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**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re:)	
)	
Calpine Corporation, <u>et al.</u> ,)	Chapter 11
)	
Debtors.)	Case No. 05-60200 (BRL)
)	Jointly Administered
)	

**NOTICE OF MOTION OF THE DEBTORS FOR ENTRY OF AN ORDER
AUTHORIZING THE IMPLEMENTATION OF
THE CALPINE INCENTIVE PROGRAM**

PLEASE TAKE NOTICE that a hearing (the "Hearing") for the above motion (the "Motion") will be held before the Honorable Burton R. Lifland, United States Bankruptcy Judge, on **April 26, 2006 at 10:00 a.m. (EST)**, or as soon thereafter as counsel may be heard, United States Bankruptcy Court for the Southern District of New York, One Bowling Green, New York, New York 10004, to consider the Motion.

PLEASE TAKE FURTHER NOTICE that you need not appear at the Hearing if you do not object to the relief requested in the Motion.

PLEASE TAKE FURTHER NOTICE that the Hearing may be continued or adjourned from time to time without further notice other than an announcement of the adjourned date or dates at the Hearing or at a subsequent hearing.

PLEASE TAKE FURTHER NOTICE that the Motion may be examined and inspected by interested parties between the hours of 9:00 a.m. and 4:30 p.m. (Prevailing Eastern Time), during the days when the Court is in session, at the offices of the Clerk of the Bankruptcy Court, United States Bankruptcy Court for the Southern District of New York, One Bowling Green, New York, New York 10004-1408, or viewed online at <http://www.nysb.uscourts.gov>.

PLEASE TAKE FURTHER NOTICE that objections, if any, to the relief requested in the Motion must comply with the Federal Rules of Bankruptcy Procedure and the Local Rules of the United States Bankruptcy Court for the Southern District of New York, must be set forth in a writing describing the basis therefor and must be filed with the Court electronically in accordance with General Orders M-182 and M-193 by registered users of the Court's electronic case filing system (the User's Manual for the Electronic Case Filing System can be found at www.nysb.uscourts.gov, the official website of the Bankruptcy Court) and, by all other parties in interest, on a 3-1/2 inch disk, preferably in Portable Document Format (PDF), Word Perfect or any other Windows-based word processing format (with a hard copy delivered directly to Chambers) and served in accordance with General Order M-182 or by first-class mail upon each of the following: (i) the Office of the United States Trustee for the Southern District of New York, 33 Whitehall Street, 21st Floor, New York, New York 10004, Attn: Paul K. Schwartzberg, Esq.; (ii) attorneys for the Debtors, Kirkland & Ellis LLP, Attn: Matthew A. Cantor, Esq.; (iii) attorneys for the Official Committee of Unsecured Creditors, Akin Gump Strauss Hauer & Feld LLP, 590 Madison Avenue, New York, New York 10022-2524, Attn: Philip Dublin, Esq.; and (iv) all other entities set forth in the Debtors' Master Service List established pursuant to that certain Order Establishing Notice Procedures in the Debtors' chapter

11 cases, dated so as to be received no later than **5:00 p.m. (EST) on April 21, 2006.**

Dated: April 6, 2006
New York, New York

Respectfully submitted,

/s/ Richard M. Cieri

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**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re:)	
)	
)	Chapter 11
Calpine Corporation, <u>et al.</u> ,)	
)	Case No. 05-60200 (BRL)
Debtors.)	Jointly Administered
)	

**DEBTORS' MOTION FOR AN ORDER AUTHORIZING
THE IMPLEMENTATION OF THE CALPINE INCENTIVE PROGRAM**

The above-captioned debtors hereby move the Court for entry of an order, substantially in the form attached hereto as **Exhibit A**, authorizing the implementation of the Calpine Incentive Program. In support of this Motion, the Debtors respectfully state as follows:

Introduction

The Debtors seek the Court's authorization to implement the Calpine Incentive Program that provides market-based compensation opportunities for select members of Debtors' workforce. The purpose of the Calpine Incentive Program is to return the overall compensation opportunity for certain of Calpine's key employees to market-competitive levels in order to ensure the continued effective job performance necessary for Debtors' ongoing business operations and successful reorganization—and to do so in a way that not only preserves but

enhances the value of Debtors' estate. The proposed Calpine Incentive Program accomplishes these dual goals and will yield positive results for Calpine, its employees, and the estates.

Jurisdiction

The Court has jurisdiction over this matter pursuant to 28 U.S.C. § 1334. This matter is a core proceeding within the meaning of 28 U.S.C. § 157 (b)(2). Further, venue is proper pursuant to 28 U.S.C. §§ 1408 and 1409.

The statutory predicates for the relief requested herein are sections 105(a), 363(b), and 503(c)(3) of the Bankruptcy Code, 11 U.S.C. §§ 101-1330, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCA").

Background

Calpine Corporation and its direct and indirect subsidiaries (collectively, "Calpine"), is involved in the development, construction, ownership and operation of power generation facilities and the sale of electricity and its by-product, thermal energy, primarily in the form of steam, predominantly in North America. Calpine is committed to providing clean, efficient, cost-competitive electricity to its customers and operates the largest fleet of natural gas-fired power plants in North America. Presently, Calpine generates nearly 27,000 megawatts of electricity -- enough to meet the needs of almost 27 million households. In addition, Calpine has ownership interests in, and operates, geothermal steam fields and geothermal power generation facilities. Calpine operates 19 geothermal power plants at The Geysers region of Northern California, generating up to 750 megawatts of renewable "green" power or nearly 40% of the geothermal energy in the United States, making Calpine the largest producer of geothermal energy in North America.

