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UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re PACIFIC GAS AND ELECTRIC COMPANY, a California corporation, Debtor.	Case No. 01-30923-SFM Chapter 11
SIERRA PACIFIC INDUSTRIES, a California corporation, Plaintiff, v. PACIFIC GAS & ELECTRIC CO., a California corporation, CALIFORNIA INDEPENDENT SYSTEM OPERATOR, a California public benefit corporation, Defendants.	Adversary Proceeding No. 01-3087

MEMORANDUM DECISION REGARDING MOTION OF SIERRA PACIFIC INDUSTRIES FOR PARTIAL SUMMARY JUDGMENT ON EIGHTH CAUSE OF ACTION

On July 10, 2001, plaintiff Sierra Pacific Industries ("SPI") filed its motion for partial summary judgment on the eighth cause of action in its Complaint (the "Motion"). In particular, SPI requested a determination that defendant Pacific Gas and Electric Company ("PG&E") breached four agreements, known as Power Purchase

Agreements ("PPAs" or the "Contracts"), under which SPI sold power to PG&E and that (1) SPI properly canceled the Contracts prior to the date on which PG&E filed its voluntary chapter 11 petition (the "Petition Date"), (2) SPI has no further obligations to PG&E under the canceled Contracts, and (3) PG&E is not entitled to payments under Section E-11 of the Contracts ("Section E-11"). SPI calls Section E-11 a minimum "liquidated damages" provision for PG&E's benefit if SPI breaches or terminates the Contracts without cause and PG&E calls it a "security provision" for the "return of overpayments" from PG&E to SPI under the Contracts. PG&E claims that the return of overpayments will compensate it because the Contracts were "front-loaded" to encourage construction of cogeneration facilities and now, once terminated, it will not enjoy the long term benefits of those Contracts.[1]

The matter came on for hearing on September 13, 2001. Gordon P. Erspamer, Esq., Roger E. Collanton, Esq. and Adam A. Lewis, Esq. appeared for SPI, and Bruce A. Wagman, Esq. and Mark H. Penskar, Esq. appeared for PG&E. Norma Formanek, Esq. appeared on behalf of defendant the California Independent System Operator ("CalISO"). For the reasons set forth below, the court will grant SPI's Motion.[2]

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[1] The Contracts actually have "levelized" payments over their entire 30-year term, but inflation generally means that a given number of dollars is worth more today than it will be in 10, 20 or 30 years so the effect is a "modest amount of front-loading." Decision 92-12-021 (Re Biennial Resource Plan Update), 47 CPUC 2d 1, 35 (1992) ("D.92-12-021").

[2] The following discussion constitutes the court's findings of fact and conclusions of law. Fed. R. Bankr. P. 7052(a).

An abbreviated procedural history is as follows. The Complaint was filed in the Superior Court of the State of California, County of Sacramento, on April 2, 2001, just before the Petition Date of April 6, 2001. SPI later filed a notice of removal of that action, but did so in the United States Bankruptcy Court for the Eastern District of California, Sacramento Division (A.P. No. 01-2184), which transferred the matter (now designated as A.P. No. 01-3087) to this court.

SPI and PG&E have agreed, in a stipulation approved by this court, that the automatic stay shall not apply for purposes of the Motion. PG&E has not filed an Answer to the Complaint, but has filed a Statement of Application of Automatic Stay in Lieu of Response to Complaint. CalISO has filed an Answer but has not participated in the proceedings on the Motion.

SPI previously moved for a preliminary injunction, and at a hearing on May 21, 2001, the court granted SPI's motion and indicated its preliminary conclusion that SPI properly canceled the Contracts prior to the Petition Date after PG&E's material breach by its failure to pay approximately $18 million[3] in prepetition payments owed to SPI, and alternatively because of PG&E's failure to give adequate assurances of future performance under the Contracts. The court also stated its preliminary conclusion that SPI would have no future obligation to supply power to PG&E under the Contracts. In its opposition to the Motion PG&E has raised no new arguments and the court hereby

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[3] PG&E concedes that approximately $17 million is owed for "energy and as-delivered capacity" and approximately $675,000 is owed for "firm capacity."

adopts its comments at the May 21 hearing as its findings of fact and conclusions of law on those portions of the Motion.

