50. AWWC will hold all of KAWC's common stock and shall not transfer any of that stock without prior Commission approval even if the transfer is pursuant to a corporate reorganization as defined in KRS 278.020(6)(b).

51. If any state regulatory commission, except the New Jersey Board of Public Utilities, imposes conditions on RWE, Thames, TWUS, or AWWC as a condition for its approval of the proposed merger and those conditions would benefit ratepayers in any other jurisdiction, proportionate net benefits and conditions will be extended to KAWC ratepayers.

52. KAWC will retain its current name and will continue as a corporation organized under Kentucky law.

53. KAWC's headquarters will remain in Lexington, Kentucky.

54. RWE, Thames, TWUS, AWWC, and KAWC will honor all existing KAWC contracts, easements, or other agreements with the LFUCG, and will negotiate with the LFUCG in good faith regarding the renewal of those agreements.

55. KAWC will not, for at least one year from the date of the consummation of the merger or until March 16, 2004, whichever occurs later, eliminate any non-management or union employee positions, except for those positions related to the transfer of accounting and call center functions to AWWC Service Company that were planned prior to the announcement of the Acquisition Agreement.

56. RWE, Thames, TWUS, AWWC, and KAWC will maintain a sound and constructive relationship with those labor organizations that may represent certain AWWC or KAWC employees, will remain neutral respecting an individual's right to choose to be a trade union member, will continue to recognize the unions that currently

have collective bargaining agreements with KAWC, and will honor any agreements with those unions.

57. RWE, Thames, TWUS, and AWWC agree that the Franklin Circuit Court of this Commonwealth has personal jurisdiction to hear and consider any legal action or proceeding that the Commission may bring against them to enforce the provisions and conditions set forth in this Order and the Commission's Orders of May 30, 2002 and July 10, 2002 in Case No. 2002-00018. They further agree to waive all objections and defenses based upon personal jurisdiction to any action that the Commission may bring in Franklin Circuit Court to enforce the provisions and conditions set forth in these Orders.

58. RWE, Thames, TWUS and AWWC shall appoint an agent in Kentucky for the limited purpose of accepting the service of process of any action that the Commission may bring to enforce the provisions and conditions set forth in this Order and the Commission's Orders of May 30, 2002 and July 10, 2002 in Case No. 2002-00018.

59. TWUS shall not be involved in the operational control of KAWC or AWWC without prior Commission approval.

60. TWUS shall not engage in any commercial transactions involving the sale or exchange of goods or services with KAWC or AWWC. "Commercial transactions" does not include financial transactions such as the payment of dividends or the filing of a consolidated federal tax return.

61. Following completion of the proposed transaction, the membership of the Boards of Directors of TWUS and AWWC shall be the same.

BEFORE THE
WEST VIRGINIA PUBLIC SERVICE COMMISSION

Joint Petition for the Consent and Approval of the Acquisition of the Outstanding Common Stock of American Water Works Company, Inc., the Parent Company and Controlling Shareholder of West Virginia-American Water Company	:	Case No. 01-1691-W-PC

Direct Testimony of
Scott J. Rubin

on Behalf of
Consumer Advocate Division

June 5, 2002

Table of Contents

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 17870.

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 Consumer Advocate Division 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 West Virginia subsidiary, West Virginia-American Water Company (WVAWC).

Q. ARE YOU PERFORMING THIS REVIEW SOLELY FOR THE CONSUMER ADVOCATE DIVISION?

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

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

A. I was employed by the Pennsylvania Office of Consumer Advocate (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 petition and supporting testimony of the applicants, as well as 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 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 SUBJECT TO PROTECTION AS CONFIDENTIAL INFORMATION?

A. Yes, the applicants allege that some of the information they provided should be exempt from public disclosure. When I refer to information that they allege to be confidential, I will mark it by enclosing it in brackets and using a double underline like this {**begin confidential** example **end confidential**}.