On December 20, 2005, the Debtors filed their voluntary petitions for relief (the "Chapter 11 Cases") under chapter 11 of the Bankruptcy Code. The Debtors are operating their businesses

and managing their properties as debtors-in-possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. On January 6, 2006, the United States Trustee appointed an official committee of unsecured creditors pursuant to section 1102 of the Bankruptcy Code (the “Committee”). No trustee or examiner has been appointed in these Chapter 11 Cases.

Calpine filed voluntary petitions to restructure under Chapter 11 of the U.S. Bankruptcy Code in order to allow continued operations at its power plants and facilities in the U.S., Canada, and Mexico, strengthen its balance sheet, protect its assets, and enhance the value of its business.

In 2004 and 2005, Calpine was ranked a Fortune 250 company. The Debtors’ Chapter 11 Cases comprise one of the ten largest reorganizations in history. The Debtors’ operations are spread throughout 21 states of the United States and three provinces in Canada. Moreover, the Debtors’ organizational and capital structure is unusually large and complex. There are over 270 Debtors, with many more affiliated non-debtor entities. The relationships among these hundreds of Debtors and between the Debtors and third-parties are governed by thousands of executory contracts, including power contracts subject to Federal Energy Regulatory Commission jurisdiction that raise novel legal issues. As of December 31, 2004, the Debtors’ total consolidated funded debt was approximately \$18.0 billion, consisting of multiple layers of secured and unsecured project and parent-level debt financings. The Debtors also have issued various forms of equity and preferred securities at various levels of the capital structure. In turn, the debt and equity are held by literally thousands of separate creditors and equity holders, making any effort to accomplish a consensual restructuring more laborious and time consuming. For example, there are multiple ad hoc committees in addition to the Official Committee, not to speak of the countless creditors that have decided to represent their interests independently, adding evermore layers of complexity to these Chapter 11 Cases.

Since commencing the Chapter 11 Cases just over three months ago, the Debtors have implemented first day relief, secured post-petition financing, successfully addressed a myriad of complex operational and legal issues, developed a close working relationship with the major creditor groups and other constituencies and commenced the massive process of restructuring their overall operations and finances. Indeed, Debtors have already reduced their pre-petition workforce by more than 10% with further announced reductions to be implemented in phases that will ultimately reduce Debtors' workforce from a pre-petition headcount of 3,208 to 2,025 by the completion of the restructuring process.

Requested Relief

The Debtors seek authority to implement the Calpine Incentive Program (the "Program") that consists of four components:

- a. the Emergence Incentive Plan ("EIP");
- b. the Management Incentive Plan ("MIP");
- c. the Supplemental Bonus Plan ("SBP"); and
- d. the Discretionary Bonus Plan ("DBP").

The Program should be approved because it is the product of the Debtors' sound business judgment and is justified by the facts and circumstances of the Debtors' case. Moreover, the Program, while developed by Debtors, is the product of extensive negotiation with the Committee and as proposed herein has the full support of the Committee. The Program has been carefully structured to balance the need to motivate and provide appropriate market-competitive compensation to Debtors' workforce, while at the same time ensuring that the estate receives enhanced value in exchange for payments under the Program—the result being a net win for all. The core components of the Program—the Emergence Incentive and Management Incentive

Plans—demand the achievement of specific reorganization objectives (aimed at headcount reduction, cost-cutting, cash-flow improvement, and transaction goals), or demonstrable increases in the adjusted enterprise value of Calpine before payments will be made. By linking increased compensation opportunity to enhanced value for the estate, the Program successfully and fairly aligns the interests of Calpine, its employees, and its creditors.

I. THE CALPINE INCENTIVE PROGRAM

A. The Debtors' Need For The Calpine Incentive Program

Preserving and enhancing the value of the Debtors' estates depends on maintaining the focus, morale and loyalty of Calpine's workforce through the provision of market-competitive compensation. Many of the employees have developed valuable institutional knowledge regarding the Debtors' commercial operations, plant operations and relationships with the Debtors' counterparties, customers, vendors, regulators and advisors—relationships that are critical to the Debtors' successful operations.

Likewise, a large portion of Debtors' workforce holds highly skilled and critical industry-specific positions, including high-level operators and technicians who are highly desired and marketable to competitors and energy traders and transmission employees who possess significant industry and critical skills necessary to run Debtors' day-to-day businesses. The successful management of the Debtors' ongoing business activities depends on maintaining a consistent, focused and enthusiastic effort by these employees and others.

Calpine's abrupt entry into Chapter 11 and current financial situation has raised substantial, real concerns for Debtors' employees including the overall reduction in competitive compensation opportunities as a result of the suspension of Debtors' pre-petition bonus programs, the lack of any long-term incentive, and the possibility of a sale, merger, or reduction in force resulting in a loss of employment. Employees' concerns are further exacerbated by

management's efforts to begin to control costs and implement workforce reductions even at this early stage of these Chapter 11 Cases. Indeed, the Debtors have already eliminated approximately 10% of the pre-petition workforce.

