

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of California-American Water Company (U210-W), a California Corporation, RWE Aktiengesellschaft, a Corporation Organized Under the Laws of the Federal Republic of Germany, Thames Water Aqua Holdings GmbH, a Corporation Organized Under the Laws of the Federal Republic of Germany, and American Water Works Company, Inc., for an Order Authorizing the Sale by Thames GmbH of up to 100% of the Common Stock of American Water Works Company, Inc. Resulting in a Change of Control of California-American Water Company and For Such Related Relief as May be Necessary to Effectuate Such Transaction.

A.06-05-025
(Filed May 22, 2006)

**COMMENTS
OF THE DIVISION OF RATEPAYER ADVOCATES TO
ADMINISTRATIVE LAW JUDGE GALVIN'S PROPOSED
DECISION**

[REDACTED VERSION]

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April 17, 2007

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I. INTRODUCTION

Pursuant to the California Public Utilities Commission's ("Commission") Rules of Practice and Procedure, Rule 14.3(a), (b), & (c), the Division of Ratepayer Advocates ("DRA"), hereby respectfully files its Comments to Administrative Law Judge ("ALJ") Michael Galvin's Proposed Decision ("PD") in this proposed application.

The Joint Applicants, consisting of California-American Water Company ("Cal-Am"), RWE Aktiengesellschaft ("RWE") - a corporation organized under the laws of the Federal Republic of Germany, Thames Water Aqua Holdings GmbH ("Thames GmbH") – a corporation organized under the laws of the Federal Republic of Germany, and American Water Works Company, Inc. ("American Water"), request authorization from

the Commission for the sale by Thames GmbH of up to 100% of the common stock of American Water, resulting in a change of control of Cal-Am.

RWE, Thames GmbH, American Water and Cal-Am request the Commission's approval of the sale of up to 100% of the shares of common stock of American Water in one or more public offerings (initial public offering or "IPO") to be conducted in accordance with the United States Securities Act of 1933. The sale of the common stock of American Water would result in a change of control of Cal-Am.

In 2002 when the Joint Applicants first came to the Commission for authority for RWE to acquire American Water, they promised improved service and access to capital and that customers would be held harmless. To a certain extent, the instant case is the final act of the earlier merger. Before the Commission unilaterally approves Cal-Am's divestiture request, it needs to ensure that RWE has delivered on the commitments it made a half-decade ago.

It is legal error for the PD to conclude the Commission will not apply the "ratepayer benefit" standard when it cites "supposed" ratepayer benefits in the decision.

The PD states "We are not using the ratepayer benefit standard for this application and pursuant to the October 6, 2006 assigned Commissioner Scoping Memo and Ruling, we find that there are no adverse impacts on ratepayers or the public interest. Furthermore, after examining the case, we do find that there are ratepayer benefits to the transaction." P.3. However, even though the PD states that the Commission will not apply the "ratepayer benefit" standard, it cites "supposed" ratepayer benefits from the Proposed Transaction. DRA will discuss these "supposed" ratepayer benefits later in its Comments.

Thus, it appears that the Commission will apply the "ratepayer indifference" standard in assessing the proposed application, despite its contention to the contrary, but if the Commission applies this standard, it cannot cite benefits as well to show why the Commission should approve this Proposed Transaction. *See* PD, p.35, Conclusion of Law#1. It is legal error to inconsistently apply a standard in reviewing a proposed transaction before the Commission.

II. IT IS FACTUAL ERROR FOR THE PD TO STATE THERE ARE NO ADVERSE IMPACTS ON RATEPAYERS OR THE PUBLIC INTEREST WITH THE PROPOSED TRANSACTION

The PD states that "...we find there are no adverse impacts on ratepayers or the public interest." *See* p. 3. This statement is factually incorrect unless the Commission imposes conditions on the approval of this Proposed Transaction because ratepayers have already been harmed as a direct result of the Proposed Transaction. For example, Standard & Poors downgraded American Water's debt after the divestiture was proposed, moreover Cal-Am has deferred implementing information technology ("IT") improvements in its system. *See* DRA Opening Brief, p.4. & p.33-38.

