Pacific Gas and Electric Company
Gas Procurement Department
77 Beale Street, B5F
San Francisco, CA 94105

April 13, 2005

VIA ELECTRONIC MAIL

El Paso Natural Gas Company
Post Office Box 1087
Colorado Springs, CO 80944
Attention: Sean Kolassa

Re: Contract Restructuring

Dear Mr. Kolassa:

As you know, Pacific Gas and Electric Company ("PG&E") and El Paso Natural Gas Company ("El Paso") have been engaged in discussions regarding a possible extension of PG&E's existing firm service transportation arrangements at a discount below El Paso's full tariff rate. In this letter, we explain why we think El Paso should be willing to grant a discount to PG&E under the market circumstances we face in California. In fact, we think the case for a discount is very strong.

PG&E procures large volumes of natural gas for resale to our retail core gas customers in northern and central California. PG&E maintains gas transportation service agreements with various Canadian and interstate pipeline companies in order to transport gas supplies into PG&E's service area.

On April 30, 2005, the largest firm transportation service contract between PG&E and El Paso will expire (Contract 9Q7P). However, PG&E desires to replace all of its existing El Paso transportation agreements. After careful consideration of market conditions and evaluation of potential alternatives, PG&E agreed to restructure its existing El Paso contracts to reflect our needs and the market value for such capacity.

PG&E is not interested in renewing its El Paso Waha receipt capacity because gas supplies delivered at the Waha receipt point or from the Permian Basin are not competitive with other available sources in PG&E's market area. For instance, Waha gas supplies typically trade at prices up to 20 cents per MMBtu higher than supplies from the San Juan Basin. Furthermore, the value of released Waha to PG&E Topock capacity is essentially zero most of the year, yielding no benefits to PG&E's gas customers.

The proposed terms for the restructured contracts are shown in Table I, below. Contracts I, II and III replace PG&E's existing Transportation Service Agreements 9Q7P, 9R2C and 9NK7.

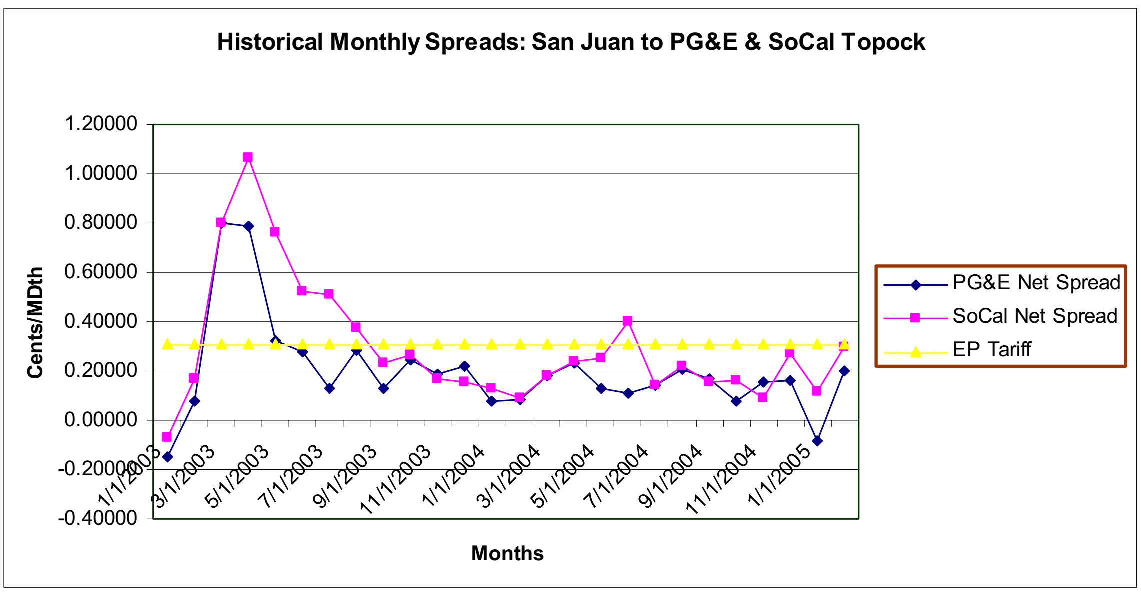
Table I El Paso – PG&E Restructured Transportation Service Agreements

	End Date	Contract Length (yrs)	Average Volume (MDth/Day)	Reservation Rates
Contract I	4-30-07	2	25	$0.255
Contract II	4-30-08	3	90	$0.270
Contract III	4-30-10	5	85	$0.280
			200	

