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, AG 1-83, AG 1-89, Staff 2-1).

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, AG 1-98, p. 2)

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." (AG 1-69, p. 55) In addition, RWE's internal analyses concerning the acquisition identify the possibility of selling {**begin protected** **end protected**} (AG 1-88, p. 87)

5. Thames, AWW, and KAWC have stated that they will not attempt, either directly or indirectly, to charge any of the acquisition premium or goodwill to KAWC or any other operating utility of AWW. (AG 1-41, AG 1-109, AG 1-110, PSC-9, Staff 1-8, Staff 2-2). 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." (AG 1-41, p. 2)

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

A. There are several risks. First, the issuance of a substantial amount of new debt increases the risks for consumers. The primary risk is that the company may need to take measures to generate sufficient cash flow to meet its debt payments. Under normal conditions, one would not expect this to be a concern (if it were, RWE's bond ratings would not be investment-grade), but under stressed conditions RWE's increased debt burden could strain the company's cash flow. This is particularly the case in light of RWE's recently announced acquisitions of Transgas (a Czech gas utility) and Innogy (a British electric utility), which also will be financed solely with new debt. In fact, in order to pay for these acquisitions, last month RWE announced plans to issue additional debt of up to €10 billion in Europe (approximately $8.9 billion)[1] plus $7.5 billion in the United States. (RWE presentation: Core Business Drives Growth, Analyst and Investor Conference, March 26, 2002, Essen, Germany, p. 14.) Last month, apparently as a result of the significant planned increase in indebtedness, Moody's downgraded RWE's bonds to a single A rating. (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 KAWC AND ITS CUSTOMERS?

A. If RWE needs to raise or conserve cash, it could reduce its spending on needed capital expenditures at KAWC or other regulated subsidiaries. It also could take other actions that might not be in the best interests of KAWC customers, such as reducing expenditures on preventative maintenance, reducing levels of customer service, engaging in more risky ventures (which ultimately could lead to even higher capital costs), among others. I am

[1] Throughout this testimony, euros (€) are converted to U.S. dollars ($) using the exchange rate of €1 = $0.8918, the closing exchange rate on Friday, April 19, 2002, as reported by the *Wall Street Journal*.

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

Similarly, earlier this month, Standard & Poor's downgraded the bonds of the utility subsidiaries of Allegheny Energy, primarily because of the increased risk of Allegheny's unregulated operations. S&P's credit analyst for Allegheny explained the downgrade as follows: "Standard & Poor's considers all of the company's core subsidiaries to have the same default risk, and thus the same corporate credit rating. The levelization resulted in the downgrade of the corporate credit ratings of the regulated subsidiaries." S&P's discussion also noted that Allegheny's unregulated operations were "the weakest of the company's core subsidiaries" and that "concerns at Allegheny revolve around its growing trading and merchant business outside of its provider of last resort

(PLR) load. … The trading operation and merchant power generation are generally considered to be more risky" than the regulated utilities. (Standard & Poor's Corporate Ratings, Allegheny Energy's, Subsidiaries' Ratings Lowered; Off Watch, Apr. 4, 2002.)

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

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

In fact, when Moody's recently downgraded RWE, it also downgraded Thames to one "notch" below RWE. Moody's explained that Thames' ratings are "linked to those of RWE." (Schedule SJR-1)

Q. ARE THERE OTHER ELEMENTS OF THE TRANSACTION THAT CREATE FINANCIAL RISK FOR KAWC'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 AG 1-83 and AG 1-84, the applicants were asked to provide "all documents in the possession of AWW" concerning the ability of RWE and Thames to successfully operate AWW and KAWC 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 response to a follow-up question, AWW asserted its belief that RWE and Thames had the financial and managerial expertise to operate AWW and KAWC, but it confirmed that AWW did not prepare any documents or reports supporting its conclusion. (AG 2-14)

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. (AG 1-87; 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 AG 1-174, the applicants state that as of September 30, 2001, RWE had future liabilities of €10.53 billion ($9.39 billion) for nuclear waste disposal and €2.26 billion ($2.02 billion) for liabilities related to coal mining activities. RWE's annual report for 2001 updates these figures to €11.52 billion ($10.27 billion) for nuclear waste disposal (€914 million ($815 million) of which has been funded) and €2.29 billion ($2.04 billion) for coal mining liabilities. (RWE Annual Report for the truncated financial year July-December 2001, Mar. 26, 2002, p. 112.)

