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Decision 02-12-068 December 19, 2002

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Joint Application of California-American Water Company (U-210-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, Thames Water Plc, a corporation organized under the laws of the United Kingdom and Wales, and Apollo Acquisition Company, a Delaware Corporation, for an order Authorizing Apollo Acquisition Company to merge with and into 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.	Application 02-01-036 (Filed January 28, 2002)

(See Appendix A for list of appearances.)

OPINION CONDITIONALLY APPROVING APPLICATION

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OPINION CONDITIONALLY APPROVING APPLICATION

I. Summary

In this decision, we conditionally approve a settlement agreement which places certain conditions upon the transfer of control of California-American Water Company (Cal-Am). As a result, we approve an indirect transfer of control of Cal-Am, where RWE Aktiengesellschaft (RWE) would purchase the stock of Cal-Am's parent, American Water Works Company (American).

II. The Proposed Acquisition

A. The Companies Involved

Cal-Am is a class A water utility serving about 170,000 customers and is a wholly owned subsidiary of American. Cal-Am provides water service to domestic and industrial customers in six separate systems, including Coronado and a portion of San Diego, six cities and certain unincorporated portions of the Monterey Peninsula in Monterey County, and portions of three cities and unincorporated portions of Los Angeles County, and the City of Thousand Oaks in Ventura County. The Commission recently approved Cal-Am's acquisition of Citizens Utilities Company of California's (Citizens) water utility assets in: (1) Larkfield, Sonoma County; (2) Felton, Santa Cruz County; (3) Montara, San Mateo County; and (4) scattered locations in Sacramento and Placer Counties.[1]

American is a Delaware Corporation headquartered in New Jersey, whose principal business is operating water and wastewater companies, such as Cal-Am, that provide service to about 2.6 million customers in the United States and in three Canadian provinces. American Water Works Service Company (the

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[1] See Decision (D.) 01-09-057, 2001 Cal. PUC LEXIS 826 (Cal-Am/Citizens merger).

Service Company) is a wholly owned subsidiary of American that provides professional and staff services to American's utility subsidiaries at cost pursuant to approved agreements between them and the Service Company.

According to their respective annual reports for 2001, American's total revenues for 2001 were $1,438,887,000, while Cal-Am's were $76,639,907.80. Thus, Cal-Am's total operating revenues are about 5 % of American's. Cal-Am's customer base comprises about 6.4 % of American's.

RWE, Germany's fifth largest industrial group, is an international multi-service provider with core businesses in electricity, water, gas, waste management, and utility-related services. RWE is organized under the laws of the Federal Republic of Germany. RWE currently derives more than 90% of its revenues from non-water utility operations, and is the third largest company in the global water business. Through Thames Water Aqua Holdings GmbH (Thames Holdings), RWE provides water and waste water services to about 43 million people worldwide, including (through Thames Water Plc (Thames Water)) to 12 million people in and around London.[2] Thames Holdings is a wholly owned subsidiary of RWE and is organized under the laws of the United Kingdom and Wales. (We refer to the Thames companies as Thames, and to Thames Water Plc as Thames Water. Many references in this decision are to Thames Water.)

B. Overview of the Proposed Transaction

Under the proposed transaction, RWE will purchase all of the stock of Cal-Am's parent, American, pursuant to the Agreement and Plan of Merger

[2] Thames is the largest water and wastewater utility in the United Kingdom. In the United States, Thames water has offices in five states and Puerto Rico.

dated September 16, 2001 between American and Thames. Under the agreement, American will merge into a corporate shell entity, the Apollo Acquisition Company, that is a subsidiary of Thames Holdings created solely to accommodate the acquisition of American. After the transaction, American will become the wholly owned subsidiary of Thames Water Aqua U.S. Holdings, Inc. (Thames USA), which is organized in the United States. Thames USA is a wholly owned subsidiary of Thames Holdings, which is a wholly owned subsidiary of RWE.

Thames Holdings will purchase from American's shareholders all outstanding American common stock at $46/share and will assume American's existing debt. The total purchase price is $7.6 billion, consisting of $4.6 billion in cash and the assumption of $3.0 billion in debt. The purchase price includes a $2.8 billion acquisition premium, which is about 2.6 times American's book value of about $1.8 billion.

Cal-Am will continue to be the operating public utility providing water utility service under the Commission's jurisdiction in the areas where it is authorized to do so.

III. Procedural Background

This application was assigned to Commissioner Duque and Administrative Law Judge (ALJ) Econome. The Office of Ratepayer Advocates (ORA), the City of Thousand Oaks (Thousand Oaks), and Montara Sanitary District (MSD) filed timely protests. The Commission held a prehearing conference on April 4, 2002, where Commissioner Duque designated ALJ Econome as the principal hearing officer. The April 11, 2002 Scoping Memo of the Assigned Commissioner and ALJ confirmed this designation.

The Commission held public participation hearings in Monterey on June 4, 2002, in Montara on June 17, 2002, in Newbury Park on June 20, 2002, and in Sacramento on July 8, 2002.

The Commission held evidentiary hearings from July 29 through August 9, 2002, during which applicants, the Utility Workers Union of America AFL-CIO (Union), the protestants listed above, and the City of San Diego (San Diego) participated. The Union submitted testimony supporting the application. ORA, MSD, San Diego, and Thousand Oaks each opposed the application for varying reasons. Generally, these parties argued that there were either insufficient benefits to the proposed transaction, or unreasonable risks, or both. Some of the risks these parties enumerated include: (a) increased business and financial risk; (b) diminished local control and accountability; (c) concern that Cal-Am will indirectly pass through in rates the acquisition premium or will decrease service; and (d) diminished corporate focus on water issues when the water portion of the business may have to compete with potentially more lucrative lines of business.

Shortly before hearings began, ORA and applicants participated in settlement discussions. A settlement conference was properly noticed and held on July 29 and 30. On July 31, ORA, applicants, and the Union signed a settlement agreement which they filed with the Commission on August 1, 2002 (settlement), together with a motion requesting Commission approval of the settlement. Applicants served supplemental testimony further explaining the settlement terms, and the settling parties were subject to cross-examination on August 6. On that day San Diego, which had opposed the application, entered into a stipulation which caused it to withdraw its opposition and support the settlement. MSD and Thousand Oaks continued their opposition.

IV. Standards of Review

A. Standard of Review for Settlements

We review this contested settlement pursuant to Rule 51.1(e) of the Commission's Rules of Practice and Procedure (Rules), which provides that, prior to approval, the Commission must find a settlement "reasonable in light of the whole record, consistent with the law, and in the public interest." If the Commission determines that a settlement fails any one of these requirements, the Commission must reject it, or approve it subject to conditions sufficient to meet the requirements of Rule 51.1(e).

B. Standard of Review for This Acquisition

We begin our analysis by summarizing the statutes with most direct bearing on whether this merger is consistent with the law and in the public interest.

Pub. Util. Code § 851, in relevant part, requires Commission approval before a public utility may sell the whole or any part of its system; § 852 requires a public utility to secure Commission authority before acquiring any capital stock of any other public utility; § 854(a) requires Commission authorization before any person or corporation may acquire or merge with any public utility; and § 854(d) requires the Commission to consider reasonable "options" to the applicants' proposal recommended by other parties, in order to determine whether comparable short-term and long-term economic savings can be achieved through other means while avoiding the possible adverse consequences of the proposal. The Commission has long interpreted the above code sections to prohibit acquisitions, mergers, and transfers of control unless the Commission finds the proposed transaction to be in the public interest.

