3. Reference Mr. Rubin's testimony at page 4, lines 3-11. Produce a copy of Mr. Rubin's testimony in these proceedings, and a copy of any commission order in such proceedings which relates or refers to Mr. Rubin's testimony.

Answer:
Of the cases listed, Mr. Rubin submitted testimony only in cases involving the RWE-Thames-American Water Works merger. Testimony involving that merger was submitted in Kentucky, New Jersey, Pennsylvania, and West Virginia. Copies of his testimony in those cases and the commission orders in Kentucky, Pennsylvania, and West Virginia are attached. Mr. Rubin does not have a copy of the commission order in New Jersey.

Responsible witness: Scott J. Rubin

BEFORE THE
COMMONWEALTH OF PENNSYLVANIA
PUBLIC UTILITY COMMISSION

Joint Application of Pennsylvania-American Water Company and Thames Water Aqua Holdings GmbH for Approval of a Change in Control of Pennsylvania-American Water Company	:	Dockets No. A-212285 F.0096 Dockets No. A-230073 F.0004

Direct Testimony of
Scott J. Rubin

on Behalf of
Pennsylvania Office of Consumer Advocate

April 16, 2002

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I. Introduction

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Scott J. Rubin. My business address is 3 Lost Creek Drive, Selinsgrove, PA.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am an independent attorney and consultant. My practice is limited to matters affecting the public utility industry.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

A. I have been asked by the Pennsylvania Office of Consumer Advocate (OCA) to review the proposed acquisition of American Water Works Company, Inc. (AWW) by RWE AG (RWE), a multinational corporation based in Essen, Germany. The transaction is structured as an acquisition by Thames Water Aqua Holdings GmbH (Thames), a British corporation that is a wholly owned subsidiary of RWE. My review includes the identification of potential risks and benefits from the acquisition, with a particular focus on the risks and benefits to the customers of AWW's Pennsylvania subsidiary, Pennsylvania-American Water Company (PAWC).

Q. ARE YOU PERFORMING THIS REVIEW SOLELY FOR THE OCA?

A. No, I am not. While my testimony in this case is prepared solely for the OCA, I also have been retained by public advocates in Kentucky, New Jersey, and West Virginia to conduct similar reviews in those jurisdictions.

Q. WHAT ARE YOUR QUALIFICATIONS TO PROVIDE THIS TESTIMONY IN THIS CASE?

A. I was employed by the OCA from 1983 through January 1994 in increasingly responsible positions. Since January 1994, I have been an independent public utility consultant and attorney. I have developed substantial expertise in matters relating to the economic regulation of public utilities. I have published articles, contributed to books, written speeches, and delivered numerous presentations, on both the national and state level, relating to regulatory issues. From 1990 until I left the OCA, I was one of two senior attorneys in that Office. Among my other responsibilities in this position, I had a major role in setting the OCA's policy positions on water and electric matters. In addition, I was responsible for supervising the technical staff of that Office. I have testified as an expert witness before utility commissions or courts in the District of Columbia and in the states of Arizona, Delaware, Kentucky, Maine, New Jersey, New York, Ohio, Pennsylvania, and West Virginia. I also have testified as an expert witness before the U.S. House of Representatives Science Committee and the Pennsylvania House of Representatives Consumer Affairs Committee. I also have served as a consultant to several national utility trade associations and to state and local governments throughout the country. Appendix A to this testimony is my curriculum vitae.

Q. WHAT IS YOUR UNDERSTANDING OF THE PROPOSED TRANSACTION BETWEEN AWW AND RWE?

A. RWE, through its subsidiary Thames, is acquiring all of the common stock of AWW at the price of $46.00 per share payable in cash. At year-end 2001, AWW had approximately 100 million shares of common stock outstanding, resulting in a purchase price of approximately $4.6 billion. In addition, RWE will be assuming the outstanding debt of AWW, which is estimated to be approximately $3.0 billion by the time of closing (currently projected to be during the first half of 2003).

The acquisition will be made by Thames using funds supplied to it by RWE.

RWE anticipates funding the entire $4.6 billion purchase price through the issuance of bonds in U.S. dollars. Upon conclusion of the acquisition, AWW will be a subsidiary either of Thames or of a new subsidiary created by Thames.

Q. WHAT DOCUMENTS HAVE YOU REVIEWED IN PREPARING YOUR TESTIMONY?

A. I have reviewed the application and supporting testimony of the applicants, as well as all of the documents provided by the applicants during discovery. I also have reviewed applications, testimony, and discovery responses filed by other AWW subsidiaries and Thames before other state utility commissions. In addition, I have reviewed all documents filed by AWW with the Securities and Exchange Commission (S.E.C.) concerning the transaction, as well as the annual reports for AWW and RWE for 2000 and 2001 (AWW's 2001 annual report is not yet available, but I have reviewed the Form 10-K that it filed with the S.E.C. on March 28, 2002) and various other S.E.C. filings of AWW during the past two or three years. I also reviewed various presentations and reports of RWE and Thames, including financial reports of RWE subsidiaries, presentations to securities analysts in Europe, and similar documents available from RWE's Internet site. Finally, I have attempted to follow news reports and analyses concerning AWW, RWE, and Thames in the popular, trade, and financial media.

Q. ARE SOME OF THESE DOCUMENTS ALLEGED BY THE APPLICANTS TO BE CONFIDENTIAL?

A. Yes, the Applicants allege that some of the documents they provided during discovery are confidential. I will clearly mark any references to such allegedly confidential information in this testimony by enclosing it in brackets like this { }.

II. Outline of Testimony

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. My testimony begins, in Sections III through VI, with a discussion of various categories of risk associated with the proposed acquisition. In these sections, I am referring to risks to the customers of PAWC as a result of the change in ownership and control of PAWC's parent company. These risks include risks from change in management, risks from RWE's need to finance (and ultimately pay for) the acquisition, risks of changes in the regulatory jurisdiction of the Commission as a result of the transaction, and risks to the quality of service received by PAWC's customers.

In Section VII, I summarize the conditions that the Commission should impose on the acquisition in order to alleviate, or at least minimize, the risks that I identify. Without these conditions, I would conclude that the risks to consumers from the transaction would be substantial and would constitute a substantial detriment to PAWC's customers and the Commonwealth as a whole. These conditions, then, are necessary to neutralize the potential detriment from the acquisition; they do not provide consumers or the public with any benefit vis-à-vis their current position.

Section VIII of the testimony discusses the synergies and other savings that should be created by the acquisition. Also included in this section is a recommendation for allocating those savings to PAWC's consumers. The allocation of savings to consumers is necessary as a matter of fairness, as a way to provide further mitigation of the risks posed by the transaction, and as a means to provide the public with affirmative benefits from the transaction as required under Pennsylvania law.

III. Management Risks

Q. WILL THE PROPOSED ACQUISITION OF AWW RESULT IN A CHANGE IN KEY MANAGEMENT PERSONNEL?

A. There is always a possibility that the new owners will decide to make management changes, or that existing officers and managers will decide that they do not want to work for the new owners. In this case, AWW is taking steps to try to entice their existing officers and managers to remain with the company, at least through the closing of the transaction. AWW has established a $15 million pool for the payment of "retention bonuses." These bonuses represent a multiple of an employee's annual salary (the bonuses range from 75% to 200% of the employee's annual salary, depending on the employee). Seventy-five percent of the bonus is payable on the date when RWE purchases AWW, with the remaining 25 percent payable six months after closing.

Q. WILL ANY EMPLOYEES OF PAWC, OR THE OTHER AWW SUBSIDIARIES THAT PROVIDE SERVICES TO PAWC, RECEIVE THESE RETENTION BONUSES?

A. I don't know. The applicants were asked for a list of employees who were offered these bonuses, but the information was not provided. (OCA I-93)

Q. SHOULD ANY OF THE RETENTION BONUS PAYMENTS BE INCLUDED IN PAWC'S COST OF SERVICE?

A. Absolutely not. These payments should be borne solely by AWW and its shareholders, and should not be passed through to the operating utilities either directly or indirectly. These are costs associated solely with the proposed sale of the company to RWE; they would not be necessary but for this transaction and they are not a routine part of providing safe and reliable service to consumers.

