RWE

# Strategic Alignment of the Group

## Meeting of the Supervisory Board of RWE AG
## September 16, 2005

# Strategic considerations

RWE

- USA as a core region
  - Does the isolated presence in the USA create value for RWE?
  - Is maintaining this presence justified in light of the risks and resources required?
- Water as a core business
  - Is RWE the optimal owner of a business that offers no significant synergies with its core energy business?
  - Is maintaining a position in the water business justified by the limited return on capital that goes along with relative stability?
- Portfolio considerations
  - Would greater financial flexibility enhance RWE's starting position with a view to the consolidation of the European energy industry?

# Multi-utility strategy

RWE

- Rationale for "Multi utility" focus
  - Balanced risk distribution: reduced dependency on electricity in Germany
  - All utility offerings from a single provider: assumes customer demand for integrated energy (and similar) services and solutions
- Assumed success factors
  - Value creation through cross selling and bundled products
  - Expansion of the customer base
  - Achievement of low-cost leadership in all segments due to economies of scale
- Focusing on water
  - Low future expectation for the core market Germany, significant drop in electricity prices and declining market share
  - RWE already has water expertise in Germany
  - The global water market as the utility segment with the greatest potential for growth
- Diversification of risk across various utilities and regions

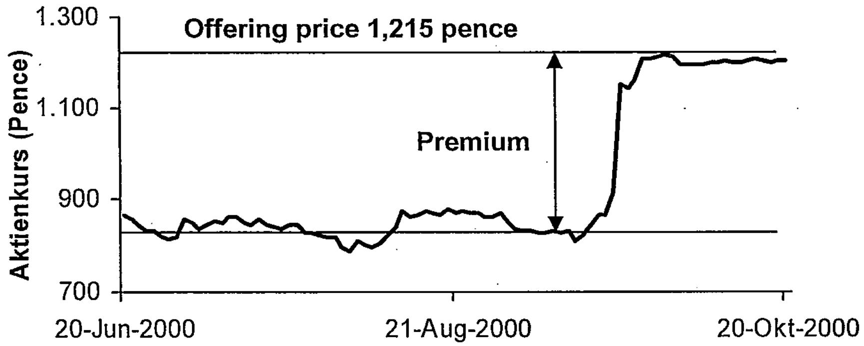
# Goals of the acquisitions in the water sector

RWE

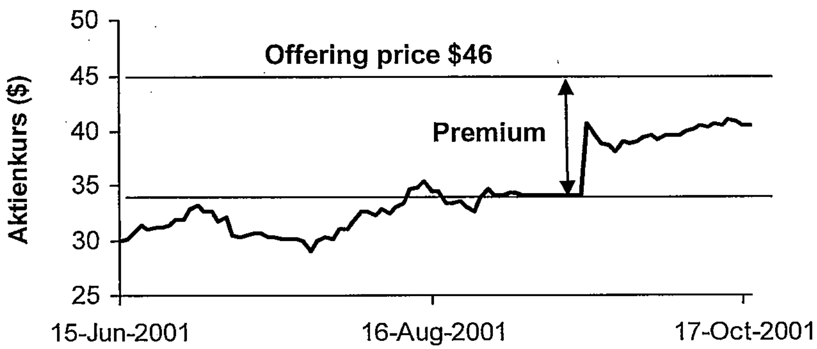
- Establishing the water business
  - TW: achieving critical mass in the water business
  - AW: expanding the global no. 3 position in the water market → water is to become the "most profitable and fastest growing" business segment of RWE, contributing about one third of EBITDA in 2003
- Growing to international dimensions
  - TW: achieving a major position in the UK and gaining control of the "best positioned" company in the global water business
  - AW: achieving market leadership in the USA
  - Building on the water customer base for multi-utility services
  - International expansion and integration of TW's international flavor and expertise into the Group
- Realizing growth
  - Global water market: quintupling from $80 billion (2000) to $400 billion (2010)
  - Thames Water: at least doubling sales in the non-regulated UK water business by 2005 from 15% to 30% - 40%
  - AW: rapidly growing US water market, the largest regional market in the world

# Acquisition premiums

## Thames Water:




## American Water:




## Observations

- High premium for entering into the water business as well as for expected growth, especially in the international business
- Purchase price for regulated business: app. 15% premium above RAB
- 47% premium relative to the 3-month average Thames Water share price

