

DEPARTMENT OF WATER RESOURCES

California Energy Resources Scheduling
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August 10, 2001

President Loretta Lynch
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, California 94102

Chief Administrative Law Judge Lynn Carew
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, California 94102

RE: Applications 00-11-038; 00-11-056; 00-10-028; Draft Rate Agreement
between DWR and CPUC

Dear President Lynch and Chief ALJ Carew:

The Department of Water Resources (the "Department") respectfully requests that the Assigned Commissioner and the Assigned Administrative Law Judge accept into the record of the above referenced proceedings the facts and comments contained the attached letter (and its attachments) from the Department regarding the Draft Rate Agreement by and between the Department and the California Public Utilities Commission ("Commission"). In the Assigned Commissioner's Ruling Regarding the Draft Rate Agreement Between the Commission and the California Department of Water Resources of July 18, 2001, comments on the draft Rate Agreement were requested for submission on or before August 1, 2001. The letter primarily addresses the requirements of the financial community to successfully market the bonds that will finance the power purchases called for by AB1X. As further described in the attached letter, the necessity of the Rate Agreement to this financial structure was firmly established in meetings which concluded on August 3, 2001, after comments were scheduled to be submitted. The acceptance of this information will not prejudice any party but will serve the public's interest in assuring that the Commission's decision will be informed by the fullest available set of facts.

The Department thanks you for your consideration of this request.

Sincerely,

A handwritten signature in black ink, appearing to read "Raymond D. Hart".

Raymond D. Hart
Deputy Director

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Pursuant to Sections 80110 and 80130, the Department requests that the Commission approve, execute and deliver the Rate Agreement in the form published, and to determine that the Rate Agreement shall have the force and effect of a financing order.

As we have discussed with Commission staff and counsel to the Commission in the course of negotiations concerning the Rate Agreement over the last several months, the Rate Agreement will play a critical role with respect to the Department's ability to carry out the power supply program specified in Division 27 of the Water Code, and to operate effectively in both the power procurement markets and the capital markets. In particular, adoption of the Rate Agreement is necessary for the Department to sell and issue the bonds (the "Bonds") to finance a portion of the costs of the power being purchased by the Department ("DWR Power") for the retail end use customers ("Customers") of Pacific Gas & Electric Company, Southern California Edison Company and San Diego Gas & Electric Company (collectively, the "IOUs"). The Bonds are to be revenue bonds, payable from the revenues and other moneys on deposit in the Electric Power Fund (the "Fund") established by the Act. Neither the faith and credit nor the taxing power of the State will be pledged for the payment of debt service on the Bonds. No source of payment other than the Fund will be obligated for the payment of the Bonds. As a result, Bondholders and the providers of any credit enhancement for the Bonds will necessarily rely on the availability, adequacy and timeliness of the flow of revenues to the Fund.

Representatives of the Department met with each of the major rating agencies at the end of last week to discuss the contemplated financing structure, as well as with potential providers of bond insurance and other market participants. Those discussions affirmed the view that we conveyed in the extensive discussions with Commission staff and counsel to the Commission regarding the Rate Agreement that the Rate Agreement would be an essential component of the financing. In particular, our meetings with these market participants have made clear that it will be necessary to have specific enforceable commitments by the Commission and the Department as to the timing of rate adjustments in order to obtain necessary ratings and to successfully market the Bonds. The reasons are briefly discussed below. Unless these commitments can be provided, the ability of the Department to continue to operate effectively, at the lowest cost to ratepayers, and to issue the Bonds will be jeopardized.

The structure of the financing relies on the fact that the Department's revenues for the power purchase program will be derived from the sale of DWR Power by the Department to Customers in accordance with the Act. Such revenues will be used to pay the operating expenses of the Department (including the costs of purchasing the power being sold by the Department), to pay debt service on the Bonds (and related expenses) and to establish cash flow, operating and debt service reserves. Customer payments for DWR Power are to be determined on the basis of charges ("Department

Charges") imposed upon Customers for DWR Power. Department Charges are to be determined by the Commission pursuant to the Act and the Rate Agreement in amounts sufficient for the Department to recover its revenue requirements. . As a result, retail customers will receive the benefit of any operating "surplus" which may arise. The Rate Agreement will establish the terms upon which the Department will advise the Commission of its revenue requirements and upon which the Commission will calculate and impose Department Charges from time to time. Consequently, the Rate Agreement plays an essential role in assuring the availability, adequacy and timeliness of the revenues needed to buy power, pay other Department expenses and pay debt service on the Bonds.