Q. WHY ARE THESE FUTURE LIABILITIES IMPORTANT?

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

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

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

A. As of December 31, 2001, RWE's shareholders' equity totaled €11.13 billion ($9.93 billion). So its future liabilities for nuclear waste disposal and decommissioning are approximately equal to its total shareholders equity.

Q. WHY IS ANY OF THIS IMPORTANT?

A. As I discuss elsewhere in the testimony, the financial health of the parent can have a direct and serious impact on the utility subsidiary's ability to raise capital. This transaction would dramatically change the nature of the holding company that owns KAWC. 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 KAWC.

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 KAWC and its customers, since KAWC's ability to raise and obtain capital will be dependent on the financial condition of RWE.

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

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

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

end protected}

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

A. Yes, this transaction also creates a risk that KAWC 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 KAWC 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 Kentucky.

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, while Thames states that it is "committed to continue to fund KAWC to the extent necessary to maintain its high level of service and water quality," it also cautions that "the level of funding is a policy matter, which must be reviewed from time to time." (PSC-11(e))

Moreover, 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 KAWC to disclose all uses made of KAWC 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 KAWC to obtain a certificate of public convenience from the Commission prior to the sale or transfer by KAWC of any land in Kentucky, regardless of the book value of the land.

> <u>Condition 5.</u> Prohibit KAWC 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 KAWC 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 KAWC, AWW, Thames, or RWE or any of their subsidiaries from pledging any of the assets of KAWC or the stock of KAWC for any purpose without first having obtained a certificate of public convenience from the Commission.

> <u>Condition 8.</u> Require KAWC 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 KAWC and whether the budget as approved will impose any limitations on

KAWC's ability to provide safe, adequate, and reliable service to its customers.

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

Condition 10. Require KAWC'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 KAWC.

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

Condition 13. Prohibit KAWC 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 KAWC IS CAPITALIZED. AREN'T THESE TYPES OF RESTRICTIONS VERY UNUSUAL?

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

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

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

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

V. Regulatory Risks

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

A. Yes, it does. The transaction would create additional "generations" of holding companies above KAWC. At the present time, KAWC 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 KAWC is in the water business and it is owned by a company that is also in the water business. As of December 31, 2000 (the latest time period for which I have comparable information), KAWC accounted for between 3% and 4% of AWW's customers, revenues, assets, and net income. (These figures are calculated by comparing KAWC's financial statements with those of AWW, as of December 31, 2000. KAWC'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, KAWC 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 KAWC. 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 KAWC'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 KAWC. First, and perhaps most importantly, the Commission may lose the ability to approve and condition future changes in control of KAWC. 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 KAWC.

Moreover, the Commission's access to information about KAWC'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. (AG 1-147) Moreover, the Thames-AWW transition plan states that RWE "requires all Divisions and their subsidiaries to report under IAS." As a result, AWW and KAWC 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." (AG 1-69, 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 KAWC'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 KAWC. I recommend that the Commission adopt the following conditions:

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

> Condition 16. Require that whenever KAWC 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 KAWC 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 KAWC 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 KAWC 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 KAWC?

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 KAWC'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 KAWC 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 KAWC 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 KAWC 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 KAWC to continue to protect and safeguard the condition of all of its watershed land holdings surrounding its reservoirs and well fields in Kentucky.

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

> Condition 2. Require KAWC 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 KAWC, which are American Water Works Service Co.; American Water Capital Corp.; and American Water Resources, Inc. (copies of the agreements between KAWC and these affiliates were provided in AG 1-133).

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

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

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

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

Condition 9. Require KAWC 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 KAWC'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 KAWC.

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

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

Condition 16. Require that whenever KAWC 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 KAWC 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 KAWC 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 KAWC 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 KAWC to continue to protect and safeguard the condition of all of its watershed land holdings surrounding its reservoirs and well fields in Kentucky.

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 KAWC by Thames and RWE. Implementing these conditions does not provide any benefit to KAWC's consumers. The conditions are designed to try to preserve the current condition of KAWC's consumers.