Debtors' employees are currently without any incentive compensation opportunity because Calpine lacks an approved bonus program for 2006 and beyond. As a result, based on analyses performed by Watson Wyatt, in the absence of approval and implementation of the Calpine Incentive Program proposed herein, average compensation for Debtors' employees is, at all levels, considerably *below market*—ranging from 71% below market at the executive vice president level to 22% below market for all other employees below the manager level.¹

The impact of a below market compensation opportunity does not fall solely on the shoulders of Debtors' employees. Where, as here, employees had available to them market competitive bonus opportunities and similar compensation incentives pre-petition, the absence of these compensation components during the period of reorganization has reduced employees' overall compensation substantially and increased the likelihood of—at best—employee distraction and, consequently, reduced efficiency and productivity and—at worst—uncontrolled attrition. Indeed, since December 31, 2005, approximately 186 of Debtors' employees—including several members of senior management—have chosen to leave the company, representing an increase of 372% over the rate of attrition for the same period last year. In addition, at least three new hires have been “no shows” as a result of the bankruptcy filing.

¹ The Watson Wyatt analysis excludes compensation for Debtors' CEO and CFO/CRO who are not included in the proposed Calpine Incentive Program, but do have a separate emergence incentive opportunity.

Costs to Calpine associated with recruiting and training replacement employees in critical or skilled positions can easily equal as much as one year's salary per employee.

Calpine must implement programs now to motivate and attract executives and other employees who possess unique or critical knowledge of the businesses. It is critical that Calpine properly motivate those employees who will be formulating and implementing the initiatives necessary for the Debtors to accomplish their financial and operational goals during the Chapter 11 Cases. Likewise, the institutional knowledge and operations skills possessed by Debtors' workforce, which cannot be replaced readily on the open market, are necessary not only to maintain ongoing operations, but also to assure successful completion of the restructuring. Debtors need the support and commitment of these employees to stabilize their operations, initiate their business plan to return to profitability, and put themselves in a position to grow for the future.

The Calpine Incentive Program is designed to address the concerns of Debtors' employees as well as its creditors and to align the interests of these respective constituencies. The Program will foster increased employee morale and provide motivation to the employees to focus on and work towards the reorganization of Calpine by returning workforce compensation to market-competitive levels. This is particularly necessary because the compensation opportunity for Debtors' employees will otherwise remain substantially below market if the Calpine Incentive Program is not implemented. Further, the employees are intimately familiar with the Debtors' businesses, and their enthusiasm and experience is critical for the efficient management of the Debtors' continuing operations and the achievement of restructuring goals.

At the same time, the Debtors are mindful of the financial constraints under which they operate and the interests of the estate's creditors. Therefore, the core components of the Calpine

Incentive Program—the Emergence Incentive Plan and Management Incentive Plan—have been carefully tailored (through market benchmarking analyses) to avoid unnecessary or excessive incentive payments and have been designed to tie rewards to the achievement of two goals, both of which directly benefit the estate and its creditors: enhancing the adjusted enterprise value of Debtors’ estate and meeting defined restructuring objectives. Further, the Program in general is calculated to provide awards commensurate with the value that each employee contributes to Debtors’ ongoing operations and the success of these Chapter 11 Cases.

B. Development Of The Calpine Incentive Program

To assist with the development of the Emergence Incentive Plan and the Management Incentive Plan, the Debtors retained Watson Wyatt Worldwide, a leading global human resources consulting firm. Watson Wyatt specializes in the design of employee and executive compensation and incentive programs. Watson Wyatt has access to a wealth of market compensation data, including data specific to companies in Chapter 11 proceedings, and has substantial expertise in designing such programs for companies in the midst of restructuring or bankruptcy.

Together, the Debtors and Watson Wyatt analyzed the need for and merits of the EIP and MIP and designed them with three principles in mind: they must be (a) market-based, (b) performance-linked, and (c) cost-effective. Debtors and Watson Wyatt first sought to ensure that compensation is based on market-to-market comparisons, considering comparable employers as well as typical chapter 11 practice. To guide the design, the Debtors and Watson Wyatt conducted a comprehensive review of incentive-based programs implemented in other large chapter 11 cases. The Debtors and Watson Wyatt designed the EIP and MIP to be comparable in design and scope with the programs implemented in those cases.

Second, Debtors and Watson Wyatt designed a compensation structure that creates value in Debtors' estate and meets the requirements of BAPCA by requiring a high-level of performance from participants tied to critical reorganization goals and which does not reward employees solely for continued employment.

The vast majority of the cost of the proposed Calpine Incentive Program relates to the core plans described above—the Emergence Incentive Plan and the Management Incentive Plan. While discussing these plans with the Committee, various changes were proposed, negotiated, and agreed upon—the net effect of which resulted in a more modest Emergence Incentive Plan and Management Incentive Plan than originally put forth by Debtors. At the same time, continuing developments in the course of Debtors' ongoing operations and restructuring efforts, including additional workforce reductions, made clear the need for additional compensation plans both to provide a minimal amount of flexibility in remunerating employees in situations not contemplated by the formal EIP and MIP and to address the under-compensation of employees positions critical to Debtors' ongoing operations. Accordingly, Debtors proposed to the Committee, and negotiated the terms of, two additional plans—the Supplemental Bonus Plan, applicable only for 2006, and the Discretionary Bonus Plan, a limited fund which allows for flexibility in awarding relatively modest lump-sum payments on an ad hoc basis. Both plans have been thoroughly vetted and approved by the Committee and are described in greater detail below.