In order to determine whether the proposed transaction is in the public interest, the parties differ on whether the Commission should apply the "ratepayer indifference standard" (i.e., a showing that no negative effects result from the change of control), or whether the Commission should require that the transaction offer ratepayers some equitable share of the benefits the transaction will generate. (See D.00-05-047, 2000 Cal.PUC LEXIS 314, concerning California Water Services Company's purchase of Dominguez Water Company, et al. (CWS/Dominguez merger) and D.01-09-057, 2001 Cal. PUC LEXIS 826, concerning the Cal-Am/Citizens merger.)

In D.00-05-047, the Commission approved the merger under the ratepayer indifference standard.[3] The dissent stated that approvals for transfers of utility property under § 851 et seq. should include a finding of ratepayer benefit. (See D.00-05-047, 2000 Cal. PUC LEXIS 314 **60-61.) The dissent also stated that while it is not necessary to address the public interest considerations listed in Pub. Util. Code § 854(b) and § 854(c), since these sections do not apply by their terms to water utilities, this itemization of issues may inform the Commission's deliberations on how to strike the public interest balance. (*Id.* at note 2.)

[3] D.00-09-042, which denied rehearing of D.00-05-047 on various grounds, including the standard of review, stated that the issue of the appropriate standard of review of mergers under § 851 et seq. (i.e., ratepayer indifference vs. ratepayer benefit) is very much alive in Commission proceedings, but declined to address the issue further. D.00-09-042 denied rehearing on the standard of review because it found that D.00-05-047, although expressly relying only on ratepayer indifference, actually satisfied the more stringent ratepayer benefit standard by finding definite, quantifiable benefits flowing from the merger.

In the Cal-Am/Citizens merger, the Commission concluded that, for an acquisition subject to § 2720[4] to be in the public interest under § 851 and § 854(a), it must offer ratepayers an equitable share of the benefits the transaction will generate. (See D.01-09-057, 2001 Cal. PUC LEXIS 826, * 107, Conclusion of Law 8). The Commission also concluded that while § 854(b) and § 854(c) do not by their terms apply to water utilities, the Commission may, but need not, consider the extent to which the factors set forth in those sections bear on the public interest. (*Id.* at Conclusion of Law 9.)

Both the Cal-Am/Citizens merger and the CWS/Dominguez merger differ from this transaction in two respects. First, the Cal-Am/Citizens and CWS/Dominguez transactions involved the merger of California water utilities, and applicants in those proceedings projected operational and administrative synergies from the merger of the affected entities. In this case, applicants are not merging California water utilities; rather, this transaction involves an acquisition at the holding company level. For that reason, applicants do not demonstrate that the transaction will eliminate redundancies; rather, they project that Cal-Am will operate its business as usual, and will achieve benefits from operating practices, etc., over time.

Second, unlike this transaction, the CWS/Dominguez and the Cal-Am/Citizens mergers both involved recovery of the acquisition premium authorized by Pub. Util. Code § 2720, where in this case applicants state that they are not seeking to increase Cal-Am's rate base, as they believe they have a right

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[4] Section 2720 is part of the Public Water Systems Investment and Consolidation Act of 1997 (Pub. Util. Code § 2718 et seq.), which sets out a procedure for establishing rates at fair market value following the completion and approval of an acquisition of a public water system by a regulated water utility.

to do under § 2720, and thus are not placing these associated costs on ratepayers.[5]

Although this acquisition differs significantly from the CWS/Dominguez and Cal-Am/Citizens mergers, the Commission does not have to determine whether some other standard should apply because we find the settlement, as modified by the conditions we impose in today's decision, meets the higher standard adopted in D.01-09-057 that ratepayers receive an equitable share of the benefits of the transaction. In order to examine this equitable sharing, as well as other aspects of this settlement that may inform the Commission how to strike the public interest balance, we review the settlement pursuant to the criteria set forth in § 854(b) and (c), even though these sections are not by their terms applicable to this transaction.

C. § 854(b) and (c)

Pub. Util. Code § 854(b) and (c) are applicable to certain mergers, acquisitions, or changes in control involving electric, gas or telephone utilities and are not by their terms applicable to this transaction. However, as stated above, in other mergers and acquisitions where § 854(b) and (c) do not apply, the Commission can consider these factors in determining if the transaction is in the public interest.

Because the bulk of this decision is structured around the elements of § 854(b) and (c), we set forth those provisions here. Pub. Util. Code § 854(b) provides that before authorizing the merger, acquisition, or control of any

[5] We question whether applicants would have the right to increase Cal-Am's ratebase pursuant to § 2720 for this type of transaction, but need not reach that issue here because applicants do not seek to do so.

California electric, gas, or telephone utility, where any of the utilities that are parties to the proposed transaction has gross annual California revenues exceeding five hundred million dollars, the Commission shall find that the proposal does all of the following:

(1) Provides short-term and long-term economic benefits to ratepayers.

(2) Equitably allocates, where the commission has ratemaking authority, the total short-term and long-term forecasted economic benefits, as determined by the commission, of the proposed merger, acquisition, or control, between shareholders and ratepayers. Ratepayers shall receive not less than 50 percent of those benefits.

(3) Not adversely affect competition.[6]

Pub. Util. Code §854(c) provides that before authorizing the merger, acquisition, or control of any California electric, gas or telephone utility where any of the entities that are parties to the proposed transaction has gross annual California revenues exceeding 500 million dollars, the Commission shall consider each of the criteria listed below and find, on balance, that the transaction is in the public interest.

(1) Maintain or improve the financial condition of the resulting public utility doing business in the state.

(2) Maintain or improve the quality of service to public utility ratepayers in the state.

(3) Maintain or improve the quality of management of the resulting public utility doing business in the states.

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[6] Section 854(b)(3) requires the Commission to request an advisory opinion from the Attorney General regarding whether competition will be adversely affected and what mitigation measures could be adopted to avoid this result.

(4) Be fair and reasonable to affected public utility employees, including both union and nonunion employees.

(5) Be fair and reasonable to the majority of all affected public utility shareholders.

(6) Be beneficial on an overall basis to state and local economies, and to the communities in the area served by the resulting public utility.

(7) Preserve the jurisdiction of the commission and the capacity of the commission to effectively regulate and audit public utility operations in the state.

(8) Provide mitigation measures to prevent significant adverse consequences which may result.

V. The Conditions in the Settlement, Discussed According to the Requirements of Pub. Util. Code § 854(b) and (c)

A. The Settlement

Because some of the settlement language is imprecise and subject to interpretation, the Commission held half a day of hearing on the settlement in order to more clearly understand its terms. Appendix B sets forth the settlement, as annotated by the Commission's specific understanding of the terms of the settlement where appropriate. We approve the settlement based on that understanding and as further set forth in this decision.

Before discussing the settlement according to the individual requirements of § 854(b) and (c), we comment on one overarching issue, that is, the Commission's ability to enforce the settlement, because the settlement's value is significantly diminished if the Commission cannot enforce it. MSD and Thousand Oaks criticize the settlement because they believe RWE, Thames, and American have not submitted to the Commission's jurisdiction to enforce it.

We disagree. Pursuant to § 854, the Commission has broad authority to approve or deny applications for transfers of utility ownership or control.

Implicit in this authority is the right to place reasonable conditions upon the transferor or transferee, should the need for conditions arise. This decision includes such conditions, both as embodied in the settlement and as further directed. The right to impose these conditions carries with it the right to enforce the conditions at the Commission in Commission proceedings. "Without the latter right, the former is meaningless." (*Re San Diego Gas and Electric Company*, D.86-03-090, 20 CPUC2d 660, 686; See also D.02-01-037, 2002 Cal.PUC LEXIS 7, as modified by D.02-07-044.)