In other words, the conditions only try to ensure that KAWC'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 KAWC 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, AG 1-98, p. 3)

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, AG 1-98, p.14)

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." (AG 1-98, p. 19) 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." (AG 1-98, p. 19)

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 (AG 1-103 supplemental). 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, AG 1-103, p. 55 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 (AG 1-87) showing that {**begin confidential**

end confidential} (AG 1-87, p. 28) That same page 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} (AG 1-87, p. 100)

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

{begin confidential

end confidential} (AG 1-87, p. 41)

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 (AG 1-88, beginning on page 165), Thames identifies the following as being among the "potential additional benefits" from acquiring AWW: **{begin confidential**

end confidential} (AG 1-88, p. 220)

A subsequent Thames board presentation, dated May 8, 2001 (AG 1-88, beginning on page 55) 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} (AG 1-88, p. 79) Further, Thames provides a very similar analysis to that which Goldman Sachs prepared for AWW. The Thames analysis shows **{begin confidential**

end confidential} (AG 1-88, p. 86)

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: {**begin protected**

end protected}

(AG 1-88, p. 87) 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} (AG 1-88, p. 91)

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." (AG 1-69, 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 {**begin protected**

end protected}

(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 {**begin protected**

end protected}

(p. 15) Similarly, in the area of real property management, the companies state that they will {**begin protected**

end protected} (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 KAWC?

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 (AG 1-88, beginning on page 1), 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 KENTUCKY?

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 KAWC. All of the savings estimates are confidential, so I will discuss the specific calculations below. My allocations of the savings to KAWC are based on figures taken from the annual reports of KAWC and AWW (using figures as of December 31, 2000, which are the latest comparable figures available) and, in one instance, from information on the number of customers in each state where there is a contested proceeding involving the merger.

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

A. I will use the following information: (1) KAWC's level of O&M expenses for calendar year 2000, which is $15,432,000; (2) KAWC's total amount of long-term debt as of December 31, 2000, which is $75,830,000; (3) the ratio of KAWC's O&M expenses in 2000 to AWW's water O&M expenses in 2000, which is $15,432,000 / $551,443,000 = 2.8%; (4) the ratio of KAWC's net income in 2000 to AWW's corporate net income in 2000, which is $5,666,000 / $161,061,000 = 3.5%; and (5) the ratio of KAWC customers to the total number of AWW customers in states where there is a formal proceeding regarding the approval of this transaction, which is 102,000 / 1,871,000 = 5.5% as I show on Schedule SJR-3.

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

A. **{begin confidential**

end confidential}

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

A. I recommend that the Commission allocate at least $1.5 million in savings to the customers of KAWC. This is not a precise calculation, but it reflects my judgment of a reasonable estimate of savings given the range of $0.9 million to $3.5 million set forth above.

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

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

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

A. Yes. I recommend that the Commission require KAWC to reduce its base rates by $1.5 million within 5 business days after the transaction closes and to keep that reduction in place for at least 24 months. This would be achieved by prohibiting KAWC from filing for a base rate increase before the transaction closes, and by extending that prohibition for at least 17 months after the transaction closes. (The 24 months during which the $1.5 million reduction is in effect is made up of the 17 months after closing when KAWC is prohibited from filing for a base rate increase, plus the 7 months during which that rate increase request would be suspended by the Commission.) As I mentioned above, there are other ways in which similar value can be provided to KAWC's customers and I recognize that other parties might prefer one option over another. My personal preference is to provide these benefits in a way that is readily apparent to consumers and that is easily quantifiable. If the Commission finds that other methods should be used to pass on these savings to consumers, I would strongly recommend that the Commission provide a specific quantification of the benefits that would be received by consumers, so that the public can easily understand and verify the magnitude of benefits they are receiving from this acquisition.

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

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

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

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

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

A. No. In my opinion, it would not be in the best interests of KAWC's customers for the Commission to approve this transaction.

Q. ARE THERE CONDITIONS THAT SHOULD BE IMPOSED WHICH WOULD MITIGATE THE RISKS BORNE BY KAWC'S CUSTOMERS AS A RESULT OF THIS TRANSACTION, IF CONSUMMATED?

A. Yes. The Commission should specifically adopt the conditions summarized in Section VII of my testimony. In addition, the Commission should require KAWC to provide at least $1.5 million in savings to its customers. If the Commission fails to adopt the conditions that I 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. Similarly, if the Commission fails to require that significant savings are provided to consumers, such that essentially all of the benefits from the acquisition flowed to the shareholders, officers, and key employees of AWW, then KAWC's consumers would be better off if this transaction did not occur.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

Appendix A

Scott J. Rubin
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Current Position

Public Utility Attorney and Consultant, Selinsgrove, PA. 1994 to present. I provide legal, consulting, and expert witness services to various organizations interested in the regulation of public utilities.

Previous Positions

Lecturer in Computer Science, Susquehanna University, Selinsgrove, PA. 1993 to 2000.

