidity. PG&E NEG's and its subsidiaries' ability to meet these calls on their liquidity will vary with market price volatility, uncertainty with respect to PG&E NEG's financial condition, and the degree of liquidity in the energy markets. The actual calls for collateral will depend largely upon the ability to enter into forbearance agreements and pre- and early-pay arrangements with counterparties, the continued performance of PG&E NEG companies under the underlying agreements, whether counterparties have the right to demand such collateral, the execution of master netting agreements and offsetting transactions, changes in the amount of exposure, and the counterparties' other commercial considerations.

### **Tolling Agreements**

PG&E ET has entered into tolling agreements with several counterparties under which at its discretion, it supplies the fuel to the power plants and then sells the plant's output in the competitive market. Payments to the counterparties are reduced if the plants do not achieve agreed-upon levels of performance. The face amount of PG&E NEG's and its subsidiaries' guarantees relating to PG&E ET's tolling agreements is approximately \$600 million. The tolling agreements are with: (1) Liberty Electric Power, L.P. (Liberty) guaranteed primarily by PG&E NEG and secondarily by PG&E GTN for an aggregate amount of up to \$150 million; (2) DTE-Georgetown, LLC (DTE) guaranteed by PG&E GTN for up to \$24 million; (3) Calpine Energy Services, L.P. (Calpine) for which no guarantee is in place; (4) Southaven Power, LLC (Southaven) guaranteed by PG&E NEG for up to \$175 million; and (5) Caledonia Generating, LLC (Caledonia) guaranteed by PG&E NEG for up to \$250 million.

### ***Liberty***

Liberty has provided notice to PG&E ET that the ratings downgrade of PG&E NEG constituted a material adverse change under the tolling agreement requiring PG&E ET to replace the guarantee and post security in the amount of \$150 million. PG&E ET has not posted such security. Under the terms of the guarantees, Liberty has the right to terminate the agreement and seek recovery of a termination payment for a maximum amount of up to \$150 million. Liberty first must proceed against PG&E NEG's guarantee, and can demand payment under PG&E GTN's guarantee only if PG&E NEG is in bankruptcy or Liberty has made a payment demand on PG&E NEG which remains unpaid five business days after the payment demand is made. In addition, PG&E ET has provided notices to Liberty of several breaches of the tolling agreement by Liberty and has advised Liberty that, unless cured, these breaches would constitute a default under the agreement. If these defaults remain uncured, PG&E ET has the right to terminate the agreement and seek recovery of a termination payment.

### ***DTE Georgetown***

By letter dated October 14, 2002, DTE provided notice to PG&E ET that the downgrade of PG&E GTN constituted a material adverse change under the tolling agreement between PG&E ET and DTE and that PG&E ET was required to post replacement security within ten days. By letter dated October 23, 2002, PG&E ET advised DTE that because there had not been a material adverse change with respect to PG&E GTN within the meaning of the tolling agreement, PG&E ET was not required to post replacement security. If PG&E ET was required to post replacement security and it failed to do so, DTE would have the right to terminate the tolling agreement and seek recovery of a termination payment.

### ***Calpine***

The tolling agreement states that on or before October 15, 2002, Calpine was to have issued a full notice to proceed under its construction contract to its engineering, procurement, and construction contractor for the Otay Mesa facility. On October 16, 2002, PG&E ET asked Calpine to confirm that it had issued this full notice to proceed and Calpine was not able to do so to the satisfaction of PG&E ET. Consequently, PG&E ET advised Calpine by letter dated October 30, 2002, that it was terminating the tolling agreement effective November 29, 2002. Calpine has indicated that this termination was improper and constituted a default under the agreement, but has not taken any further action.

### ***Southaven and Caledonia Tolling Agreements***

PG&E ET signed a tolling agreement with Southaven dated as of June 1, 2000, under which PG&E ET is required to provide credit support as defined in the tolling agreement. PG&E ET satisfied this obligation by providing an investment-grade guarantee from PG&E NEG as defined in the tolling agreement. The amount of the guarantee now does not exceed \$175 million. By letter dated August 31, 2002, Southaven advised PG&E ET that it believed an event of default under the tolling agreement had taken place with respect to this obligation because PG&E NEG was no longer investment-grade as defined in the tolling agreement and because PG&E ET had failed to provide, within 30 days from the downgrade, substitute credit support that met the requirements of the tolling agreement. Southaven has the right to terminate the agreement and seek a termination payment. In addition, PG&E ET has provided Southaven with a notice of default respecting Southaven's performance under the agreement and concerning the inability of the facility to inject its output into the local grid. Southaven has not cured this default and on February 4, 2003, PG&E ET provided a notice of termination.

In addition, PG&E ET signed a tolling agreement with Caledonia dated as of September 20, 2000, under which PG&E ET is required to provide credit support as defined in the tolling agreement. PG&E ET satisfied this obligation by providing a guarantee from PG&E NEG that was investment-grade as defined in the tolling agreement. The amount of the guarantee does not exceed \$250 million. By letter dated August 31, 2002, Caledonia advised PG&E ET that it believed an event of default under the tolling agreement had taken place with respect to this obligation because PG&E NEG was no longer investment-grade as defined in the tolling agreement and because PG&E ET had failed to provide, within 30 days from the downgrade, substitute credit support that met the requirement of the tolling agreement. Caledonia has the right to terminate the agreement and seek a termination payment. In addition, PG&E ET provided Caledonia with a notice of default respecting Caledonia's performance under the agreement and concerning the inability of the facility to inject its output into the local grid. Caledonia has not cured this default and on February 4, 2003, PG&E ET provided a notice of termination.