After negotiations between Debtors' management and the Committee regarding the Program had concluded, and the Committee indicated its support for each of the plans that make up the Calpine Incentive Program, Debtors presented to the Program to the Compensation

Committee of the Board of Directors for review and consideration. After discussion, the Compensation Committee approved the Calpine Incentive Program on April 4, 2006.

C. Description Of The Calpine Incentive Program

The proposed Calpine Incentive Program consists of four components: the “Emergence Incentive Plan,” the “Management Incentive Plan,” the “Supplemental Bonus Plan,” and the “Discretionary Bonus Plan.” The Debtors, assisted in part by Watson Wyatt, arrived at these proposed plans after lengthy consideration of a number of alternative designs for incentive compensation programs and consultation with various constituencies in these cases. The plans that make up the Calpine Incentive Program proposed herein have the full support of the Committee.

1. The Emergence Incentive Plan

The Emergence Incentive Plan provides cash awards—payable only at emergence—to selected senior employees in the positions most capable of influencing the success of Debtors’ ongoing business and reorganization efforts. The purpose of the EIP is to provide a compelling and market-competitive cash incentive designed to encourage key management personnel to maximize the value of the enterprise while working toward a successful reorganization of Debtors’ business. The plan is specifically geared toward rewarding those employees who will devote their energies, knowledge, and creativity to consummating a successful plan of reorganization.

There are three principal benefits of the EIP. *First*, the plan is simple in concept and administration. The structure of the EIP mirrors that of the incentive opportunities jointly developed by Calpine and the Committee for Debtors’ chief executive officer and chief financial officer. *Second*, the structure of the EIP motivates eligible employees to increase Debtors’ enterprise value—directly benefiting all stakeholders—by tying EIP award level to value

creation. Compensation for eligible employees increases proportionate to the value created for Debtors and their creditors. Thus, the financial interests of Calpine, creditors and core management are aligned. *Third*, the EIP is designed to provide a market-competitive long-term compensation opportunity for eligible employees. Accordingly, compensation levels for eligible employees are in line with long-term equity and cash-based opportunities at comparable institutions.

The Debtors have identified approximately 20 senior employees, which includes primarily executive vice presidents and a select group of senior vice presidents, who will be eligible to participate in the Emergence Incentive Plan.² These employees were selected because of their unique ability to influence and directly contribute to the success of the reorganization and creation of value in Debtors' estate.

The Emergence Incentive Plan provides for a variable cash award contingent upon the achievement of certain performance metrics. These cash payments will not be made until Debtors' emergence from Chapter 11 and will be distributed among eligible employees at the discretion of the chief executive officer.³

The Emergence Incentive Plan consists of an incentive pool created according to adjusted enterprise value ("AEV"). AEV is defined as Total Enterprise Value, as set forth in a confirmed Plan of Reorganization, less the book value of all project debt (including notes payable, capital

² The EIP does not include the CEO or CFO/CRO who have separate emergence incentive opportunities based on similar performance metrics.

³ Employees who terminate their employment voluntarily will not be eligible for any payment under the Emergence Incentive Plan. If (i) the employee's employment is terminated involuntarily (and not for cause), (ii) the employee's business unit is sold prior to emergence or (iii) the employee dies or becomes disabled, then he or she would remain eligible for payment under the plan. Such payments, however, would be deferred until active participants receive their payment.

leases, project loans, and project-level preferred interests). AEV targets shall be adjusted for any asset sales that are completed during the pendency of the Chapter 11 Cases. The Emergence Incentive Plan begins with an incentive pool of \$5.45 million earned for the successful consummation of a plan of reorganization *and* a threshold AEV of at least \$5.0 billion—a substantial achievement given Debtors’ current financial condition. Thus, no incentive pool is created unless an AEV of \$5.0 billion is attained. At the same time, as shown below, exceptional performance by Debtors’ management team is compensated with commensurate increases to the incentive pool. As AEV increases beyond \$5.0 billion, so does the size of the incentive pool—there is an increase of \$285,000 for each incremental increase of \$100 million to AEV.

To arrive at the proposed incentive pool amounts, Debtors, in consultation with the Committee, assumed a target AEV of \$8.0 billion and calculated a target total incentive opportunity for participants from which the incremental pool values were determined for both increasing and decreasing potential AEV. The total incentive pool of \$14 million at an AEV of \$8.0 billion was determined by examining the base salaries for the selected EVP and SVP participants and calculating an incentive pool equivalent to 80% of SVP salaries and 150% of EVP salaries for a two-year period.

The EIP is reasonable and within market practice with respect to the potential levels of awards to senior management. To ensure the reasonableness of the EIP, Watson Wyatt performed two analyses—the first to benchmark the level of potential EIP compensation on a per employee basis and the second to benchmark the overall potential cost of the plan to Debtors. Based on data available to Watson Wyatt, the potential EIP opportunity is within the range of market competitive practice for long-term incentive compensation for employees holding comparable positions within comparable organizations. For example, at an AEV of \$5.0

billion—assuming relatively equivalent awards to eligible employees based on their level—the EIP provides an incentive opportunity that approximates 50% of the median competitive long-term compensation opportunity available in the market as benchmarked by Watson Wyatt. Similarly, under the same distribution assumptions, with the incentive pool at levels commensurate with an AEV of \$8.0 billion, awards to eligible employees would approximate the median competitive long-term compensation opportunity as benchmarked by Watson Wyatt.

