STATE OF CALIFORNIA
DEPARTMENT OF WATER RESOURCES

Supplemental Testimony of Douglas Montague
on behalf of the California Department of Water Resources[1]
in Application 00-11-038 *et al.*—
Bond Charge Phase of the Rate Stabilization Proceeding

August 13, 2002

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1 *In order to assist the California Public Utilities Commission and to facilitate the allocation of responsibility among various customer classes for the Department's costs, the Department is voluntarily submitting Prepared Testimony in this proceeding. By submitting this prepared testimony, the Department does not intend to be bound by any obligations applicable to parties in this proceeding. The Department's prepared testimony is provided as an accommodation to the Commission and does not constitute a waiver of any of its legal rights, including, but not limited to, the right to object to the use of this prepared testimony in any judicial or administrative proceeding.*

Q. Please state your name.

A. My name is Douglas Montague.

Q. By whom are you employed?

A. I am a Principal of Montague DeRose and Associates, LLC. ("MDA"). MDA serves as a consultant to the California Department of Water Resources ('the Department" or "DWR") in connection with the Department's power purchase program.

Q. Please provide a brief description of your professional training.

A. I have served as either an investment banker or financial advisor to municipal clients primarily in California, Utah, Nevada, Washington and Arizona since 1984. I began my municipal finance career with Lehman Brothers in its New York headquarters in 1984. Over the next nine years, I completed, as financial advisor or underwriter, more than $22 billion of short term and long-term financings. I joined CS First Boston in 1993 to manage the firm's Los Angeles public finance office and continued coverage of state and county level issuers. In 1995, I established Montague DeRose and Associates. I have completed a variety of different types of financings including fixed and variable rate, sales tax supported, revenue bonds secured from a variety of revenue sources, certificates of participation, lease revenue bonds, pension obligation bonds, Mello-Roos bonds, single issuer and joint powers authority structures.

I received a Bachelor of Arts degree in Business Management from the University of Utah and a Master of Business Administration degree in Finance from the Wharton School of the University of Pennsylvania.

Q. Have you ever testified before the California Public Utilities Commission?

A. No.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to sponsor the attached report containing supplemental information concerning the Department's projected Bond Related Costs for 2003 and 2004.

Q. Do you have any further testimony?

A. Not at this time.

SUPPLEMENTAL INFORMATION REGARDING DWR BOND CHARGES

The purpose of document is to update and supplement my testimony presented to the Commission on July 9, 2002 on behalf of the California Department of Water Resources in Application 00-11-038 *et al*.—Bond Charge Phase of the Rate Stabilization Proceeding ("the Proceeding"). Consistent with my written testimony, subsequent telephonic conference calls and cross-examination in connection with the Proceeding, the following information is intended to serve as an update to the status of the California Department of Water Resources' ("the Department" or "DWR") efforts to complete the issuance of Power Supply Revenue Bonds to finance the power costs it incurred during the 2001 energy crisis.

Long-Term Credit Ratings

On August 9, 2002, the Department received the last of its long-term credit rating indications from the three nationally-recognized rating agencies, Moody's Investors Service, Standard & Poor's and Fitch Ratings. The process of presenting the proposed Power Supply Revenue Bond credit structure to the rating agencies, answering their questions, modeling their many operating "stress" scenarios, receiving their feedback on credit structure and negotiating changes to the structure to achieve the level of ratings the Department, the State Treasurer's Office and their team of financing professionals deemed optimal, was both lengthy and resource intensive. While at this point in time, the specific ratings assigned to the Power Supply Revenue Bonds have only been released on a confidential basis to the municipal bond insurance companies and commercial banks that are evaluating the Power Supply Bonds to provide credit enhancement for the bonds, the Department expects to be able to make these ratings public in the next several weeks.

The results of the most recent feedback from the rating agencies is reflected in the provisions of the Addendum to Summary of Material Terms ("the Addendum") to be considered by the Commission on August 12, 2002. The Addendum supersedes the Addendum to Summary of Material Terms approved by the Commission on July 17, 2002. It is possible that the Summary of Material Terms may require further amendment based on additional requirements that might be imposed by the bond insurers and commercial banks providing credit enhancement for the bonds. Nevertheless, the new Addendum reflects the current best projection by the Department's financing team of the financing structure to be implemented. The terms agreed to in the Rate Agreement and Summary of Material Terms with all applicable addenda will be reflected in a bond indenture that serves as the principal agreement between the Department and bond holders (the "Indenture").