Q. HAS THE COMPANY INDICATED WHETHER IT WILL CHARGE THESE COSTS TO CONSUMERS?

A. The company has stated that it will not attempt to charge these costs, either directly or indirectly, to consumers (OCA I-82, I-93, and I-94). These responses also state that the costs will not be borne by the subsidiaries at all, but will be paid by the parent company (AWW).

Q. WHAT DO YOU RECOMMEND?

A. I recommend that the Commission explicitly condition its approval of the acquisition as follows:

> Condition 1. Prohibit PAWC from including in its rates, in any fashion, any portion of the costs associated with the retention bonus program.

Q. ARE RETENTION BONUSES SUFFICIENT TO ENSURE THAT KEY OFFICERS AND MANAGERS WILL REMAIN WITH PAWC?

A. No, they are not. A retention bonus program is designed to keep key personnel in the company until the acquisition and for a short period of time (six months, in this instance) thereafter. After that, there is no certainty that key people will remain with the company.

Q. WHY SHOULD CONSUMERS OR THE COMMISSION CARE IF KEY EMPLOYEES REMAIN WITH PAWC?

A. Consumers and regulators usually should not be concerned if there is a routine change in management; however, wholesale changes in management can lead to periods of inaction, loss of focus, and even a failure of the company to meet its responsibilities. For example, losing one manager through a planned retirement usually is not a problem. Losing ten managers in a period of a few weeks could pose serious problems.

Q. WHAT DO YOU RECOMMEND?

A. I recommend that the Commission condition its approval of the acquisition to impose a reporting requirement on PAWC. Specifically:

> <u>Condition 2.</u> Require PAWC to notify the Commission and intervenors within five business days if any of its officers, managers, or key employees leaves the employ of the company. (I would define "key employee" as anyone who received a retention bonus payment.) The notification should include an explanation of the reasons why the employee is leaving the company and the plans for replacing the employee. I recommend that this requirement remain in place for two years after the acquisition is closed. I also would extend this notification requirement to officers of AWW and to officers, managers, and key employees of those AWW subsidiaries that supply essential services to PAWC, which are American Water Works Service Co.; American Water Capital Corp.; American Water Services, Inc. (formerly known as AmericanAnglian Environmental Technologies, Inc.); and American Water Resources, Inc. (copies of the agreements between PAWC and these affiliates were provided in OCA I-41).

Q. WHAT WILL THIS REPORTING REQUIREMENT ACCOMPLISH?

A. The reporting requirement will provide the Commission and parties with information that might be used to investigate potential problems within the company or, perhaps, to identify the need for a management audit or other study of PAWC's operations to ensure that it continues to meet its obligations to customers and the public.

IV. Financial Risks

Q. IS RWE PAYING A PREMIUM ABOVE BOOK VALUE FOR AWW?

A. Yes, it is. RWE estimates the purchase price of $4.6 billion for AWW's common equity represents a premium above book value of approximately $2.8 billion (OCA I-16). In other words, RWE is paying approximately 2.6 times book value for AWW's common stock.

Q. DOES THIS CREATE ANY CONCERNS FOR PAWC'S CUSTOMERS?

A. Yes, it does. Whenever a utility is purchased for substantially more than book value, concerns are raised about how the purchaser will achieve a reasonable return on its investment, thereby ensuring its financial health. This is particularly a concern with AWW where nearly all of its business is regulated.

Q. BEFORE YOU GO ANY FURTHER, HOW DO YOU KNOW THAT NEARLY ALL OF AWW'S BUSINESS IS REGULATED?

A. AWW's Form 10-K, dated March 28, 2002, divides the company into two "segments" for reporting purposes: regulated and unregulated. During 2001, the regulated segment accounted for more than 95 percent of the revenue from external sources ($1,377 million out of a total of $1,439 million); all of the net income ($196.1 million out of a total of $193.4 million); and 95 percent of the assets ($6,317 million out of a total of $6,630 million) (these figures exclude the "other" category shown in AWW's report).

Q. CAN YOU ILLUSTRATE THE PROBLEM OF A UTILITY BEING PURCHASED FOR SUBSTANTIALLY MORE THAN BOOK VALUE?

A. Yes, I will give a simple example. Let us assume that a utility has a book value of $1,000 and that its overall cost of capital is 10 percent. That means that its investors anticipate receiving a return of $100 on the $1,000 invested in the utility's rate base. But what happens if another company buys this utility for $2,600? If the utility's rates continue to be set based on the historical cost, or book value, of the assets, then the utility will still earn a return of $100. This represents a return to the new investors of just 3.8 percent, which is well below their cost of capital in this example. In order to earn a 10 percent return on the purchase price, of course, the return would need to increase to $260.

Q. ARE THERE OTHER WAYS THAT INVESTORS COULD EARN A REASONABLE RETURN ON THEIR INVESTMENT?

A. Yes, I will list several ways that a purchaser could try to achieve a reasonable return on its investment in a regulated utility where the purchase price greatly exceeds book value.

1. The purchaser could fund the purchase price with capital that is less costly than the weighted cost of capital. If regulators do not reduce the authorized cost of capital to reflect this fact, then the purchaser can achieve a return that more closely matches the cost of capital that it invested in the purchase. For example, if the purchaser in my example is able to borrow the entire purchase price at a 5 percent interest rate, then its cost of capital would be 5% x $2,600, or $130.

2. The new purchaser can find ways to make the utility more efficient. If it can avoid recognizing all of those cost savings in rates, then it can come closer to receiving its cost of capital. Similarly, the new purchaser may decide to defer maintenance or otherwise reduce expenditures in an attempt to come closer to achieving its desired return.

3. The purchaser may be able to leverage the utility's assets to provide unregulated services, which might allow the purchaser to receive a return higher than the regulated return. If the costs associated with these unregulated operations are not properly allocated to the unregulated business, then it can further increase the opportunity of the purchaser to achieve its required return on the full purchase price.

4. The purchaser may sell some of the assets that it acquired. This may have the effect of achieving an immediate return of some of the capital that it invested, reducing its debt burden, and providing an opportunity to reinvest that capital in an attempt to achieve its desired rate of return.

5. The purchaser may attempt to include some of the acquisition adjustment (or goodwill) in rate base, allowing it to increase the rates charged to utility customers.

Q. HOW DOES RWE PLAN TO EARN A REASONABLE RETURN ON ITS PURCHASE OF AWW?

A. RWE has not stated specific plans, but it has provided several indications of the strategy that it intends to pursue. I will review the same five options that I outlined in my previous answer.

1. RWE intends to issue bonds to raise the $4.6 billion needed to purchase AWW's common equity (see, for example, OCA I-86 and OCA I-92).

2. RWE apparently believes that it can improve AWW's efficiency in several areas. I will discuss these in Section VIII of the testimony, where I discuss synergies from the merger.

3. RWE plans to use AWW's assets to grow in several areas. Mr. Bunker, the Chief Financial Officer for Thames, identified "four key development areas" for AWW, including external growth through additional acquisitions, internal growth through

"growing the rate base," increasing its provision of operating and maintenance services to municipally owned water systems, and "cross selling of wastewater services" (that is, providing wastewater services in areas where it currently provides regulated water service). (Analysts Presentation and Q&A, Sept. 17, 2001, London, England, provided in response to OCA I-6.)