The EIP is reasonable and within market practice with respect to the potential cost of the program as a function of revenues or total assets. Watson Wyatt analyzed available data regarding both retention and incentive plans approved in other bankruptcy and restructuring cases involving companies with revenues in excess of \$4.5 billion. Based on Watson Wyatt’s analyses, the potential aggregate EIP cost is within the range of programs approved in other chapter 11 cases, both when measured as a percentage of annual revenues and when measured as a percentage of total assets.⁴

2. The Management Incentive Plan

The Debtors seek also to implement a Management Incentive Plan for approximately 600 of Debtors’ employees who occupy positions critical to the operation of Calpine’s ongoing business as well as Debtors’ specific reorganization goals. At its core, the MIP will be similar to the traditional bonus programs (the “Bonus Programs”) utilized by the Debtors pre-petition. The Management Incentive Plan will consist of awards as described below to be paid for performance

⁴ While separate from the EIP, Debtors have proposed for the CEO and CFO/CRO similar individual incentive opportunities. In performing its analyses, Watson Wyatt compared the total cost of Debtors’ potential emergence incentive payments (including both the EIP and the incentive opportunities for Debtors’ CEO and CFO/CRO) to the cost of retention and incentive programs approved for other companies in bankruptcy or restructuring because those programs generally included the companies’ chief executive and chief financial officers.

for the calendar year 2006 and beyond. Like the EIP, the Management Incentive Plan is also self-funded—meaning MIP payments will only be made under this plan to the extent that performance objectives set by the Debtors (in consultation with the Committee) are actually achieved.

The MIP is designed to achieve two goals. *First*, the plan creates value by motivating employees to work effectively and expeditiously to achieve critical short term operational and financial goals—both of which advance the interests of creditors and the estate in a timely emergence from restructuring. Thus, the MIP meets the goal of aligning the interests of Calpine, its creditors, and its employees so that success is shared by all. *Second*, the plan provides market-competitive compensation opportunities for participants that are consistent with Calpine’s historical practices while tempered by the financial constraints under which Calpine operates. Market-competitive compensation helps achieve the goal of preserving a critical asset of the Debtors—their human capital—by promoting employee loyalty and morale and militating against attrition.

Pre-petition, Debtors administered a host of bonus programs both on a company-wide and business-unit basis, each with its own eligibility criteria and method for calculating awards. The MIP is designed to replace all of Debtors’ pre-petition programs with one unified program that is streamlined for ease of administration and focused on reorganization objectives. Unlike the MIP, Debtors’ pre-petition bonus programs had the following interrelated components:

(1) *Pre-petition Management Incentive Program*

The Pre-petition Management Incentive Program was the primary Bonus Program utilized by the Debtors to reward employees for their contribution to the achievement of predetermined corporate business objectives. All non-union employees working for the Debtors, other than those employees eligible for the O&M Bonus (defined below), were eligible for

participation in the program.⁵ The bonus pool was determined by comparing the target bonus pool based on projected performance goals to the actual performance of Calpine. Individual bonuses were then based upon (a) the size of the bonus pool; (b) the employee's position, level of responsibility and market practices associated with that position; (c) the employee's individual contribution to corporate goal attainment; and (d) the employee's individual job performance. The Debtors paid \$21.5 million in bonuses under the program in March 2005 for the calendar year 2004. The Debtors did not pay, and are not seeking approval to pay, bonuses pursuant to the former Management Incentive Program for performance for the calendar year 2005.

(2) *Calpine Corporation Operation and Maintenance Hourly Bonus Plan*

The Calpine Corporation Operations and Maintenance Hourly Bonus Plan (the "O&M Bonus") was an annual bonus available to certain employees based upon achievement of certain facility goals. Awards were dependent upon plant performance targets as set by the plant manager at each location, as approved by the Compensation Committee. The Debtors paid approximately \$6.6 million in March 2005 for the O&M Bonuses for the calendar year 2004. The Debtors did not pay, and are not seeking approval to pay, bonuses pursuant to the O&M Bonus plan for performance for the calendar year 2005.

(3) *Calpine Construction Completion Bonus Plan*

The Debtors offered certain business units within Calpine the opportunity to set incentives and award bonuses based on various construction completion projects (the "Construction Completion Bonuses"). All construction site employees that had contributed to

⁵ Construction site employees were eligible for the MIP in years where no Construction Completion Bonuses (as defined herein) are awarded.

the successful construction project were eligible for a Construction Completion Bonus. In years that Construction Completion Bonuses were not awarded, the employees otherwise eligible were permitted to participate in the pre-petition Management Incentive Program. The Debtors did not pay, and are not seeking approval to pay, bonuses pursuant to the Construction Completion Bonus plan in 2005.

(4) *Calpine Merchant Services Incentive Plan*

The Calpine Merchant Services Incentive Plan (the “CMSIP”) was a bonus program offered exclusively to “line function” employees of Calpine Merchant Services, LP (“CMSC”). The Debtors paid \$9.8 million in March 2005 under the CMSIP for the calendar year 2004. The Debtors did not pay, and are not seeking approval to pay, bonuses pursuant to the CMSIP bonus plan for performance for the calendar year 2005.