Applicants do not dispute our authority to enforce the conditions we approve in today's decision at the Commission. Applicants' witnesses for both RWE and Thames and American testified that by signing the settlement, they intended the settlement conditions bind RWE, Thames, and American, as well as Cal-Am.[7]

Applicants also provided these assurances at the December 12, 2002 final oral argument before the Commission as evidenced by the following exchange:

> "Commissioner Lynch: So your position is that the PUC need not go to court to enforce the commitments that you are making in this merger, that we can enforce it as the regulatory entity over the holding company?

[7] See e.g., Reporter's Transcript (RT), pp. 857-858, 871, and 915. For example, James McGivern, the Managing Director-Americas for Thames, testified that "the intention of me signing [the settlement] on behalf of RWE and Thames is to give the Commission assurance that these commitments – RWE and Thames is standing behind them and will ensure that they are complied with. That was the whole point." (RT at 853.) McGivern also testified that "in signing this document under the name of RWE and Thames it's my full intention that the Commission can enforce each of these conditions against RWE and Thames." (RT at 857.)

"Mr. McGivern: The PUC can enforce that order, yes.

"Commissioner Lynch: The order over the holding company to ensure that the holding company commit the appropriate capital, all necessary capital funding to meet the regulated entity's statutory needs?

"Mr. McGivern: My understanding is: We've signed a stipulation with the ORA, it is embodied in the proposed decision. Those commitments are contractual conditions enforceable on RWE and Thames, and are enforceable by you, as a PUC, contractually, without the need to go to court.

"Commissioner Brown: Within the jurisdictional venue of the PUC?

"Mr. McGivern: That's my understanding, yes." (RT At 1090.)

We hold that the Commission can enforce the settlement and additional conditions approved in this decision at the Commission in Commission proceedings. We next embark on a more detailed review of the settlement terms.

B. § 854(b)(1)—Provides Short-Term and Long-Term Economic Benefits to Ratepayers

1. Summary

The settling parties believe the settlement provides ratepayers with both short-term and long-term economic benefits, including quantifiable and non-quantifiable benefits. These include (a) sharing best practices; (b) lowering Cal-Am's cost of debt; (c) deferring a rate increase; (d) implementing two public assistance programs; and (e) adopting affiliate transaction rules.

MSD and Thousand Oaks disagree, arguing that applicants have not, for the most part, quantified or performed any studies or analyses of cost savings, efficiencies, or other synergies savings that may be achieved as a result of the proposed transaction.

We find that the proposed transaction, with the conditions agreed to in the settlement as further conditioned by this decision, provides ratepayers with sufficient short-term and long-term benefits so that we can approve the transaction. First, we briefly discuss each of the benefits asserted by the settling parties. We then include a broader benefits discussion in light of the specific nature of this transaction.

2. Sharing Best Practices

Applicants testified that one of the principal benefits that Cal-Am and its ratepayers would receive from the proposed transaction is the sharing of best practices. These include the following:

a) Security

Applicants believe that Thames, with water operations around the globe, has established and tested security protections that American currently does not have, due to Thames' considerable experience in operating water facilities and systems in regions with heightened ongoing security concerns (i.e., in Great Britain, which has been subject to threat by the IRA for decades, and in the Middle East, which has been problematic since at least the Gulf War.) Applicants also believe that while American currently has secure facilities, it can improve, and Thames will provide American faster access to additional cost-effective security protections. MSD argues that there is no security benefit to this acquisition because American's facilities are already secure.

The record indicates that American has conducted secure water operations. However, the Service Company's Senior Vice President, Daniel L. Keheller, testified that while he believes American currently has secure facilities, there is more that they can do, and he believes that Thames will provide American faster access to cost-effective security protection. We find such

enhanced access to additional security protections, although monetarily unquantifiable at this time, to be a benefit of this transaction.

b) Design and Build

Applicants believe Cal-Am will benefit by using the design/build process employed by Thames Water as opposed to the design/bid/build process Cal-Am uses for construction. Their witness, Andrew M. Chapman, provided testimony on how this process has already benefited Elizabethtown Water Company, which Thames recently purchased.[8]

Condition 29 of the settlement commits applicants to "seek to employ Thames' advanced project delivery experience to compliment American's capability." Based on Cal-Am's forecasted capital expenditures for a full rate cycle, applicants believe such savings would reduce its capital expenditure requirements by about $2.2 million. We find using Thames Water's design/build process is a short-term benefit to ratepayers, because reducing capital costs should translate into lower rates than would have occurred if the improved construction methods were not used.

c) Research and Development (R&D)

Applicants expect Cal-Am to benefit significantly from Thames Water's more extensive R&D. American has a $3 million R&D budget and a staff of 14, while Thames Water has a $13 million R&D budget and a staff of about 100 focusing on water production and delivery. Applicants specifically identified desalinization as one area where Cal-Am might immediately benefit, because

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[8] Chapman, President of Elizabethtown Water Company, gave an example of how his company saved about $1 million on a pipeline project and about $1.5 million on the Canal Road Treatment plant expansion.

Thames Water is a world leader in the areas of water reuse and desalinization. Applicants plan to share Thames' existing R&D with American at no cost. According to applicant, Thames Water's ability to significantly use renewable power in London is also supported by RWE's very large R&D budget. Applicants also said that Thames Water developed cutting edge technology in network planning and modeling, pipe leak detection, pipeline renovation systems, and low dig and trenchless technologies. These best practices will also be available in order to improve Cal-Am's operations.

MSD and Thousand Oaks disagree that Thames Water's R&D will benefit Cal-Am's ratepayers. MSD believes that Cal-Am has failed to show that its own R&D programs are deficient, and it is unclear what the ultimate cost to Cal-Am will be for access to this R&D. According to MSD, even if ratepayers benefit in some way from this R&D, the record does not contain information for the Commission to make a cost/benefit analysis.

We find that access to R&D to be a substantial, albeit an unquantifiable benefit of this transaction, because Thames Water will share its embedded R&D with American at no cost, and Thames Water has had a substantially higher R&D budget than has American. Also, Condition 22 of the settlement requires Cal-Am to match in its future rate proceedings the cost of implementing any best practice with a reasonable estimate of savings or increased revenues, and Cal-Am will not implement the best practice if increased revenues or decreased expenses do not justifiably exceed the costs of such practices. This condition will ensure that the Commission will consider both the costs and savings of a best practice in Cal-Am's future rate proceedings.

d) Service Standards

Applicants explained that Thames Water has a 99.89% track record of compliance with the United Kingdom's drinking standards, and a 99.99% compliance record for wastewater effluent. Since 1998, Thames Water has invested in excess of $6 billion to enhance service quality, including constructing an advanced water treatment system and major renovations of water mains and sewage treatment works. This background should be beneficial in enhancing Cal-Am's future service quality.

e) Customer Service

In order to assist integration between the call center and the field service, Thames Water has developed a technology that provides for a direct, real-time link between the Customer Service Center system and the field technicians. We find that Cal-Am's customers can benefit from this system by having their problems ascertained, analyzed, and addressed by field personnel in a more accurate, timely, and efficient manner.

3. Lowering Cal-Am's Cost of Debt

Cal-Am ratepayers will benefit from this transaction because Cal-Am will have a lower cost of debt and cost of capital as a result of the transaction. RWE has an A+ credit and bond rating from Standard and Poors (S&P), and an A1 credit rating from Moody's. American Water Capital Corporation's (AWCC)[9] comparable ratings from S&P are A- and BBB+, and Baa1 from Moody's. This means that RWE will be able to borrow money at a lower cost than AWCC under the current ratings.

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[9] AWCC is the source of Cal-Am's debt capital.