Additionally, other costs will increase going-forward once Cal-Am's parent company emerges as a publicly-traded company after the Proposed Transaction is concluded. For example, ratepayers will be asked to shoulder: 1) Securities & Exchange Commission compliance costs ("SEC"); 2) Sarbanes-Oxley Act compliance costs; 3) investor relation costs; 4) New York Stock Exchange ("NYSE") listing fees; and 5) external audit fees. *See* DRA Opening Brief, p.3-4.

Lastly, directors' & officers' liability insurance and a potential employee stock purchase program will also add to costs ratepayers will incur because of the Proposed Transaction. *See id.* at p.4. Thus, it is factually inaccurate to state that the Proposed Transaction has no adverse impacts on ratepayers or the public interest. Ratepayers have already been impacted negatively with the Standard & Poor's downgrading and the loss of the IT improvements.

Unless the Commission imposes more of DRA's conditions that will better protect ratepayers from the Proposed Transaction, Cal-Am's ratepayers will be harmed by the IPO because it will inevitably result in additional on-going costs, higher debt costs, and the loss of IT improvements.

III. IT IS FACTUAL ERROR FOR THE PD TO STATE DRA DOES NOT OPPOSE THE PROPOSED TRANSACTION

The PD states: "DRA does not oppose the proposed transaction. However, it recommends that 17 conditions be imposed upon American Water and Cal-Am to ensure

Cal-Am's ratepayers benefit from the proposed transaction." P.12 Additionally, Finding of Fact 18 states: "DRA does not oppose the grant of this application." P.32. Here, the PD inaccurately summarizes DRA's position on the Proposed Transaction and commits factual error in this representation.

DRA argues that the Proposed Transaction is in the public interest *only* if certain conditions are imposed. DRA argues in its Opening Brief that the Commission must impose conditions to ensure that the Proposed Transaction will be in the public interest and that without such conditions ratepayers will suffer actual harm from the transaction. DRA reiterates its Opening Brief position that absent certain conditions or commitments, the transaction will not be in the public interest. Thus, the Commission should not approve the transaction unless the conditions are adopted to mitigate the negative impacts on ratepayers.

For example, DRA states:

The Joint Applicants have agreed to some of DRA's proposed conditions, but none of these protect the ratepayers from the Proposed Transaction's harms. Thus, DRA only recommends approval of the Joint Applicants' Proposed Transaction if the Commission imposes conditions identified in DRA's Exh. #14, that will ensure that the Proposed Transaction will be in the public interest and will produce actual benefits to ratepayers.

DRA Opening Brief, p. 3.

Specifically, DRA argues several conditions which will help to offset harms that have already occurred, such as the debt rating decrease and STEP program/IT improvement benefits loss. Thus, on page 13 of its Brief, DRA reiterates:

Unless the Commission imposes conditions, such as limiting Cal-Am's cost of debt rates to levels based on debt ratings prior to announcement of the Proposed Transaction (Condition 9), requiring a strong capital structure for American Water (Condition 10), disallowing new on-going costs caused by the transaction for a five year period (Condition 11), deferring rate increases to Cal-Am's ratepayers for one year (Condition 15), committing

shareholder funds up to \$100,000 annually for a five-year period to develop a low-income assistance program (Condition 16), and committing shareholder funds of up to \$100,000 annually for a five-year period to assist small troubled water systems (Condition 17), on the Joint Applicants, the Proposed Transaction will not be in the public interest. In fact, ratepayers will be harmed from increased costs associated with the divestiture.

Therefore, it is factual error to conclude that DRA does not oppose the Proposed Transaction. It does oppose it unless Commission imposes DRA's proposed conditions.

IV. IT IS FACTUAL ERROR FOR THE PD TO DESCRIBE RWE'S CHOICE TO DIVEST AS A CHANGE IN ITS CORE BUSINESS

The PD states: "Due to changed circumstances, RWE has refocused its core business on the rapidly changing European energy markets that are experiencing increased competition, growing customer needs and rising costs. To do so, RWE made a business decision to withdraw from its non-core businesses." P. 8. Finding of Fact 13 also states that "RWE seeks to transfer its indirect control of Cal-Am because it has refocused its core business on the rapidly changing European energy market and has made a business decision to withdraw from the water business." PD at p.32. The PD concludes that RWE's choice to divest American Water is due to a change in its core business.

