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

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, Pennsylvania, 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 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 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.

II. Outline of Testimony

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. My testimony begins, in Sections III with a discussion of the Standard of Review. Sections IV through VI contain a discussion of various categories of risk associated with the proposed acquisition. In these sections, I am referring to risks to the customers of NJAWC as a result of the change in ownership and control of NJAWC's parent company. These risks include risks from change in management, risks from RWE's business profile and other business units, and risks of changes in the regulatory jurisdiction of the Board as a result of the transaction.

In Section VII, I discuss the effects of the proposed transaction on competition in New Jersey. Finally, in Section VIII, I summarize the conditions that the Board 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 NJAWC'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.

III. Standard of Review

Q. WHAT SPECIFIC AUTHORITY DO THE JOINT PETITIONERS SEEK FROM THE BOARD IN THIS PROCEEDING?

A. Joint Petitioners filed a Petition seeding Board approval of the merger pursuant to N.J.S.A. 48:3-10 and 48:2-51.

Q. WHAT DO THESE STATUTES REQUIRE?

A. I have been advised by counsel that N.J.S.A. 48:3-10 prohibits New Jersey public utilities from selling or transferring capital stock to any other public utility and from selling majority interest in capital stock to any corporation without Board authorization. In considering requests under this provision, I am advised that the Board must determine, *inter alia*, if the utility is able to meet pension benefit commitments previously made to employees.

N.J.S.A. 48:2-51.1 imposes additional requirements on the Joint Petitioners. I am advised that, under this statute, written Board approval is required for any person to acquire control of a New Jersey public utility. Under the statute, the Board is required to evaluate four specific areas in making a public interest finding. The statute states in relevant part:

> In considering a request for approval of an acquisition of control, the board shall evaluate the impact of the acquisition on competition, on the rates of ratepayers affected by the acquisition of control, on the employees of the affected public utility or utilities, and on the provision of safe and adequate utility service at just and reasonable rates …

I understand that the Board will make specific findings on each aspect of the public interest standard outlined in the merger statutes. Ultimately, the Board must determine whether the transaction will result in an impact on competition, rates, New Jersey employees, and the provision of safe and adequate water service at just and reasonable rates.

Q. HAS THE BOARD INTERPRETED THESE REQUIREMENTS IN OTHER MERGER PROCEEDINGS?

A. Yes. I have been advised by counsel that in prior merger proceedings the Board has alternately used a "no harm" standard and a "positive benefit" standard to evaluate applications for changes in control. Under the "positive benefit" standard, merger applicants must prove positive benefits would result from a merger relative to the statutory review requirements. A "no harm" standard requires merger applicants to merely demonstrate that a merger will not produce an adverse result relative to the four areas specified in the statute.

I am advised that the Ratepayer Advocate will take the position that the Board should use the "positive benefit" standard in this proceeding. That is, Joint Petitioners need to demonstrate that New Jersey ratepayers will receive positive net benefits resulting from the merger that could not have been achieved in the absence of the merger.

IV. 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 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 NJAWC, OR THE OTHER AWW SUBSIDIARIES THAT PROVIDE SERVICES TO NJAWC, RECEIVE THESE RETENTION BONUSES?

A. Yes, the following employees of NJAWC will receive retention bonuses in the amounts shown:

Robert Gallo	President	$382,500
William Clarkson	Director, Business Development	84,713
Gary Clarke	Vice President, Human Resources	78,750
William Davis	Vice President and Treasurer	92,250
Lendel Jones	Director, Government Affairs	58,388
Karl Kyriss	Vice President, Operations	96,750
Michael Sgro	Counsel	100,688
Total		$894,039

In addition, 18 employees of American Water Works Service Company, which provides various services for NJAWC, will receive bonuses totaling $2,975,000. (RAR-R-84)

Q. SHOULD ANY OF THE RETENTION BONUS PAYMENTS BE INCLUDED IN NJAWC'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 (RAR-R-84). This response also states 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 Board explicitly condition its approval of the acquisition as follows:

> Condition 1. Prohibit NJAWC 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 NJAWC?