- Premium paid for growth options as well
- The events of September 11, 2001 dragged the market valuation down
- 46% premium relative to the 3-months average for AW shares of common stock

*{Aktienkurs = Share price}*

# Development of the global water market

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- Accessible market significantly smaller than expected
  - Slower liberalization
  - Resistance to privatization
- Risks higher than expected
  - Unreliable regulatory authorities (unkept promises, for instance China, Indonesia)
  - Highly politicized decision-making processes and frequent resistance to foreign ownership (Chile, Turkey)
  - Technical risks (leakage)
  - Asymmetrical distribution of risks (reward for outperformance is lower than risk when not achieving output goals)
  - In many cases, returns did not justify the increased risk, especially in the international water business
- Pressure for efficiency – has significantly increased in saturated market
  - Near-term improvements achieved
  - Outperforming set targets would be very difficult to accomplish

# Performance problems and weak growth: American Water:

- Performance
  - Cumulative expected value added from the acquisitions: [redacted]
  - [redacted]
  - Reasons: lower levels of interest, delayed and smaller rate increases, higher operating costs (in part due to 9/11), lower growth
- Growth
  - Regulated baseline business largely on plan (growth through investments)
  - Only some portions of the acquisition strategy could be realized
  - Non-regulated segment clearly below expectations
    - Weak sales team
    - AW must once again become a "market maker"

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

# Regulatory framework

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### UK

- Potential with respect to outperformance is decreasing
- Strict liability rules for services provided
- Non-paying customers **must** receive further deliveries
- Asymmetric risk profile

### USA

- Increasing public resistance to company privatizations
- Increasing regulatory requirements, outdated infrastructure
- "Rate shocks" – substantial drops in demand after sudden high rate increases
- Unfavorable regulatory environment in some US states

### UK and USA

- Guaranteed rate of return limited to app. 6% maximum after taxes; limited room for outperformance
- Increasingly demanding environmental standards

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Outperformance

Underperformance

[redacted]

RWE

[redacted]

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[redacted]

[redacted]

# Limited synergies with other RWE segments

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- American Water
  - Limited synergies with Thames Water exist
  - No synergies with the energy sector because the planned entry into the US electricity market did not occur
- Thames Water
  - Limited synergies with npower exist (joint service offerings) but are realized mostly on the part of npower
  - Very limited synergies with water and energy operations in Continental Europe
  - Limited purchasing and IT benefits from being part of the RWE Group

# Many companies have abandoned diversification and restructured

RWE

| Company | Strategy in/up until 2002 | | | | | Strategy now (2005) | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Electr. | Gas | Water | Wast. | Telecom. | Electr. | Gas | Water | Waste | Telecom. |
| 1. Scottish Power | ✓ | ✓ | ✓ | – | ✓ | ✓ | ✓ | – | – | – |
| 2. Centrica | ✓ | ✓ | ✓ | – | ✓ | ✓ | ✓ | – | – | ✓ |
| 3. Enel | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | – | ✓ | – |
| **4. RWE** | ✓ | ✓ | ✓ | ✓ | ✓[1] | ✓ | ✓ | ✓ | – | – |
| 5. E.ON | ✓ | ✓ | ✓ | – | ✓[2] | ✓ | ✓ | – | – | – |
| 6. Endesa | ✓ | ✓ | ✓ | – | ✓ | ✓ | ✓ | – | – | ✓ |
| 7. Suez | ✓ | ✓ | ✓ | ✓ | – | ✓ | ✓ | ✓ | ✓ | – |
| 8. Véolia | ✓ | – | ✓ | ✓ | – | ✓ | ✓ | ✓ | ✓ | – |
| 9. Nuon | ✓ | ✓ | ✓ | – | – | ✓ | ✓ | – | – | – |
| 10. Scottish & Southern | ✓ | ✓ | ✓ | – | ✓ | ✓ | ✓ | – | – | ✓ |