MSD believes that applicants have not demonstrated that there will be material benefits from RWE's enhanced access to capital, arguing that American's embedded cost of debt will change only gradually as existing debt is retired and new debt is issued. MSD estimates the benefit for each customer would be about $1 per year.[10] MSD also argues that applicants did not do any detailed analysis to quantify this benefit, and due to the fluctuating nature of capital markets, RWE's credit rating will change over time and in fact has recently been downgraded (although it is still higher than American's). According to MSD, the difference between RWE's and American's current credit rating is insufficient to demonstrate any material economic benefit over a sustained period of time.

Cal-Am's ratepayers have already benefited from RWE's higher credit rating in receiving a lower cost of debt as a result of this pending transaction. Daniel L. Kelleher, Senior Vice President of the Service Company, testified that in December 2001, Cal-Am received, as part of a debt offering from RWE to AWCC, $123.5 million at a rate of 25 basis points less than what AWCC could have obtained on its own. This resulted in a savings, or benefit, to Cal-Am's ratepayers of about $300,000 per year, or about $1.5 million over a five-year period, which is the length of the bond.

Given the current credit ratings, Cal-Am's ratepayers should benefit in the future from this transaction due to RWE's access to capital at lower costs. In response to arguments that RWE would not maintain its credit ratings, applicants' witness Ahern stated that further downgrade is unlikely, explaining that RWE's high investment grade bond ratings are based upon both its strong

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[10] ORA estimated the per customer benefit to be between $2.23 and $3.76/year.

historical financial statements and solid business fundamentals. Ahern also noted that S&P recently stated that RWE's acquisition-related event risk appears to have been reduced, and RWE's most recent financial statement supports this testimony.

Moreover, condition 19 in the settlement protects ratepayers because, for a period of five years following the close of the transaction, Cal-Am agrees it will not seek a cost of new debt greater than it would have sought if American had remained an independent entity.[11] When asked by the ALJ to clarify this condition, the settling parties agreed it meant that, for the five year period described above, Cal-Am will not seek a cost of debt greater than A- for secured debt and Baa1 for senior unsecured debt. Thus, for this five year period, ratepayers will benefit by any further reduction on the cost of debt provided by RWE, but are guaranteed a cost of debt no higher than American's current cost of debt. This is a significant benefit for ratepayers.[12]

4. Deferring a Rate Increase

Condition 1 in the settlement requires Cal-Am to defer a rate increase for one year in each of its districts (stay out provision). Applicants did not quantify this benefit because they cannot know now what increases, if any, the Commission may order in future rate cases. Nonetheless, the settling parties believe this condition provides tangible benefits because it defers a rate increase where one is likely to occur.

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[11] For purposes of this condition, the settling parties state that Cal-Am agrees that at present its cost of new debt is based on AWCC's current S&P credit rating of A- for secured debt and current Moody's credit rating of Baa1 for senior unsecured debt.

[12] We discuss MSD's argument that MSD could obtain better access to capital as a municipal utility in our discussion of § 854(d) below.

MSD and Thousand Oaks argue that this asserted benefit is speculative, referencing the Cal-Am/Citizens merger, D.01-09-057, 2001 Cal. PUC LEXIS 826 * 50-51, where the Commission did not give weight to the stay out benefits Cal-Am claimed as quantifiable benefits in that proceeding.

The Cal-Am/Citizens merger is not analogous, because in that merger, where the Commission concluded that the stay-out provision was not a quantifiable benefit, the time for Cal-Am to have filed these rate cases had passed, and any rate increases were foregone whether or not the merger was approved. Thus, the alleged benefits were not dependent upon the Commission approving the Cal-Am/Citizens merger. Here, the stay out benefits are contingent upon whether the Commission approves this transaction, and Cal-Am has pending rate case applications for the Monterey, Sacramento, Felton, Montara, and Larkfield districts.

Even though Cal-Am is requesting a rate increase for Monterey, ORA requests a rate decrease of 8.4% for the year deferred by the settlement agreement. The settling parties argue that it is likely the Commission will order a rate increase because the water industry is highly capital intensive, that ratepayers are likely to see increases for years to come, and that the Commission has granted rate increases in the past, notwithstanding ORA's request to the contrary.

Generally, a rate increase deferral should benefit ratepayers to the extent the Commission orders a rate increase for Cal-Am. We are concerned regarding the level of ratepayer benefits this condition provides, as well as the problem of "rate shock," if the rates deferred in one year are imposed on ratepayers the following year together with next the scheduled increase, and the two combined increases are large. For example, if the Commission were to order a rate increase for the Los Angeles districts, under the settlement, the tariffs implementing the

rate increase would be deferred for a year and would then be imposed on ratepayers at the same time as the step increase.

We want to ensure this proposal provides sufficient ratepayer benefit and also to guard against the possibility of "rate shock," or a large rate increase occurring at one time. We therefore modify condition 1 so that in each instance where the rate increase is deferred, it may be implemented in the following year. However, the step or attrition year increase for that following year will also be deferred. Pursuant to Assembly Bill (AB) 2838[13] requiring Cal-Am's districts to file general rate cases every three years, the districts would then begin a new rate case cycle.

Although we find this stay out provision as conditioned will benefit ratepayers to the extent the Commission orders a rate increase for Cal-Am, we cannot quantify on this record the likelihood of our ordering a rate increase in the future, or the amount of such increase, and therefore cannot quantify the benefits associated with this condition at this time.

5. Public Assistance Programs

Applicants have agreed to commit up to $500,000 of shareholder funds for two programs intended to benefit California ratepayers. Applicants have committed up to $50,000 a year for five years to help establish a low-income assistance program for Cal-Am's ratepayers. This commitment is embodied in Condition 23 of the settlement agreement.[14]

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[13] Assembly Bill 2838, approved by the Governor on September 20, 2002, requires the Commission to establish a schedule for water corporations such as Cal-Am to file a rate case every three years.

[14] Condition 23 states that Thames will commit shareholder funds up to $50,000 annually for a five year period from the close of the transaction to develop, promote or

Footnote continued on next page

Applicants have also committed up to $50,000 a year for five years to fund a Small System Technical Advisory Team (SSTAT) that will provide short-term technical and managerial assistance to troubled water systems in California. This commitment is embodied in Condition 24 of the settlement agreement.[15] Applicants would make available assistance in areas such as business practices, compliance with regulatory and water quality requirements, and technical, managerial, and operational support. This assistance would be temporary, with a view to transitioning the troubled system to an effective long-term solution.

Both MSD and Thousand Oaks believe that these programs offer no material benefit to ratepayers because they are ill-defined, and language of the settlement permits applicants not to spend anything on these programs.

The settling parties deliberately left the program parameters open, because these are pilot programs to be developed in conjunction with the Commission. We find these public purpose programs should benefit ratepayers if properly implemented. The Director of the Water Division should immediately designate Commission personnel to participate with applicants in developing these programs, and Commission personnel and applicants should hold their first meeting on these programs no later than 15 days from the effective date of this decision. The Director of the Water Division shall thereafter submit a program plan to the Commission for its consideration. The Director should also explore

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otherwise get a low-income assistance program underway in cooperation with the Commission. Cal-Am will not seek recovery of those contributions from ratepayers.

[15] Condition 24 states that Thames will commit shareholder funds up to $50,000 annually for a five year period from the close of the transaction to establish in cooperation with the Commission, a SSTAT by Cal-Am within six months of the close of the transaction. Cal-Am will not seek recovery of those contributions from ratepayers.

whether existing programs comparable to each proposal exist, and whether these monies can more effectively be used directed toward these existing programs. We intend that applicants spend the fully allocated annual sum for these two programs even if the funds are not expended during the five-year period, and require applicants to file annual reports to the Commission's Water Division and ORA with an accounting of monies spent on each of these public purpose programs.[16]

6. Affiliate Transaction Rules

Applicants have agreed to a comprehensive set of affiliate transaction rules, which are incorporated in to the settlement. This is a benefit to ratepayers, because currently there are no standardized, Commission approved affiliate transaction rules that apply to transactions between Cal-Am and its parent and affiliates.