4. The Transition Implementation Plan of Thames and AWW states that they will "identify current and future … surplus property assets and establish method and programme of disposal to achieve best value." (Thames Water & American Water Works Transition Implementation Plan, Issue 1.4, Feb. 2002, p. 55, non-proprietary version provided to the Kentucky Office of Attorney General on April 5, 2002) In addition, RWE's internal analyses concerning the acquisition identify the possibility of selling **{begin confidential**

end confidential} (Project Apollo Due Diligence Report, August 12, 2001, p. 19, provided in OCA I-11; Project Trident Board Presentation to RWE, May 8, 2001, p. 32, provided in OCA I-91)

5. Thames, AWW, and PAWC have stated that they will not attempt, either directly or indirectly, to charge any of the acquisition premium or goodwill to PAWC or any other operating utility of AWW. OCA I-17. However, the applicants also have attempted to reserve the right "to point out in briefs or testimony that this transaction represents a major investment in AWW, and that investment is being made at a substantial cost to RWE. To the extent that others seek to pass on savings produced because of this transaction to ratepayers, it would only appear appropriate to recognize

the considerable costs being incurred by RWE to make this investment in the AWW system." (OCA I-18)

Q. WHAT RISKS ARE CREATED FOR PAWC CUSTOMERS BY RWE'S PLANS?

A. There are several risks. First, the issuance of a substantial amount of new debt increases the risks for consumers. The primary risk is that the company may need to take measures to generate sufficient cash flow to meet its debt payments. Under normal conditions, one would not expect this to be a concern (if it were, RWE's bond ratings would not be investment-grade), but under stressed conditions RWE's increased debt burden could strain the company's cash flow. This is particularly the case in light of RWE's recently announced acquisitions of Transgas (a Czech gas utility) and Innogy (a British electric utility), which also will be financed solely with new debt. In fact, in order to pay for these acquisitions, last month RWE announced plans to issue additional debt of up to €10 billion in Europe (approximately $11.35 billion)[1] plus $7.5 billion in the United States. (RWE presentation: Core Business Drives Growth, Analyst and Investor Conference, March 26, 2002, Essen, Germany, p. 14.) Last month, apparently as a result of the significant planned increase in indebtedness, Moody's downgraded RWE's bonds to a single A rating. (OCA II-4)

Q. HOW COULD CASH CONSERVATION MEASURES OR THE PERFORMANCE OF RWE'S UNREGULATED OPERATIONS AFFECT PAWC AND ITS CUSTOMERS?

A. If RWE needs to raise or conserve cash, it could reduce its spending on needed capital expenditures at PAWC or other regulated subsidiaries. It also could take other actions

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[1] Throughout this testimony, euros (€) are converted to U.S. dollars ($) using the exchange rate of €1 = $1.135, as reported in the *Wall Street Journal* on April 11, 2002.

that might not be in the best interests of PAWC customers, such as reducing expenditures on preventative maintenance, reducing levels of customer service, engaging in more risky ventures (which ultimately could lead to even higher capital costs), among others. I am sure that the applicants and all parties hope that such matters are never taken and that RWE's business prospers just as it plans. It must be recognized, however, that utility holding companies' plans do not always come to fruition and that the consequences to the regulated utilities and their customers can be severe.

Q. DO YOU HAVE ANY EXAMPLES OF WHERE THIS HAS HAPPENED?

A. Yes, unfortunately there are several examples of this occurring just in the past few months. Last month, the *Indianapolis Star* reported that retail customers of Indianapolis Power & Light Co. "may have to pay for investors' waning confidence in AES Corp., the utility's Virginia-based parent." The article reports that the utility's bond ratings were likely to be downgraded because of the parent company's financial problems. Among the concerns are that the parent had borrowed $750 million against the utility's equity, and that the parent was considering selling 20 percent of its interest in the utility in order to raise additional cash. (Customers May Pay for Waning Confidence in Indianapolis Power & Light Parent, *The Indianapolis Star*, Mar. 4.)

Similarly, just two weeks ago, Standard & Poor's downgraded the bonds of West Penn Power Co. and two other utility subsidiaries of Allegheny Energy, primarily because of the increased risk of Allegheny's unregulated operations. S&P's credit analyst for Allegheny explained the downgrade as follows: "Standard & Poor's considers all of the company's core subsidiaries to have the same default risk, and thus the same corporate credit rating. The levelization resulted in the downgrade of the corporate credit ratings of the regulated subsidiaries." S&P's discussion also noted that Allegheny's unregulated operations were "the weakest of the company's core subsidiaries" and that "concerns at Allegheny revolve around its growing trading and merchant business outside of its provider of last resort (PLR) load. ... The trading operation and merchant power generation are generally considered to be more risky" than the regulated utilities. (Standard & Poor's Corporate Ratings, Allegheny Energy's, Subsidiaries' Ratings Lowered; Off Watch, Apr. 4, 2002.)

In February, Utilicorp (an energy utility based in Missouri) faced a similar fate. The utility's debt was downgraded to the lowest investment-grade level because of the poor performance and increased risk of its parent's unregulated operations. (Kansas Regulators To Probe Utilicorp's Affiliate Deals, *Dow Jones Newswires*, Mar. 14, 2002.)

In March, it also was reported that Portland General Electric Co., an electric utility in Oregon, faced sanctions from the federal government – including the inability to sell power to the government – because of the bankruptcy and questionable dealings of its parent, Enron Corp. (Enron To Challenge GSA Suspension Of Portland General, *Dow Jones Newswires*, Mar. 18, 2002)

In fact, when Moody's recently downgraded RWE, it also downgraded Thames to one "notch" below RWE. Moody's explained that Thames' ratings are "linked to those of RWE." (OCA II-4)

Q. ARE THERE OTHER ELEMENTS OF THE TRANSACTION THAT CREATE FINANCIAL RISK FOR PAWC'S CUSTOMERS?

A. Yes, the fact that the transaction is a cash buyout, rather than a merger or other stock-based transaction, creates additional concerns. In a true merger, where two companies come together to form a new, third company, the stockholders and management are expressing confidence in the ability of the new company to serve their interests and the interests of the company's customers. In an all-cash transaction, however, the stockholders of the selling company are simply cashing out their investment. Their only investigation into the acquiring company concerns its ability to raise the cash to buy them out.

Q. ARE YOU SUGGESTING THAT THAMES AND RWE DO NOT KNOW HOW TO RUN A UTILITY?

A. No, I am certainly not suggesting that. What I am suggesting, though, is that AWW did not conduct the type of investigation into RWE's plans that the Commission may have grown to expect in cases where two utilities were merging and shareholders were dependent on the expertise of the new company to safeguard their investment. For example, in OCA I-86 and OCA I-87, the applicants were asked to provide "all documents in the possession of AWW" concerning the ability of RWE and Thames to successfully operate AWW and PAWC on an on-going basis. The response to those questions provides no documents that would have been in AWW's possession prior to signing the acquisition agreement.

In addition, the analysis from Goldman Sachs (AWW's financial advisor for the transaction) that was presented to AWW's directors before agreeing to the transaction (OCA I-90; see also the Definitive Proxy Statement of Dec. 5, 2001, which discusses Goldman Sachs' opinion) contains analyses of the reasonableness of the purchase price, but does not contain any information about the financial health of RWE and Thames, beyond their ability to raise the cash to pay the purchase price.

Q. HAVE YOU IDENTIFIED ANY POTENTIAL CONCERNS WITH RWE'S FINANCIAL CONDITION?

A. I have reviewed numerous published reports about RWE and Thames, but I have not conducted anything close to a due diligence review of the companies.

Q. HAS YOUR LIMITED REVIEW IDENTIFIED ANY CONCERNS?

A. Yes, I am concerned that RWE appears to be a much more risky company than AWW. For example, RWE has substantial financial exposure to the decommissioning of nuclear power plants in Europe (it also has nuclear fuel related operations in the United States that also could face substantial liabilities). In addition, it has sizeable holdings in Europe and the United States in the coal markets. I am not suggesting that these investments are necessarily bad, but only that they carry with them substantial risk, particularly from more stringent environmental regulations.

Q. CAN YOU BE MORE SPECIFIC ABOUT THE NATURE OF THE RISKS ASSOCIATED WITH RWE'S INVESTMENTS IN NUCLEAR POWER AND COAL?

A. Yes. In response to OCA I-102, the applicants state that as of September 30, 2001, RWE had future liabilities of €10.53 billion ($11.95 billion) for nuclear waste disposal and €2.26 billion ($2.57 billion) for liabilities related to coal mining activities. RWE's annual report for 2001 updates these figures to €11.52 billion ($13.07 billion) for nuclear waste disposal (€914 million ($1.04 billion) of which has been funded) and €2.29 billion ($2.60 billion) for coal mining liabilities. (RWE Annual Report for the truncated financial year July-December 2001, Mar. 26, 2002, p. 112.)

Q. WHY ARE THESE FUTURE LIABILITIES IMPORTANT?

A. Moody's has identified these future liabilities as a potential cause for concern. On September 17, 2001, Moody's stated that it was seeking "clarification of the company's pension and nuclear liabilities management," among other issues. On December 14, 2001, Moody's reaffirmed RWE's bond ratings, noting that "RWE does not foresee any external funding requirement for mining and nuclear liabilities for several decades."

