February 21, 2002

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

California Department of Water Resources Revenue Requirements

The California Department of Water Resources (the Department) has reviewed the comments submitted in connection with the Department's pending revenue requirement. In response to such comments, we have concluded that the adjustments described below can be made to our pending revenue requirement.

On December 6, 2001, we submitted additional data relating to our November 5, 2001 Determination of Revenue Requirement, including a discussion of certain amounts that the Department was to be billed by the California Independent System Operator (ISO) that were not included in the Department's revenue requirement and certain changes to reflect changes from accrual to cash for revenues and expenses ("leads and lags") calculations for 2002.

We did not adjust our revenue requirements to reflect such matters since they did not in the aggregate materially affect our revenue requirement. It was our intention to reflect the impact of such matters in the next revenue requirement. We did so based upon, among other things, uncertainty as to the time and amount of reimbursement for such ISO-related costs. Based upon our review of the published draft order addressing utility retained generation (URG) (Re: A–00-11-038) we now understand that the California Public Utilities Commission (the Commission) is considering requiring the investor owned utilities to reimburse the Department for a portion of such ISO-related costs during the current revenue requirement period. We believe that is the right result.

If the utilities are so ordered and the Department in fact is reimbursed by the utilities for such ISO-related costs by no later than September 1, 2002, then the Department's revenue requirement for this calendar year as submitted November 5, 2001 can be reduced by an amount equal to $609,000,000 representing those leads and lags adjustments. Since the need to include that amount in the revenue requirement has become contingent on the Commission's decision on the ISO-related costs, the Department agrees that its revenue requirement should be contingently reduced by $609,000,000, provided however, that if the Commission does not, by March 22, 2002 order the utilities to reimburse the Department for these ISO related costs, with such reimbursement to be paid in full on or before September 1, 2002, then the Department's revenue requirement will be automatically adjusted, as of March 22, 2002 to reinstate such $609,000,000. In that event, such amounts will be recovered on such schedule and in such manner as the Commission shall determine in order to allow the Department to recover such costs prior to September 1, 2002.

In calculating its November 5, 2001 revenue requirements the Department also took into account amounts payable as principal and interest on the Department's Interim Loan during the fourth quarter. The Department presently expects to issue bonds for the purpose of repaying such Interim Loan (as well as the General Fund) prior to the time such payments are due. Assuming that this occurs, such payments would not be required. Based upon such expectation and our expectation as to Department expenditures and revenues for the time prior to such payments becoming due, the Department agrees that its revenue requirement should also be contingently reduced by a net amount of $349,000,000, contingent on the sale of the Bonds in advance of the fourth quarter's payments on the Interim Loan. The date on which the Bonds will be sold cannot be determined at this time. In the event that the Bonds are not sold by September 1, 2002, then the revenue requirement for the balance of the current year will again take such principal and interest payments into account and we understand that the charges established by the Commission will be revised by the Commission at such time to reflect the reinstatement of such amount as part of the revenue requirement to the extent necessary to assure that the revenues derived from the Department's charges will be sufficient to provide for all of the Department's revenue requirements as and when due.

These contingent reductions have an effect on the Department's financing projections because of, among other things, the reduced revenues received by the Department prior to the issuance of the bonds. This reduction could result in the need to increase the principal amount of bonds to be issued by as much as $250,000,000 more than the maximum par amount contained in the Summary of Material Terms which we submitted on February 15, 2002. Therefore we are amending the Summary of Material Terms as reflected in Attachment A to this letter. There is only one change in Attachment A: $10,850,000,000 as it appears in paragraph "I" is increased to $11,100,000,000. We note that in accordance with the Summary, the Department will issue no more Bonds than it determines are necessary to repay advances from the General Fund and the Interim Loan, to fund the reserves and accounts as described in the Summary and to pay costs of issuance using all Bond proceeds and all Department Electric Power Fund balances available at the time of issuance of the Bonds. Over the next two weeks, we will be consulting with the Commission with a view to avoiding or reducing any increase in the amount of the Bonds and to consider reflecting a reduction in the authorized material terms, if appropriate.

We understand that the adjustments described above can be implemented within existing overall rates.

We would appreciate these changes being reflected in the decision establishing Department charges in response to our November 5, 2001 revenue requirement submission.

Peter S. Garris
Deputy Director

Attachment

Attachment A

CALIFORNIA DEPARTMENT OF WATER RESOURCES

SUMMARY OF MATERIAL TERMS OF FINANCING DOCUMENTS

(Submitted in connection with Section 7.10 of a proposed Rate Agreement between California Department of Water Resources and the California Public Utilities Commission[1])

I. MAXIMUM AMOUNT OF BONDS AUTHORIZED: The Department will issue no more Bonds than it determines are necessary to repay advances from the General Fund and the Interim Loan, to fund the reserves and accounts as described below and to pay costs of issuance using all Bond proceeds and all Department Electric Power Fund balances available at the time of issuance of the Bonds; provided, however, the maximum aggregate principal amount of Bonds which will be issued will not exceed $11,100,000,000.