It is important to note that, balances in the Electric Power Fund at the end of any year will be taken into account by the Department in determining the revenue requirement for subsequent years

In connection with the preparation of the disclosure and marketing materials related to the sale of the Bonds, a cash flow model is being prepared that will estimate and project, among other things, the amount of DWR Power to be delivered to Customers each month, the amount of Customer payments collected and remitted to the Department each month, the amounts expended each month by the Department (including for debt service on the Bonds), and the resulting balance in the Fund each month. The objective of preparing the cash flow model is to demonstrate that the amounts available in the Fund from time to time will be sufficient to pay all of the Department's obligations, including debt service on the Bonds, and to maintain appropriate reserves and cash flow "coverage". The cash flow model will also be used to evaluate the results of certain scenarios known as "stress tests", in which certain of the assumptions concerning the costs and revenues of the Department are modified to determine the impact of certain problem events (such as a dramatic increase in loads or costs) on the availability, adequacy and timeliness of revenues to satisfy the Department's obligations.

The assumptions built into the cash flow model and the stress tests are tied directly to the provisions of the Rate Agreement that specify the obligations of the Department with respect to advising the Commission of its revenue requirements, and the obligations of the Commission with respect to calculating and imposing Department Charges, and the relative timing of each of those actions under various circumstances. The results of the cash flow modeling and the stress tests will be carefully evaluated by the credit rating agencies, potential credit enhancement providers and potential purchasers of the Bonds to determine whether, for example, under various possible scenarios, Department Charges can, if necessary, be adjusted quickly enough to result in revenues being available on a timely basis to pay all of the Department's obligations without depletion of the Department's reserves.

Consistent with the practice of public power agencies nationally, the Department is contractually obligated to pay expenses for the purchase of power and other related expenses prior to the payment of debt service. As a result it is essential that the Rate Agreement provide for payment of both operating expenses and bond-related costs in order to assure that revenues are available to pay bondholders and avoid a breach of the Department's power purchase contracts.

During the week of July 30th and ending on August 3, the Department had numerous meetings with credit rating agencies, credit enhancement providers and investors. During the course of virtually each of those meetings, those market participants confirmed the critical importance of the Rate Agreement in their deliberations. In particular, it is apparent that the provisions of the Rate Agreement providing for the calculation and imposition of new Department Charges within 30 days following receipt by the Commission of the appropriate documents from the Department will be an essential factor in the determination of the amounts of the various reserves needed to secure the Bonds, and will be a critical element in the deliberations of the credit rating agencies, credit enhancement providers and investors. Those market participants have identified the Rate Agreement as a critical element in concluding that the perceived risks relating to payment of the Bonds are mitigated. The power procurement markets and capital markets impose higher costs for higher levels of perceived risk. As a result, the successful implementation of the financing plan at favorable rates (including obtaining the necessary ratings on the Bonds) and the repayment of the General Fund for advances to buy power will depend directly on the Rate Agreement, as well the other matters before the Commission.

The Rate Agreement in the form published is the product of intense negotiations over several months between the Department and its advisers and Commission staff and counsel to the Commission. As in any successful negotiation, the parties compromised on various points. While the published Rate Agreement does not reflect all of the provisions initially requested by the Department, the Department believes that, in its totality, the Rate Agreement provides the assurances necessary for the sale of the Bonds on favorable terms. Each and every provision of the Rate Agreement in its published form, taken together, form the necessary framework for Department operations and a Bond issuance that minimizes costs to ratepayers in the State.

Execution of the Rate agreement will directly benefit ratepayers in the State. Division 27 of the Water Code provides that all costs of the Department in implementing the power supply program are ultimately paid by ratepayers. Failure of the Commission to approve the Rate Agreement in the form published would materially increase the overall costs of the program that must be recovered from rates.

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It is also important to note that the Rate Agreement will provide assurances to all parties that contract with the Department, including power suppliers, that the Department will have the ability to meet all of its contractual obligations as and when due. Such assurances will help lower the Department's costs and thereby benefit ratepayers.