I am not certain if this remains an accurate statement. According to press accounts, Germany has decided to close all nuclear power plants within the next 20 years. (German Industry Looks for Way to Save Nukes, *The Electricity Daily*, Mar. 22, 2002; German Phase-Out is Now Law, *Nucleonics Week*, Feb. 7, 2002) It appears, therefore, that RWE may need to accelerate the funding of its nuclear decommissioning and waste disposal liabilities which could have a significant effect on its financial position.

Q. WHY COULD THESE LIABILITIES HAVE A SIGNIFICANT EFFECT ON RWE?

A. As of December 31, 2001, RWE's shareholders' equity totaled €11.13 billion ($12.63 billion). So its future liabilities for nuclear waste disposal and decommissioning are approximately equal to its total shareholders equity.

Q. WHY IS ANY OF THIS IMPORTANT?

A. As I discuss elsewhere in the testimony, the financial health of the parent can have a direct and serious impact on the utility subsidiary's ability to raise capital. This transaction would dramatically change the nature of the holding company that owns PAWC. AWW is a company that operates almost exclusively in the relatively low-risk regulated water industry. In contrast, RWE is involved in electricity, natural gas, coal, nuclear fuel, energy trading, waste disposal, water, and wastewater, among other lines of business. Two aspects of its business, nuclear and coal, carry with them substantial future liabilities for waste disposal, decommissioning, and reclamation. If RWE were to fail to adequately anticipate and fund those liabilities, or if changes in the law were to accelerate the date on which those costs must be incurred, there could be a serious financial impact on RWE and, ultimately, on AWW and PAWC.

Q. HAVEN'T AWW'S SHAREHOLDERS ASSESSED THIS RISK AND DECIDED THAT IT WAS REASONABLE TO BECOME PART OF A COMPANY WITH A DIFFERENT RISK PROFILE?

A. Based on the information I have seen, it does not appear that AWW's shareholders made such an assessment. As I discussed earlier, AWW's shareholders are not deciding to become part of RWE and have not decided to assume RWE's risk profile. AWW's shareholders are simply cashing out their investment. The only analysis presented to shareholders concerned RWE's ability to raise the cash to pay the $4.6 billion purchase price for AWW's stock. Shareholders were not presented with any information about RWE's long-term prospects or risks and, indeed, those are irrelevant to AWW's shareholders. But they are very relevant to PAWC and its customers, since PAWC's ability to raise and obtain capital will be dependent on the financial condition of RWE.

Q. HAVE ANY AWW OFFICERS MADE COMMITMENTS TO REMAIN WITH RWE AND CONTINUE TO OVERSEE AWW'S OPERATIONS?

A. Yes, as I discussed previously AWW is paying about $15 million to try to retain its officers and other key personnel. However, none of those commitments lasts more than six months after the acquisition occurs.

In addition, Thames has agreed to make James Barr, the President and CEO of AWW, the President and CEO of Thames' water operations in North and South America and a Director of Thames. However, this commitment does not have any specific duration. {**begin confidential**

end confidential}

Q. ARE THERE OTHER FINANCIAL RISKS ASSOCIATED WITH THIS TRANSACTION?

A. Yes, this transaction also creates a risk that PAWC might not be able to obtain the capital that it needs or might not be appropriately capitalized. Within a large, multinational corporation like RWE, each subsidiary must compete with the other subsidiaries (and potential new subsidiaries) for access to capital. While the parent company may appear to have unlimited supplies of capital, in fact that is never the case. Each investment must compete with other potential uses of capital and be judged on its ability to produce a return for the parent company.

Q. ISN'T THAT ALSO TRUE TODAY, WHEN PAWC IS DEPENDENT ON ITS PARENT, AWW, FOR ACCESS TO CAPITAL?

A. Yes, it is also true today, but there is a major difference. AWW is almost exclusively in the business of owning and operating regulated water utilities. Those companies are all located in the United States and compete for capital with each other on relatively equal footing; the expected returns on their investments are roughly comparable to one another. In contrast, RWE has investments in regulated and unregulated companies in approximately 120 countries. It also continues to evaluate new opportunities for the use of its capital (such as the acquisition of new companies). It is unknown whether RWE will continue to be willing to make capital available to regulated water operations in Pennsylvania.

Q. HAVE THAMES OR RWE MADE ANY COMMITMENT TO ADEQUATELY CAPITALIZE AWW AND ITS SUBSIDIARIES?

A. I am not aware that they have made any binding commitments to do so. In fact, in the New Jersey proceeding to approve this transaction, the Staff of the Board of Public Utilities (Board) inquired into precisely this issue and received the following response from RWE and New Jersey-American Water Co. (NJAWC): "RWE will allocate capital among its various operations worldwide in order to meet the obligations imposed on such subsidiaries, including in the case of NJAWC, the regulatory and service obligations of NJAWC. By acquiring NJAWC, RWE undertakes the legal responsibility to provide safe and reliable service pursuant to applicable statutes. RWE/NJAWC will undertake the capital investments necessary to satisfy these obligations, <u>assuming that the Board continues to provide NJAWC with an opportunity to achieve a reasonable return on investment</u>. ... A change in the investment climate in Europe versus the United States would influence the capital allocation process only to the extent that RWE has discretionary investment opportunities." (NJ Data Request OCE-3, a copy of which is attached hereto as Schedule SJR-1, emphasis added)

Q. ARE YOU AWARE OF ANY INSTANCES WHERE IT HAS BEEN ALLEGED THAT A UTILITY'S PARENT COMPANY HAS FAILED TO PROVIDE IT WITH ACCESS TO CAPITAL?

A. Yes, during California's electricity crisis last year, allegations were made that the parent companies of Pacific Gas & Electric Co. and Southern California Edison Co. drained capital from the utilities and failed to provide the utilities with adequate working capital to purchase electricity and otherwise meet their obligations to provide service. This was allegedly one of the factors that precipitated the bankruptcy of PG&E and the financial crisis at Southern California Edison.

Q. YOU RAISED SEVERAL CONCERNS ABOUT FINANCIAL RISKS ASSOCIATED WITH THIS TRANSACTION. WHAT DO YOU RECOMMEND TO MINIMIZE THESE RISKS?

A. I recommend that the Commission impose the following conditions on this transaction:

> Condition 3. Require PAWC to disclose all uses made of PAWC personnel, assets, and equipment for any unregulated purpose. The disclosure should be made within 30 days after the use of such personnel, assets, or equipment and should specifically describe the activities; identify the personnel, assets, or equipment involved; and estimate the fully allocated cost of such personnel, assets, and equipment.

> Condition 4. Require PAWC to obtain a certificate of public convenience and necessity from the Commission prior to the sale or transfer by PAWC of any land in Pennsylvania, regardless of the book value of the land or other threshold requirements contained in 66 Pa. C.S. § 1102(a)(3).

> Condition 5. Prohibit PAWC from including in its rates, in any fashion, any portion of the acquisition premium or goodwill associated with this transaction.

> Condition 6. Prohibit PAWC from including in its rates, in any fashion, any portion of the costs associated with analyzing, negotiating, consummating, or seeking approval of this transaction.

> Condition 7. Prohibit PAWC, AWW, Thames, or RWE or any of their subsidiaries from pledging any of the assets of PAWC or the stock of PAWC for any purpose without first having obtained a certificate of public convenience and necessity from the Commission.

> Condition 8. Require PAWC to include in its Annual Report to the Commission copies of its requested and approved construction budgets for the then-current year (for example, the report filed in the Spring of 2005 for the year ending December 31, 2004, would include the requested and approved construction budgets for the year 2005). Included should be an explanation of the reasons why the budget was not funded to the full extent proposed by PAWC and whether the budget as approved will impose any limitations on PAWC's ability to provide safe, adequate, and reliable service to its customers.

Condition 9. Require PAWC to report to the Commission within five business days any downgrading of the bonds of RWE, Thames, AWW, or any subsidiary of AWW, including a full English-language copy of the report issued by the bond rating agency.

Condition 10. Require PAWC's Annual Report to the Commission to include a complete, English-language copy of the annual reports of RWE and Thames.

Condition 11. Require RWE, Thames, and AWW to commit that no capital investment shall have a higher priority than the capital requirements, including working capital, of PAWC.