II. MATURITY OF BONDS: The Bonds will be issued pursuant to a plan of finance which provides that the final maturity of the series of Bonds with the longest maturity will be no earlier than 19 years from the date of issuance of the first series of Bonds and no later than 21 years from the date of issuance of the first series of Bonds. Such plan of finance will provide that debt service payable on the Bonds will be substantially level, with principal payments commencing no later than 2004. Individual series of bonds issued pursuant to such plan of finance, or individual Bonds of any series, may mature prior to such final maturity date and have different amortization schedules. These maturity dates and amortization requirements do not apply to credit and liquidity facilities, interest rate swap agreements and similar arrangements ancillary to the Bonds.

III. FLOW OF FUNDS:

The Indenture will provide for the establishment of the following primary accounts within the Electric Power Fund:

- Operating Account
- Priority Contract Account
- Operating Reserve Account
- Bond Charge Collection Account
- Bond Charge Payment Account
- Debt Service Reserve Account

Power Charge revenues and Bond Charge revenues will be applied in the manner summarized below. Such revenues will be applied in the order of priority listed.[2]

Power Charge Revenues

Initially deposited in Operating Account. Amounts held in the Operating Account will be applied as follows:

[1] Capitalized terms used but not defined in this Summary have the respective meanings given to those terms in the proposed Rate Agreement.

[2] Where different uses are described with the same number followed by a letter, this indicates that revenues will be applied to such different uses on a parity basis.

1. Transfer to Priority Contract Account, by the fifth business day of each month, an amount such that balance held in that account is at least equal to the Priority Long Term Power Contract costs anticipated for the balance of the month and the first 5 business days of the next following month. If necessary, additional amounts will be transferred to Priority Contract Account as necessary to pay Priority Long Term Power Contract costs. Payment of Priority Long Term Power Contract costs is the sole use of this Account.

2. Pay other operating expenses, except those described in another paragraph.

3. Pay scheduled principal and interest on the Interim Loan, if and to the extent it remains outstanding.

4. Transfer to Bond Charge Collection Account to extent necessary to reimburse that Account for previous transfers from the Bond Charge Collection Account to (1) Priority Contract Account for payment of Priority Long Term Power Contract costs or (2) Operating Account for payment of Interim Loan.

5a. Transfer to Bond Charge Payment Account, if there are insufficient moneys in the Bond Charge Payment Account to pay debt service.
5b. Pay certain Department obligations to be secured on a parity with Bonds such as amounts due to credit or liquidity facility providers or providers of interest rate swaps (hereinafter referred to as "Parity Obligations"), if not paid from Bond Charge Payment Account.
5c. Pay bond trustee and other fiduciary costs, if not paid from Bond Charge Payment Account.

6a. Replenish Debt Service Reserve Account, if required as result of the use of Bond Charge revenues for Priority Long Term Power Contract costs or Interim Loan, or a change in investment value.
6b. Fund and replenish reserves, if any, established for Parity Obligations.

7. Reimburse and pay interest on post-11/15/01 advances, if any, from General Fund if and to the extent they remain outstanding.

8. Reimburse and pay interest, in accordance with a schedule to be approved by the Commission, on pre-11/15/01 advances from General Fund if and to the extent they remain outstanding.

9. Replenish Operating Reserve Account to its requirement.

10. Pay subordinated Department obligations such as certain amounts owed to interest rate swap counterparties in certain circumstances (hereinafter referred to as "Subordinated Obligations") and related reserves if not paid from Bond Charge Payment Account, and subordinated indebtedness and related reserves, if any.

11. Pay other costs incurred by the Department under the Act.

Bond Charge Revenues

Initially deposited in a Bond Charge Collection Account. Amounts in the Bond Charge Collection Account will be applied as follows:

1. Transfer to Priority Contract Account for Priority Long Term Power Contract costs, if not paid from Priority Contract Account, Operating Account or Operating Reserve Account.

2. Transfer to Operating Account for Interim Loan, if not paid from Operating Account or Operating Reserve Account.

3a. Transfer to Bond Charge Payment Account for monthly deposits to provide for Bond debt service three months prior to the date such debt service is due.
3b. Transfer to Bond Charge Payment Account for specified costs incidental to payment and security of Bonds (including credit and liquidity facility costs).
3c. Transfer to Bond Charge Payment Account for trustee and other fiduciary costs.
3d. After Department is no longer selling Power, pay Servicing Agreement costs, administrative costs, and certain other costs incurred by the Department under the Act.

4a. Replenish Debt Service Reserve Account, if not replenished from Operating Account.
4b. Fund and replenish reserves, if any, for Parity Obligations.