The following changes in financing structure have been proposed in response to rating agency comments and are reflected in the Addendum.

Minimum Operating Expense Available Balance

The Addendum states, "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. The Minimum Operating Expense Available Balance is to be calculated by the Department at the time of each determination of a revenue requirement. The Minimum Operating Expense Available Balance for so long as the Department continues to purchase the Residual Net Short, may be an amount up to and including $1,000,000,000, and thereafter 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."

The rating agencies have required this high level of reserves in the Department's Operating Account due to concerns in several areas. These areas of concern include, but are not limited to the following:

- The rating agencies are concerned that the Department may be obligated to purchase the Residual Net Short beyond the December 31, 2002 deadline for such purchases contained in Assembly Bill 1X ("AB1X"). There appears to be significant skepticism among the rating analysts that the Department, the Commission and the investor owned utilities ("IOUs") will manage the successful transition of Residual Net Short purchases from the Department to the IOUs. In addition to the operational logistics involved, the transition of the Residual Net Short is complicated by SCE and PG&E's current lack of investment grade credit ratings. Investment grade credit ratings are viewed as necessary by the rating agencies to assure that sellers of energy will be willing to transact business with the IOUs in the future.

  In the most extreme case, at least one of the rating agencies believes the Department must be financially prepared in the event that the Residual Net Short is not transitioned to the IOUs during the life of the bonds. In this case, assuming that the Department is not given legal authority to enter into additional long-term contracts after 2002, the Department's existing long-term contracts would gradually expire over time. The result would be an increasing Residual Net Short subject to the risks of the spot market. The volatility in power purchase costs that the Department might experience under this scenario could be several times greater than the volatility to which the Department is currently subject.

- In addition to the concern that the Department may be obligated to purchase an ever larger Residual Net Short, the rating agencies are also concerned that if the Department is responsible for spot market purchases beyond the AB1X December 31, 2002 deadline, the volatility in fuel and energy prices in the spot market could exceed that projected by the Department and its consultants in its operating models and sensitivity analyses.

- The rating agencies are concerned that the Department's annual revenue requirement process may be delayed or otherwise adversely affected by litigation. The rating agencies point to litigation pursued by PG&E regarding the Department's process for determining its revenue requirement.

The change from a $150 million to a $1 billion Minimum Operating Expense Available Balance is the most significant change in the Department's projected financing needs. It will necessitate the issuance of additional bonds and has resulted, along with other changes described herein, in the Department's request for an increase in the bond issuance limit prescribed in the Summary of Material Terms from $11.1 billion to $11.95 billion of net bond proceeds.

While the increase in the Minimum Operating Expense Available Balance is expected to result in negative arbitrage on the additional funds held in the Operating Account, the Department's economic analysis of the benefits of the lower interest cost and more advantageous bond structure that are achieved by obtaining higher credit ratings far outweigh the cost of any negative arbitrage that will be incurred on the additional reserves. In addition, if responsibility for the Residual Net Short is effectively transferred to the IOUs, the Minimum Operating Expense Available Balance can be reduced to a level that approximates the projected monthly volatility in the account. Freed-up reserves can be used to either retire the additional debt issued to fund the higher account balance or can be used for more immediate ratepayer relief. The Commission, after consultation with the Department, will be responsible for determining the use of the excess amounts.

Based on the Department's most recent analysis, utilizing a hypothetical final issuance date for bonds of October 10, 2002, the initial funding of the Operating Account would be $1.259 billion.

Operating Reserve Account Requirement

The Addendum states, "The Bond Indenture will provide that the Operating Reserve Account Requirement shall be calculated, in respect of each Revenue Requirement Period, as the greater of (a) the largest aggregate amount projected by DWR by which Operating Expenses exceed Power Charge Revenues during any consecutive seven calendar months commencing in such Revenue Requirement Period and (b) either (i) 18% of DWR's projected annual Operating Expenses for any Revenue Requirement Period in which DWR is procuring all or a portion of the Residual Net Short and which commences prior to 2006, or (ii) 12% of DWR's projected annual Operating Expenses for any Revenue Requirement Period in which DWR is not procuring all or a portion of the Residual Net Short or which commences after 2005, provided, however, that solely for purposes of (b) above, for Revenue Requirement Periods commencing after 2003, the projected amount shall not be less than the applicable percentage of Operating Expenses for the most recent 12 month period for which reasonably full and complete Operating Expense information is available, adjusted in accordance with the Indenture to the extent the Department no longer is financially responsible for any particular Power Supply Contract; and provided further, however, that at the time of the issuance of the Bonds such requirement may be set at an amount not to exceed the amount specified by the Summary of Material Terms."