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 BOARD CARE IF KEY EMPLOYEES REMAIN WITH NJAWC?

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, loss of institutional memory or history, 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 Board condition its approval of the acquisition to impose a reporting requirement on NJAWC. Specifically:

> Condition 2. For two years following Board approval of the merger, NJAWC shall notify the Board, the Ratepayer Advocate and any intervenors within five business days if any of the officers, managers, or key employees[1] of NJAWC, AWW, or AWW subsidiaries that supply essential services to NJAWC[2] leaves the employ of the company. The notification should include an explanation of the reasons why the employee is leaving the company and the plans for replacing the employee.

Q. WHAT WILL THIS REPORTING REQUIREMENT ACCOMPLISH?

A. The reporting requirement will provide the Board, the Ratepayer Advocate and interested parties with information that can be used to investigate potential problems within the company or, perhaps, to identify the need for a management audit or other study of NJAWC's operations to ensure that it continues to meet its obligations to customers and the public in the provision of safe, adequate and proper water service.

Q. HAS THE COMPANY MADE ANY COMMITMENT REGARDING LOCAL RESIDENCY REQUIREMENTS FOR THE BOARD OF DIRECTORS OF NJAWC?

A. Yes. The Company has stated that of the eleven members that currently comprise the NJAWC Board of Directors, 6 are New Jersey residents. In response to Ratepayer

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[1] I would define "key employee" as anyone who received a retention bonus payment.

[2] Copies of the agreements between NJAWC and these affiliates were provided in RAR-R-56.

Advocate request RAR-R-46, regarding expected changes in the composition of the NJAWC Board of Directors after the merger, the Company responded:

> Thames plans on continuing significant local representation on the Boards of Directors of Americans' operating utilities. Any change in the composition of the Board of Directors of NJAWC as a result of this transaction will not lessen the percentage of New Jersey residents on the Board.

Q. HAS THE COMPANY MADE ANY SIMILAR COMMITMENT REGARDING THE GEOGRAPHIC AFFILIATIONS OF DIRECTORS ON THE BOARDS OF AWW OR THAMES?

A. No. With regard to the composition of the AWW Board of Directors, the Company has merely stated that "consistent with New Jersey law Thames will appoint all members of the AWW Board of Directors." RAR-R-69. With regard to Thames, that Company has responded that there are no U.S. nationals on either the Board of Thames Plc or the Board of Thames Holdings. The Company advises, however, that "after the closing of this transaction, James Barr, the President and CEO of AWW, will join the Board of Directors of Thames Plc." RAR-R-70.

Q. DO YOU KNOW OF ANY INSTANCE WHERE AN ACQUIRING COMPANY HAS AGREED TO CONSIDER LOCAL AFFILIATIONS WHEN APPOINTING DIRECTORS OF A HOLDING COMPANY?

A. Yes. In the United Water Resources, Inc. ("UWR") merger[3] with Lyonnaise American Holding ("LAH") the parties agreed:

> For a minimum of three years following the date of this Order, a majority of the individuals appointed to serve on the UWR Board of Directors shall be United States nationals. To ensure appropriate local input, [Suez Lyonnaise des Eaux] and LAH shall make familiarity with New Jersey

[3] I/M/O the Joint Petition of Lyonnaise American Holding Inc and United Water Resourece, Inc. for Approval of a Change in Ownership and Control of the New Jersey Operating Utilities, BPU Docket No. WM99110853.

> interests and concerns an important consideration in appointing directors to serve on the Board of UWR.

Q. IN YOUR OPINION, SHOULD THE BOARD SHOULD IMPOSE A SIMILAR CONDITION ON RWE/THAMES BEFORE GRANTING THE REQUESTED APPROVAL?