(5) *Marketing & Sales Incentive Plan*

The Debtors permitted certain business units within Calpine to provide additional compensation under the Marketing and Sales Incentive Plan (the “MSIP”), which rewarded employees for value created based on certain stated measures associated with the volume of power sale contracts procured both individually and as a business unit. The Debtors paid \$2.6 million under the MSIP for 2004. The Debtors did not pay, and are not seeking approval to pay, bonuses pursuant to the MSIP for performance for the calendar year 2005.

* * *

In the place of Debtors’ pre-petition Bonus Programs, Debtors have proposed the MIP. Instead of the multiple Bonus Programs addressed above, select employees will participate in a single bonus plan, although the performance measures and bonus allocation will vary relative to the individual employee’s role within Calpine and contribution to the reorganization.

In contrast to Debtors' pre-petition Bonus Programs—which looked at calendar year goals and performance—the Short Term Incentive Program will measure performance in separate six-month performance periods. The change is designed to minimize difficulty in forecasting goals and defining performance measures. Each eligible employee's bonus opportunity for a performance period will equal one-half of his or her pre-petition annual bonus opportunity.⁶ In general, expressed as a percentage of salary, the MIP target awards for employees at various levels are as follows: executive vice president (100%), senior vice president (40%), vice president (30%), director (25%), and certain managers (20%).

The first performance period will run from January 1, 2006 to June 30, 2006. During this period, performance will be measured relative to four goals: (a) delivery of a Business Plan to the Board of Directors by June 1, 2006; (b) achievement of a target-adjusted cash flow that is calculated as an improvement to the DIP budget; (c) achievement of specific headcount reductions and cost-cutting goals; and (d) the achievement of a working capital target.⁷

The second performance period would run from July 1, 2006 to December 31, 2006. The performance measures for this period will be set forth in the Business Plan required to be

⁶ If maximum performance goals are attained, participants are eligible to receive 110% of their target MIP award. Likewise, if minimum performance goals are attained, participants are eligible to receive 90% of their target MIP award.

⁷ For employees with responsibility related to the delivery of the Business Plan, MIP awards will be weighted according to achievement of specific goals as follows: 34% for delivery of a Business Plan by June 1, 2006; 33% for meeting cash flow goals; and 33% for achieving headcount reduction and cost-cutting goals. For Calpine Energy Services employees, MIP awards will be allotted 34% for achievement of the working capital target; 33% for meeting cash flow goals; and 33% for achieving headcount reduction and cost-cutting goals. For employees working on a specific transaction, 100% of their MIP award will be based on achievement of the transaction-specific goals. In addition, these employees may receive award payments sooner than the six-month performance period distribution date depending on the date on which a transaction closes. All other employees' MIP awards will be allocated 50% for the achievement of cash flow goals and 50% for meeting headcount reduction and cost-cutting goals.

delivered to the Board of Directors prior to the end of the first performance period. These six-month performance periods will continue while the Debtors remain in chapter 11.

Payments under the MIP will only be made if performance objectives are achieved. Assuming that performance objectives are met, employees at the level of director and below will receive their awards in the form of semi-annual payments—one-third of the award will be paid mid-year and the remaining two-thirds as soon as practical after year-end results. For employees at the vice president level and above, payments of any MIP award earned will be made once annually as soon as practical after year-end results. Employees selected for participation must be employed on the date of payment to receive any portion of their award. The Debtors estimate that, if performance targets are met, the proposed Management Incentive Plan will cost approximately \$23.5 million for 2006.⁸

As with the EIP, Watson Wyatt analyzed available market data to assess the reasonableness of the MIP in comparison to market-competitive compensation opportunities for Calpine's employees. For employees at the director level and above (the group for which Watson Wyatt possessed market data), the MIP opportunity for each employee level was within the range of competitive practice. Thus, the EIP is reasonable and within market practice with respect to the potential levels of award to Debtors' employees.

3. The Supplemental Bonus Plan

The Supplemental Bonus Plan has been designed to address the immediate potential for the loss of key human capital in functions that are critical to Debtors' ongoing business and which are highly mobile in the market. Under the SBP, persons identified by Debtors' as

⁸ Debtors estimate an equivalent expense for 2007.

performing a critical function and being at significant risk of being hired away from the company will be provided with a supplemental cash award. Only employees at the level of vice president and below are eligible for participation in the SBP. None of the persons selected for participation in the SBP will be “insiders” of the Debtors.

Payment of the SBP award will be made in two equal installments—the first installment upon Court approval of the plan and the second at year-end. Employees selected for participation must be employed on the date of payment to receive the award. Any recipient of a SBP award who voluntarily terminates his or her employment before the second installment at year-end forfeits the right to the second installment payment and must refund a pro rata portion of the first installment payment. The aggregate cost of the Supplemental Bonus Plan is \$6 million.

4. The Discretionary Bonus Plan

The final component of the Calpine Incentive Program is the Discretionary Bonus Plan. Under this plan, a pool in the amount of \$500,000 will be created annually from which individual bonus payments of no more than \$25,000 per employee, per year, may be awarded at the sole discretion of Debtors’ chief executive officer. Only employees at the level of director and below will be eligible for discretionary bonus payments. The purpose of the plan is to allow Debtors flexibility to reward employees when necessary to deal with isolated issues that inevitably arise during the restructuring period and which are not accounted for in the more formal and structured incentive programs proposed herein. Both the size of the requested fund and the limitation on individual employee awards evidence a measured approach by Debtors to the creation of this flexible ad hoc bonus plan.