Condition 12. Require PAWC to maintain a capital structure that contains at least 35% common equity and prohibit PAWC from paying any dividend to its parent company that would reduce PAWC's equity ratio to less than 35%, without the Commission's prior approval.

Condition 13. Prohibit PAWC from paying any dividend to its parent company that exceeds more than 80% of its earnings attributable to common equity in the then-current year.

Q. CONDITION 11 THROUGH CONDITION 13 DEAL WITH RESTRICTIONS ON THE WAY IN WHICH PAWC IS CAPITALIZED. AREN'T THESE TYPES OF RESTRICTIONS VERY UNUSUAL?

A. No, these types of restrictions are becoming increasingly common, as utilities become part of ever larger holding company structures. Each of these conditions has been adopted by at least one regulatory commission in the United States. For example, in a number of cases, the California Public Utilities Commission has required the parent company to give the utility "first call on capital" and to give the utility's capital needs "first priority by the board of directors." See, e.g., *Roseville Telephone Co.*, 67 CPUC2d 145 (Cal. PUC 1996). A similar requirement has been imposed in Louisiana. *Entergy Corp.*, 146 PUR4th 292 (La. PSC 1993).

The Connecticut Department of Public Utility Control has prohibited a utility from paying more than 80% of its annual earnings as dividends to the parent. In addition, that commission required that "the holding company shall maintain, as its top priority, the provision of quality service in Connecticut" by the utility. This was coupled with a restriction on holding company investment in unregulated operations. *Southern New England Telephone Co.*, 71 PUR4th 446 (Ct. DPUC 1985).

In Oregon, the Public Utilities Commission has required a utility to obtain prior approval from PUC before making a distribution to the parent company that would result in the utility's equity ratio falling below 40%. The utility also must notify the PUC of its intention to transfer more than 5% of its retained earnings to the parent or to pay a special dividend to the parent. *Scottish Power*, 196 PUR4th 349 (Ore. PUC 1999).

Similarly, the Massachusetts Department of Telecommunications and Energy has placed an obligation on a utility's parent company "to give first priority to the capital needs of the regulated utility and to protect its financial integrity." The DTE also reserved the right to impose restrictions on dividend payments if it appeared that such payments were "inappropriate." *Berkshire Gas Co.*, Docket Nos. DTE 98-61 and 98-87, slip op. (Mass. DTE, Nov. 6, 1998).

V. Regulatory Risks

Q. DOES THE PROPOSED TRANSACTION RESULT IN ANY REGULATORY CONCERNS?

A. Yes, it does. The transaction would create additional "generations" of holding companies above PAWC. At the present time, PAWC has a corporate parent, AWW. The proposed acquisition of AWW would create at least a corporate grandparent (Thames) and a corporate great-grandparent (RWE). Given the way the transaction is structured, it is even possible for one more layer to be created, since the applicants have asked for the flexibility to have Thames create a new subsidiary that would own AWW. That would result in Thames becoming the great-grandparent, and so on.

Q. WHY ARE YOU CONCERNED ABOUT THESE ADDITIONAL LAYERS OF OWNERSHIP?

A. I am concerned because each additional layer makes it more difficult to fully understand and regulate a utility. For example, right now we know that PAWC is in the water business and it is owned by a company that is also in the water business. As of December 31, 2001, PAWC accounted for approximately 22% of AWW's customers and revenues, approximately 26% of AWW's assets, and approximately 33% of AWW's net income. (These figures are calculated by comparing PAWC's Financial Statements with those of AWW, as of December 31, 2001. PAWC's Financial Statement can be found on its Internet site, while AWW's can be found in its Form 10-K, filed with the S.E.C. on March 28, 2002.) If this transaction occurs, PAWC will be just a minute part of RWE, a company operating in some 120 countries in electricity production, electricity distribution, natural gas, water, wastewater, solid waste, coal mining, nuclear fuel cycle, and several other lines of business. Even though AWW operates in more than 20 states, it is possible to monitor its activities and financial condition to determine if they might have an impact on PAWC. That will be essentially impossible with RWE – its businesses are too diverse to monitor effectively from this country. In addition, as I discussed earlier, these additional layers can carry with them additional risk that can affect PAWC's access to capital.

Q. DO YOU HAVE PARTICULAR CONCERNS OF A REGULATORY NATURE?

A. Yes, I do. I already have discussed the issue of financial risk and I have recommended conditions to deal with those issues. In addition, strictly from a regulatory perspective, I am concerned that this transaction could result in the Commission losing some of its ability to effectively regulate PAWC. First, and perhaps most importantly, the Commission may lose the ability to approve and condition future changes in control of PAWC. The Commission's policy statement on changes in control (52 Pa. Code § 69.901) states that it has jurisdiction over the change in control of a utility or its parent, regardless of the tier of ownership at which the change occurs. I recognize, however, that some utilities disagree with the Commission's interpretation of its authority. In a case like this, where the proposed transaction would add several layers of ownership above the utility, it is extremely important for the Commission to ensure that it will continue to have jurisdiction over changes in control of PAWC.

Moreover, the Commission's access to information about PAWC's owners will become much more limited than it is now. RWE's common stock is not traded in the United States and, consequently, RWE does not file its annual reports and other documents with the S.E.C. RWE, as a German company, also is not subject to United States accounting standards and, instead, complies with International Accounting Standards (IAS). During discovery, the applicants referred to a 50-page document prepared by a major accounting firm that discusses the major differences between U.S. and international accounting standards. (OCA I-55) Moreover, the Thames-AWW transition plan states that RWE "requires all Divisions and their subsidiaries to report under IAS." As a result, AWW and PAWC will be required to convert their financial reporting and accounting systems to comply with IAS, a conversion process that the companies term "particularly demanding and complex." (Thames Water & American Water Works Transition Implementation Plan, Issue 1.4, Feb. 2002, p. 16, non-proprietary version)

Compounding these issues are differences in language (RWE conducts its business in German) and currency (RWE's financial statements are prepared in euros). Both of those issues will make it more difficult for the Commission and other interested parties to monitor the activities of PAWC's ultimate owner.

Q. WHAT DO YOU RECOMMEND TO ADDRESS THESE CONCERNS?

A. There are several actions that the Commission should take to ensure that it will be able to continue to regulate PAWC. I recommend that the Commission adopt the following conditions:

<u>Condition 14.</u> Require PAWC to file an application requesting Commission approval of any transaction that would change the entity that ultimately owns or controls the common stock of PAWC or AWW. Included in this condition is a waiver by PAWC of any arguments it may have that limit the Commission's jurisdiction over changes in control above the parent level.

<u>Condition 15.</u> Require that whenever PAWC is requested to provide documents to the Commission, or in any proceeding before the Commission, concerning the operations of RWE or any other subsidiaries or holdings of RWE, that those documents be provided in English. If the original document is not in English, then PAWC must certify the accuracy of the English-language translation.

Condition 16. Require that whenever PAWC is requested to provide documents to the Commission, or in any proceeding before the Commission, concerning the operations of RWE or any other subsidiaries or holdings of RWE, that all financial statements be provided in their original currency and in U.S. dollars (converted as of the date of the financial statement). For example, RWE's financial statements as of December 31, 2001, would be required to be provided in U.S. dollars using the conversion rate between dollars and euros on December 31, 2001.

Condition 17. Require PAWC to keep its books and records at a location within the United States.

VI. Service Quality Risks

Q. IS IT POSSIBLE FOR THIS TRANSACTION TO ADVERSELY AFFECT THE QUALITY AND RELIABILITY OF SERVICE THAT PAWC CUSTOMERS RECEIVE?

A. Yes, it is. One of the major risks associated with this type of transaction is the risk that the new owner will put pressure on AWW and PAWC to reduce costs. Obviously, sound cost reductions that result from efficiencies, synergies, and the implementation of best practices are to be encouraged (I discuss this in Section VIII, below). The risk, however, is that cost-cutters might become overzealous or fail to properly distinguish between "fat" and "muscle" and thereby adversely affect the safety, quality, and reliability of service.

Q. ARE YOU SUGGESTING THAT THE APPLICANTS INTEND TO HARM THE QUALITY OF SERVICE PROVIDED BY PAWC?

A. No, I am not suggesting that at all. I understand the companies' commitment to the provision of high-quality service and I have no reason to doubt their good intentions. What I am suggesting is that, either as a result of changes in management personnel or simply as a result of someone not foreseeing the consequences of a cost-cutting plan, it is necessary to ensure that there is not a reduction in the quality of service provided to PAWC's customers.