A. Yes. The Board should include the following condition in any Board Order approving the merger:

> <u>Condition 3.</u> For a minimum of three years following the date of this Order, a majority of the individuals appointed to serve on the AWW Board of Directors shall be United States nationals. To ensure appropriate local input, RWE and Thames shall make familiarity with New Jersey interests and concerns an important consideration in appointing directors to serve on the Board of AWW.

V. RWE-Related Business Risks

Q. ARE THERE ELEMENTS OF THE PROPOSED TRANSACTION THAT CREATE FINANCIAL RISK FOR NJAWC'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 Board 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, 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. (see 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 have potential business liabilities that have nothing to do with the regulated water utility business that AWW is in. 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. As of December 31, 2001, RWE had future liabilities of €11.52 billion ($11.26 billion)[4] for nuclear waste disposal (€914 million ($893 million) of which has been funded) and €2.29 billion ($2.24 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

[4] Euros (€) are converted to U.S. dollars ($) using the exchange rate of €1 = $0.9775 as of July 31, 2002.

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 ($10.89 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. Utility holding companies with high bond ratings can still have serious problems. For example, 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 IS ANY OF THIS IMPORTANT?

A. This transaction would dramatically change the nature of the holding company that owns NJAWC. 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 NJAWC.

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 NJAWC and its customers.

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. 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, the companies have stated:

> 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. (BPU Staff OCE-3, 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 RWE-RELATED BUSINESS RISKS ASSOCIATED WITH THIS TRANSACTION. WHAT DO YOU RECOMMEND TO MINIMIZE THESE RISKS?

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

> <u>Condition 4.</u> Require NJAWC to include in its Annual Report to the Board 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 NJAWC and whether the budget as approved will impose any limitations on NJAWC's ability to provide safe, adequate, and reliable service to its customers.

> <u>Condition 5.</u> Require NJAWC's Annual Report to the Board to include a complete, English-language copy of the annual reports of RWE and Thames.

VI. 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 NJAWC. At the present time, NJAWC 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 NJAWC is in the water business and it is owned by a company that is also in the water business. As of

December 31, 2001, NJAWC accounted for approximately 13% of AWW's customers, 19% of revenues, 24% of net income, and approximately 16% of AWW's assets. (These figures are calculated by comparing NJAWC's financial statements with those of AWW, as of December 31, 2001.) If this transaction occurs, NJAWC 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 NJAWC. 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 NJAWC'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 the RWE-related business risks and I have recommended conditions to deal with those issues. I also understand that Mr. Rothschild has addressed certain concerns about the impact of this transaction on the appropriate capital structure to be used in NJAWC's future rate cases. In addition, strictly from a regulatory perspective, I am concerned that this transaction could result in the Board losing some of its ability to effectively regulate NJAWC. First, and perhaps most importantly, the Board may lose the ability to approve and condition future changes in control of NJAWC. In a case like this, where the proposed transaction would add several layers of ownership above the utility, it is extremely important for the Board to ensure that it will continue to have jurisdiction over changes in control of NJAWC.

Moreover, the Board's access to information about NJAWC'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. (RAR-F-3) Moreover, the Thames-AWW transition plan states that RWE "requires all Divisions and their subsidiaries to report under IAS." As a result, AWW and NJAWC 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 Board and other interested parties to monitor the activities of NJAWC's ultimate owner.

Q. WHAT DO YOU RECOMMEND TO ADDRESS THESE CONCERNS?

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

> <u>Condition 6.</u> Require NJAWC to file an application requesting Board approval of any transaction that would change the entity that ultimately owns or controls the common stock of NJAWC or AWW. Included in this condition is a waiver by NJAWC of any arguments it may have that limit the Board's jurisdiction over changes in control above the parent level.

<u>Condition 7.</u> Require that whenever NJAWC is requested to provide documents to the Board, or in any proceeding before the Board, 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 NJAWC must certify the accuracy of the English-language translation.

<u>Condition 8.</u> Require that whenever NJAWC is requested to provide documents to the Board, or in any proceeding before the Board, 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 9.</u> Require NJAWC to keep its books and records at a location within the United States and to specifically identify where the records are located.