Some of the more notable rules include Rule 7 [requiring Cal-Am's affiliates to allocate common costs so that ratepayers do not subsidize Cal-Am's affiliates];[17] and Rules 9 and 11 [requiring Cal-Am to price tangible and intangible goods or assets transferred to affiliates at the higher of cost or fair market value if the item was included in Cal-Am's rate base]; Rules 10 and 13 [requiring Cal-Am to develop a verifiable and independent appraisal of fair market value for goods and assets transferred to an affiliate]; and Rules 15 and 16

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[16] The accounting should state, inter alia, the amount of funds spent and what the funds were used for.

[17] At the evidentiary hearings, the settling parties clarified that Rule 7 and Rule 14 mistakenly refer to "affiliate sister companies" instead of "affiliated companies." (RT 935. Affiliated companies also include the holding company.) We make this correction to the settlement and adopt the settlement as corrected.

[requiring services to and from affiliates be priced so that Cal-Am ratepayers do not subsidize affiliates.] These rules are similar to the affiliate transaction rules the Commission adopted in *Re Southern California Water Company*, D.98-06-047, 80 CPUC 2d 580, 586-589, but modified by the settling parties to conform to applicants' corporate structure.

7. Discussion Regarding Benefits

MSD and Thousand Oaks argue that applicants have not met their burden in demonstrating that the above items are benefits of the transaction, largely because applicants have not, for the most part, quantified or performed any studies of savings or efficiencies, so that the Commission can immediately pass through a monetary benefit to ratepayers through a rate reduction. These parties argue that absent studies quantifying the alleged benefits, there is no basis for determining whether there will be net economic benefits as a result of the transaction, and how to equitably allocate them between ratepayers and shareholders.

We find that this transaction will generate both quantifiable and unquantifable short and long-term benefits. The quantifiable benefits include the $2.2 million benefits in implementing the design/build process, lowering Cal-Am's cost of debt (estimated at $1.5 million over five years from a recently-completed refinancing), and $500,000 over five years to implement two public service programs. Although remaining benefits discussed above are unquantifiable, we nonetheless find them to be valid and significant benefits in light of the nature of the transaction and the settlement agreement.

The motivation for this transaction is not synergies, or the savings that may result from merging two water companies, such as the mergers involved in CWS/Dominguez and Cal-Am/Citizens. Rather, through acquiring American,

RWE and Thames seek to establish a large presence in North America. Although applicants believe operational benefits, which will translate to financial benefits, will accrue over time, and promise that ratepayers will receive these benefits, they state it is difficult to quantify the bulk of them at this time. In fact, applicants have promised they do not intend to make wholesale changes at American, and expect Cal-Am, for the most part, to operate as it has in the past.

Furthermore, unlike CWS/Dominguez and Cal-Am/Citizens, applicants here do not seek to pass through to ratepayers any costs of the transaction, including the acquisition premium, which they believe they are entitled to request pursuant to § 2720. (See Settlement Conditions 17 and 18 and discussion below.) Thus, applicants have waived any right they may have to request this premium, in part to convince us that the transaction is in the public interest. Also, the settling parties have proposed a ratemaking mechanism which commits applicants to pass through 100% of the future benefits of this transaction to ratepayers. Condition 20 requires applicants, for a full rate case cycle, to implement a mechanism to track the savings and costs resulting from the transaction, and a methodology to allocate all net savings, and to submit a detailed written description of this methodology in Cal-Am's future general rate case filings.

MSD criticizes condition 20 as vague, and believes that the ratemaking process is subject to applicants' manipulation so that 100% of the benefits will not be passed through to ratepayers. MSD believes it will be difficult to distinguish the alleged benefits of this transaction from the alleged benefits of the Cal-Am/Citizen's merger, which, under the terms of D.01-09-057, will largely accrue to shareholders in future rate cases. Thus, according to MSD, Cal-Am will have an incentive to attribute future benefits to the Cal-Am/Citizens transaction rather than to the instant one.

Applicants state that they will use the same mechanism to track the savings from this transaction as they have already implemented to track the savings from the Cal-Am/Citizens transaction. Other parties and the Commission also will review these tracking mechanisms in future rate cases, thus providing additional safeguards. Because there exists a future incentive for applicants to find savings attributable to the Cal-Am/Citizens merger rather than to this transaction, we hold here that applicants have the burden of establishing from which transaction the benefits accrue. If applicants do not meet this burden, the Commission will attribute the benefits to this transaction rather than to the Cal-Am/Citizens transaction, to assure ratepayers that they receive 100% of the benefits of this transaction.

We therefore find sufficient short-term and long-term benefits to this transaction to find it in the public interest. Because of the nature of this transaction, the fact that applicants will not pass on to ratepayers any portion of the acquisition premium or transaction costs, and the relevant settlement conditions, we make our finding regarding benefits on a record that includes less up-front quantification of ratepayer benefits than we would otherwise prefer.[18]

C. § 854(b)(2)—Equitable Allocation of Benefits

Pub. Util. Code § 854(b)(2) requires that ratepayers receive an equitable allocation of the forecasted total short-term and long-term benefits. According to the statute, an equitable allocation is not less than 50% of those benefits.

Applicants have agreed in conditions 17 and 18 not to pass on to Cal-Am ratepayers any transaction-related costs, and to forego the step up in rate base

[18] Our analysis also might require a more rigorous demonstration of quantifiable benefits if this transaction were subject to § 854(b) and (c).

they believe is authorized by Pub. Util. Code §§ 2718—2720.[19] Based upon applicants' representations and these conditions, we find that applicants are not entitled to recover either the acquisition premium or any transaction-related costs in current or future rates.

Applicants have agreed to pass on to ratepayers 100% of the transaction's benefits. Although many of the benefits are not quantified, applicants intend that ratepayers will realize these future benefits in rates. Condition 20 [requiring Cal-Am to track future savings and costs from this transaction] and condition 22 [where Cal-Am will assess the costs and benefits before implementing any of the best practices] help to assure that the ratepayers realize future benefits from this transaction. In order to most effectively implement condition 22, applicants shall track the (1) savings and increased revenues, and (2) the costs of implementing best practices in separate memorandum accounts.

Both MSD and Thousand Oaks believe that Cal-Am will in fact try to recover the premium or some transaction-related costs from ratepayers in the future, either through a reduction in service quality or through increased rates, and what they term the imprecision of the ratemaking process.

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[19] Condition 17 states that neither Cal-Am nor its ratepayers, directly or indirectly, will incur any transaction costs or other liabilities or obligations arising from Thames' and RWE's acquisition of American. All costs of the transaction will be absorbed by the shareholders with no attempt to seek recovery from ratepayers at any time. Cal-Am will not incur any additional indebtedness, issue any additional securities, or pledge any assets to finance any part of the purchase price paid by Thames for American stock.

Condition 18 states that the premium Thames pays for American stock, as well as all transaction-related costs, including external advisors, early termination costs, change in control payments, or retention bonuses paid to Cal-Am or American employees as a result of the proposed transaction, will not be "pushed down" to Cal-Am, and there will be no attempt to recover such costs in any future rate proceeding.