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 WVAWC as a result of the change in ownership and control of WVAWC'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 WVAWC'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, my conclusion is that the risks to consumers from the transaction are substantial and will constitute a substantial detriment to WVAWC's customers and the State 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 WVAWC's consumers. The allocation of savings to consumers is necessary as a matter of fairness and as a way to provide further mitigation of the risks posed by the transaction.

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. (Definitive Proxy Statement, Dec. 5, 2001, pp. 29-30)

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

A. Yes, the following employees of WVAWC will receive retention bonuses in the amounts shown: Chris Jarrett (President) - $300,000; James Hamilton (Director, Business Development) - $67,950; and Daniel Bickerton (Director, Business Development) -

$67,950. In addition, 18 employees of American Water Works Service Company, which provides various services for WVAWC, will receive bonuses totaling $2,975,000.

Q. SHOULD ANY OF THE RETENTION BONUS PAYMENTS BE INCLUDED IN WVAWC'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 (CAD 1-7, CAD 1-18, CAD 1-19). 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 WVAWC 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 WVAWC?

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 WVAWC?

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 WVAWC. Specifically:

> <u>Condition 2.</u> Require WVAWC 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 WVAWC, which are American Water Works Service Co.; American Water Capital Corp.; and American Water Resources, Inc. (copies of the agreements between WVAWC and these affiliates were provided in CAD 2-41).

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 WVAWC'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 $2.9 billion (CAD 2-16). In other words, RWE is paying approximately 2.6 times book value for AWW's common stock.

Q. DOES THIS CREATE ANY CONCERNS FOR WVAWC'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, CAD 1-17).

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, CAD 2-6)

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." (p. 55) In addition, RWE's internal analyses concerning the acquisition identify the possibility of selling some of AWW's land holdings with an estimated value of $100 million.

5. Thames, AWW, and WVAWC have stated that they will not attempt, either directly or indirectly, to charge any of the acquisition premium or goodwill to WVAWC or any other operating utility of AWW. (CAD 2-17). 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." (CAD 2-18)

Q. WHAT RISKS ARE CREATED FOR WVAWC 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, RWE has announced plans to issue additional debt of up to €10 billion in Europe (approximately \$9.2 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.) In March, apparently as a result of the significant planned increase in indebtedness, Moody's downgraded RWE's bonds to a single A rating. (Moody's Downgrades RWE To A1, Negative Outlook, Places Innogy's Baa1 Under Review For Upgrade Following Innogy Acquisition Announcement, Mar. 22, 2002, attached hereto as Schedule SJR-1)

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

A. If RWE needs to raise or conserve cash, it could reduce its spending on needed capital expenditures at WVAWC or other regulated subsidiaries. It also could take other actions that might not be in the best interests of WVAWC customers, such as reducing

[1] Throughout this testimony, euros (€) are converted to U.S. dollars (\$) using the exchange rate of €1 = \$0.9212, the closing exchange rate on Friday, May 24, 2002, as reported by the *Wall Street Journal*.

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 actions 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. Recently, 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, in April, Standard & Poor's downgraded the bonds of the utility subsidiaries of Allegheny Energy, including Monongahela Power, 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 unregulated operations. (Kansas Regulators To Probe Utilicorp's Affiliate Deals, *Dow Jones Newswires*, Mar. 14, 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." (Schedule SJR-1)

Q. ARE THERE OTHER ELEMENTS OF THE TRANSACTION THAT CREATE FINANCIAL RISK FOR WVAWC'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 CAD 1-11 and CAD 1-12, the applicants were asked to provide "all documents in the possession of AWW" concerning the financial capability of RWE and Thames to successfully operate AWW and WVAWC 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 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. (CAD 1-15; see also the Definitive Proxy Statement of Dec. 5, 2001, which discusses Goldman Sachs' opinion)

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 CAD 2-82, the applicants state that as of September 30, 2001, RWE had future liabilities of €10.53 billion ($9.70 billion) for nuclear waste disposal and €2.26 billion ($2.08 billion) for liabilities related to coal mining activities. RWE's annual report for 2001 updates these figures to €11.52 billion ($10.61 billion) for nuclear waste disposal (€914 million ($842 million) of which has been funded) and €2.29 billion ($2.11 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.