VII. Competition

Q. ARE THERE ANY ADDITIONAL FACTORS THAT THE BOARD SHOULD CONSIDER WHEN EVALUATING THE MERGER PETITION?

A. Yes, pursuant to N.J.S.A. 48:2-51.1, I am advised that the Board is required to evaluate the effect the acquisition will have on competition.

Q. HAS THE COMPANY ADDRESSED THIS ISSUE?

A. Yes, Joint Petitioners claim:

> The transaction contemplated by the Agreement will not adversely impact competition because after the transaction is consummated New Jersey-American will continue to serve its customers in its current franchise territories. The classic concept of competition for customers does not exist in the regulated water industry.

Q. DO YOU HAVE ANY COMMENTS ON THIS STATEMENT?

A. Yes, while it is true that the current franchise of NJAWC is not competitive, there is competitive bidding within the state of New Jersey that may be adversely affected by the merger. This is a circumstance unique to New Jersey and relates to the proposed common ownership of NJAWC and Elizabethtown Water Company.

Q. CAN YOU EXPLAIN YOUR CONCERN IN THIS AREA?

A. Yes, the common ownership, and ultimately perhaps the consolidation, of NJAWC and Elizabethtown Water will further limit the competitive bidding on public contracts in the state. For example, both Elizabethtown and NJAWC bid for the purchase of water systems in the Borough of Manville, the Borough of Chester, and the Borough of Andersen. There are a limited number of privately owned water utilities in the state with the resources necessary to bid on these public/private contracts. The consolidation of these two former competitors will reduce the number of bidders available and may adversely affect the competitive market for these services.

VIII. 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:

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

> <u>Condition 2.</u> For two years following Board approval of the merger, NJAWC shall notify the Board, the Ratepayer Advocate and any intervenor

within five business days if any of the officers, managers, or key employees[5] of NJAWC, AWW, or AWW subsidiaries that supply essential services to NJAWC leaves the employ of the company. The notification should include an explanation of the reasons why the employee is leaving the company and the plans for replacing the employee.

<u>Condition 3.</u> For a minimum of three years following the date of this Order, a majority of the individuals appointed to serve on the AWW Board of Directors shall be United States nationals. To ensure appropriate local input, RWE and Thames shall make familiarity with New Jersey interests and concerns an important consideration in appointing directors to serve on the Board of AWW.

<u>Condition 4.</u> Require NJAWC to include in its Annual Report to the Board 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 NJAWC and whether the budget as approved will impose any limitations on NJAWC's ability to provide safe, adequate, and reliable service to its customers.

<u>Condition 5.</u> Require NJAWC's Annual Report to the Board to include a complete, English-language copy of the annual reports of RWE and Thames.

<u>Condition 6.</u> Require NJAWC to file an application requesting Board approval of any transaction that would change the entity that ultimately owns or controls the common stock of NJAWC or AWW. Included in this condition is a waiver by NJAWC of any arguments it may have that limit the Board's jurisdiction over changes in control above the parent level.

<u>Condition 7.</u> Require that whenever NJAWC is requested to provide documents to the Board, or in any proceeding before the Board, 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 NJAWC must certify the accuracy of the English-language translation.

<u>Condition 8.</u> Require that whenever NJAWC is requested to provide documents to the Board, or in any proceeding before the Board, 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

[5] I would define "key employee" as anyone who received a retention bonus payment.

provided in U.S. dollars using the conversion rate between dollars and euros on December 31, 2001.

Condition 9. Require NJAWC to keep its books and records at a location within the United States and to specifically identify where the records are located.

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 NJAWC by Thames and RWE. Implementing these conditions does not provide any benefit to NJAWC's consumers. The conditions are designed to try to preserve the current condition of NJAWC's consumers. In other words, the conditions only try to ensure that NJAWC's consumers do not end up worse off as a result of this transaction.