The remaining issue presented by the Motion[4] is whether SPI has any payment obligations to PG&E (either directly or by setoff against what PG&E owes it) under Section E-11.[5] The court starts with the standard principle of contract law that a party cannot recover damages for its own breach. See Wood, Curtis & Co. v. Scurich, 5 Cal. App. 252, 253-256 (1907). See generally 10 Cal.

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[4] SPI filed an objection and motion to strike portions of various declarations filed by PG&E in opposition to the Motion, and PG&E filed a response. The court has considered the declarations and they do not change the court's findings of fact and conclusions of law herein, so the court will not rule of the objections and motion to strike as they are now moot.

[5] PG&E argues that SPI cannot move for summary judgment based on Section E-11 because its Complaint does not mention that section or "SPI's debt" thereunder. PG&E cites cases holding that a party cannot move for summary judgment on a claim not pleaded in the complaint. See, e.g., Coleman v. Quaker Oats Co., 232 F.3d 1271, 1291-1294 (9th Cir. 2000) (noting potential for unfairness if plaintiff does not reveal theories either in complaint or in discovery prior to summary judgment), cert. denied sub nom Gentile v. Quaker Oats Co., ___ U.S. ___, 121 S.Ct. 2592, 150 L.Ed.2d 751 (2001). PG&E argues that the Complaint requests only a declaration of SPI's obligation to provide future services, not its payment obligations under Section E-11.

PG&E misreads the Complaint. First, the Eighth Cause of Action seeks a declaration that SPI properly canceled and has no future performance obligations under the Contracts, and any future payments owed by SPI under Section E-11 would be one type of future performance obligation. Second, the Eighth Cause of Action also seeks"a declaration that [SPI] is entitled to the amounts it is owed by [PG&E] under the [Contracts], plus interest[] and consequential damages." The Motion addresses one possible element of "the amounts [SPI] is owed," namely the lack of setoff under Section E-11.

Moreover, there is no unfair surprise to PG&E. Setoff is an affirmative defense that SPI had no obligation to include in its Complaint. In addition, SPI believes Section E-11 only applies if SPI (not PG&E) breaches the Contracts, so there would have been no reason to discuss Section E-11 in the Complaint. PG&E did not ask for more time or additional discovery, and it has suggested no way in which it was unfairly surprised by having to defend its position that it is entitled to a setoff under Section E-11.

Jur. 3d Contracts § 310 at nn. 43-45 and accompanying text (1974). More particularly, if an agreement contains a liquidated damages clause the breaching party cannot enforce that clause, and the court finds below that Section E-11 is a liquidated damages clause. See Gogo v. Los Angeles County Flood Control Dist., 45 Cal. App. 2d 334, 339-345 (where defendant largely caused delays, plaintiff contractor was entitled to return of full amount of liquidated damages withheld by defendant for failure to complete project within time designated in contract), motion to recall remittitur denied, 47 Cal. App. 2d 96 (1941).[6]

PG&E argues that the payments under Section E-11 are not damages but a "recalculation" that is "triggered by a change in circumstances" and is "unaffected by breach or cancellation." PG&E elaborates that Section E-11 "provides [a] 'make-right' remedy in the interests of fairness, regardless of any breach by either party. The clause does not use the word 'breach' or in any way suggest a breach is required to trigger the provision . . . ."