Despite this recent development, though, RWE changed its method for accruing nuclear decommissioning costs between June 30, 2001, and December 31, 2001. Specifically, RWE changed from accruing decommissioning costs over a 19-year period to a 25-year period (compare page 144 of RWE's annual report for the 12 months ending June 30, 2001, and page 115 of its partial-year report for the six months ending December 31, 2001).

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 ($10.25 billion). So its future liabilities for nuclear waste disposal and decommissioning are approximately equal to its total shareholders equity.

Q. RWE'S BONDS HAVE A HIGHER RATING THAN AWW'S. CAN'T WE JUST RELY ON THE BOND RATINGS TO ASSESS THE RELATIVE RISKS OF THE COMPANIES?

A. No, regulators need to be concerned with much more than just credit ratings. Credit ratings are designed to provide information on the ability and willingness of corporations to repay their debts. Bond ratings tell us little if anything about the quality of service that a company provides to its customers, it willingness to invest in capital improvements, or the many other factors that should concern economic regulators.

Q. WOULD WVAWC'S ABILITY TO RAISE CAPITAL BE ENHANCED IF THIS TRANSACTION IS CONSUMMATED?

A. Not necessarily. A major factor is the willingness of RWE to provide the necessary capital to AWW and WVAWC. Let me give you an example. For many years, the only AAA-rated utility in the United States was Citizens Utilities. Citizens maintained relatively low levels of debt and high cash flows, two factors that gave debt investors a great deal of security. However, several of the utilities that Citizens owned had serious problems with the quality of service provided to customers, in large part because Citizens did not always invest the capital that was needed to upgrade facilities and otherwise ensure the safety and reliability of service.

Q. ARE THERE OTHER EXAMPLES OF UTILITY HOLDING COMPANIES WITH HIGH BOND RATINGS BUT SERIOUS PROBLEMS?

A. Yes, I have not studied this question in great detail, but I know for instance that Enron Corporation (the parent of Portland General Electric Co., an electric utility in Oregon) enjoyed a bond rating of AA until it disclosed that it had inflated its earnings by hundreds of millions of dollars, ultimately prompting its bankruptcy. Enron found many ways to keep debt off of its balance sheet, making investors and rating agencies believe that its interest obligations were relatively small compared to its cash flows. The collapse of Enron affects not only its investors, but also the customers of its utility subsidiary.

Q. WHY HAVE AWW'S BONDS BEEN RATED LOWER THAN RWE'S?

A. I do not know all of the factors that rating agencies considered, but a major factor is AWW's willingness to issue new debt to finance its operations. AWW typically has net debt equal to between 50 and 60 percent of its assets. In contrast, as of March 31, 2002 (and historically), RWE has negative net debt; that is, the value of its cash and marketable securities is more than the amount of debt that it issued. Of course, bond investors feel better about a company that has more cash than debt and, other things being equal, such a company will have much higher bond ratings. But at the same time, regulators should look very carefully at a company that is not using much debt to fund its operations. That could be an indication that it will be difficult for subsidiaries to obtain the capital necessary to maintain and upgrade facilities.

Q. ARE THERE ANY SUCH INDICATIONS IN RWE'S OPERATIONS?

A. I have not conducted a detailed study of RWE's history of making capital improvements in its utility operations. I would note, however, that RWE's quarterly report for the first quarter of 2002 seems to point with pride to the fact that RWE's capital expenditures were much lower in the quarter than they were in the comparable quarter of 2001. In fact, RWE's expenditures on fixed assets were 26% lower in the first quarter of 2002 than they were in the first quarter of 2001. (RWE Report on the First Quarter of Fiscal 2002, released May 15, 2002, p. 8)