Companies that have sold their water business

[1] In 1996
[2] sold in 1999

# Capital markets perception of the water business

- Inadequate recognition of the water sector
  - Most analysts view RWE as an energy company
  - Water undervalued as part of the RWE portfolio (especially in the USA)
- Water as stand-alone business
  - Valuations of regionally concentrated "pure" water supply companies currently high
  - Major differences in the valuations of water companies in the UK and the USA
    - UK average for water EV/EBITDA 2005E: times 8.6
    - US average for water EV/EBITDA 2005E: times 14.2
  - Higher return on equity due to higher gearing ratio
- Potential interested buyers
  - Investment opportunities in companies with stable earnings and protected against inflation are very much sought after
  - New type of financial buyers are making direct investments (for instance pension funds)

# American Water possible options

American Water

| | |
| --- | --- |
| Hold | ■ New management<br>■ Continued restructuring and closer ties to the Group Center |
| Public offering | ■ Placement of 100% of the shares in American Water on an American stock exchange in one or several steps |
| Private placement | ■ Placement of 100% of the shares with at least 11 institutional investors at less than 10% each (regulatory threshold) |
| Sale to a single financial investor | ■ Regulated business very attractive for infrastructure funds, insurance firms and pension funds |
| Sale to a strategic investor | ■ Few strategic investors in the market |

# American Water
# Possible timeline

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**Supervisory Board meeting 09/16/2005**

- Presentation of strategic options

**Extraordinary Board of Management Meeting + Supervisory Board Meeting late October**

- Decision on sale of AW
- Public announcement

**Hold**

- New management
- Continued restructuring and closer ties to the Central Group

**Public offering**

- Additional preparations

**Private placement/ M&A deal**

- Official approach to investors
- Due diligence
- Negotiations
- Closing

**Implementation**

- Choice of alternative
- Consultation with regulatory authorities
- Monitoring regulatory process

[redacted]

[redacted]

# Valuation

RWE

- American Water
  - In the USA, the value of companies is primarily calculated as a multiple of net earnings
  - The seven listed water companies in the USA are traded at multiples (based on 2005 estimates) of between 20 x - 35 x earnings; the average is plus/minus 26 x earnings
- Thames Water
  - In the UK, the value of a regulated business is generally calculated as a multiple of regulated asset base (RAB)
  - The six listed water companies in the UK are currently traded in a range between 96% - 113%, with an average of about 105%
  - In comparable transactions, purchase prices have been paid in a range from 108% - 123%; the average was about 115%

# Expected reaction of the capital markets

RWE

# Our response to the reaction of the capital markets

[redacted]

[redacted]

[redacted]

[redacted]

- as illustration only -

[redacted]

# Conclusion: what has changed?

| | 2000/2001 | 2005 |
|---|---|---|
| Strategic fit | •Multi utility<br>•Strategy for USA<br>•Global player | •Focus on electricity/gas<br>•Europe as core region<br>•Regional players successful |
| Valuation | •Performance and growth justify premium | •Market values Water less favorably as part of RWE<br>•Growth expectations not met<br>•Increased risk foreseeable |
| Profitability | •Power generation Germany = problem | •Power generation = success factor |
| Free cash flow | •No bottleneck | •Bottleneck<br>o Increased investments in electricity/gas<br>o Clear dividend target<br>o Necessary for external growth |
| Rating | •Criteria met (A+)<br>•Better risk profile with Water | •Criteria have been tightened<br>•Exit improves key indicators<br>•Risk downgrade because of reinvestment risk |
| Reinvestment risk | •Reduction of net cash position | •Can be controlled through phased exit coupled with special dividend and medium-term acquisition |
| Timing | | •Favorable window – interest rates, Infrastructure funds<br>•Acquisition – high valuation, flexible timing |
| European environment | •Consolidation barely perceived | •Specific deals announced |

# Next steps

RWE

- American Water
  - Finalize internal preparations for a transaction **_by mid-October_**
  - Extraordinary Board of Management and Supervisory Board meeting **_Early November_**
  - Kick-off American Water sales process **_after extraordinary Supervisory Board meeting_**
  - Alternatively: Implement restructuring plan
- Thames Water
  - Hold option
    - Integrate TW management into the AW process
  - Sale option
    - Unwinding of interest rate hedging positions
    - Examination of incoming (unsolicited) offers **_after the start of the American Water process_**
    - Initiation of the selling process **_2006_**