The settlement we adopt precludes applicants from passing through these costs to ratepayers. Further settlement conditions ensuring that Cal-Am's financial condition and service quality will not deteriorate as a result of the acquisition, discussed below, also mitigate these concerns. Pursuant to AB 2838, Cal-Am is now required to file general rate cases every three years, where the Commission will review Cal-Am's operations to ensure that these conditions are fulfilled.

Cal-Am convincingly argues it intends to recoup the premium from future growth opportunities, as well as obtaining operation and maintenance contracts, as applicants suggest. Although, as Thousand Oaks argues, there might not be additional growth opportunities in the Thousand Oaks area, applicants are focused on additional growth opportunities throughout the Untied States.

In its reply brief, MSD explained for the first time specifically how it believes RWE plans to recover at least a portion of the acquisition premium in rates. Essentially, MSD argues that as a result of this acquisition, RWE will pay American and Cal-Am shareholders in full for the premium they incurred in acquiring the water facilities of Citizens. This is so, according to MSD, because this transaction contains a $2.8 billion acquisition premium beyond the book value of the assets. MSD argues that once the shareholders are paid for their interest in American, there is no longer a justification for the Commission to set Cal-Am's rates in former Citizens districts above Cal-Am's cost of service to reflect and pay off the Citizens acquisition premium. According to MSD, to do so (as currently required by the Alternative Sharing Proposal adopted in D.01-09-057) would in fact require Cal-Am ratepayers in the former Citizens districts to pay in their rates a portion of the acquisition premium incurred by RWE. The ALJ requested further briefing from the settling parties addressing this argument.

Applicants respond that RWE will pay American's shareholders who own the shares at the time of sale $46 for each share of American's common stock, and that RWE has not agreed to pay American 2.6 times its book value. According to applicants, at the time of the transaction's closing, American's assets will include Citizens' assets, including the premium Cal-Am paid for the Citizens assets, and the premium is therefore simply an asset of Cal-Am.

In D.01-09-057, we approved an Alternative Sharing Mechanism in the context of the Citizens transaction, which is a separate transaction from the one we consider here. We therefore disagree with MSD and do not eliminate this mechanism because the monies Cal-Am will obtain as a result of the Alternative Sharing Mechanism are incorporated into the asset value of Cal-Am.

D. § 854(b)(3)—Not Adversely Affect Competition

The proposed transaction is an acquisition at the holding company level and does not involve the merger of two California utilities. After the acquisition, Cal-Am will continue to serve the same area as before the transaction. The Commission will have the same jurisdiction over Cal-Am as it does today. Neither RWE nor Thames own or control other water utilities in or contiguous to California. Also, water is a monopoly service. Therefore, this acquisition should not adversely affect competition.

E. § 854(c)(1)—Maintain or Improve Financial Condition

As discussed above, this transaction will benefit ratepayers by providing greater access to capital and a lower cost of debt.

MSD and Thousand Oaks argue that RWE's business ventures have greater risk than American's, and that this transaction will therefore expose Cal-Am's ratepayers to increased business and financial risk. MSD argues that the majority of RWE's revenues come from energy-related businesses, and not

water utility and related services, as do American's. These RWE businesses include electric generation, coal mining, nuclear energy, energy commodity trading, and oil and gas exploration and development. MSD argues that the recent bankruptcies of energy trading companies and utilities illustrate this increased business and financial risk. MSD also argues that Cal-Am will have to compete for corporate resources, including capital, with other more lucrative investments.

Applicants offered testimony that RWE's diversified portfolio of businesses mitigates risk and constitutes a source of financial strength and stability, and that RWE's high investment grade bond ratings are based upon, in part, cash flow generation from its diversified portfolio of regulated businesses. Although the theory is that a diverse portfolio mitigates business risk, it is still important to examine the content of the portfolio.

Prior to its acquisition of Thames, the majority of RWE's business was providing electric service and electric energy-related products and services. The riskiest parts of RWE's business, such as energy commodity trading on electricity, gas, coal, and oil, constitute a very small portion of the business. After its acquisition of Thames in 2000, RWE became the third largest company in the global water business. Although a small part of RWE's business is comprised of riskier ventures, this business and financial risk is mitigated by RWE's diverse portfolio, as well as by certain settlement conditions.

Condition 2 ensures that RWE, Thames, and American will provide Cal-Am with the capital necessary for it to conduct its operations. Condition 2 states that "Cal-Am will be provided with adequate capital to fulfill all of its service obligations prescribed by the Commission and Cal-Am will comply with all applicable California and federal statutes, laws and administrative regulations."

MSD says this condition does not impose a binding obligation on RWE, Thames, or American, and does not assure the Commission that, should RWE encounter financial difficulty, Cal-Am's capital requirements will be given priority over competing capital requirements of RWE's other business interests. According to MSD, this condition does not provide an enforceable legal basis for the Commission to exercise jurisdiction over the financial assets of RWE which may be located in other countries.

Applicants disagree, stating that for the last quarter century, American has supplied Cal-Am the capital necessary for Cal-Am to fulfill all of its service obligations prescribed by the Commission, and that by condition 2, RWE and Thames commit to do the same. Thus, applicants understand, and we share the understanding, that condition 2 requires RWE, Thames, and American to provide Cal-Am with all necessary capital to fulfill all of its obligations prescribed by this Commission. Applicants do not promise to give Cal-Am's financial needs "first priority" because American has many United States regulated water subsidiaries in various states, and cannot prioritize Cal-Am to the exclusion of others. We do not believe the absence of "first priority" language with respect to financing is pivotal, because under the settlement, RWE, Thames, and American are required to provide Cal-Am with all necessary capital to fulfill its obligations.

At oral argument, applicants underscored that in enforcing applicants' commitment to provide Cal-Am with all necessary capital to fulfill all of its obligations prescribed by the Commission, that the Commission shall have recourse to any capital (as defined in this decision) in the possession of any of the parents, including the ability to recapture any past dividends paid by the utility. (RT 1160-1161.)

Applicants also understand, and we share the understanding, that the term "capital" as used in condition 2 is broader than just investment in plant and facilities. Specifically, McGivern agreed and we find that the definition of "capital" in condition 2 is the same definition of capital used by the Commission in D.02-01-039, *Investigation into Pacific Gas and Electric Company, Southern California Edison Company and San Diego Gas and Electric Company and their respective holding companies*, Findings of Fact 5 and 6, 2002 Cal. PUC LEXIS 5 *57. This means that the term "capital" encompasses "money and property with which a company carries on its corporate business; a company's assets, regardless of source, utilized for the conduct of the corporate business and for the purpose of deriving gains and profits; and a company's working capital, " and is not limited to mean only "equity capital, infrastructure investment, or any other term that does not include, simply, money or working cash." (*Id.*) Finally, although it may be difficult to exercise jurisdiction over RWE's financial assets in other countries if financial difficulties arise, as MSD argues, the reverse is also true. If RWE encounters financial difficulties abroad, it will be difficult for those tribunals to exercise jurisdiction over Cal-Am's assets.

Other conditions mitigate any potential business or financial risk. Condition 5 provides that the transaction will not result in any adverse changes in Cal-Am policies with respect to financing, accounting, and capitalization. In condition 15, as we understand it, RWE, Thames, and American agree to maintain Cal-Am's equity at or above 35% of total capital, and if Cal-Am's common equity falls below 35% of total capital, then Cal-Am shall within 30 days provide a detailed written plan to return Cal-Am's equity capital to a minimum of 35%. Although this number is lower than Cal-Am's traditional equity ratio of 40-45%, it imposes a reasonable limit to trigger notification to this Commission.