Q. IN YOUR OPINION, IS IT IN THE BEST INTERESTS OF NJAWC'S CUSTOMERS FOR THE BOARD TO ALLOW THAMES TO PURCHASE AWW?

A. In my opinion, it would not be in the best interests of NJAWC's customers for the Board to approve this transaction unless the transaction is conditioned as I recommend and as the Ratepayer Advocate's other witnesses recommend. If the Board fails to adopt the conditions that we recommend, and thereby fails to protect consumers from the increased risks and other potential adverse effects of the acquisition, then consumers would be better off if this transaction did not occur.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

BEFORE THE
NEW JERSEY BOARD OF PUBLIC UTILITIES

Joint Petition of New Jersey-American Water Company, Inc. and Thames Water Aqua Holdings GmbH for Approval of Change in Control of New Jersey-American Water Company, Inc.	: : : :	BPU Docket No. WM0112083

Surrebuttal Testimony of
Scott J. Rubin

on Behalf of
Division of Ratepayer Advocate

August 16, 2002

I. Introduction

Q. PLEASE STATE YOUR NAME.

A. My name is Scott J. Rubin. I submitted direct testimony in this case on August 1, 2002.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. I will be responding to portions of the rebuttal testimony filed by James McGivern and Robert Gallo.

Q. TURNING FIRST TO MR. GALLO'S REBUTTAL TESTIMONY, ON PAGE 8 HE DISCUSSES A PROPOSED MODIFICATION IN YOUR CONDITION 2. DO YOU AGREE WITH HIS PROPOSED CHANGE?

A. No, I do not. I proposed that the Board require New Jersey American Water Company (NJAWC) to notify the board of the departure of key personnel at NJAWC or at any affiliate that provides essential services for NJAWC. Mr. Gallo has proposed two modifications. First, he asks that NJAWC be given 30 days to provide any notification to the Board. I accept this modification. Second, he proposes that the notification apply only to key personnel of NJAWC and not to affiliates. I do not accept this change.

Q. WHY SHOULD THE BOARD BE NOTIFIED ABOUT THE DEPARTURE OF KEY PERSONNEL AT NJAWC AFFILIATES?

A. The affiliates are providing NJAWC with services that NJAWC must provide as part of its obligation to serve the public. The corporate structure that places these services in an affiliate is simply a convenience and, one would hope, a matter of providing similar services to a number of affiliates more cost-effectively. Ultimately, though, the obligations remain with NJAWC and the other operating utilities. It is important for the

Board to be informed of changes in key personnel that could affect NJAWC's ability to serve its customers in a reliable manner.

Q. PLEASE IDENTIFY THE SPECIFIC AFFILIATES THAT ARE PROVIDING ESSENTIAL SERVICES TO NJAWC.

A. The affiliates in question are American Water Resources, Inc. (AWR), American Water Works Service Company, Inc. (AWWSC), and American Water Capital Corp. (AWCC). All of these companies are wholly owned subsidiaries of American Water Works Co. (AWW), NJAWC's parent. The agreements between NJAWC and each of these companies were provided in response to RAR-R-56.

Q. WHAT SERVICES ARE PROVIDED BY AWR THAT YOU CONSIDER TO BE AN ESSENTIAL PART OF NJAWC'S OBLIGATION TO SERVE THE PUBLIC?

A. AWR is providing NJAWC with granular activated carbon (GAC) for its Delaware River and Jumping Brook treatment plants. GAC is an essential component of the treatment process at these plants and AWR is one of the few providers in the United States of GAC of a quality suitable for treating potable water.

In addition, AWR has entered into an agreement with NJAWC to sell NJAWC's customers water service line insurance, in-home water softeners, and point-of-use water treatment devices. While these types of services are neither essential nor available exclusively from NJAWC, once the customer enters into such an agreement, it may be difficult and expensive to change service providers.

Q. WHAT SERVICES ARE PROVIDED BY AWWSC THAT YOU CONSIDER TO BE AN ESSENTIAL PART OF NJAWC'S OBLIGATION TO SERVE THE PUBLIC?