Despite the PD and the Joint Applicants' assertions that RWE's reason for divesting American Water is its change in core business focus to the European power and energy markets, DRA determined through discovery (CA-DRA-04-Q10) of RWE's Supervisory Board of the Board of Directors meeting minutes that demonstrate RWE wants to divest American Water because of **BEGIN PROPRIETARY**

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[REDACTED]

[REDACTED] **END**

PROPRIETARY

RWE's Board Minutes demonstrate that it is factual error to conclude RWE is divesting American Water *only* to refocus its core business to the energy markets when as the minutes illustrate, that RWE was not fully aware of the **BEGIN PROPRIETARY**

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] **END PROPRIETARY** These are the real reasons why RWE is divesting itself of American Water.

California's ratepayers, however, should not now be responsible for higher future capital and operating costs and higher debt costs as a result of RWE's **BEGIN PROPRIETARY** [REDACTED] **END PROPRIETARY**

V. IT IS FACTUAL ERROR FOR THE PD TO DOWNPLAY THE PROPOSED TRANSACTION'S DEBT COST IMPACTS

The PD states: "Applicants do not expect the current cost of American Water's capital to change as a result of the proposed transaction except due to changes in interest rates. The cost of debt that American Water will incur is expected to be in line with the costs it would incur as a non-core operation of RWE." P.10.

The PD's statement above is factually inaccurate in that DRA has clearly shown that the Proposed Transaction has already caused a downgrading of American Water's debt rating, which results in higher debt costs to ratepayers. Lower debt ratings result in higher debt cost rates. The PD fails by not addressing the actual harms that have *already* occurred and will continue as a result of the downgrading, which is a direct result of the Proposed Transaction.

Losing the backing of the larger, stronger RWE affects debt ratings as illustrated below in a June 7, 2004 report from Moody's Investor Service:

The rating of AWCC ("American Water Credit Corporation") incorporates the benefit of AWW's ownership by RWE. The consolidated financial metrics of AWW ("American Water Works") would not support the Baa1 rating of AWCC on a

stand-alone basis. The rating incorporates Moody's view that AWW derives significant financial flexibility from the ability to defer (if necessary) its preferred dividend payments to the parent, and its ability to borrow from the RWE family of companies.

See CA-DRA-03-Q006 & DRA Opening Brief, p.26.

In the same data request response, a February 14, 2006 Standard & Poor's report indicated that AWCC rating will remain on Credit/Watch with negative implications. This rating for AWCC reflects American Water's stand-alone credit quality, noting that in November of 2005, RWE announced its intention to sell its U.S. water businesses. The report stated that American Water's stand-alone financial risk profile is weak for the rating. The Joint Applicants have indicated that both the 2003 upgrade to AWCC and the 2005 downgrade were related to the RWE acquisition and the RWE divestment announcement, respectively. (Tr. Vol. 4, pp. 173-174, Bigelow/Joint Applicants & DRA Opening Brief, p.26)

The Joint Applicants further agreed that after RWE's purchase, "...the American Water Works' crediting rating by S&P was improved one notch under RWE's ownership, and that because RWE loaned money to American Water at market rates in the U.S., that that one notch improvement,...would have had some benefit in the cost of capital for Cal-Am." (Tr. Vol. 4, p.173, Bigelow/Joint Applicants & DRA Opening Brief, p.26.)

Thus, as the Joint Applicants have acknowledged, RWE's backing or lack of backing of American Water has impacted past debt costs and has presently impacted them again. As DRA argued earlier, ratepayers have already been harmed by the downgrading from an "A" to an "A-."

And the difference in the cost of debt between an "A" versus an "A-" by Standard & Poors is generally about 15 basis points. (Tr. Vol. 6, p. 327, Woolridge/DRA & DRA Opening Brief, p.27.) Mr. Bigelow stated during hearings, American Water has gone out for the private placement of \$500 million of bonds to refinance the RWE debt and received offers for \$900 million of bonds at the Company's current debt rating. (Tr. Vol. 4, pp. 148-149, Bigelow/Joint Applicants) However, American Water with this private

placement had to utilize its current Standards & Poors debt rating of “A-.” If the debt rating had remained at an “A,” the rates would be lower. Thus, it is factually inaccurate for the PD to downplay the higher debt costs American Water has already incurred as a direct result of the divestiture announcement.