The new provision for a "floor" in the calculation of the Operating Account Requirement was required by the rating agencies to address concerns that the Department had too much discretion in the formulation of the "stress" scenario that serves as the basis for the calculation of projected seven-month operating volatility. The two levels of the floor, 18 and 12 percent, are intended to correspond to the higher level of perceived operating risk during the period in which the Department is responsible for the Residual Net Short and the lower volatility expected after the transition of the Residual Net Short.

The Department's current calculations indicate that the Operating Reserve Account will be initially funded based on the 18 percent floor. The resulting deposit as of a new October 10, 2002 hypothetical final bond closing date will be $777 million.

In my professional judgment, the credit structure demanded by the rating agencies in order to receive the most cost effective ratings on the Power Supply Revenue Bonds requires certain reserves and operating accounts to be funded at levels that may be higher than generally accepted industry standards for revenue bonds. However, the Department's situation is without precedent, and it is also my judgment that failure to meet these funding levels would result in a significantly more costly financing structure. It continues to be my judgment that this credit structure will provide ratepayers with an efficient, low cost long-term financing vehicle for power costs incurred during the 2001 energy crisis.

Funding of Accounts at Bond Closing

As indicated in my July 9, 2002 testimony, at the time of the closing of the last of the series of Power Supply Revenue Bonds, the bond and power-related accounts are expected to be funded at the levels described in the Summary of Material Terms as modified by any applicable addenda. DWR's then current Electric Power Fund balance will be combined with proceeds of the bond issues to fund all accounts. The following is a revised indicative breakdown of account funding based on the assumption that the closing the sale of the last series of bonds occurs on October 10, 2002. It is important to note, however, that these projected levels of funding are still subject to final input from the bond insurers and letter of credit banks and could change prior to the issuance of the Power Supply Revenue Bonds.

Projected Sources and Uses of Funds at Assumed 10-10-02 Final Bond Closing

Estimated Sources of Funds	($ Millions)
Principal amount of Bonds	$11,757
Original Issue Premium	92
DWR Electric Power Fund	2,037
Total Sources	$13,886

Estimated Uses of Funds	
Repayment of Interim Loan (including accrued interest)[1/]	$3,469
Repayment of State Loans (including accrued interest)	6,618
Deposit to Debt Service Reserve Account[2/]	974
Costs of issuance (including underwriters' discount)	118
Fees and expenses of providers of credit facilities and bond insurers	94
Deposit to Bond Charge Collection Account[3/]	53
Deposit to Bond Charge Payment Account[4/]	158
Deposit to Priority Contract Account[5/]	366
Deposit to Operating Account[6/]	1,260
Deposit to Operating Reserve Account[7/]	777
Total Uses	$13,886

1/ Interest on the Interim Loan will be paid through September 30, 2002 and is not shown in this table.
2/ Equals projected Maximum Annual Debt Service on all Bonds.
3/ One month's estimated 2002 Bond Related Costs.
4/ The sum of three months' estimated 2002 Bond Related Costs.
5/ The next projected monthly amount due on Priority Long-Term Power Contracts.
6/ The initial deposit is the amount required to be in the account when the last bond sale closes such that the minimum daily balance in the account is not projected to drop below the $1 billion target balance through 2002.
7/ 18 percent of projected annual Operating Expenses for 2003.

To assist in the comparison of this updated sources and uses of funds to the initial information provided on July 9, 2002, the prior summary table follows.