A. The agreement between NJAWC and AWWSC encompasses nearly every aspect of owning and operating a public utility. Article 1 of the agreement states that AWWSC "shall furnish" and NJAWC "shall purchase from [AWWSC] the following services: Accounting, Administration, Communication, Corporate Secretarial, Engineering, Financial, Human Resources, Information Systems, Operations, Rates and Revenue, Risk Management, and Water Quality." The agreement goes on to describe in detail the types of services that NJAWC must purchase from AWWSC. Without quoting several pages of the agreement, it is fair to summarize the agreement as requiring AWWSC to provide NJAWC with nearly every essential service, including: financial reporting, tariff preparation and administration; billing and customer service; recommending operating expenditures; internal auditing; public relations; various engineering services; developing financing plans and programs; various personnel services (including pension, payroll, and insurance); computer systems; insurance; and water quality testing.

In short, AWWSC will either provide or consult with NJAWC about nearly everything that a water utility needs to provide service to its customers.

Q. WHAT SERVICES ARE PROVIDED BY AWCC THAT YOU CONSIDER TO BE AN ESSENTIAL PART OF NJAWC'S OBLIGATION TO SERVE THE PUBLIC?

A. AWCC provides NJAWC with various financial services. The agreement describes these services as including short-term loans, long-term borrowings, and cash management.

Q. WHAT DO YOU RECOMMEND?

A. I recommend that, because NJAWC affiliates are providing essential services to NJAWC, that NJAWC be required to notify the Board if any key personnel at those affiliates leave the employ of AWW.

Q. ON PAGES 8 AND 9 OF HIS REBUTTAL TESTIMONY, MR. MCGIVERN STATES THAT THE PETITIONERS ARE NOT WILLING TO AGREE WITH THREE OF THE CONDITIONS THAT YOU RECOMMEND. WHAT IS YOUR GENERAL RESPONSE TO HIS REJECTION OF THESE CONDITIONS?

A. I am disappointed that the petitioners are not willing to accept these conditions. The three conditions should not have a serious impact on the ability of Thames and RWE to operate the business as they see fit. Rather, the conditions are designed to ensure a smooth transition to new ownership and to provide a modest level of protection to NJAWC's customers from unforeseen events.

Q. MR. MCGIVERN REJECTS YOUR CONDITION 3 CONCERNING A TRANSITIONAL REQUIREMENT THAT THE BOARD OF DIRECTORS OF AWW CONTAINS A MAJORITY OF U.S. NATIONALS. HOW DO YOU RESPOND?

A. In my appearances in other states regarding RWE's acquisition of AWW, the petitioners repeatedly criticized me for recommending conditions that did not apply to other utilities. With this condition, though, I am proposing a condition that was imposed by the Board on United Water Resources when it was acquired by Suez, a French holding company. By recommending this condition, I am simply recommending that RWE and Thames compete on a level playing field with Suez (the parent of United Water) in terms of its U.S. operations. I also would note that the condition I propose, and the condition that the Board adopted for Suez, just applies during a three-year transitional period. I do not consider this to be an onerous requirement, but simply a way of helping to ensure a smooth transition to foreign ownership and control.

Q. ON PAGES 14-18 OF HIS REBUTTAL, MR. MCGIVERN CRITICIZES YOU FOR COMPARING RWE TO OTHER HOLDING COMPANIES SUCH AS ENRON AND TO MISCHARACTERIZING THE RISKS ASSOCIATED WITH RWE'S DIVERSIFICATION. HOW DO YOU RESPOND?

A. Mr. McGivern and I have a different focus in this case. Mr. McGivern touts his company's plans for the future. I am concerned about what would happen if the future is not as rosy as Mr. McGivern hopes it will be. Recent experience in the utility industry shows, over and over again, that plans do not always come to fruition. The most severe examples of this are Enron, Worldcom, and Global Crossing. But there are numerous other examples, as well, including several electric utility holding companies and telecommunications companies that are losing money, reducing their workforce, canceling new plants, and seeing their bonds approach junk-bond ratings.