Please see additional correspondence describing the critical importance of the Rate Agreement.

We greatly appreciate the willingness of the Commission to consider the Rate Agreement at its August 23 meeting. It is essential that the Commission approve and execute the Rate Agreement in the form published as expeditiously as possible in order to permit the Department to implement the financing and achieve the purposes and policies expressed in the Act.

Thank you for your assistance and attention to this important matter.

Sincerely,



Raymond D. Hart
Deputy Director

JPMorgan

Garth Salisbury
Managing Director
Head of Western Region

August 10, 2001

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Thomas Hannigan
Director
California Department of Water Resources
1416 9th Street
Sacramento, CA 95814

Dear Mr. Hannigan:

At the request of the Department of Water Resources (the "Department"), this letter provides the views of JP Morgan regarding the Rate Agreement scheduled for adoption by the California Public Utilities Commission on August 23, 2001.

JP Morgan is the Senior Managing Underwriter for the State of California in connection with the sale of the Department's Power Supply Revenue Bonds (the "Bonds"). In that capacity, over the last several months we have had numerous extended discussions concerning the Department and the Bonds with a wide variety of market participants, including the credit rating agencies, credit enhancement providers, and the investment community. Virtually all of those discussions have demonstrated that adoption of the Rate Agreement is absolutely necessary for the sale of the Bonds at favorable interest rates. We therefore request that the Commission adopt the Rate Agreement in the form published on July 18, 2001.

The Rate Agreement is necessary for a number of reasons. Section 80110 of the Water Code provides that the Department shall be entitled to the recovery of its revenue requirements, and thereby provides the basic security structure for the Bonds. However, given the complexity of the current situation, and the magnitude of the Bond offering, the capital markets will require specific irrevocable contractual assurances that the provisions of Division 27 of the Water Code will be carried out in a timely manner. The Rate Agreement, with its detailed mechanisms relating to the method and timing of the Department's communication of the revenue requirement to the Commission, and the Commission's required actions in response, is the only way to provide those contractual assurances. Unless those contractual assurances are provided, the ability of the Department to obtain the investment grade ratings needed to issue the bonds will be put at risk. This would also jeopardize the ability of the Department to reimburse the General Fund for approximately \$6 billion in outstanding loans.

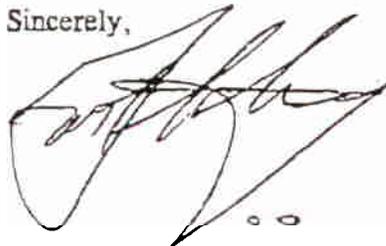
We also acted as lead arranger and book manager in the Department's \$4.3 billion Bridge Loan in June of this year. The anticipated source of repayment for the Bridge Loan is the proceeds of the Bonds. Therefore, in connection with securing ratings on the Department's obligations under the Bridge Loan, the credit rating agencies were required to analyze the security structure for the Bonds, and the likelihood that the Bonds would be issued in the time period contemplated. Each of the credit rating agencies identified the execution of the Rate Agreement as one of the most critical elements necessary for such timely Bond issuance with the investment grade ratings required by state law (Section 80130 of the Water Code).

In our discussions with market participants, a great deal of emphasis was placed on the "cash flow" of the Department, and the mechanisms that allow the Department to react to rapidly changing circumstances which may arise in the future. In order to demonstrate the ability to withstand potential financial stress, the Department must have a clearly articulated procedure for the communication of its revised revenue requirements, as well as an irrevocable commitment of the Commission to respond to any potential revised revenues requirements within a specific time period. The Rate Agreement provides the Department with the mechanism market participants will demand in this respect.

In addition, the existence of a contractual relationship between the Department and the Commission is a critical element for implementing the non-impairment provisions of state law (in Division 27 of the Water Code) that assure prospective purchasers of the Bonds that their right to repayment will not be subject to impairment in the future as a result of changes in law or Commission policy.

In summary, in our view adoption of the Rate Agreement in the form published on July 18, 2001 is absolutely necessary for the sale of the Department's Bonds.

Sincerely,

A handwritten signature in black ink, appearing to be "Mark S. Folson", written over a horizontal line. The signature is stylized and cursive.