As described above, condition 19 also guarantees that for five years, Cal-Am will not seek a cost of debt greater than that based on American Water Capital Corporation's current S&P credit rating of A- for secured debt and Moody's credit rating of Baa1 for senior unsecured debt. Condition 16 requires RWE and AWCC to notify the Commission in writing within 30 days of any downgrading to the bonds of RWE or AWCC, and will include with such notice the complete report of the issuing bonding rating agency. Although not stated in the settlement agreement, we require such notice to be made to the Director of the Commission's Water Division, the Commission's Executive Director, and ORA.

Condition 26 states that Cal-Am has historically transferred on a quarterly basis 75% of its net income to its parent as a dividend, and requires that if Cal-Am's payment of a dividend or transfer of funds to American represents more than the historical percentage of Cal-Am's annual net income, Cal-Am shall notify the Commission. In adopting condition 26, we require Cal-Am to provide the Commission with the required notice no later than 30 days prior to Cal-Am's payment of a dividend or transfer of such funds to its parent. Cal-Am shall provide this notice to the Director of the Water Division, the Commission's Executive Director and ORA.

The settlement's affiliate transaction rules provide additional protection that Cal-Am's financial position will be maintained or improved because these rules provide new protections to ensure that Cal-Am does not subsidize its affiliates. Also, pursuant to condition 27, Cal-Am's parent and affiliates will not acquire Cal-Am assets at any price if such transfer of assets would impair Cal-Am's ability to fulfill its obligation to serve or to operate in a prudent and efficient manner. We find the above-discussed conditions sufficiently mitigate the transaction's business and financial risk.

F. § 854(c)(2)—Maintain or Improve the Quality of Service

We find that Cal-Am's service quality, with the settlement conditions as modified, should not be adversely affected as a result of the transaction. Applicants agree in condition 6 that there will be no adverse impact on customer service as a result of the transaction, and that RWE and Thames will maintain American's and Cal-Am's levels of commitment to high quality utility service and will fully support maintaining Cal-Am's record for service quality. In addition, condition 5 provides that the transaction will not result in any adverse changes in Cal-Am policies with respect to customers, employees, operations, maintenance, or other matters affecting the public interest or utility operations.

Cal-Am has committed to maintaining fully operational field offices to maintain service quality, and has agreed not to close any local field offices as a result of this transaction. (See condition 7.) However, this condition does not preclude Cal-Am from making local operational changes in connection with integrating water and wastewater systems acquired in other transactions.

At the public participation hearings, a number of customers expressed their concern about foreign ownership of Cal-Am to the extent such ownership made it difficult for them to obtain responsive customer service. MSD and Thousand Oaks also voice concerns about foreign ownership of Cal-Am.

Having Cal-Am representatives available locally is an important aspect of customer service. Condition 7 mitigates against this potential lack of responsiveness by providing that the local field offices will not be closed as a result of this transaction. However, the next sentence in condition 7 gives management full discretion to consolidate for any other reason, and severely diminishes the effectiveness of this condition. We therefore impose the following further condition. During the five years following the completion of this

transaction, applicants shall not close any of Cal-Am's existing field offices for any reason without first receiving this Commission's permission to do so through filing an application.

Additionally, Cal-Am has recently routed its calls to American's National Call Center located in Illinois. American has developed service level targets intended to place its call center in the top 25% of call center operations as measured by standard measurement techniques used in most major call centers. Completion of the Citizens acquisition on January 15 and subsequent integration of Citizens into the call center resulted in some performance declines. Cal-Am provided the following data with respect to: (a) number of calls answered by a live person within 30 seconds;[20] (b) percentage of customers who hang up after entering the queue to speak with a call center representative (abandonment rate); and (c) percentage of calls answered and resolved by the first operator contact (first call effectiveness).

	Target	**Week Ended 1/12/02**	**Week Ended 8/02/02**
% of calls answered within 30 seconds	> 80%	86%	61%
% of calls abandoned after 30 seconds	< 5%	1%	7%
First call effectiveness	>85%	Not available	90% (average for July 2002)

[20] At oral argument, Kelleher stated that this statistic means the number of calls answered by a live person, and not a recording, within 30 seconds. (RT at 1111.)

We do not have the record here to comment on whether Cal-Am's targets are too high, but we believe Cal-Am should be, at the very least, meeting its own internal targets. In order to mitigate customer concerns about lack of responsiveness due to foreign ownership, we require Cal-Am's customer call center to meet the above targets for each of the categories listed above, averaged on a quarterly basis. We require that, for five full years following the effective date of this decision, Cal-Am shall make quarterly filings listing the above service quality targets, as well as the rates actually achieved. Cal-Am shall file these reports with the Director of the Water Division and ORA, on January 15, April 15, July 15, and October 15, commencing on the first quarter following the effective date of this decision. The reports shall be for the preceding three months (the January filing will be for October –December, etc.). The Commission may examine these reports in Cal-Am's general rate case or other appropriate proceeding.[21]

Cal-Am has also agreed that the transaction will not cause it to diminish staffing that would result in service degradation. (See condition 12.) As discussed above, RWE, Thames, and American agree that Cal-Am will have the necessary capital to meet its future service obligations. As mitigated by the settlement and the further conditions we impose, we find that the transaction should not adversely affect Cal-Am's service quality.

[21] Nothing in this decision precludes the Commission from setting other, more stringent service quality standards for Cal-Am in another proceeding.

G. § 854(c)(3)—Maintain or Improve the Quality of Management

Certain settlement conditions attempt to ensure that there will be no adverse impacts on Cal-Am's management and management structure. By condition 9, applicants agree that there will be no change of Cal-Am's operational control as a result of this transaction. We interpret this condition as binding on RWE, Thames, American, and Cal-Am, and committing them not to change Cal-Am's operational control as a result of this transaction. Additionally, condition 8, as we interpret it, provides that RWE, Thames, American, and Cal-Am shall not change Cal-Am's existing management and officers as a result of this transaction. MSD criticizes these conditions as illusory; however, the conditions as we interpret them, clearly place an obligation on RWE, Thames, American, and Cal-Am.

Condition 10 also prohibits Thames from making any layoffs of management until March 31, 2004, or one year after the transaction closes, whichever is later, thus ensuring continuity of management during this transitional period.[22]

MSD argues that the above conditions, as interpreted by the Commission, are still insufficient to ensure the proposed transaction does not result in a loss of local autonomy, control, and accountability for decisions affecting local water issues and concerns because Cal-Am will be part of the RWE corporate enterprise, which association will inevitably diminish the autonomy, responsibility, and accountability of local managers for local water issues and concerns. Thousand Oaks makes similar arguments.

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[22] Although condition 10 only specifically mentions Thames, we read it as binding upon all applicants and American as well.

Applicants' witnesses offered extensive testimony on the issue of local control, explaining their understanding that the water business is a local business, and that the operation of Cal-Am will not change as a result of this transaction. In addition to the conditions listed above, applicants have also given retention bonuses (paid by shareholders) for key managers who remain with Cal-Am for a period after the transaction is complete. Condition 4 provides that Cal-Am's books and records will be maintained and housed in California. Under condition 7, Cal-Am will maintain its business headquarters in California, and as discussed above, Cal-Am has also agreed not to close any of its district offices as a result of this transaction.

The City of San Diego dropped its opposition to the transaction in exchange for applicants' agreement to the following condition: The management of Cal-Am has and will continue to have full authority with regard to any decisions concerning Cal-Am's relationship with the City of San Diego including, but not limited to, any water supply and franchise agreements. We adopt San Diego's condition as part of our approval of this transaction. In fact, San Diego's condition is a functional equivalent of condition 9, where applicants agree not to change Cal-Am's operational control as a result of this transaction.