Q. WHAT DO YOU CONCLUDE ABOUT THE USE OF BOND RATINGS TO ASSESS THE FINANCIAL CAPABILITY OF A UTILITY HOLDING COMPANY?

A. Bond ratings are just one piece of useful information. Regulators, though, must look at much more than just bond ratings to assess whether a company has both the capability and the willingness to fund capital improvements in utility operations. In addition, regulators must look at the risks of other subsidiaries having a call on any capital that is available. In the case of RWE, I highlighted concerns with its nuclear power and coal mining operations that carry with them substantial needs for cash in the future to fund decommissioning and coal mine restoration. Finally, regulators also must be aware that changes in the parent company's bond ratings and financial health will directly affect the utility subsidiaries. As I mentioned earlier, when RWE was downgraded recently, the rating agency also downgraded Thames at the same time. The downgrading had nothing to do with Thames' operations as such; the downgrading was based on RWE's issuance of new debt to fund acquisitions.

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 WVAWC. 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 WVAWC.

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 WVAWC and its customers, since WVAWC'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. In fact, RWE's internal report on the merger discusses the need to keep "the top management until the end of the transaction" and the "departure of the CEO as planned." (Project Apollo Presentation to the Supervisory Board of RWE AG, Aug. 22, 2001, p. 42) It is at least questionable, therefore, whether Mr. Barr will remain with the company after the transaction is completed.

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

A. Yes, this transaction also creates a risk that WVAWC 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 WVAWC 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 West Virginia.

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 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-2, 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:

> <u>Condition 3.</u> Require WVAWC to disclose all uses made of WVAWC 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.

<u>Condition 4.</u> Require WVAWC to obtain a certificate of public convenience from the Commission prior to the sale or transfer by WVAWC of any land in West Virginia, regardless of the book value of the land.

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

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

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

<u>Condition 8.</u> Require WVAWC 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 WVAWC and whether the budget as approved will impose any limitations on WVAWC's ability to provide safe, adequate, and reliable service to its customers.

<u>Condition 9.</u> Require WVAWC 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.

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

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

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

<u>Condition 13.</u> Prohibit WVAWC 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 WVAWC 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 expressed concern about a utility 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 directors (who were largely the same as the parent company's directors) "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 WVAWC. At the present time, WVAWC 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 WVAWC is in the water business and it is owned by a company that is also in the water business. As of December 31, 2001, WVAWC accounted for approximately 6% of AWW's customers, revenues, and net income, and approximately 8% of AWW's assets. (These figures are calculated by comparing WVAWC's financial statements with those of AWW, as of December 31, 2001. WVAWC's annual report to the Commission can be found on the Commission's 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, WVAWC 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 WVAWC. 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 WVAWC'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 WVAWC. First, and perhaps most importantly, the Commission may lose the ability to approve and condition future changes in control of WVAWC. 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 WVAWC.

Moreover, the Commission's access to information about WVAWC'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. (CAD 2-55) Moreover, the Thames-AWW transition plan states that RWE "requires all Divisions and their subsidiaries to report under IAS." As a result, AWW and WVAWC 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." (p. 16)

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 WVAWC'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 WVAWC. I recommend that the Commission adopt the following conditions:

> Condition 14. Require WVAWC to file an application requesting Commission approval of any transaction that would change the entity that ultimately owns or controls the common stock of WVAWC or AWW. Included in this condition is a waiver by WVAWC 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 WVAWC 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 WVAWC must certify the accuracy of the English-language translation.

<u>Condition 16.</u> Require that whenever WVAWC 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.

<u>Condition 17.</u> Require WVAWC to keep its books and records at a location within the United States and to specifically identify where the records are located.

VI. Service Quality Risks

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

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 WVAWC'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 WVAWC 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:

> <u>Condition 18.</u> Require WVAWC 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.
>
> <u>Condition 19.</u> For the annual reports covering the years 2002 through 2008, require WVAWC 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.
>
> <u>Condition 20.</u> Require WVAWC to continue to protect and safeguard the condition of all of its watershed land holdings surrounding its surface water and groundwater supplies in West Virginia.