Q. WHAT DO YOU RECOMMEND TO GUARD AGAINST THIS RISK FROM THE TRANSACTION?

A. I recommend that the Commission require, as a condition of approving the transaction, that PAWC commit to at least maintaining its existing level of customer service. The specific condition that I recommend is modeled on a provision contained in a New Jersey settlement involving the acquisition of another water utility (*Lyonnaise American*

Holding, Inc., Docket No. WM99110853 (NJ BPU), slip op. July 20, 2000). Specifically I recommend the following conditions:

> Condition 18. Require PAWC to use its best efforts to maintain all applicable water quality standards and to maintain or improve water service standards including, but not limited to, the following: water service related interruptions and employee response time thereto; and customer complaint and customer inquiry response time.

> Condition 19. For the annual reports covering the years 2002 through 2008, require PAWC to include in its annual report to the Commission a table that shows each water quality standard, the number of water service interruptions, the average employee response time to water service interruptions, the number of customer complaints, and the customer inquiry response time for each year from 2000 through the then-current year. For example, the annual report for the year ending December 31, 2004, would include a table showing data for the years 2000, 2001, 2002, 2003, and 2004.

> Condition 20. Require PAWC to continue to protect and safeguard the condition of all of its watershed land holdings surrounding its reservoirs and well fields in Pennsylvania.

VII. Summary of Conditions to Protect Consumers from Risks

Q. PLEASE SUMMARIZE THE CONDITIONS THAT YOU CONCLUDE ARE NECESSARY TO PROTECT CONSUMERS FROM RISKS ASSOCIATED WITH THE ACQUISITION OF AWW BY THAMES AND RWE.

A. Following are the conditions that I recommended in Sections III-VI, above:

> Condition 1. Prohibit PAWC from including in its rates, in any fashion, any portion of the costs associated with the retention bonus program.

> Condition 2. PAWC should be required to notify the Commission and intervenors within five business days if any of its officers, managers, or key employees leaves the employ of the company. (I would define "key employee" as anyone who received a retention bonus payment.) The notification should include an explanation of the reasons why the employee is leaving the company and the plans for replacing the employee. I recommend that this requirement remain in place for two years after the acquisition is closed. I also would extend this notification requirement to officers of AWW and to officers, managers, and key employees of those AWW subsidiaries that supply essential services to PAWC, which are American Water Works Service Co.; American Water Capital Corp.; American Water Services, Inc. (formerly known as AmericanAnglian Environmental Technologies, Inc.); and American Water Resources, Inc.

> Condition 3. Require PAWC to disclose all uses made of PAWC personnel, assets, and equipment for any unregulated purpose. The disclosure should be made within 30 days after the use of such personnel, assets, or equipment and should specifically describe the activities; identify the personnel, assets, or equipment involved; and estimate the fully allocated cost of such personnel, assets, and equipment.

> Condition 4. Require PAWC to obtain a certificate of public convenience and necessity from the Commission prior to the sale or transfer by PAWC of any land in Pennsylvania, regardless of the book value of the land or other threshold requirements contained in 66 Pa. C.S. § 1102(a)(3).

> Condition 5. Prohibit PAWC from including in its rates, in any fashion, any portion of the acquisition premium or goodwill associated with this transaction.

> Condition 6. Prohibit PAWC from including in its rates, in any fashion, any portion of the costs associated with analyzing, negotiating, consummating, or seeking approval of this transaction.

Condition 7. Prohibit PAWC, AWW, Thames, or RWE or any of their subsidiaries from pledging any of the assets of PAWC or the stock of PAWC for any purpose without first having obtained a certificate of public convenience and necessity from the Commission.

Condition 8. Require PAWC to include in its Annual Report to the Commission copies of its requested and approved construction budgets for the then-current year (for example, the report filed in the Spring of 2005 for the year ending December 31, 2004, would include the requested and approved construction budgets for the year 2005). Included should be an explanation of the reasons why the budget was not funded to the full extent proposed by PAWC and whether the budget as approved will impose any limitations on PAWC's ability to provide safe, adequate, and reliable service to its customers.

Condition 9. Require PAWC to report to the Commission within five business days any downgrading of the bonds of RWE, Thames, AWW, or any subsidiary of AWW, including a full copy of the report issued by the bond rating agency.

Condition 10. Require PAWC's Annual Report to the Commission to include a complete, English-language copy of the annual reports of RWE and Thames.

Condition 11. Require RWE, Thames, and AWW to commit that no capital investment shall have a higher priority than the capital requirements, including working capital, of PAWC.

Condition 12. Require PAWC to maintain a capital structure that contains at least 35% common equity and prohibit PAWC from paying any dividend to its parent company that would reduce PAWC's equity ratio to less than 35%, without the Commission's prior approval.

Condition 13. Prohibit PAWC from paying any dividend to its parent company that exceeds more than 80% of its earnings attributable to common equity in the then-current year.

Condition 14. Require PAWC to file an application requesting Commission approval of any transaction that would change the entity that ultimately owns or controls the common stock of PAWC or AWW. Included in this condition is a waiver by PAWC of any arguments it may have that limit the Commission's jurisdiction over changes in control above the parent level.

Condition 15. Require that whenever PAWC is requested to provide documents to the Commission, or in any proceeding before the Commission, concerning the operations of RWE or any other subsidiaries or holdings of RWE, that those documents be provided in English. If the original document is not in English, then PAWC must certify the accuracy of the English-language translation.

Condition 16. Require that whenever PAWC is requested to provide documents to the Commission, or in any proceeding before the Commission, concerning the operations of RWE or any other subsidiaries or holdings of RWE, that all financial statements be provided in their original currency and in U.S. dollars (converted as of the date of the financial statement). For example, RWE's financial statements as of December 31, 2001, would be required to be provided in U.S. dollars using the conversion rate between dollars and euros on December 31, 2001.

Condition 17. Require PAWC to keep its books and records at a location within the United States.

Condition 18. Require PAWC to use its best efforts to maintain all applicable water quality standards and to maintain or improve water service standards including, but not limited to, the following: water service related interruptions and employee response time thereto; and customer complaint and customer inquiry response time.

Condition 19. For the annual reports covering the years 2002 through 2008, require PAWC to include in its annual report to the Commission a table that shows each water quality standard, the number of water service interruptions, the average employee response time to water service interruptions, the number of customer complaints, and the customer inquiry response time for each year from 2000 through the then-current year. For example, the annual report for the year ending December 31, 2004, would include a table showing data for the years 2000, 2001, 2002, 2003, and 2004.

Condition 20. Require PAWC to continue to protect and safeguard the condition of all of its watershed land holdings surrounding its reservoirs and well fields in Pennsylvania.

Q. WHAT IS THE PURPOSE OF THESE CONDITIONS?

A. These conditions are designed to alleviate or minimize the risks of adverse consequences associated with the proposed acquisition of AWW and PAWC by Thames and RWE. Implementing these conditions does not provide any benefit to PAWC's consumers. The conditions are designed to try to preserve the current condition of PAWC's consumers. In other words, the conditions only try to ensure that PAWC's consumers do not end up worse off as a result of this transaction.

VIII. Synergies from the Acquisition

Q. THE APPLICATION AND TESTIMONY FILED BY THE APPLICANTS DO NOT REFER TO ANY SYNERGIES OR OTHER SAVINGS THAT ARE EXPECTED TO RESULT FROM THIS TRANSACTION. FROM YOUR REVIEW OF THE TRANSACTION AND RELATED DOCUMENTS, DO YOU EXPECT SYNERGY SAVINGS TO RESULT FROM THE TRANSACTION?

A. Yes, I do expect there to be savings to AWW and PAWC as a result of the transaction. From my review of numerous documents associated with this transaction, it appears that RWE and Thames believe this to be the case also.

Q. RWE, THAMES, AND AWW HAVE SAID IN THEIR PUBLIC STATEMENTS THAT THE PURPOSE OF THE TRANSACTION IS TO SERVE AS A PLATFORM FOR GROWTH, NOT TO REDUCE COSTS AT AWW. DO YOU DISAGREE?

