Hearing Date: April 26, 2006 at 10:00 a.m. (EST)

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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

DEBTORS' REPLY IN SUPPORT OF THEIR MOTION FOR AN ORDER AUTHORIZING THE IMPLEMENTATION OF THE CALPINE INCENTIVE PROGRAM

I. INTRODUCTION

On April 6, 2006 the above-captioned debtors ("Calpine" and, collectively, the "Debtors") moved the Court for entry of an order authorizing the implementation of the Calpine Incentive Program, consisting of the Emergence Incentive Plan ("EIP"), the Management Incentive Plan ("MIP"), the Supplemental Bonus Plan ("SBP") and the Discretionary Bonus Plan ("DBP") (the "Motion"). The proposed Calpine Incentive Program remains unchanged from the description set forth in the April 6, 2006 Motion with one exception. Based on the continuing discussions the Debtors have had with interested parties, as well as Debtors' continuing review of the Calpine Incentive Program, Debtors have incorporated

a new calculation of Adjusted Enterprise Value into the EIP portion of the Calpine Incentive Program.

Like the CEO and CFO/CRO Employment Agreements, the EIP relies upon triggers keyed to AEV in determining whether incentive compensation is awarded. The EIP applies to twenty select senior employees and aligns the most senior management's incentives with the CEO and CFO/CRO's incentive compensation opportunities. The change to the method of calculating AEV reflects a more objective measure of value by incorporating the post-emergence market value of Calpine's securities, among other things. The revised definition is:

> AEV shall be equal to:
>
> 1. The market value of corporate-level debt (i.e., non-project level debt);
> 2. plus the market value of preferred equity;
> 3. minus cash (other than any cash held by companies with project-level debt) on the balance sheet of any of the reorganized companies upon the consummation date;
> 4. plus the market value of Calpine's common stock (and any other equity-linked securities including warrants) excluding non-vested equity (including options) issued as part of the management incentive compensation pursuant to a Plan of Reorganization.
>
> All market prices shall be calculated beginning on the 60th trading day following the consummation date and for the following ten (10) trading days. Prices for debt and preferred equity shall be calculated as an average price based on AdvantageData (ADI quote), Factset, Markit Loans (LoanX) and Bloomberg. Volume weighted-average prices for common equity shall be determined by reference to Bloomberg's AQR function.
>
> AEV shall be further adjusted for the exclusion of any corporate level debt used to refinance project level debt.

With that one adjustment to the EIP, the Calpine Incentive Program will be presented to the Court for approval on April 26, 2006.

II. RESPONSE TO OBJECTIONS

The Motion is not without objection. Alan Ku, an individual and former employee of Calpine, filed an Objection on April 21, 2006. *See* Docket No. 1311, Objection of Alan Ku, Individual Shareholder of Calpine Corporation, To Debtors' Motion for an Order Authorizing

the Implementation of the Calpine Incentive Program. ("Ku Objection"). Mr. Ku objects to the EIP and MIP portions of the Calpine Incentive Program,[1] asserting:

1) the Calpine Incentive Program does not comply with sound exercise of Debtors' business judgment, (Ku Objection at 4-5); and
2) the Calpine Incentive Program violates the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), (Ku Objection at 5-6).

Neither of Mr. Ku's Objections have merit. Calpine's Motion should be granted.

A. The Calpine Incentive Program Represents A Proper Exercise of Debtors' Business Judgment.

Debtors' Motion details the purpose and justifications of the two components of the Calpine Incentive Program at issue. Motion at 5-18. Debtors' Motion also details the process relied upon in calculating, discussing, negotiating, and ultimately approving the Calpine Incentive Programs. Motion at 8-10. In addition, Debtors retained outside expert compensation consultants to benchmark the compensation provided by the EIP and MIP provisions. Motion at 8-10. Faced with details of both the process and the substance of the Debtors' decision to implement the Calpine Incentive Program, Mr. Ku argues that the EIP "may well constitute no more than an unmerited gift to a few select insiders"[2] and that the Calpine Incentive Program is not "proven by the empirical departures." Ku Objection at 5, 6.

Mr. Ku, as a party in interest seeking to challenge the debtor's valid business purpose must "produce some evidence supporting [his] objections." *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 155 (Bankr. D. Del. 1999). Mr. Ku fails to provide any evidence and the

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1 Mr. Ku objects to the EIP and MIP, but does not object to the provisions of the SBP or DBP. Those portions of the plan are not at issue and not discussed in this Reply Brief. This Court should approve the SBP and DBP provisions for the unrefuted reasons in Debtors' Motion. Motion at 18-23.