PG&E's argument is contrary to the language of the

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[6] This does not mean that PG&E could not reduce SPI's damages if it showed that SPI failed to mitigate those damages, nor that PG&E is barred from asserting a setoff for any independent obligations from SPI to PG&E or any damages subsequently caused by SPI. See Aetna Cas. & Sur. Co. v. Board of Trustees of Rincon Val. Union School Dist., 223 Cal. App. 2d 337, 340-341 (1963) (following Gogo but noting that defendant "retains its right to show actual damages sustained by contractor's subsequent delays" after the delays caused by defendant's breach). PG&E has not yet asserted any such defenses or counterclaims, but PG&E might not have been obligated to raise them in proceedings on this Motion if they arose outside of the Contracts. This memorandum decision does not attempt to resolve whether any such defenses or counterclaims exist or if so, whether they survive the Motion.

Contracts.[7] Section E-11 is entitled "Minimum Damages." It provides for payments by SPI to PG&E based on failures by SPI to live up to its commitments in the Contracts:

> (a) In the event [SPI's] firm capacity [its obligation to deliver specified kilowatts of capacity for the duration of the Contracts] is derated or [SPI] terminates this Agreement, the quantity by which the firm capacity is derated or the firm capacity shall be used to calculate the payments due [PG&E] in accordance with [the formula in] Section (d). [Emphasis added and deleted.]

PG&E states that "derating" under Section E-11 can be triggered by its own "unilateral" action and "does not necessarily indicate any liability on the part of [SPI]." Section E-4(b) of the Contracts provides, however, that:

> . . . [PG&E] may derate the firm capacity in accordance with Section E-2(e) as a result of appropriate data showing [SPI] has failed to meet the performance requirements of Section E-2. [Emphasis added and deleted.]

The "performance requirements of Section E-2" already include various circumstances that would excuse SPI's performance, which reinforces the notion that not meeting those requirements is a "failure" to abide by the Contracts' terms. In other words, derating is not a "no-fault" unilateral decision, as PG&E implies.

Moreover, in Article 2 the Contracts speak in terms of "damages" and "breach," apparently referring to Section E-11 (and another "minimum damages provision in Section B(a)):

> This Agreement contains certain provisions

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[7] The four Contracts differ somewhat in their terms, but they appear to be identical in all material respects for purposes of this memorandum decision. Two of the contracts are designated as standard forms Interim Standard Offer #4 PPAs or "ISO4" contracts, and the other two are designated as long-term energy and capacity PPAs.

> which set forth methods of calculating damages to be paid to [PG&E] in the event [SPI] fails to fulfill certain performance obligations. The inclusion of such provisions is not intended to create any express or implied right in [SPI] to terminate this Agreement prior to the expiration of the term of agreement. Termination of this Agreement by [SPI] prior to its expiration date shall constitute a breach of this Agreement and the damages expressly set forth in this Agreement shall not constitute [PG&E's] sole remedy for such breach. [Emphasis added and deleted.]

The Contracts say nothing about the consequences of any breach by PG&E. In fact, the Contracts do not appear to contemplate that PG&E might ever breach its obligations. In that context it is not surprising the Section E-11 does not specify what happens if PG&E, rather than SPI, "terminates," "breaches," or "fails" to perform its obligations.

Perhaps most convincing of all is the potentially enormous amount of "minimum damages" under Section E-11. Among other sums, Section E-11(d) would require SPI to pay as much as five times the difference between the fixed firm capacity payment under the Contracts and the "current firm capacity price" over the remaining term of the Contracts. At oral argument the parties' counsel advised the court that if Section E-11 applies SPI would likely owe more to PG&E than the entire approximately $18 million owed by PG&E. In other words, PG&E could simply refuse to pay $18 million and SPI would have no practical alternative but to perform under the Contracts, as PG&E reads them. This is hardly the appropriate result that should follow PG&E's material breaches.

Section E-11 seems designed at the very least to take away the benefit of SPI's bargain under the Contracts, and more likely to charge SPI with an amount designed to offset the presumed

prejudice to PG&E of having to replace SPI with another cogenerator or "qualifying facility" ("QF").[8] The court finds it extremely doubtful that the parties would intend to place all of these adverse consequences on SPI when PG&E is the breaching party. If that is what the parties intended they would have had to say so very clearly.