Lastly, the PD states that “Even though DRA estimated that a one-step downgrade in an S&P credit rating would increase the cost of new debt by 0.15%, it acknowledges that a credit rating is not the sole criteria for determining the cost of new debt.” P.19. Even though DRA has acknowledged a utility’s credit rating is not the sole criteria that determines the new cost of debt, the Joint Applicants have not disputed the fact that it is at least one criteria that is considered. In addition, the Joint Applicants have not rebutted or provided evidence contrary to the 0.15% impact.

VI. IT IS FACTUAL ERROR FOR THE PD TO OVERESTIMATE THE PROPOSED TRANSACTION'S BENEFITS

The PD states: “Furthermore, after examining the case, we do find that there are ratepayer benefits to the transaction.” P.3. Further, Finding of Fact No. 17 states: “Ratepayer benefits identified by applicants include a solid capital structure, ability to raise capital on a going forward basis, becoming a United States public traded company, local control, enhancement of employee relations, and transparency to Cal-Am ratepayers.” P.32.

Again, DRA argues that it is legal error to state the Commission will only be applying the “ratepayer indifference” standard, but then cites ratepayer benefits in its arguments to show why the “ratepayer indifference” standard is satisfied when determining if the Proposed Transaction is in the public interest. It is legal error for the Commission to inconsistently apply its decision criteria in this manner.

1. American Water’s current “solid capital structure” and “ability to raise capital on a going forward basis.”

Regarding the ratepayer benefit of a “solid capital structure” and the “ability to raise capital on a going forward basis,” American Water currently already has a solid

capital structure and a strong ability in raising capital under RWE ownership. Therefore, these are not *new* ratepayer benefits from the Proposed Transaction. In fact, with the Proposed Transaction, ratepayers will be losing the backing of RWE's capital structure, which previously provided American Water with an "A" credit rating. As noted earlier, the cost of raising capital has already increased beyond what it would otherwise be if RWE's decision to divest had not lowered American Water's debt ratings. *See* DRA Opening Brief at p.25-27. Thus, it is factual error to laud a "solid capital structure" and the "ability to raise capital on a going forward basis" as substantial benefits from the Proposed Transaction when these benefits already exist without the Proposed Transaction.

2. The "supposed" benefit of "becoming a United States publicly traded company" and the "transparency to Cal-Am ratepayers."

Even though both the PD and the Joint Applicants argue that "becoming a publicly traded company" and the "transparency to Cal-Am ratepayers" benefit ratepayers, these benefits apparently cannot be quantified since DRA has demonstrated that higher costs will result with this "new status" and "transparency." *See* DRA Opening Brief at p.22 & 32-33. With this "new status" and "transparency," there will be new Sarbanes-Oxley & SEC compliance costs, NYSE listing fees, higher external auditing fees, and investor relation costs. Ratepayers need to be protected from these types of "benefits".

In fact, American Water's most recent estimate of SOX compliance costs is \$29 million. *See* DRA Opening Brief at p.32. This \$29 million represents funds that American Water will be expending to primarily benefit its shareholders and not its ratepayers, since SOX compliance is meant to protect shareholders and not ratepayers.

And as a public utility in the State of California, American Water is already required to file extensive information on Cal-Am before the Commission in the rate setting process, which is the mechanism that protects ratepayers already. For instance, American Water must submit a consolidated annual report on Cal-Am and separate annual reports for each of its districts. American Water and Cal-Am must submit various

other compliance reports ordered by various Commission decisions. And specifically, for a rate case, Cal-Am must submit: 1) recorded revenues; 2) proposed revenues; 3) proposed rate increases; 4) impacts on current revenue requirement; 5) recorded operating expenses; 6) proposed capital budget in the test year; and 7) how Cal-Am forecasted operating expenses for the test year. Thus, under RWE ownership, American Water must already provide pertinent and relevant information that impacts Cal-Am's ratepayers.