D. Basis For The Requested Relief

The Debtors seek authority pursuant to sections 363(b) and 503(c)(3) of the Bankruptcy Code to implement the Calpine Incentive Program.

As recently amended by the BAPCA, section 503(c) restricts transfers or payments by debtors to the extent that such payments are both outside the ordinary course. While transfers to employees are covered, the predominate focus of the amendments to section 503(c) is on payments made to “insiders” of the debtor(s). However, section 503(c) was not intended to foreclose a chapter 11 debtor from reasonably compensating employees, including “insiders,” for their contribution to the Debtors’ reorganization, precisely Debtors’ goal here in structuring the Calpine Incentive Program.

Instead, the amended section 503(c) restricts payments and other transfers in three ways. First, section 503(c)(1) limits payments to “insiders” to the extent such payments are made “for the purpose of inducing such person to remain with the debtor’s business.” Second, section 503(c)(2) places restrictions on “severance payments” to “insiders.” Third, section 503(c)(3) limits payments made to management and employees, among others, made outside of the ordinary course unless such payments are shown to be justified under the facts and circumstances of the chapter 11 case.

Neither section 503(c)(1) nor 503(c)(2) is applicable here because the proposed Calpine Incentive Program does not include retention payments to “insiders” or severance payments of any kind. Even to the extent proposed payments pursuant to the Emergence Incentive Plan and the Management Incentive Plan will be made to persons who may qualify as “insiders,” those awards are not “retention” payments that are restricted under section 503(c)(1) because they are not provided “for the purpose of inducing [the insiders] to remain” with Debtors’ business. Rather, both the EIP and MIP are incentive programs that reward employees for performance

tied directly to critical restructuring related goals for the purpose of creating value in the Debtors' estate and do not provide compensation for mere continued employment—the hallmark of a “retention” program. Likewise, even if the Court were to determine that awards under the Supplemental Bonus Plan or Discretionary Bonus Plan were made “for the purpose of inducing such person to remain with the [Debtors'] business[,]” section 503(c)(1) does not prohibit such transfers unless made to “insiders.” No SBP or DBP award will be made to an “insider” of the Debtors, so section 503(c)(1) is not applicable.

Similarly, section 503(c)(2) is not applicable because the proposed awards under any of the four plans that make up the Calpine Incentive Program are not “severance payments” made to compensate employees who have lost their jobs.

Instead, section 503(c)(3) governs. The transfers and payments proposed herein, certain of which may be characterized as out of the ordinary course, are justified by the facts and circumstances in this case, and therefore meet the standard of section 503(c)(3). Employee morale, focus, and performance, much of which may have been adversely impacted by the chapter 11 filing, are critical to the ongoing success and reorganization of Calpine. Human capital is Calpine's most valuable resource, and the importance of preserving and enhancing the value of this resource cannot be overstated.

As set forth above in Section I.A, the Calpine Incentive Program has been carefully designed to address the concerns of Debtors' employees as well as its creditors and to align the interests of these respective constituencies. Indeed, the Program was thoroughly vetted and approved by the Committee before Debtors filed this Motion requesting approval the Court's authorization to implement the Program. Through a return to appropriate market-level compensation for select members of Debtors' workforce, the Program will foster increased

employee morale and provide motivation to those employees to focus on and work towards the reorganization of Calpine. At the same time, the Calpine Incentive Program is tailored to avoid unnecessary or excessive incentive payments by linking rewards to the achievement of goals that directly benefit the estate and its creditors.

Moreover, section 363 of the Code provides further support for the approval of the Emergence Incentive Plan and Management Incentive Plan. Section 363(b) provides, in relevant part, that “the trustee, after notice and a hearing, may use, . . . other than in the ordinary course of business, property of the estate.” 11 U.S.C. § 363(b)(1). A court has the statutory authority to authorize a debtor to use property of the estate pursuant to section 363(b)(1) when such use is an exercise of the debtor’s sound business judgment and is proposed in good faith. In re Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983); see also Fulton State Bank v. Schipper, 933 F.2d 513, 515 (7th Cir. 1991) (a debtor’s decision must be supported by “some articulated business justification”); Stephen Indus., Inc. v. McClung, 789 F.2d 386, 390 (6th Cir. 1986) (adopting the “sound business purpose” standard for sales proposed pursuant to section 363(b)); In re Montgomery Ward Holding Corp., 242 B.R. 147, 153 (Bankr. D. Del. 1999); In re Ernst Home Center, Inc., 209 B.R. 974, 979 (Bankr. W.D. Wash. 1997); In re Delaware & Hudson Ry. Co., 124 B.R. 169, 176 (D. Del. 1991).

Under section 363(b), a debtor has the burden to establish it has a valid business purpose for using estate property outside the ordinary course of business. Lionel Corp., 722 F.2d at 1070-71. Once the debtor has articulated such a valid business purpose, however, a presumption arises that the debtor’s decision was made on an informed basis, in good faith, and in the honest belief that the action was in the debtor’s best interest. In re Integrated Resources, Inc., 147 B.R. 650, 656 (S.D.N.Y. 1992). A party in interest seeking to challenge the debtor’s valid business

purpose must “produce some evidence supporting its objections.” Montgomery Ward, 242 B.R. at 155.