A. I disagree in part. I agree that RWE and Thames hope to use AWW's assets as a platform for growth in the United States. In addition, though, they also have identified several areas in which they can improve the efficiency of AWW's operations and thereby reduce costs. These are the synergistic effects of the transaction.

Q. HAVE THE COMPANIES MADE ANY PUBLIC STATEMENTS THAT LEND SUPPORT TO YOUR VIEW THAT THEY WILL BE ABLE TO ACHIEVE SYNERGY SAVINGS?

A. Yes, they have. On the day that the transaction was announced, September 17, 2001, the companies held several conferences with the media and investment analysts. During the London conference, Dr. Sturany, the Chief Financial Officer for RWE, stated: "Over the last ten years American Water has grown its rate base at approximately 11% per annum. This performance will be enhanced by working with Thames Water which will provide

American Water with the opportunity to exchange worldwide best practice in operational skills." (Analysts Presentation and Q&A, Sept. 17, 2001, London, England, provided in response to OCA I-6)

At the German conference that same day, Dr. Sturany was asked about the synergy savings from the transaction. His response indicates that they anticipate savings, but they have not attempted to quantify them or be more specific because of a fear that regulators would attempt to capture those savings for customers. Specifically, he stated: "As you may know, if there are synergies they would be clawed back by the Regulator, so obviously there could be kind of good cooperation but it is not the time now." (RWE's Acquisition of AWW Wires Conference Call + Questions and Answers, Sept. 17, 2001, provided in response to OCA I-6)

Later in that same conference, Mr. Bunker (Thames' Chief Financial Officer) responded in a similar fashion to another question about synergies, stating: "The important thing to understand which – you will appreciate these are highly regulated businesses, therefore we are not doing this from the point of view of synergies. In a sense, if we were to do that the Regulator would then seek to claw back those benefits. But what we clearly will be trying to do is ensure we share best practice from our world-wide operations (I'm speaking for Thames in that regard) which hopefully will improve the quality and the service for American's customers base." Dr. Sturany then added: "On top of that, in the non-regulated field, of course, specially in wastewater services, that is the experience of Thames which will help to grow and boost Azurix, the non-regulated business."

These public statements indicate that RWE and Thames expect there to be synergy savings from the acquisition of AWW. They simply do not want to quantify them and run the risk that this Commission and other regulators will require those benefits to be passed on to consumers.

Q. FROM YOUR REVIEW OF INTERNAL RWE AND THAMES DOCUMENTS BEFORE THE TRANSACTION WAS ANNOUNCED, DOES IT APPEAR THAT THEY ANTICIPATED SYNERGY SAVINGS FROM THE TRANSACTION?

A. Yes, it is very clear that RWE and Thames expect to generate substantial savings by combining Thames and AWW's operations. I will begin with the detailed due diligence report prepared by Thames on August 12, 2001 (OCA I-11). At the outset of that report, Thames identifies the following areas within AWW where savings could be achieved:

{begin confidential

end confidential} (Project Apollo Due Diligence Report, Aug. 12, 2001, p. 8)

Later in that report, Thames discusses the extent to which its operations will be integrated with AWW: "The contrast between the Apollo [AWW] and Trident [Thames] merger and Regal [RWE] and Trident is that the latter integration was actioned particularly around control issues: accounting, finance, tax, legal etc. with the minimal operational and technical matters being pursued in a subproject. The integration of Apollo and Trident will require a very broad range of market facing, operational, technical and commercial work-streams in a rapidly growing business and developing market." (Id., p. 22; from a non-proprietary version supplied to the Kentucky Office of Attorney General on Apr. 5, 2002)

Later in the Due Diligence report, Thames identified specific areas where it anticipates cost savings in AWW's regulated business. These include: {**begin confidential** **end confidential**} (Id., p. 32)

Q. DOES THE DUE DILIGENCE REPORT ATTEMPT TO QUANTIFY THESE BENEFITS?

A. No, it does not, with two exceptions. On page 28 of the report, Thames quantifies two areas of savings. First, it identifies savings of {**begin confidential** **end confidential**} from the provision of {**begin confidential** **end confidential**}. (Also see page 52 of the Due Diligence Findings, dated Aug. 14, 2001, provided in OCA I-11 which confirms that this is an annual estimate.) In addition, it anticipates saving {**begin confidential** **end confidential**} from reduced expenses {**begin confidential** **end confidential**}

Q. DOES THE DUE DILIGENCE FINDINGS REPORT OF AUGUST 14, 2001, THAT YOU REFERRED TO PROVIDE FURTHER INFORMATION ABOUT THE MAGNITUDE OF ANTICIPATED SYNERGY SAVINGS FROM THE ACQUISITION?

A. Yes, it does. The due diligence findings report contains detailed financial model results that are used to justify the ultimate premium which RWE was willing to pay to acquire

AWW. Page 41 of the August 14 report contains a section entitled {**begin confidential**

end confidential}

Q. DO OTHER PRE-ANNOUNCEMENT DOCUMENTS SHOW AN EXPECTATION THAT THERE WILL BE SYNERGY SAVINGS FROM THE ACQUISITION OF AWW?

A. Yes. Several of the internal studies of Thames, RWE, AWW and their financial advisors indicate their assumption that there will be substantial synergy savings from the transaction. For example, on June 22, 2001, Goldman Sachs prepared a report for AWW (OCA I-14) showing that {**begin confidential**

end confidential} (p. 26) That same page shows {**begin confidential**

end confidential}

A subsequent Goldman Sachs study for AWW (prepared on July 16, 2001; OCA I-14) contains a more accurate analysis of the synergy savings required for RWE to breakeven, given the requirement under IAS that it amortize the premium paid for AWW's stock. This analysis shows that {**begin confidential**

end confidential}

Interestingly, Goldman Sachs' study from June 2001 identifies, on its last page,

{begin confidential

. **end confidential}**

Q. THE GOLDMAN SACHS DOCUMENTS TO WHICH YOU JUST REFERRED WERE PREPARED FOR AWW. ARE THERE INDICATIONS THAT THAMES AND RWE ALSO ANTICIPATED SUBSTANTIAL SYNERGY SAVINGS FROM THE ACQUISITION OF AWW?

A. Yes, there are. In its first board presentation, dated March 19, 2001 (OCA I-91), Thames identifies the following as being among the "potential additional benefits" from acquiring AWW: **{begin confidential**

end confidential} (p. 55)

A subsequent Thames board presentation, dated May 8, 2001 (OCA I-91) goes into further detail on some of the expected synergy savings from the acquisition of AWW. On page 24 of that presentation, Thames **{begin confidential**

end confidential} Further, on page 31 of that presentation, Thames provides a very similar analysis to that which Goldman Sachs prepared for AWW. The Thames analysis shows **{begin confidential**

end confidential}

Further, on page 32 of the May 8 presentation, Thames again summarizes the "potential additional benefits" from the transaction, but it adds a potential benefit that was not listed in its March 19 presentation: {**begin confidential**

end confidential} This drive to produce savings from the combination of Thames and AWW is further explained on page 36 of the May presentation, where Thames states: {**begin confidential**

end confidential}

Q. FROM YOUR REVIEW OF THESE PRE-AGREEMENT DOCUMENTS, WHAT DO YOU CONCLUDE?

A. I conclude that RWE, Thames, and AWW all went into this transaction with a clear understanding that there were opportunities to achieve substantial synergy savings by combining AWW and Thames. Indeed, all of the parties understood that in order for RWE to justify the premium that it paid for AWW's common stock, RWE would need to reduce AWW's expenses and otherwise increase the efficiency of AWW's operations. Thames itself estimated the magnitude of savings that it achieved when it acquired Elizabethtown Water Co. and quantified the potential for obtaining similar savings at AWW.

Q. IS THERE ANY INFORMATION IN THE COMPANIES' POST-AGREEMENT DOCUMENTS THAT ADDRESSES THE POTENTIAL SYNERGY SAVINGS FROM THE TRANSACTION?