And lastly the PD states "Ratepayers will benefit from public disclosure and openness of the operations of American Water and Cal-Am." P.16. As one can see, ratepayers are already well-protected in the rate case process while under the current structure- specifically enjoying the financial advantages of being part of RWE and thus not having to pay SOX compliance costs.

In addition, the Joint Applicants acknowledge that American Water's financial statements are already audited under RWE ownership. *See* DRA Opening Brief at p.22. Thus, one cannot consider the costs to pay additional auditing fees as a real benefit to ratepayers either when becoming a publicly-traded company.

Thus, it is again factual error to laud "becoming a publicly traded company" and the "transparency to Cal-Am ratepayers" as substantial benefits of the Proposed Transaction.

3. Local Control

The PD states that "local control" is a benefit from the Proposed Transaction- "There will be no change in the management of Cal-Am or American Water in the ordinary course of business." P.11. It is again factual error for the Commission to assert this since as illustrated earlier, if RWE had to retain American Water, it would **BEGIN**

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[REDACTED]

[REDACTED]

[REDACTED] **END PROPRIETARY** *See* DRA Opening Brief, p. 42 & 44.

Thus, it is again factual error to laud “local control” as a substantial benefit of the Proposed Transaction.

VII. IT IS FACTUAL ERROR FOR THE PD TO CONCLUDE A RATE INCREASE DEFERRAL WILL HARM RATEPAYERS

The PD states that DRA provides no analysis to substantiate that its proposed one year deferral of rate increases will benefit ratepayers. *See* p.25. DRA continues to argue its proposed condition deferring rate increases, ensures that there is a benefit to ratepayers as a result of the Proposed Transaction. As stated in DRA’s Reply Brief, this benefit to ratepayers will help to offset some of the harms that have already occurred, such as the debt rating downgrading, the increased costs resulting from the Proposed Transaction, and the deferral and cancellation by American Water of several IT initiatives that were set to directly benefit customers. *See* p.11.

The PD also states that DRA acknowledges the deferral or rate changes may “result in rate shock to the ratepayers of Cal-Am when the authorized but delayed rates go into effect...” DRA has not made these assertions, and they are not contained in the transcript pages the PD cites. This mischaracterization of DRA’s position is a factual error.

Again, DRA argues in its Reply Brief that the Joint Applicants have not demonstrated that rate shock would occur as a result of a one year deferral of rate increases and that ratepayers are clearly better off if an increase in rates is put off by one year through the savings they experience in that year. *See id.* It is factual error to assert otherwise.

To argue that ratepayers are better off paying higher rates and not receiving a deferral of rate increases is simply erroneous. Instead, the Joint Applicants have not demonstrated that the deferral for one year would have the severe repercussions on Cal-Am’s financial health as they contend.

VIII. IT IS LEGAL ERROR FOR THE PD TO CONCLUDE CAL-AM WILL RECOVER ALL OF ITS EXPENSES & COSTS

The PD states: “Cal-Am will lose \$26.8 million of authorized revenue, approximately 24% of its 2011 projected revenues, and more than eliminate its authorized earnings for one entire year if Condition Number 15 (deferral of rate increases for one year) is adopted.” P.34. The PD commits legal error when making this conclusion because it erroneously assumes that Cal-Am will actually recover all of its projected revenues, i.e., that the Commission will not modify or lower its request. Moreover, the decision errs in concluding this \$26.8 million figure Cal-Am and the PD cite is “authorized”- amounts *are not* authorized until the Commission reviews such figures and issues a decision.

The Commission cannot rely upon Cal-Am’s figures because they assume the Commission will adopt 100% of their requested increases in its upcoming general rate cases.

IX. IT IS FACTUAL ERROR FOR THE PD TO STATE DRA CONCURS WITH CAL-AM THAT IT WILL NOT BE ALLOWED TO RECOVER THE COST OF SERVICE APPLICABLE TO LOW-INCOME RATEPAYERS IF ITS CONDITION 16 IS ADOPTED

The PD’s Finding of Fact 43 states: "DRA concurs that Cal-Am will not be allowed to recover the cost of service applicable to low-income ratepayers if its Condition Number 16 is adopted." P.35. This statement is a factual error because Cal-Am recovers costs associated with providing services at a lower cost to low-income customers in rates, but it is only the \$100,000 per year we recommend in Condition Number 16 that shareholders would fund and not recover from ratepayers.