Projected Sources and Uses of Funds
at Assumed 08-15-02 Final Bond Closing

Estimated Sources of Funds	**($ Millions)**
Principal amount of Bonds	$11,100
DWR Electric Power Fund	2,183
Total Sources	$13,283
Estimated Uses of Funds	
Repayment of Interim Loan (including accrued interest)[1/]	$3,492
Repayment of State Loans (including accrued interest)	6,571
Deposit to Debt Service Reserve Account[2/]	929
Costs of issuance (including underwriters' discount)	111
Fees and expenses of providers of credit facilities and bond insurers	64
Deposit to Bond Charge Collection Account [3/]	48
Deposit to Bond Charge Payment Account [4/]	143
Deposit to Priority Contract Account [5/]	359
Deposit to Operating Account [6/]	670
Deposit to Operating Reserve Account [7/]	896
Total Uses	$13,283

It is still important to remember that the timing of the closing of the last series of Power Supply Revenue Bonds will significantly affect the amounts required to be initially deposited in the Department's various accounts.

Interest Rate Assumptions

The interest rate assumptions used in current modeling of the Department's projected debt service on fixed and variable rate Power Supply Revenue Bonds to be issued were again generated by JP Morgan, the senior managing underwriter for the bonds, based on historical averages of bond indices and the best judgment of the firm's underwriting and sales professionals. The revised assumptions based on the increased bond issue size and updated interest rates projections are as follows:

Revised Estimated Composition of Bond Issuance

Debt Instrument	Amount / % of Total Debt		All-In Average Interest Rate
Tax-Exempt Fixed Rate Bonds	$5.676 billion	49%	5.76%
Taxable Fixed Rate Bonds	$1.090 billion	9%	6.96%
Tax-Exempt Variable Rate Bonds	$2.939 billion	25%	4.76%
Tax-Exempt Hedged Variable Rate Bonds	$2.051billion	17%	5.33%
Total Bonds / Wtd. Average Composite Rate	$11.757 billion	100%	5.38%

These revised interest rate assumptions continue to accurately represent an estimate of interest rates that might be negotiated for the bonds by DWR plus a reasonable "cushion". The cushion acts as a "reserve" to protect DWR from general increases in interest rates that may occur between the time of the filing of its 2003 revenue requirement and the sale of its bonds. Given the unprecedented size of the Power Supply Revenue Bond issuance, the cushion is also required to protect the Department in the event investors demand a large interest rate premium in order to purchase the large quantity of bonds that must be sold. The revised projected interest rates are based on the assumption that the bonds are assigned "A" level ratings by a majority of the credit rating agencies.

Bond Maturity Schedules

The Summary of Material Terms contemplates that the Power Supply Revenue Bonds will be amortized over 20 years, with the first principal payment being made to investors in 2004 and that principal and interest payments will be structured such that the aggregate debt service on all bonds is approximately equal in each year. The Addendum gives the Department modest flexibility in its amortization structure allowing for a variation of up to five percent from the lowest annual debt service to the highest.

Bond Insurance Costs

The municipal bond insurers are in the process of completing their own independent review of the credit but will also rely heavily on the credit ratings for the bonds issued by the rating agencies which were just made available to them on August 9. The Department and the Treasurer's Office continue to work with the insurers to any answer remaining questions they may have and to move them toward firm insurance commitments in the next several weeks. As mentioned in my July 9, 2002 testimony, bond insurance is projected to provide economic benefit to DWR significantly in excess of its cost. Therefore, the Department continues to seek to obtain as much bond insurance from "AAA" rated insurers for the Power Supply Revenue Bonds as it can secure at a reasonable cost. The Department's current analysis reflects the amount of insurance capacity and the cost of insurance expected based on the confirmed ratings on the bonds.

The Department's revised Bond Charge Cash Requirements through 2004 are illustrated below:

California Department of Water Resources
Power Purchase Program
Revenue Requirement Final Determination
($ Millions)

Retail Customer Bond Charge Cash Requirement

	A	B	C = A + B	D	E	F = D + E	G
Period	Debt Service Payments	Changes to Bond Charge Account Balances	Total Bond Charge Account Expenses	Interest Earnings on Bond Charge Account Balances	Net Transfers from Power Charge Accounts	Bond Charge Account Revenues net of Bond Charges	Retail Customer Bond Charge Revenue Requirement
2003	632	535	1,167	27	-	27	1,140
2004	976	(143)	833	48	-	48	784

The Department's estimate of debt service payments for 2004 is a reasonable proxy for debt service for the years 2005 through 2022.