When key employees are an essential component of the debtor’s continued operations, this has been generally sufficient to meet the legal standard for approval of the reorganization incentive program. See In re America West Airlines, Inc., 171 B.R. 674, 678 (Bankr. D. Ariz. 1994) (approving the award of “success bonuses” to certain officers and employees as within a debtor’s sound business judgment); In re Interco Inc., 128 B.R. 229, 234 (Bankr. E. D. Mo. 1991) (approving performance-based program). Bankruptcy courts have been directed to “exercise great deference in reviewing a corporation’s decision to pay its employees.” In re Crystal Apparel, 207 B.R. 406, 410 (S.D.N.Y. 1997) (holding that “golden parachute” employment contracts may constitute transactions undertaken in the ordinary course of business). In this regard, courts have clearly articulated “that section 363(c)(1) [of the Bankruptcy Code] authorizes a debtor to provide for employee compensation in routine situations.” In re Enron Corp., 2003 WL 1562202 at 18 (Bankr. S.D.N.Y. March 21, 2003).

Implementing the Calpine Incentive Program has a sound business purpose—preserving and maximizing the value of the Debtors’ estates and motivating the covered employees to perform at optimal levels during the pendency of the Chapter 11 Cases. Debtors’ employees are experienced and talented business people who are intimately familiar with the Debtors’ businesses. Debtors’ success or failure in consummating a plan of reorganization, and maximizing value for creditors, hinges on the efforts of the Debtors’ employees. To maintain a cohesive and motivated management team during a bankruptcy process, debtors frequently implement various combinations of compensation programs. Without such programs, essential

employees may not be motivated to perform at their highest levels if they perceive that the benefits from such performance are negligible.

The Calpine Incentive Program is designed to provide incentives sufficient to (a) motivate the employees and (b) maximize the value of the Debtors' estates. At the same time, keeping in mind the financial constraints under which the Debtors operate, these plans have been carefully structured to avoid unnecessary or excessive expenditure. In light of the foregoing, the Debtors believe that the incentives proposed herein are reasonable and appropriate and that the requested approval of the Program will allow the Debtors to motivate employees to maximize the value of the Debtors' estates. The approval of the Calpine Incentive Program is therefore in the best interest of the Debtors, their creditors and other parties in interest.

Memorandum of Law

This Motion includes citations to the applicable authorities and a discussion of their application to this Motion. Accordingly, the Debtors respectfully submit that such citations and discussion satisfy the requirement that the Debtors submit a separate memorandum of law in support of this Motion pursuant to Rule 9013-1 of the Local Bankruptcy Rules for the Southern District of New York.

Notice

Notice of this Motion has been provided to: (a) the United States Trustee for the Southern District of New York; (b) counsel to the administrative agents for the Debtors' prepetition secured lenders; (c) counsel to the ad hoc committees; (d) counsel to the Committee; and (e) the 2002 notice parties. In light of the nature of the relief requested herein, the Debtors submit that no other or further notice is required. A copy of the Motion is also available on the website of the Debtors' notice and claims agent, Kurtzman Carson Consultants LLC, at <http://www.kccllc.net/calpine>.

No Prior Request

No prior motion for the relief requested herein has been made to this or any other court.

Conclusion

WHEREFORE, the Debtors respectfully request an entry of an order, substantially in the form attached hereto as Exhibit A, (a) authorizing the implementation of the Calpine Incentive Program and (b) granting such other further relief as is just and proper.

Dated: April 6, 2006
New York, New York

Respectfully submitted,

/s/ Richard M. Cieri
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Matthew A. Cantor (MC 7727)
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Counsel for the Debtors

EXHIBIT A

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re:)	
)	
Calpine Corporation, <u>et al.</u> ,)	Chapter 11
)	
Debtors.)	Case No. 05-60200 (BRL)
)	Jointly Administered
)	

**ORDER AUTHORIZING
THE IMPLEMENTATION OF THE CALPINE INCENTIVE PROGRAM**

Upon the motion (the “Motion”)¹ of the above-captioned debtors (collectively, the “Debtors”) for entry of an order authorizing the implementation of the Calpine Incentive Program and granting other related relief; it appearing that the relief requested is in the best interest of the Debtors’ estates, their creditors and other parties in interest; it appearing that the Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334; it appearing that this proceeding is a core proceeding pursuant to 28 U.S.C. § 157(b)(2); it appearing that venue of this proceeding and this Motion in this District is proper pursuant to 28 U.S.C. §§ 1408 and 1409; notice of this Motion and the opportunity for a hearing on this Motion were appropriate under the particular circumstances and that no other or further notice need be given; and after due deliberation and sufficient cause appearing therefor, it is hereby ORDERED

1. The Motion is granted in its entirety.

¹ Capitalized terms used but not otherwise defined herein shall have the meanings set forth in the Motion.

2. The Calpine Incentive Program, including the Emergence Incentive Plan, the Management Incentive Plan, the Supplemental Bonus Plan, and the Discretionary Bonus Plan, is approved in all respects.

3. The Debtors are authorized to take all actions necessary to effectuate the relief granted pursuant to this Order in accordance with the Motion.

4. The terms and conditions of this Order shall be immediately effective and enforceable upon its entry.

5. The requirement set forth in Rule 9013-1(b) of the Local Bankruptcy Rules for the Southern District of New York that any motion or other request for relief be accompanied by a memorandum of law is hereby deemed satisfied by the contents of the Motion or otherwise waived.

6. The Court retains jurisdiction with respect to all matters arising from or related to the implementation of this Order.

Dated: _____, 2006

UNITED STATES BANKRUPTCY JUDGE