Senior Assistant Consumer Advocate, Office of Consumer Advocate, Harrisburg, PA. 1990 to 1994. I supervised the administrative and technical staff and shared with one other senior attorney the supervision of a legal staff of 14 attorneys.

Assistant Consumer Advocate, Office of Consumer Advocate, Harrisburg, PA. 1983 to 1990.

Associate, Laws and Staruch, Harrisburg, PA. 1981 to 1983.

Law Clerk, U.S. Environmental Protection Agency, Washington, DC. 1980 to 1981.

Research Assistant, Rockville Consulting Group, Washington, DC. 1979.

Current Professional Activities

Member, American Bar Association, Public Utility Law Section.

Member, American Water Works Association.

Admitted to practice law before the Supreme Court of Pennsylvania, the New York State Court of Appeals, the United States District Court for the Middle District of Pennsylvania, the United States Court of Appeals for the Third Circuit, and the Supreme Court of the United States.

Previous Professional Activities

Member, American Water Works Association, Rates and Charges Subcommittee, 1998-2001.

Member, Federal Advisory Committee on Disinfectants and Disinfection By-Products in Drinking Water, U.S. Environmental Protection Agency, Washington, DC. 1992 to 1994.

Chair, Water Committee, National Association of State Utility Consumer Advocates, Washington, DC. 1990 to 1994; member of committee from 1988 to 1990.

Member, Board of Directors, Pennsylvania Energy Development Authority, Harrisburg, PA. 1990 to 1994.

Member, Small Water Systems Advisory Committee, Pennsylvania Department of Environmental Resources, Harrisburg, PA. 1990 to 1992.

Member, Ad Hoc Committee on Emissions Control and Acid Rain Compliance, National Association of State Utility Consumer Advocates, 1991.

Member, Nitrogen Oxides Subcommittee of the Acid Rain Advisory Committee, U.S. Environmental Protection Agency, Washington DC. 1991.

Education

J.D. with Honors, George Washington University, Washington, DC. 1981.

B.A. with Distinction in Political Science, Pennsylvania State University, University Park, PA. 1978.

Publications and Presentations

"Quality of Service Issues," a speech to the Pennsylvania Public Utility Commission Consumer Conference, State College, PA. 1988.

K.L. Pape and S.J. Rubin, "Current Developments in Water Utility Law," in *Pennsylvania Public Utility Law* (Pennsylvania Bar Institute). 1990.

Presentation on Water Utility Holding Companies to the Annual Meeting of the National Association of State Utility Consumer Advocates, Orlando, FL. 1990.

"How the OCA Approaches Quality of Service Issues," a speech to the Pennsylvania Chapter of the National Association of Water Companies. 1991.

Presentation on the Safe Drinking Water Act to the Mid-Year Meeting of the National Association of State Utility Consumer Advocates, Seattle, WA. 1991.

"A Consumer Advocate's View of Federal Pre-emption in Electric Utility Cases," a speech to the Pennsylvania Public Utility Commission Electricity Conference. 1991.

Workshop on Safe Drinking Water Act Compliance Issues at the Mid-Year Meeting of the National Association of State Utility Consumer Advocates, Washington, DC. 1992.

Formal Discussant, Regional Acid Rain Workshop, U.S. Environmental Protection Agency and National Regulatory Research Institute, Charlotte, NC. 1992.

S.J. Rubin and S.P. O'Neal, "A Quantitative Assessment of the Viability of Small Water Systems in Pennsylvania," *Proceedings of the Eighth NARUC Biennial Regulatory Information Conference*, National Regulatory Research Institute (Columbus, OH 1992), IV:79-97.

"The OCA's Concerns About Drinking Water," a speech to the Pennsylvania Public Utility Commission Water Conference. 1992.

Member, Technical Horizons Panel, Annual Meeting of the National Association of Water Companies, Hilton Head, SC. 1992.

M.D. Klein and S.J. Rubin, "Water and Sewer -- Update on Clean Streams, Safe Drinking Water, Waste Disposal and Pennvest," *Pennsylvania Public Utility Law Conference* (Pennsylvania Bar Institute). 1992.

Presentation on Small Water System Viability to the Technical Assistance Center for Small Water Companies, Pa. Department of Environmental Resources, Harrisburg, PA. 1993

"The Results Through a Public Service Commission Lens," speaker and participant in panel discussion at Symposium: "Impact of EPA's Allowance Auction," Washington, DC, sponsored by AER*X. 1993.