2 Mr. Ku also asserts that the AEV calculation was potentially not related to increases in value or improvements to Debtors' estate. Given the changes in calculating the AEV, changes fully approved by the Committee as well as the First and Second Liens, Mr. Ku's objection on this ground is moot.

extent of his argument is that he questions the underlying validity of the business purpose and the accuracy of the empirical justifications. Ku Objection at 5, 6. Simple second-guessing of the Debtors' justifications and business purpose is not sufficient to challenge the exercise of Debtors' business judgment. This Court should find that the Calpine Incentive Program is proper exercise of Debtors' business judgment and is supported by the Motion.

B. The Emergence Incentive Program and the Management Incentive Program Are Properly Analyzed Under 503(c)(3) and Permissible Under BAPCPA.

The Calpine Incentive Program provides compensation opportunities to employees based on increases in the value of the Company, not based on retention or simply staying employed at Calpine. No employee will be entitled to incentive compensation simply for remaining with the Debtors through the bankruptcy period. Instead, under the EIP and the MIP, certain thresholds must be met before ***any*** incentive compensation is provided. The EIP incentive pool is keyed to the AEV calculations – the higher the AEV, the greater the incentive compensation. At the same time, if the threshold AEV is not met, then no EIP incentive is paid. Motion at 11. Likewise, the MIP threshold includes a gateway determination based on Debtors' cash flow as well as individual performance targets for each participant in the MIP. If the threshold targeted cash flow is not met, then MIP incentive is not paid. Under the statutory language of section 503(c), the Calpine Incentive Program is neither a retention nor a severance program and is properly analyzed under section 503(c)(3).

Similar to the CEO and CFO/CRO Employment Agreements, Judge Walrath's recent analysis in *In re Nobex Corporation* interpreting section 503(c) is applicable here. *See* Exhibit A, transcript from *In re Nobex Corporation*, Case No. 05-20050, (Bankr. Delaware, January 12, 2006) (Judge Walrath presiding). In confirming that a plan for incentive compensation was not a retention plan, Judge Walrath stated, "it is clear from the structure of this plan that it is not a

retention plan. It is not providing payment to the employees or senior management solely for being retained, staying on the job. In fact, they can stay on the job all they want if the criteria are not me[t]. That is, the sale does not produce sufficient funds, they will not get anything." *In re Nobex Corporation* Ex. A at 87. Likewise, participants in the EIP and MIP do not receive any of the incentive compensation simply for staying with Calpine. If the thresholds of each program are not met, then no employee receives additional compensation under the EIP and MIP.

Under the statutory language of section 503(c), the arguments presented in the Motion and Judge Walrath's analysis in *In re Nobex Corporation*, it is clear that the portions of the Calpine Incentive Program challenged by Mr. Ku as impermissible under section 503(c)(1) should be analyzed under section 503(c)(3). Further, under section 503(c)(3) this Court should approve those challenged provisions of the Calpine Incentive Program as Mr. Ku does not argue that the EIP and MIP are impermissible under 503(c)(3).

III. THERE IS NO JUSTIFICATION FOR ADJOURNMENT OF THIS HEARING.

Mr. Ku requests, in the alternative, that this Court adjourn the hearing for some indeterminate time until an equity committee may be formed and provided the opportunity to object. There are two flaws with Mr. Ku's position. First, there is no guarantee when an equity committee may be formed, or that one will be formed at all. While it is possible that such a committee will be created, this chapter 11 case has been proceeding for four months without one. Deferring resolution of this Motion, or any other, pending the hypothetical appointment of an equity committee will needlessly delay the expeditious reorganization of the Debtors and, therefore, will not benefit any interested party.

Second, and more importantly, Mr. Ku has already made known his objections to the Calpine Incentive Program. Thus, no good reason exists for the Court to delay consideration of the Motion and resolution of the objections made by Mr. Ku.

IV. CONCLUSION

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

Dated: April 25, 2006
New York, New York

Respectfully submitted,

/s/ Richard M. Cieri

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Counsel for the Debtors

EXHIBIT A

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

IN RE:	.	Case No. 05-20050
	.	
	.	
NOBEX CORPORATION,	.	
	.	824 Market Street
	.	Wilmington, Delaware 19801
Debtor.	.	
	.	January 12, 2006
. . . . .	.	2:05 p.m.