Therefore, the court finds that Section E-11 is not simply a "make-right" remedy based on a "change in circumstances." It is a liquidated damages clause for SPI's wrongful breach or termination. It does not apply to SPI's pursuit of its contractual remedies, including cancellation of the Contracts before the Petition Date, in response to PG&E's material, ongoing and substantial breach and failure to provide adequate assurances of future performance.

As noted above, the Contracts are silent on the consequences of a breach by PG&E. But it would be a strained interpretation indeed if the court were to hold that SPI could not end the contractual relationship upon PG&E's substantial breach. The right to do so is a fundamental principle of contract law, for which no citations are necessary. The ending of that relationship is not the "termination" that would allow Section E-11 to visit adverse consequences on SPI for protecting its contractual rights. SPI has every right to -- and did -- cancel the Contracts as a result of PG&E's breaches. That cancellation is not the same as

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[8] See 18 C.F.R. §§ 292.101(b)(1) and 292.201-292.207 and 16 U.S.C. § 796(17) and (18), and Decision 86-07-004, 1986 Cal. PUC LEXIS 458, *5 n. 2; 21 CPUC 2d 340 (1986) (describing use of term "qualifying facility").

termination.

The court has also reviewed the decisions and rules of the California Public Utilities Commission ("CPUC") presented by both PG&E and SPI and determined that they do not reflect any different interpretation of Section E-11. To the contrary, those CPUC materials reinforce the court's views.[9] They reflect CPUC's intent to make it "unattractive" for SPI and other QFs to terminate agreements such as the Contracts, they direct PG&E "vigorously [to] pursue recovery of all foreseeable damages in the event of a QF breaching a power purchase contract," and, like the contracts themselves, they speak of "minimum damages in the event of breach" by the cogenerator, or even "termination penalties."

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[9] PG&E cites the CPUC decisions and regulations as evidence of "the parties' intent." SPI points out that it was not a party to the negotiations that led to the standard ISO4 contracts, though it claims that PG&E was the primary drafter of those contracts. PG&E disputes that characterization, but at oral argument its counsel agreed with SPI that the court should look at the CPUC materials. Cf. Decision No. 93-12-035, 1993 Cal. PUC LEXIS 720, at *11-*13; 52 CPUC 2d 451 (1993) (rejecting PG&E's arguments that standard contract interpretation should not apply because it was "compelled" to enter into standard forms of PPA, but agreeing that "neither the utility nor the QF drafted the agreement, and ambiguity should not be construed against either party").

The court has considered all of the CPUC materials presented. CPUC materials prior to late September, 1984, when the Contracts were signed, are relevant because both PG&E and SPI presumably were aware of those decisions and factored them into their understanding of the Contracts. Cf. Mahlstedt v. Fugit, 79 Cal. App. 2d 562, 566-567 (1947) (law in force at time contract to sell a business was executed became a part of the contract and parties were presumed to have acted with knowledge of the law); Cal. Civ. C. § 1646 (contracts interpreted according to law and "usage" of place of performance or where made). CPUC decisions after that date may be relevant because of the CPUC's expertise in matters within its administrative specialty. Cf. Southern California Edison Co. v. Public Utilities Com'n, 85 Cal.App.4th 1086, 1096, 1105 (2000) (discussing deference to administrative interpretations of statutes and regulations).