I sincerely hope that RWE does not find itself in similar circumstances. I am not asking the Board to predict the future or to try to direct RWE's global business. However, I am asking the Board to recognize that the future is uncertain and to protect NJAWC's customers from some of those risks. This is even more important in this case because RWE faces risks that American Water Works, as a stand-alone company, does not face.

I gave an example of those risks in my testimony when I discussed RWE's substantial ventures into nuclear power and coal mining. As Mr. McGivern states, RWE currently has investments in marketable securities that cover much of its liability for nuclear power and coal. What he doesn't say is that those investments are not placed in segregated trust funds (as they would be if RWE's nuclear power plants were in the United States). Rather, those funds are available for RWE to use as it sees fit.

Ultimately, the Board must decide how best to protect NJAWC's customers from the risks of future corporate problems with RWE. I hope that the "safety net" I am recommending never has to be used, but I believe that the Board would be doing a disservice to the public if it failed to put the "safety net" in place.

Q. MR. MCGIVERN ALSO DISAGREES WITH YOUR PROPOSED CONDITION 4, WHICH WOULD REQUIRE THE ANNUAL REPORTING OF NJAWC'S PROPOSED AND FUNDED CONSTRUCTION BUDGETS. HOW DO YOU RESPOND?

A. Mr. McGivern recognizes the reasons why an inquiry into NJAWC's construction program is important. On page 18, he states: if "there is concern that the company is not spending enough and is thereby jeopardizing its ability to provide safe and adequate service, the Board certainly has the tools at its disposal to conduct an appropriate investigation as required and to order the appropriate remedial action." He is exactly right. What he doesn't discuss, though, is how the Board or other interested parties are supposed to have this concern when they don't have access to the relevant information. My Condition 4 simply places a reporting requirement on NJAWC so that the Board can determine if there is a need to investigate further.

Q. HAVE THAMES AND RWE AGREED TO A SIMILAR CONDITION IN OTHER STATES?

A. Yes. On May 30, 2002, as part of its review of this transaction, the Kentucky Public Service Commission issued an order that imposed a number of conditions and requirements on Thames, RWE, AWW, and Kentucky-American Water Company (KAWC). One of those requirements is nearly identical to what I recommend on this point: "KAWC shall annually file with the Commission its current 2-year capital and operation and maintenance budgets and an explanation for any reduction in a budgeted item." KAWC, Thames, AWW, and RWE accepted the conditions and requirements imposed by the Kentucky Commission and have neither appealed nor otherwise challenged that order.

Q. FINALLY, MR. MCGIVERN "STRONGLY OPPOSES" YOUR PROPOSED CONDITION 6, WHICH WOULD REQUIRE NJAWC TO SEEK BOARD APPROVAL "OF ANY TRANSACTION THAT WOULD CHANGE THE ENTITY THAT ULTIMATELY OWNS AND CONTROLS THE COMMON STOCK OF NJAWC OR AWW." HOW DO YOU RESPOND TO MR. MCGIVERN?

A. Mr. McGivern has not stated why he opposes this condition. All he says is that NJAWC is not willing to agree to make any filings with the Board that are not otherwise required by the law. He does not state why he "strongly opposes" continued Board oversight of the ultimate owner of NJAWC or why a proceeding similar to this one should not be held if the entity that ultimately owns and controls NJAWC were to change.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

4. Has Mr. Rubin reviewed the Energy Policy Act of 2005 ("EPAct of 2005")?

Answer:
Yes.

Responsible witness: Scott J. Rubin

5. If the answer to the preceding information request is in the affirmative, please describe the provisions of the EPAct of 2005 which apply to affiliate transactions between a utility and holding company affiliates?

Answer:
The Act speaks for itself. Title XII, Subtitle F (Repeal of PUHCA), consisting of 17 sections, addresses these issues.