TRANSCRIPT OF HEARING
BEFORE HONORABLE MARY F. WALRATH, CHIEF JUDGE
UNITED STATES BANKRUPTCY COURT JUDGE

APPEARANCES:

For the Debtor:	Morris, Nichols, Arsht & Tunnell By: DEREK C. ABBOTT, ESQ. ALICIA B. DAVIS, ESQ. 1201 North Market Street P.O. Box 1347 Wilmington, DE 19899 Moore & Van Allen PLLC By: W. B. HAWFIELD, JR., ESQ. DOUGLAS R. GHIDINA, ESQ. 100 North Tryon Street Suite 4700 Charlotte, NC 28202
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For the U.S. Trustee:	Office of the U.S. Trustee By: DAVID BUCHBINDER, ESQ. J. Caleb Boggs Federal Building 844 King Street, Suite 2313 Lockbox 35 Wilmington, DE 19801
For Creditors Committee:	Blank Rome LLP By: DAVID CARICKHOFF, ESQ. Chase Manhattan Centre 1201 Market Street, Suite 800 Wilmington, DE 19801
For Elan Pharma International Limited:	Flaster, Greenberg By: WILLIAM J. BURNETT, ESQ. 913 N. Market Street, Suite 1001 Wilmington, DE 19801 Dechert LLP By: CRAIG MARTIN, ESQ. Cira Centre 2929 Arch Street Philadelphia, PA 19104
For the Founders Group:	Klehr, Harrison, Harvey, Branzburg & Ellers LLP By: STEVEN K. KORTANEK, ESQ. Mellon Bank Center 919 Market Street, Suite 1000 Wilmington, DE 19801

I N D E X

WITNESSES:	Direct	Cross	Redirect	Recross	Further Redirect
Charles Dimmler	20	41 45 56	44	44	59

EXHIBITS:		MARKED	RECEIVED
For the Debtor:			
D-1	Chart	20	

THE COURT: And you are satisfied with the structure?

MR. CARICKHOFF: Yes, we are, Your Honor.

THE COURT: Thank you.

Well, let me first deal with the legal issue raised by the United States Trustee's objection. I guess I can agree with everybody that the language is not that clear, but this is my take on it.

I agree with the debtor that (c)(1) was meant to impose specific standards and criteria for a retention program. (c)(2) was meant to provide similar guidance with respect to a severance program. And (c)(3) was meant to provide a standard, albeit not as clear, for any other transfers or obligations outside the ordinary course of business.

I agree that the including transfers made to officers, managers or consultants hired after the petition date is not exclusive. That's clear from other provisions in the Bankruptcy Code.

So I do read (c)(3) to be the catch-all and the standard under (c)(3) for any transfers or obligations made outside the ordinary course of business are those that are justified by the facts and circumstances of the case. Nothing more -- no further guidance being provided to the Court by Congress, I find it quite frankly nothing more than a reiteration of the standard under 363 and -- well, 363 under which courts had previously authorized transfers outside the

ordinary course of business and that is, based on the business judgement of the debtor, the court always considered the facts and circumstances of the case to determine whether it was justified. And I'll do the same in this case.

I think in this case it is clear that from structure of the plan that this is not a retention plan. It is not providing payment to the employees or senior management solely for being retained, staying on the job. In fact, they can stay on the job all they want if the criteria are not meant. That is, the sale does not produce sufficient funds, they will not get anything.

Similarly, they can leave the day after the sale and get the incentive if in fact the sale produces more than the minimums required under this. So I see it as not a retention plan and therefore not subject to the (c)(1) strictures.

The question is whether or not, based on the evidence that was presented, whether this incentive plan or the transfers contemplated by it are justified by the facts and circumstances of the case. And I think that burden has been met here.

I do place great weight in the fact that the plan has been presented and negotiated with the creditors committee, who, as well as the debtor, has a fiduciary duty to all creditors, but has a particular interest in assuring that general unsecured creditors get some recovery.

I think it's significant that the plan provides no incentive or no payment for simply achieving a sale already contemplated by the stalking horse bid. And I think providing such would not have been justified under the circumstances of this case since that bid is already in hand.

I think it is designed to assure that senior management and the marketing team go above and beyond the -- what they are required to do as fiduciaries. Gives them an incentive to come up with additional recoveries for the general unsecured creditors. And in that sense, I think it is reasonable.

With respect to whether or not the numbers meet some standard, I've always found it hard to compare incentive plans in the context of a bankruptcy case with those articulated often by expert witnesses as to what is generally set. I think each case is fact specific and the parties with the best knowledge of the facts that are relevant are the debtor and the committee. And to the extent, the committee has felt that this is a reasonable percentage to take out of their recovery to give an incentive to management to potentially increase that recovery, I will accept as justified.

That said, I don't think given the suggested example that if somebody had come in and suggested 30 percent, I would have looked at that as scants. But even that percentage may be justified in the circumstances of a case and I would hear the

presentation on that. But I'm satisfied that what has been presented is justified under the circumstances of this case and I will approve it.