RWE

# Project Noah

## Extraordinary Meeting of the Supervisory Board of RWE AG

## Essen, November 4, 2005

# Strategic objectives – water segment

RWE

- Establish the water business and achieve international dimension
  - Successful, but acquisition premiums app. 45%
  - Water market developing regionally rather than globally
  - Resistance to privatization / foreign ownership
- Realization of profitable growth
  - Performance problems and relatively weak growth
  - Value added negative/below expectations
- Risk diversification through international multi-utility portfolio
  - International risks greater than anticipated – significant accounting losses (outside of US and UK)
  - Asymmetric risk profile
  - Strict liability rules: maximum fine 10% of sales (UK)

# Planning 2005 – 2009 vs. 2006 – 2010

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# Strategic assessment

- Limited synergies with other RWE segments
  - AW: best practice with TW almost fully used
  - Limited purchasing and IT benefits from being part of the RWE Group
- High capital intensity with little flexibility
  - Growing investment needs outside of our decision-making realm
  - Risk that investments in electricity and gas will be crowded out
- Global water and multi-utility strategy did not prove successful
  - Limited cost reduction and cross-selling potential
  - Valuation by capital markets low compared to pure water companies
  - Most competitors have arrived at similar conclusions
- Reduction of capital intensity creates value

# Arguments for a sale of Thames Water and American Water

RWE

- Balance of risk and return and less favorable than in the energy sector
  - Performance and market developments below expectations
  - Virtually no further economies of scale to be expected
  - Relations with major regulatory authorities polarized in some cases
  - Energy sector offers greater flexibility with respect to investments and is RWE's core competency
- Water undervalued in the market as a segment of RWE
  - Valuation of pure water companies currently favorable
  - Virtually no synergies with the energy sector
- Disinvestment increases financial flexibility
  - No free cash flow bottlenecks, improved financial performance indicators
  - More attractive growth opportunities in the European energy sector
  - Risk diversification achievable: geographic/regulated grid operations
  - Sale of AW/TW increases leeway for acquisitions (EUR 5 → 15 billion)

# Change in strategy

- Focusing primarily on electricity and gas in the European core region
- Water remains a regionally driven complementary business for RWE Energy
- Volatility reduced through vertical integration
- Focus on critical positions and adding value
- Positioning for consolidation in Europe

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# Implementation – illustrative timeline

RWE

- American Water
  - Initiation of the selling process *November 2005*
  - Parallel exploration: public offering vs. private placement
  - Decision on alternative for the sale *February 2006*
  - Initiation of the approval process
  - Closing of the transaction *no earlier than late 2006*
- Thames Water:
  - Initiation of the sale *approximately mid-2006*
  - Parallel exploration of options for the sale
  - Unwinding of the interest rate hedging instruments
    → realization at market values
  - Closing of the transaction *no earlier than late 2006*

# Communications – internal

RWE

- We are initiating the sale of AW and TW, proceeding in stages as we do so
- We are focusing on the European energy market
- RWE will continue to remain active in the water market in Continental Europe
  - RWE Energy plans targeted water projects in its home territory with RWE Aqua as center of competence
- Growth is to be accelerated
  - Take advantage of organic growth opportunities
  - Greater financial flexibility needed
  - Asset swaps/privatizations/selected acquisitions
- Simultaneous commitment to future strategy
  - Acquisitions: for instance gas power plants in the UK
  - Push ahead on decisions to build power plants, especially in Germany
  - Increase research & development budget

# Communications – external

RWE

- Timing favorable for planned transactions
- Commitment to the published rating and financial targets
- We maintain discipline – strict acquisition criteria
- Large volumes of bonds maturing up until 2008 (app. EUR 5 billion) guarantee return flow of funds
- New debt target: EUR 10 – 12 billion
- Temporary increase in dividend distribution rate after the closing (70% – 80%)
  - Transaction 1: at the 2007 Annual General Meeting (for 2006)
  - Transaction 2: at the 2008 Annual General Meeting (for 2007)

# Summary

- The water business strategy of RWE Energy is designed to reinforce the electricity and gas business and its continued growth
- The present plan calls for investing about EUR 200 million in the water segment through 2010 in smaller investments and under asset-light models
- As part of the strategy, additional investments in the water business are possible in the regional target markets if they meet the criteria of links with the electricity and gas business as part of privatizations and market consolidation