Responsible witness: Scott J. Rubin

6. If the answer to information request no. 4 is in the affirmative, did Mr. Rubin review the EPAct of 2005 prior to preparing his testimony in this proceeding?

Answer:
Yes.

Responsible witness: Scott J. Rubin

7. Has Mr. Rubin reviewed the FERC's rulemaking on cash management practices between utilities and holding company affiliates (RM02-14-000, RM02-14-001, Order No. 634-A)?

<u>Answer:</u>
Yes, Mr. Rubin has reviewed FERC's final rule at 105 FERC ¶ 61,098, dated October 23, 2003.

Responsible witness: Scott J. Rubin

8. If the answer to the preceding information request is in the affirmative, please state whether the stated purpose of this rulemaking is to develop rules relating to cash management reporting and documentation for transactions relating to cash management agreements between utilities and holding company affiliates.

<u>Answer:</u>
The regulation speaks for itself, but generally the answer to the question is yes.

Responsible witness: Scott J. Rubin

9. If the answer to information request no. 7 is in the affirmative, did Mr. Rubin review the rulemaking on cash management practices between utilities and holding company affiliates prior to preparing his testimony in this proceeding?

<u>Answer:</u>
Yes.

Responsible witness: Scott J. Rubin

10. Does Mr. Rubin agree that, even with the repeal of the Public Utility Holding Company Act of 1935, a utility will still be prohibited under 16 U.S.C. 824d(a) from making or paying any dividends from any funds properly included in the utility's capital account?

Answer:
No, section 824d(a) relates to just and reasonable rates.

Responsible witness: Scott J. Rubin

11. If the answer to information request no. 10 is in the affirmative, does Mr. Rubin agree that this statute helps assure that a utility is properly capitalized.

Answer:
Not applicable.

Responsible witness: Scott J. Rubin

12. Does Mr. Rubin agree that §1275 of the EPAct of 2005 provides that FERC can review the allocation of costs for the provision of non-power goods and services by a service company to a utility, at the election of either a state commission with jurisdiction over the utility, or at the election of the utility?

Answer:
No, Mr. Rubin does not agree completely with the statement made in the question. Section 1275 reads, in part, as follows:

SEC. 1275. SERVICE ALLOCATION.
(a) DEFINITION OF PUBLIC UTILITY.—In this section, the term ''public utility'' has the meaning given the term in section 201(e) of the Federal Power Act (16 U.S.C. 824(e)).
(b) FERC REVIEW.—In the case of non-power goods or administrative or management services provided by an associate company organized specifically for the purpose of providing such goods or services to any public utility in the same holding company system, at the election of the system or a State commission having jurisdiction over the public utility, the Commission, after the effective date of this subtitle, shall review and authorize the allocation of the costs for such goods or services to the extent relevant to that associate company.

An "associate company" is defined in section 1262(2) as "any company in the same holding company system with such company."

Section 201(e) of the Federal Power Act (16 USC § 824(e)) defines "public utility" as "any person who owns or operates facilities subject to the jurisdiction of the Commission under this subchapter (other than facilities subject to such jurisdiction solely by reason of section 824i, 824j, or 824k of this title)." The subchapter referred to is Title 16, Chapter 12, Subchapter II, entitled "Regulation of Electric Utility Companies Engaged in Interstate Commerce."

Thus, it appears that section 1275 of EPAct 2005 is limited to reviews that involve the provision of non-power goods or services to an electric utility engaged in interstate commerce by another company within the same holding company. Further, it appears that such review is limited "to the extent relevant to that associate company." Frankly, Mr. Rubin is not sure what that means, and it is unclear whether FERC would have jurisdiction involving costs allocated to entities within the holding company system that are not electric utilities engaged in interstate commerce, or that involve the retail operations of an electric utility.

Responsible witness: Scott J. Rubin

13. If the answer to information request no. 12 is in the affirmative, does Mr. Rubin agree that this statute helps assure that non-power goods and services provided by a service company to a utility company are priced reasonably?

Answer:
Not applicable.

Responsible witness: Scott J. Rubin