MR. ABBOTT: Thank you, Your Honor. May I have a moment to confer with my colleagues about a form of order?

THE COURT: All right.

(Pause/counsel confer.)

MR. ABBOTT: Your Honor, we had debated with the committee to some extent on the form of an order. I'd like to -- we had contemplated further tinkering with it. I'm inclined to just hand up the order. Your Honor's explanation of the ruling on the record I think is probably adequate.

(Pause/counsel confer.)

MR. ABBOTT: Your Honor, perhaps --

THE COURT: You want to take a five minute recess? Or --

MR. ABBOTT: Yes, Your Honor. Thank you.

THE COURT: All right. And you had handed me one order. I don't know what you want.

So, let's take a recess.

(Recess)

THE CLERK: You may be seated.

MR. ABBOTT: Thank you, Your Honor, for that time. It's been a long day for all of us. We are going to revise our order in accordance with the committee's comments, circulate it

EXHIBIT B

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	)	
	)	Chapter 11
Calpine Corporation, et al.,	)	
	)	Case No. 05-60200 (BRL)
Debtors.	)	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 as set forth herein.

2. The Calpine Incentive Program, as set forth on **Exhibit 1** attached hereto, including the Emergence Incentive Plan, the Management Incentive Plan, the Supplemental Bonus Plan, and the Discretionary Bonus Plan, is approved in all respects.

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

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

EXHIBIT 1

THE CALPINE INCENTIVE PROGRAM

The Calpine Incentive Program consists of four separate programs: (1) the Emergence Incentive Plan; (2) the Management Incentive Plan; (3) the Supplemental Bonus Plan and (4) the Discretionary Bonus Plan. These four programs are set forth below.

1. The Emergence Incentive Plan

   a. The Emergence Incentive Plan provides cash awards payable at emergence to selected senior employees. Approximately 20 senior employees have been selected for participation in the Emergence Incentive Plan, which includes primarily executive vice presidents and a select group of senior vice presidents.

   b. 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. 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.

   c. The Emergence Incentive Plan consists of an incentive pool created according to adjusted enterprise value ("AEV").[1] The Emergence

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[1] Debtors' definition of AEV is as follows:

AEV shall be equal to:

1. The market value of corporate-level debt (i.e., non-project level debt);
2. plus the market value of preferred equity;
3. minus cash (other than any cash held by companies with project-level debt) on the balance sheet of any of the reorganized companies upon the consummation date;
4. plus the market value of Calpine's common stock (and any other equity-linked securities including warrants) excluding non-vested equity (including options) issued as part of the management incentive compensation pursuant to a Plan of Reorganization.

All market prices shall be calculated beginning on the 60th trading day following the consummation date and for the following ten (10) trading days. Prices for debt and preferred equity shall be calculated as an average price based on AdvantageData (ADI quote), Factset, Markit Loans (LoanX) and Bloomberg. Volume weighted-average prices for common equity shall be determined by reference to Bloomberg's AQR function.

AEV shall be further adjusted for the exclusion of any corporate level debt used to refinance project level debt.

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. The incentive pool will be increased by $285,000 for each incremental increase of $100 million to AEV above $5.0 billion.

2. The Management Incentive Plan

a. The Management Incentive Plan provides the opportunity for a bonus award 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. The Management Incentive Plan will consist of awards as described below to be paid for performance for the calendar year 2006 and beyond.

b. The Management Incentive Plan will measure performance in separate six-month performance periods. Each eligible employee's bonus opportunity for a performance period will equal one-half of his or her pre-petition annual bonus opportunity.[2] In general, expressed as a percentage of salary, the Management Incentive Plan 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%).

c. The first performance period will run from January 1, 2006 to June 30, 2006. The second performance period would run from July 1, 2006 to December 31, 2006. Performance will be measured relative to goals established by the Debtors in consultation with the various creditor constituencies in these cases.

d. Payments under the Management Incentive Plan 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 Management Incentive Plan 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.

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[2] If maximum performance goals are attained, participants are eligible to receive 110% of their target Management Incentive Plan award. Likewise, if minimum performance goals are attained, participants are eligible to receive 90% of their target Management Incentive Plan award.

3. The Supplemental Bonus Plan

a. Under the Supplemental Bonus Plan, applicable only for 2006, persons identified by Debtors as 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 Supplemental Bonus Plan. None of the persons selected for participation in the Supplemental Bonus Plan will be "insiders" of the Debtors.

b. Payment of the Supplemental Bonus Plan 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 Supplemental Bonus Plan 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 pool available for Supplemental Bonus payments is $6 million.

4. The Discretionary Bonus Plan

a. Under the Discretionary Bonus 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.