On February 7, 2003, Southaven and Caledonia filed an emergency petition to compel arbitration or, in the alternative, for a temporary restraining order and preliminary injunction with the Circuit Court for Montgomery County, Maryland (Court). On March 3, 2003, the Court issued an order ruling that PG&E ET must continue to perform under the agreements. PG&E ET appealed this decision to an intermediate Maryland appellate court. However, on April 8, the highest appellate court in Maryland issued on its own motion and order taking jurisdiction of the appeal.

PG&E ET is not able to predict whether the counterparties will seek to terminate the agreements or whether the Court will grant the requested relief. Accordingly, it is not able to predict whether or the extent to which these proceedings will have a material adverse effect on PG&E NEG's financial condition or results of operations.

Under each tolling agreement, determination of the termination payment is based on a formula that takes into account a number of factors, including market conditions such as the price of power and the price of fuel. In the event of a dispute over the amount of any termination payment that the parties are unable to resolve by negotiation, the tolling agreement provides for mandatory arbitration. The dispute resolution process could take as long as six months to more than a year to complete. To the extent that PG&E ET did not pay these damages, the counterparties could seek payment under the guarantees for an aggregate amount not to exceed \$600 million. PG&E NEG is unable to predict whether counterparties will seek to terminate their tolling agreements. PG&E NEG currently does not expect to be able to pay any termination payments that may become due.

#### **Other Guarantees**

PG&E NEG has provided guarantees related to other obligations by PG&E NEG companies to counterparties for goods or services. PG&E NEG does not believe that it has significant exposure under these guarantees. The most significant of these guarantees relates to performance under certain construction contracts. In the event PG&E NEG is unable to provide any additional or replacement security that may be required as a result of rating downgrades, the counterparty providing the goods or services could suspend performance or terminate the underlying agreement and seek recovery of damages. These guarantees represent guarantees of subsidiary obligations for transactions entered into in the ordinary course of business. Some of the guarantees relate to the construction or development of PG&E NEG's power plants and pipelines. These guarantees are described below.

PG&E NEG has issued guarantees to construction financing lenders for the performance of the contractors building the Harquahala and Covert generating projects for up to \$555 million. The construction contractor and various equipment vendors currently are performing under their underlying contracts.

PG&E NEG has issued \$100 million of guarantees to the constructor of the Harquahala and Covert projects to cover certain separate cost-sharing arrangements.

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PG&E NEG has provided a \$300 million guarantee to support a tolling agreement that a wholly-owned subsidiary, Attala Energy, has entered into with another wholly-owned subsidiary, Attala Generating Company, LLC.

The balance of the guarantees are for commitments undertaken by PG&E NEG or its subsidiaries in the ordinary course of business for services such as facility and equipment leases, ash disposal rights, and surety bonds.

PG&E NEG has the following credit facilities outstanding at March 31, 2003 (in millions):

	<b>Total Bank Commitment</b>	<b>Balance</b>
PG&E NEG Inc. Tranche A (2 year facility)(a)	\$ 258	\$ 258
PG&E NEG Inc. Tranche B (364 day facility)(a)	431	431
PG&E ET & Subsidiaries Facility One	35	33
PG&E ET & Subsidiaries Facility Two	19	19
PG&E Gen	7	7
USGenNE	100	88
PG&E GTC and Subsidiaries	125	40
Total	\$ 975	\$ 876

(a) PG&E NEG is currently in default on both its Tranche A and Tranche B credit facility.

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### CASH FLOWS

#### Utility

The following section discusses the Utility's significant cash flows from operating, investing, and financing activities for the three months ended March 31, 2003, and 2002.

#### *Operating Activities*

Results from the Utility's consolidated cash flows from operating activities for the three months ended March 31, 2003, and 2002 are as follows:

	<b>Three months ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(in millions)</b>	
Net income (loss)	\$ (73)	\$ 596
Non-cash (income) expenses:		
Depreciation and amortization	310	271
Net reversal of ISO accrual and DWR revenue requirement adjustment		(970)
Increase in accounts payable	122	453
Other items of cash:		
Payments authorized by the Bankruptcy Court on amounts classified as liabilities subject to compromise	(39)	(225)

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	<b>Three months ended March 31,</b>	
	<hr/>	
Change in income tax receivable	(176)	
Other changes in operating assets and liabilities	590	1,034
	<hr/>	
<b>Net cash provided by operating activities</b>	<b>\$ 734</b>	<b>\$ 1,159</b>
	<hr/>	

Cash provided by operating activities decreased by \$425 million during the three months ended March 31, 2003, in comparison to the same period in the prior year. This decrease was mainly due to the following:

Net income decreased by \$669 million due primarily to lower electric sales volumes, an increase in revenues passed through to the DWR and an increase in the cost of electricity. See discussion of factors impacting the Utility's net income in the "Results of Operations" section of this MD&A. Net income for the three months ended March 31, 2003, included net non-cash expense of \$509 million, including \$310 million of depreciation. Net income in the three months ended March 31, 2002, included net non-cash income totaling \$742 million, including \$271 million in depreciation and a reversal of ISO charges of \$970 million.

Payments on amounts classified as liabilities subject to compromise decreased by \$186 million in 2003 compared to 2002 due to significant pre-petition amounts paid to QF's in the first quarter of 2002 based on Bankruptcy Court approved settlements.

Other changes in operating assets and liabilities provided cash flows of \$491 million in the first quarter of 2003 and \$478 million in the first quarter of 2002 primarily through the collection of customer receivables and the usage of stored gas and fuel oil inventories.

***Investing Activities***

Results from the Utility's consolidated cash flows from investing activities for the three months ended March 31, 2003, and 2002 are as follows:

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	<b>Three months ended March 31,</b>	
	<hr/>	
	<b>2003</b>	<b>2002</b>
	<hr/>	
	<b>(in millions)</b>	
Capital expenditures	\$ (371)	\$