X. CONCLUSION

It is legal error for the PD to inconsistently apply the “ratepayer indifference” standard in reviewing the Proposed Transaction. It is factual error for the PD to state ratepayers and the public interest are not adversely impacted by the Proposed Transaction. It is factual error for the PD to state DRA does not oppose the Proposed Transaction.

It is factual error for the PD to describe RWE's choice to divest as a change in its core business. It is factual error for the PD to downplay the Proposed Transaction's debt cost impacts. It is factual error for the PD to overestimate the Proposed Transaction's benefits.

It is legal error for the PD to conclude a rate increase deferral will harm ratepayers. It is legal error for the PD to conclude Cal-Am will recover all of its expenses and costs. Lastly, it is factual error for the PD to state DRA concurs with Cal-Am that it will not be allowed to recover the cost of service applicable to low-income ratepayers if the Commission adopts its Condition 16.

Respectfully submitted,

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April 17, 2007

Proposed Modifications to Findings of Fact

1. **REPLACE** on P.31 Finding of Fact #8 with:
“Applicants assert that the proposed transaction will produce unquantifiable benefits for the ratepayers of Cal-Am.”
2. **REPLACE** on P.32 Finding of Fact #13 with:
“RWE seeks to transfer its indirect control of Cal-Am for various proprietary reasons.”
3. **REPLACE** on P.32 Finding of Fact #18 with:
“DRA does oppose the grant of this application, unless the Commission imposes DRA’s conditions.”
4. **REPLACE** on P.32 Finding of Fact #19 with:
“DRA recommends that 17 conditions be imposed upon Cal-Am and American Water to ensure that ratepayers of Cal-Am are unharmed from the proposed transaction.”
5. **DELETE** on P.33 Finding of Fact #27.
6. **REPLACE** on P.34 Finding of Fact #38 with:
“DRA’s Condition Number 15 will not result in rate shock to Cal-Am’s ratepayers when the requested delays go into effect.”
7. **DELETE** on P.34 Finding of Fact #39.
8. **REPLACE** on P.35 Finding of Fact #43 with:
“DRA does not concur that Cal-Am will not be allowed to recover the cost of service applicable to low-income ratepayers if its Condition Number 16 is adopted.”
9. **DELETE** on P.35 Finding of Fact #44.

Proposed Modifications to Conclusions of Law

1. **REPLACE** on P.36 Conclusions of Law #8 with:
“Condition Number 9 should be adopted because the freezing of the cost of debt for at least five years into the future will not harm Cal-Am and its ratepayers.”
2. **REPLACE** on P.36 Conclusions of Law #9 with:
“DRA’s proposed modification to Condition Number 10 should be adopted.”
3. **REPLACE** on P.36 Conclusions of Law #11 with:
“Condition Number 13 should be adopted.”
4. **REPLACE** on P.37 Conclusions of Law #13 with:
“Condition Number 15 should be adopted.”
5. **REPLACE** on P.37 Conclusions of Law #14 with:
“Condition Number 16 should be adopted.”
6. **REPLACE** on P.37 Conclusions of Law #15 with:
“Condition Number 17 should be adopted.”
7. **REPLACE** on P.37 Conclusions of Law #18 with:
“The proposed transaction is in the public interest with the Commission imposing DRA’s conditions.”

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **[REDACTED VERSION]**
COMMENTS TO ALJ GALVIN'S PROPOSED DECISION OF THE DIVISION
OF RATEPAYER ADVOCATES in **A. 06-05-025** by using the following service:

E-Mail Service: sending the entire document as an attachment to all known parties of record who provided electronic mail addresses.

U.S. Mail Service: mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on April 17, 2007 at San Francisco, California.

/S/ CHARLENE D. LUNDY

Charlene D. Lundy

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address and/or e-mail address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.