"The Hottest Legislative Issue of Today -- Reauthorization of the Safe Drinking Water Act," speaker and participant in panel discussion at the Annual Conference of the American Water Works Association, San Antonio, TX. 1993.

"Water Service in the Year 2000," a speech to the Conference: "Utilities and Public Policy III: The Challenges of Change," sponsored by the Pennsylvania Public Utility Commission and the Pennsylvania State University, University Park, PA. 1993.

"Government Regulation of the Drinking Water Supply: Is it Properly Focused?," speaker and participant in panel discussion at the National Consumers League's Forum on Drinking Water Safety and Quality, Washington, DC. 1993. Reprinted in *Rural Water*, Vol. 15 No. 1 (Spring 1994), pages 13-16.

"Telephone Penetration Rates for Renters in Pennsylvania," a study prepared for the Pennsylvania Office of Consumer Advocate. 1993.

"Zealous Advocacy, Ethical Limitations and Considerations," participant in panel discussion at "Continuing Legal Education in Ethics for Pennsylvania Lawyers," sponsored by the Office of General Counsel, Commonwealth of Pennsylvania, State College, PA. 1993.

"Serving the Customer," participant in panel discussion at the Annual Conference of the National Association of Water Companies, Williamsburg, VA. 1993.

"A Simple, Inexpensive, Quantitative Method to Assess the Viability of Small Water Systems," a speech to the Water Supply Symposium, New York Section of the American Water Works Association, Syracuse, NY. 1993.

S.J. Rubin, "Are Water Rates Becoming Unaffordable?," *Journal American Water Works Association*, Vol. 86, No. 2 (February 1994), pages 79-86.

"Why Water Rates Will Double (If We're Lucky): Federal Drinking Water Policy and Its Effect on New England," a briefing for the New England Conference of Public Utilities Commissioners, Andover, MA. 1994.

"Are Water Rates Becoming Unaffordable?," a speech to the Legislative and Regulatory Conference, Association of Metropolitan Water Agencies, Washington, DC. 1994.

"Relationships: Drinking Water, Health, Risk and Affordability," speaker and participant in panel discussion at the Annual Meeting of the Southeastern Association of Regulatory Commissioners, Charleston, SC. 1994.

"Small System Viability: Assessment Methods and Implementation Issues," speaker and participant in panel discussion at the Annual Conference of the American Water Works Association, New York, NY. 1994.

S.J. Rubin, "How much should we spend to save a life?," *Seattle Journal of Commerce*, August 18, 1994 (Protecting the Environment Supplement), pages B-4 to B-5.

S. Rubin, S. Bernow, M. Fulmer, J. Goldstein, and I. Peters, *An Evaluation of Kentucky-American Water Company's Long-Range Planning*, prepared for the Utility and Rate Intervention Division, Kentucky Office of the Attorney General (Tellus Institute 1994).

S.J. Rubin, "Small System Monitoring: What Does It Mean?," *Impacts of Monitoring for Phase II/V Drinking Water Regulations on Rural and Small Communities* (National Rural Water Association 1994), pages 6-12.

"Surviving the Safe Drinking Water Act," speaker at the Annual Meeting of the National Association of State Utility Consumer Advocates, Reno, NV. 1994.

"Safe Drinking Water Act Compliance -- Ratemaking Implications," speaker at the National Conference of Regulatory Attorneys, Scottsdale, AZ. 1995. Reprinted in *Water*, Vol. 36, No. 2 (Summer 1995), pages 28-29.

S.J. Rubin, "Water: Why Isn't it Free? The Case of Small Utilities in Pennsylvania," *Utilities, Consumers & Public Policy: Issues of Quality, Affordability, and Competition, Proceedings of the Fourth Utilities, Consumers and Public Policy Conference* (Pennsylvania State University 1995), pages 177-183.

S.J. Rubin, "Water Rates: An Affordable Housing Issue?," *Home Energy*, Vol. 12 No. 4 (July/August 1995), page 37.

Speaker and participant in the Water Policy Forum, sponsored by the National Association of Water Companies, Naples, FL. 1995.

Participant in panel discussion on "The Efficient and Effective Maintenance and Delivery of Potable Water at Affordable Rates to the People of New Jersey," at The New Advocacy: Protecting Consumers in the Emerging Era of Utility Competition, a conference sponsored by the New Jersey Division of the Ratepayer Advocate, Newark, NJ. 1995.

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