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 WVAWC from including in its rates, in any fashion, any portion of the costs associated with the retention bonus program.

Condition 2. Require WVAWC 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 WVAWC, which are American Water Works Service Co.; American Water Capital Corp.; and American Water Resources, Inc. (copies of the agreements between WVAWC and these affiliates were provided in CAD 2-41).

Condition 3. Require WVAWC to disclose all uses made of WVAWC 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 WVAWC to obtain a certificate of public convenience and necessity from the Commission prior to the sale or transfer by WVAWC of any land in West Virginia, regardless of the book value of the land.

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

Condition 6. Prohibit WVAWC 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 WVAWC, AWW, Thames, or RWE or any of their subsidiaries from pledging any of the assets of WVAWC or the stock of WVAWC for any purpose without first having obtained a certificate of public convenience and necessity from the Commission.

Condition 8. Require WVAWC 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 WVAWC and whether the budget as approved will impose any limitations on WVAWC's ability to provide safe, adequate, and reliable service to its customers.

Condition 9. Require WVAWC 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 WVAWC'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 WVAWC.

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

Condition 13. Prohibit WVAWC 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 WVAWC to file an application requesting Commission approval of any transaction that would change the entity that ultimately owns or controls the common stock of WVAWC or AWW. Included in this condition is a waiver by WVAWC 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 WVAWC 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 WVAWC must certify the accuracy of the English-language translation.

Condition 16. Require that whenever WVAWC 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 WVAWC to keep its books and records at a location within the United States and to specifically identify where the records are located.

Condition 18. Require WVAWC 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 WVAWC 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 WVAWC to continue to protect and safeguard the condition of all of its watershed land holdings surrounding its surface water and groundwater supplies in West Virginia.

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 WVAWC by Thames and RWE. Implementing these conditions does not provide any benefit to WVAWC's consumers. The conditions are designed to try to preserve the current condition of WVAWC's consumers. In other words, the conditions only try to ensure that WVAWC'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 WVAWC 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, CAD 2-6)

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, CAD 2-6)

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. 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)

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, 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 showing that **{begin confidential**

end confidential} That same document shows **{begin confidential**

end confidential}

A subsequent Goldman Sachs study for AWW (prepared on July 16, 2001) 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, Thames identifies the following as being among the "potential additional benefits" from acquiring AWW: **{begin confidential**

end confidential}

A subsequent Thames board presentation, dated May 8, 2001, 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, Thames provides a very similar analysis to that which Goldman Sachs prepared for AWW. The Thames analysis shows **{begin confidential**

end confidential}

Later in 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: "potential economies of scale and synergy opportunities with Trident" which is the code word for Thames. 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. It is apparent from this document 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 a limited amount of detail in this 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." One of the proposed actions under this project is the development of a TW [Thames Water] Americas regional plan for future R&D program, identifying synergies with TW Global R&D." (p. 51)

Q. IS THERE ANY ADDITIONAL INFORMATION IN THE TRANSITION PLAN THAT SHOWS THE COMPANIES' PLANS TO IDENTIFY SAVINGS?

A. Yes. In two additional places, the companies further discuss their plans to generate savings from the transaction. First, in the area of finance, the companies describe a proposed action to "identify any 'quick wins' available through the current change activities and communicate to the finance community." (p. 15) Similarly, in the area of real property management, the companies state that they will "identify and prioritize property assets with high alternative use values and match with operational requirements, both current and future" and "prepare report on 'quick wins.'" (p. 56)

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

A. No, I am not. It is not possible to quantify the effects of any of these projects, or even to understand the full scope of the projects from the transition plan.

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 WVAWC?

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, there is an estimate of transaction costs and provisions (p. 54). 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 WEST VIRGINIA?

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 WVAWC. All of the savings estimates are confidential, so I will discuss the specific calculations below. My allocations of the savings to WVAWC are based on figures taken from the annual reports of WVAWC and AWW 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.