Historical and Forward Monthly Price Spreads

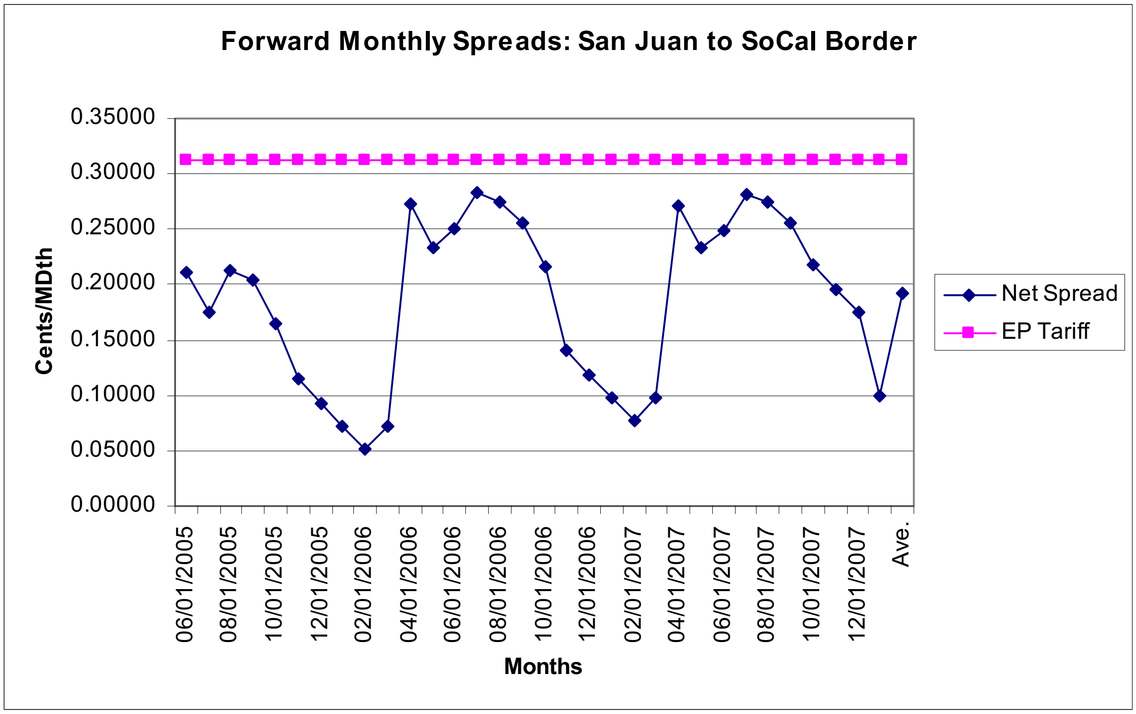
In evaluating whether to renew PG&E's Contract 9Q7P firm transportation service arrangement with El Paso, PG&E evaluated historical and forward market indicators, as well as a several competitive alternatives that were available to us at the time we started negotiating this new arrangement. As the data below indicate, recent San Juan to PG&E Topock historical price differentials have trended, with few exceptions, below El Paso's maximum California tariff rate, indicative of the lower value established by the market for such capacity.

Table II Historical Monthly Price Spreads



Perhaps even more significantly, forward monthly price quotations available to PG&E during the negotiation period were significantly below San Juan commodity prices plus El Paso's maximum rate to the Southern California border. Furthermore, Topock commodity gas transactions typically trade at discounts to the Southern California border, indicating that the market value of El Paso's northern pipeline system from San Juan to Topock is less than the market value of El Paso capacity to Southern California. Because of the numerous alternatives available for serving the PG&E service area, including the proposed development of LNG terminals on the West Coast as early as 2008, PG&E expects that the forward spreads for Topock will continue to trade below El Paso's maximum tariff rate for longer than the term of the proposed agreements.

Table III Forward Spreads



Geographic Advantage

PG&E's California pipeline system is uniquely positioned geographically to benefit from vigorous gas supply and interstate pipeline competition. PG&E is directly interconnected with four interstate natural gas pipelines, which access all the major producing basins in western North America, and we also have access to substantial natural gas storage capacity here in California. For our purposes, the increment of our retail gas load that we intend serve via the El Paso capacity we will hold under these new contracts could be served by any of these numerous transportation or storage alternatives, or by various combinations of them.

Therefore, PG&E is well positioned to receive competitive transportation offers. As part of PG&E's capacity evaluation process, PG&E actively sought alternatives to renewal with El Paso. For competitive reasons, PG&E is not at liberty to disclose to El Paso the terms of any proposal or the contents of any discussions we had with other transportation providers. But we can state that because of market conditions and transportation alternatives we considered at the onset of our negotiations, PG&E would not have agreed to enter into negotiations to extend the largest El Paso transportation contract 9Q7P, which expires on April 30, 2005, absent El Paso's willingness to restructure all three of our existing El Paso contracts at the new discounted reservation rates agreed to by El Paso and the elimination of Waha receipt capacity.

Other Considerations

PG&E also views the terms and conditions of the recently concluded arrangement between Southern California Gas Company (SoCalGas) and Transwestern Pipeline Company (Transwestern), specifying discounted reservation rates and a commitment by Transwestern to lower its fuel rate from San Juan to California. These discounts provide further evidence that the transportation services offered by U.S. Southwest pipelines is subject to significant pipeline to pipeline competition.

Conclusion

PG&E believes that the proposed restructured transportation agreements with El Paso are consistent with market conditions and comparable to PG&E's alternatives as discussed herein. Moreover, this arrangement will be subject to an Open Season and competitive bidding by other prospective shippers, which will serve as a further test of market value for this capacity.

Finally, the review and approval of this transportation arrangement by the California Public Utilities Commission, which we anticipate receiving before contract execution, will provide further confirmation that PG&E gave appropriate consideration to all competitive alternatives.

We look forward to continuing to do business with El Paso.

Sincerely,

TRISTA BERKOVITZ
Director, Gas Procurement