5. After Department is no longer selling Power, pay certain costs specified in Rate Agreement that previously had been paid from Power Charge revenues.

Debt Service Reserve Account

1. Moneys in account used to satisfy any deficiency which arises in the Bond Charge Payment Account.

2. Debt Service Reserve Account to be replenished from Power Charge revenues if a deficiency therein results from use of Bond Charge revenues for Priority Long Term Power Contract costs or Interim Loan, or from change in investment value, and from Bond Charges in other cases or if sufficient Power Charge revenues are not available for such purpose.

Operating Reserve Account

1. Moneys in Operating Reserve Account will be used to satisfy any deficiency which arises in Operating Account. Such moneys to be applied in order of priority and for the purposes specified in 1 through 6 under Power Charge Revenues above. A portion of the Operating Reserve Account (the "Priority Contract Contingency Reserve Amount") will be reserved solely for the payment of Priority Long Term Power Contract costs as described below, as the last money in the Operating Reserve Account to be spent.

2. The Operating Reserve Account is to be replenished from Power Charge revenues, after reimbursement, in accordance with a schedule approved by the Commission, of amounts advanced from the General Fund if not previously repaid.

IV. SIZING OR METHODOLOGY FOR SIZING RESERVES, FUND BALANCES AND DEBT SERVICE COVERAGE; INITIAL DEPOSITS:

Reserves, Fund Balances and Coverage

1. Debt Service Reserve Account: A Debt Service Reserve Account requirement will be established in an amount equal to 50% of maximum aggregate annual debt service, determined based on combination of known debt service in the case of fixed rate bonds and assumed rates in the case of variable rate bonds. The size of such Debt Service

Reserve Account requirement may be increased to an amount not greater than 100% of maximum aggregate annual debt service by the Department only if the Department has determined that such increase will not increase the Department's projected net debt service on the Bonds by more than 3.5% as compared to the Department's projected net debt service that would have otherwise been payable if the Debt Service Reserve Account requirement were established at 50% of maximum aggregate annual debt service, taking into account all dependent variables, including the respective ratings of the Bonds.

2. Operating Reserve Account: An Operating Reserve Account requirement will be calculated by the Department prior to the issuance of the first series of Bonds and at the beginning of each revenue requirement period including the Priority Contract Contingency Reserve Amount referred to below. Such requirement is to be equal to the largest aggregate difference between the Department's projected operating expenses and the Department's projected Power Charge revenues during any consecutive seven month period starting during the then current revenue requirement period, taking into account a range of possible future outcomes, but may be increased to an amount not to exceed $1,200,000,000 at the time of issuance of the Bonds. The Priority Contract Contingency Reserve Amount is to be the maximum amount projected to be payable on Priority Long Term Power Contracts in any month during the then current revenue requirement period.

3. Operating Account: The Department will covenant to include in its revenue requirements amounts sufficient to cause a "Minimum Operating Expense Available Balance" to be on deposit in the Operating Account by the first business day of each month. The Minimum Operating Expense Available Balance is to be calculated by the Department at the time of each determination of a revenue requirement and will be an amount equal to the largest projected difference between the Department's projected operating expenses and the Department's projected Power Charge revenues during any one month period during the then current revenue requirement period, taking into account a range of possible future outcomes.

4. Coverage: To provide for coverage of Bond Related Costs, the Department will be required to set aside in the Bond Charge Payment Account, 3 months prior to its payment date, an amount equal to estimated Bond Related Costs, based on assumptions and projections as appropriate, and to determine the Department's revenue requirements submitted to the Commission so that the amount in the Bond Charge Collection Account from time to time is equal to one month's estimated Bond Related Costs, based on assumptions and projections as appropriate. Such deposit requirements may be increased to cover a period of time not in excess of an aggregate of 6 months.

Initial Deposits

Funds are anticipated to be deposited from Bond proceeds or Department balances, upon the issuance of the initial or subsequent series of Bonds, as summarized below.

1. To the Bond Charge Collection Account and Bond Charge Payment Account, amounts necessary to initially satisfy the requirements described in “Coverage” above.

2. To the Bond Charge Payment Account, an amount to fund debt service on Bonds and other Bond Related Costs between the time the Bonds are delivered and the time when the initial Bond Charges are fully in effect and being received in amounts adequate to fund

ongoing debt service, only if such amounts are not expected to be available from Power Revenues.

3. To the Debt Service Reserve Account, an amount equal to the Debt Service Reserve Account requirement referred to above.

4. To the Operating Account, an amount equal to the Minimum Operating Expense Available Balance referred to above.

5. To the Operating Reserve Account, an amount equal to the Operating Reserve Account requirement referred to above, including the Priority Contract Contingency Reserve Amount referred to above.

6. To the Priority Contract Account, an amount equal to the maximum projected monthly amount due on Priority Long Term Power Contracts during the current revenue requirement period.