A. Yes, the companies' Transition Implementation Plan dated February 2002, which I discussed earlier, also contains information about the savings that are achievable from the combination of Thames and AWW. The only version that I have of this document is a non-proprietary version that deletes much of the detail. However, from the public version that I have, it is apparent that the companies intend to achieve savings and efficiencies in several areas. The transition plan identifies three broad categories for the transition, two of which relate directly to the identification and creation of efficiencies and synergies between Thames and AWW: "best practice – where process improvements can be achieved from combining the strengths of the two businesses" and "implementation of new processes to improve efficiency, effectiveness and business performance." (p. 4)

Q. DOES THE TRANSITION PLAN CONTAIN ANY DETAILS ABOUT SPECIFIC AREAS WHERE SAVINGS WILL BE ACHIEVED?

A. Yes, there is some detail in the non-proprietary version of the document. For example, on pages 37-39, Transition Project OP1 is described. This project's goal is to review all operating and maintenance (O&M) activities within AWW, including plant O&M, network (distribution) O&M, leakage reduction, energy management, and others. The plan states: "This review will apply to all AWW operational assets, above and below ground. Comparisons will be made with TW [Thames Water] procedures to identify opportunities to reduce risk, improve efficiency and improve regulatory compliance and levels of service where required."

Part of this project is a thorough analysis of energy management options, which is described as follows: "Following deregulation in 1999, the market has been tested in 4 states resulting in 2-3% savings in 2 of the states. A 2-year program of energy audits, in addition to bill and tariff analysis, has recently commenced to address the whole company, with the aim of reducing energy costs by 10%. Deals with power brokers are also being tested (e.g. Pittsburgh)."

Similarly, Project OP8 (p. 51) discusses ways to integrate the research and development (R&D) departments of AWW and Thames. The plan states: "The merging of the two companies' R&D capabilities will lead to opportunities to drive greater value from a combined force."

Q. ARE YOU ABLE TO QUANTIFY THE EFFECTS OF ANY OF THESE TRANSITION PROJECTS?

A. No, I am not. From the non-proprietary version of the document, it is not possible to quantify the effects of any of these projects, or even to understand the full scope of the projects. Any detail about the projects and proposed actions was redacted from the version that I have. For instance, project OP1 (the O&M review) is not a single project but, according to the critical path charts attached to the plan, there are 12 separate tasks that are part of this one project (any detail about those 12 tasks – even their names – also was redacted).

Q. BASED ON YOUR REVIEW OF COMPANY DOCUMENTS AND PUBLIC STATEMENTS, WHY HAVEN'T THE COMPANIES ACKNOWLEDGED THAT THE TRANSACTION WILL RESULT IN REDUCED COSTS FOR AWW AND PAWC?

A. There are several references in the documents, both public and confidential, to the need to avoid the "claw back" of benefits by AWW's regulators. The companies apparently believe that if they do not specifically quantify the expected savings from the merger, then regulators will not be able to reduce rates or otherwise provide some of these benefits to consumers, as a way to offset some of the substantial risks to consumers from the merger.

Q. DESPITE THEIR FAILURE TO QUANTIFY THE SYNERGY SAVINGS FROM THE ACQUISITION OF AWW, ARE THERE ANY INDICATIONS THAT RWE AND THAMES EXPECT TO HAVE TO PROVIDE SOME BENEFITS TO AWW'S CUSTOMERS?

A. Yes. In what appears to be the final presentation to RWE's Supervisory Board on August 22, 2001 (OCA I-91), there is an estimate of transaction costs and provisions (p. 53). RWE's estimate of transaction costs includes {**begin confidential** **end confidential**} Thus, it appears that RWE and Thames recognize that some level of public benefits or savings must be offered in exchange for regulatory approval of the transaction.

Q. HAVE YOU ESTIMATED THE LEVEL OF BENEFITS THAT SHOULD BE ALLOCATED TO AWW'S CONSUMERS IN PENNSYLVANIA?

A. Yes. I have used five different methods that use various aspects of savings estimates that the companies have used. I then allocate those savings to PAWC. All of the savings estimates are alleged to be confidential, so I will discuss the specific calculations below. My allocations of the savings to PAWC are based on figures taken from the annual reports of PAWC and AWW (both as of December 31, 2001) and, in one instance, from information on the number of customers in each state where there is a contested proceeding involving the merger.

Q. BEFORE YOU DISCUSS THE SPECIFIC CALCULATIONS, PLEASE PROVIDE THE PUBLIC INFORMATION ON WHICH YOU WILL RELY.

A. I will use the following information: (1) PAWC's level of O&M expenses for calendar year 2001, which is $121,866,000; (2) PAWC's total amount of long-term debt as of December 31, 2001, which is $679,575,000; (3) the ratio of PAWC's O&M expenses in

2001 to AWW's water O&M expenses in 2001, which is $121,866,000 / $595,981,000 = 20.4%; (4) the ratio of PAWC's net income in 2001 to AWW's corporate net income in 2001, which is $52,830,000 / $161,183,000 = 32.8%; and (5) the ratio of PAWC customers to the total number of AWW customers in states where there is a formal proceeding regarding the approval of this transaction, which is 606,000 / 1,871,000 = 32.4% as I show on Schedule SJR-2.

Q. PLEASE DISCUSS THE FIVE METHODS THAT YOU HAVE USED TO ALLOCATE SYNERGY SAVINGS TO PAWC.

A. **{begin confidential**

end confidential}

Q. BASED ON THOSE FIVE METHODS OF ESTIMATING SAVINGS, WHAT DO YOU RECOMMEND?

A. I recommend that the Commission allocate at least $10 million in savings to the customers of PAWC. This is not a precise calculation, but it reflects my judgment of a reasonable estimate of savings given the range of $6.5 million to $32.8 million set forth above.

Q. HOW DO YOU RECOMMEND THAT THESE SAVINGS BE PROVIDED TO PAWC'S CUSTOMERS?

A. There are a number of ways in which these benefits could be provided to PAWC's customers. The most obvious way, of course, is to order a reduction in PAWC's rates in that amount as of the date the transaction closes and to require the reduction to remain in place for an extended period of time. Other options might include requiring PAWC to expand existing programs or implement new programs for low-income consumers. Similarly, substantial benefits for consumers also could be achieved by requiring PAWC to refrain from filing another base rate proceeding for an extended period of time, or by some combination of these actions.

Q. DO YOU HAVE AN ULTIMATE RECOMMENDATION ON THE SAVINGS ISSUE?

A. Yes. I recommend that the Commission require PAWC to reduce its base rates by $10 million within 5 business days after the transaction closes and to keep that reduction in place for at least 24 months. This would be achieved by prohibiting PAWC from filing for a base rate increase before the transaction closes, and by extending that prohibition for at least 15 months after the transaction closes. (The 24 months during which the $10 million reduction is in effect is made up of the 15 months after closing when PAWC is prohibited from filing for a base rate increase, plus the 9 months during which that rate increase request would be investigated by the Commission.) As I mentioned above, there are other ways in which similar value can be provided to PAWC's customers and I recognize that other parties might prefer one option over another. My personal preference is to provide these benefits in a way that is readily apparent to consumers and that is easily quantifiable. If the Commission finds that other methods should be used to pass on these savings to consumers, I would strongly recommend that the Commission provide a specific quantification of the benefits that would be received by consumers, so that the public can easily understand and verify the magnitude of benefits they are receiving from this acquisition.

Q. WHY IS IT IMPORTANT FOR THE PUBLIC TO UNDERSTAND THE MAGNITUDE OF THE BENEFITS THEY ARE RECEIVING FROM THIS TRANSACTION?

A. The only public information, at this point, about the proposed acquisition of AWW concerns the benefits that would be received by AWW's stockholders, officers, and high-level employees. The public knows that AWW's stockholders would receive a benefit in excess of $1 billion because the $46 per share paid by RWE exceeds the market value of AWW's common stock prior to the public reports of the transaction by at least $10 per share (and probably closer to $15 per share). The public also is aware of the benefits that would be received by AWW's officers and high-level employees, amounting to $15 million in retention bonuses plus millions of dollars more if any officers subject to change in control agreements leave the company. In addition, certain officers will receive cash in exchange for unexercised stock options, as well as cashing out their own stock holdings.

It is important, therefore, for the public to see and understand that this transaction is not taking place solely to enrich the stockholders and officers of AWW; that there also is a significant benefit to the customers of AWW in general and PAWC in particular.

In my opinion, the best way to do that is to reduce rates for consumers immediately upon the closing of the transaction. As I stated earlier, there are other ways to provide benefits to consumers, and I recognize that various parties may prefer other ways to provide those benefits. Whatever method is chosen, however, I believe it is very