See Decision No. 83-09-054, 1983 Cal. PUC LEXIS 33, at *27, *37, *40, *75; 12 CPUC 2d 604 (1983) ("D.83-09-054"); Rules established for Standard Offers for Cogeneration, 1982 Cal. PUC LEXIS 1218, at *10-*11, *90, *98-*106 (termination provisions apply if "QF terminates," they are "liquidated damage clauses intended to reimburse the utility for unearned capacity payments made to QFs and, in some cases, the utility's costs of replacing the lost capacity," and they use a formula rather than a flat charge because the latter "may conflict with the accepted standard of damages in making the nonbreaching party whole."); Decision No. 83-11-047, 1983 Cal. PUC LEXIS 708, at *29; 13 CPUC 2d 194 (1983) (encouraging aggressive pursuit of foreseeable damages and overpayments in the "event of a QF breach."); Decision No. 86-07-004, 1986 Cal. PUC LEXIS 458, at *15; 21 CPUC 2d 340 (1986) (contract terms include "damage provisions to protect a utility against a QF's failure to come on-line or to perform thereafter").

Although some of the CPUC decisions use a "loan" analogy and speak in terms of "front-loading" and "security provisions for return of overpayments if the QF ceases operation before the end of the contract," they simultaneously use the terms "liquidated damages" and "breach," they speak of "incentives" for the QFs to "avoid default," and they distinguish between no-fault termination provisions, for which there would be no "minimum damages" payment, and QF "defaults" that would lead to payment of "minimum damages." D.83-09-054, 1983 Cal. PUC LEXIS at *38-39, *75; D.92-12-021, 47 CPUC 2d at 19-20, 28-31. In other words, the CPUC decisions are like the Contracts in that they almost exclusively assume any breach or termination will be something caused by the QF's

wrongful act and will give rise to "minimum damages."

One CPUC decision, however, is particularly revealing of the CPUC's intent if PG&E is the breaching party. Although it was issued well after the Contracts were executed and deals with the final version of what began as the ISO4 contract (the "FSO4"), it shows the CPUC's intent not to require "repayment" if PG&E breaches a front-loaded PPA contract:

> Utilities exercising their rights to reduce or terminate FSO4 purchase obligations should *not* be entitled to repayment of any levelized capacity payments to the QF before the effective date of the reduction or termination. . . . Requiring repayment by a nondefaulting QF would be unfair and would nullify most of the beneficial effects of allowing this modest amount of front-loading in the first place.

D.92-12-021, 47 CPUC 2d at 35 (emphasis in original). See also id. at 43 (conclusion of law no. 22).

Therefore, both the language of the Contracts themselves and the CPUC materials cited by the parties lead the court to find that the "minimum damages" under Section E-11 do not apply where PG&E is the breaching party. Based on the court's previous findings, PG&E is the breaching party.[10]

As a final argument, PG&E claims that the Contracts are divisible into "firm capacity" and "energy" contracts, which must be considered separately with respect to any alleged breach. See generally 10 Cal. Jur. 3d Contracts § 310 at nn. 48-50 and accompanying text (divisibility of contracts). The short answer

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[10] As with the Contracts themselves, the CPUC's extensive writings on the subject simply do not contemplate or deal with the possibility of a breach by the utility. They only address breaches by a QF.

to this argument is that PG&E has not explained how considering the Contracts in separate, divisible parts would lead to any different result. If PG&E succeeded in treating Section E-11 as part of a separate "firm capacity" contract, it still would have breached that contract by failing to pay SPI the "firm capacity" portion of the $18 million default, and by failing to give adequate assurances that it would perform its duties in paying for that "firm capacity" in future. PG&E's failure to pay that portion, approximately $675,000 over four months, is also a material breach of its firm capacity payment obligations.

For the foregoing reasons, the court hereby grants SPI's Motion. SPI has not asked the court to determine the amount of damages to which it is entitled, nor has it asked the court to preclude PG&E from asserting any setoffs it might have entirely separate and apart from Section E-11 of the Contracts. Those issues will have to be decided in further proceedings or by agreement of the parties.

The court will conduct a further status conference in this adversary proceeding on October 29, 2001 at 1:30 P.M.

Within 15 days counsel for SPI should present a proposed form of order consistent with the foregoing, and should comply with B.L.R. 9022-1 and 9022-2.

Dated: September 21, 2001

/s/_____
Dennis Montali
United States Bankruptcy Judge