We add two further conditions to ensure management quality. Applicants have committed that they will not change operational control, nor the management or officers as a result of this transaction. However, no settlement condition addresses the makeup of Cal-Am's board of directors, which, according to McGivern, controls the overall management decisions of Cal-Am. Currently, all 10 Cal-Am board members are United States citizens, and two are California residents. Seven either currently hold or have retired from a management or director position in American.

Because Cal-Am's board of directors sets the policy and direction for Cal-Am, we believe it is important to ensure that the board is responsive to local concerns. We therefore further condition this transaction on the requirement that for a minimum of five years from the effective date of this order, a majority of the individuals appointed to serve on the board shall be United States citizens. Additionally, in order to ensure local input, if applicants make any changes to the current composition of Cal-Am's board, we require that in the future, at least 30% of the members of Cal-Am's board be California residents, as well as United States citizens, and further, be persons who are not employees of RWE, Thames, American, Cal-Am, or any RWE affiliated entity. Finally, we require that familiarity with interests and concerns in Cal-Am's service territory shall be an important consideration in appointing directors to serve on the board.[23]

We also require applicants, for at least one year from the date of the consummation of the transaction or until March 31, 2004, whichever is later, to notify the Commission in writing within 10 days of any changes in Cal-Am's board of directors, corporate officers, or management personnel. Such notification shall be sent to the Director of the Water Division, the Commission's Executive Director, and ORA.

H. § 854(c)(4)—Be Fair and Reasonable to Employees

The settlement conditions ensure the transaction is fair and reasonable to Cal-Am's employees. The fact that the Union supports the transaction and is a party to the settlement also supports this finding.

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[23] When queried by the ALJ, the settling parties were agreeable to the Commission adding a reasonable condition regarding the makeup of Cal-Am's Board of Directors, including reasonable citizenship and residency requirements.

Condition 10 states that the transaction will have no adverse impact on Cal-Am's employees. Specifically, by this condition, Thames commits to no layoffs until the later of either March 31, 2004, or one year after the transaction closes. This condition goes beyond applicants' initial agreement with the unions because it applies to both union and nonunion employees.

Applicants also agree that there will be no changes in compensation and the value of employee benefits will not diminish because of this transaction, and that the transaction will not result in any adverse change in Cal-Am's policies with respect to its employees. (See conditions 5 and 10.) Thousand Oaks believes that applicants have violated this condition by establishing a retention bonus program to keep key managers after the merger. We do not agree, and find the intent of condition 10 is, as explained by ORA, to assure employees that their compensation and benefits will not decrease as a result of the merger.

Under condition 11, applicants agree not to change existing union agreements as a result of this transaction, and to honor all collective bargaining agreements. Union representative Bernardo R. Garcia testified that applicants' commitment to honor all collective bargaining agreements is a very important provision to the Union, because some of the agreements did not have successor provisions that would apply to a new owner.

Garcia also testified that conditions 6 and 12 provide further assurances to employees on work stability after the transaction is complete, because employees are an important part of customer service. Under condition 6, the transaction will not have an adverse impact upon customer service, and under condition 12, Cal-Am will not allow the transaction to diminish staffing that would result in service degradation.

I. § 854(c)(5)—Be Fair and Reasonable to Shareholders

American's shareholders approved the acquisition. We therefore infer that this transaction is fair and reasonable to these shareholders.

J. § 854(c)(6)—Be Beneficial to State and Local Economies and Communities in the Area Served

As discussed in Sections V.B and V.C. above, California ratepayers will receive an equitable share of both short-term and long-term benefits of this transaction. Some of these benefits include, for example, committing up to $500,000 of shareholder funds for two program that will benefit California ratepayers, and thereby, local communities. Furthermore, in Section V.G, we discuss conditions which ensure that Cal-Am's quality of management will be maintained or improved, thereby maintaining Cal-Am's current ability to respond to local concerns. For these reasons, the transaction should be beneficial to the state and local economies and communities in the area served.

K. § 854(c)(7)—Preserve the Commission's Jurisdiction and the Commission's Capacity to Effectively Regulate and Audit Public Utility Operations in the State

As stated above, the Commission has the jurisdiction to enforce the conditions approved in this order against RWE, Thames, American, and Cal-Am at the Commission in Commission proceedings. Condition 3 states existing law, that is, that the Commission will retain jurisdiction over Cal-Am's rates and services. Furthermore, in condition 3, RWE, Thames, American, and Cal-Am commit not to assert that any foreign regulator preempts the Commission's

review of the reasonableness of any cost.[24] Condition 4 requires Cal-Am to continue to keep its books and records housed and maintained in California in accordance with Commission rules. As discussed in Section V.G, Cal-Am will keep its business headquarters in California, thus making its operations easily accessible to Commission staff.

The settlement contains further requirements which enhance the Commission's ability to exercise its jurisdiction. Under condition 21, Cal-Am has agreed to provide the Commission with English-language versions of the RWE annual reports, RWE quarterly shareholder reports, and the annual RWE audit reports. This condition also requires RWE, Thames, American, and Cal-Am to convert identified financial statements into U.S. dollars at the exchange rates existing at the end of the time period for such financial reports.

As part of Condition 25, applicants agree to abide by the affiliate transaction rules attached to the settlement to the extent they do not conflict with existing affiliate agreements approved by the Commission. As stated above, these affiliate rules are a benefit to ratepayers because there are currently no standardized, Commission-approved affiliate transaction rules that apply to all transactions between Cal-Am and its parent and affiliates. Affiliate Transaction Rule 3 requires Cal-Am to provide the Commission with an annual report of all transactions between Cal-Am and its affiliated companies. Affiliate Transaction Rule 2 states that Cal-Am and its affiliated companies will provide the

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[24] At the December 12, 2002 final oral argument, in response to questions about the possible preemptive effect of international trade agreements on the Commission's jurisdiction, applicants confirmed that they are seeking to be treated like any other American-owned water company operating in California. (RT 1097-1098.) We make appropriate changes to condition 3 to reflect this assurance.

Commission with access to books and records in connection with the Commission's exercise of its regulatory responsibilities in examining any costs which Cal-Am seeks to recover in rate proceedings. In response to questions from the ALJ, applicants agreed that the access promised under Rule 2 was greater than access associated with general rate case costs.[25] As we understand Rule 2, the Commission will have access to Cal-Am and its affiliated companies' books and records as necessary in the Commission's judgment to facilitate the Commission's obligation to regulate. Affiliate Transaction Rule 1 requires all applicants to make the officers and employees of Cal-Am's holding companies and affiliates available to appear and testify in Commission proceedings if Cal-Am cannot supply the appropriate personnel to address staff's concerns.[26]

For the Commission to ensure applicants are complying with the Affiliate Transaction Rules, and to preserve the Commission's capacity to effectively regulate and audit public utility operations in the State, we further condition approval of this application on RWE, Thames, American, and Cal-Am being subject to Pub. Util. Code § 797.[27] Although these statutes by their terms do not

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[25] RT 934: 1-15.

[26] Although Affiliate Transaction Rule 1 refers to "affiliated sister companies" as defined in the Rules, McGivern testified that the rule was intended to apply to all "affiliated companies" and we adopt the settlement and affiliate rules as so corrected. (RT 932-933.)

[27] Pub. Util. Code § 797 reads as follows. "The commission shall periodically audit all significant transactions, as specified by the commission, between an electrical, gas, or telephone corporation and every subsidiary or affiliate of, or corporation holding a controlling interest in, that electrical, gas, or telephone corporation. The commission may, in this connection, utilize the services of an independent auditor, who shall be selected and supervised by the commission. Nothing in this section prohibits the commission from auditing any transaction between an electrical, gas, or telephone

Footnote continued on next page

apply to water utilities, it is necessary that they apply in this instance in order to give effect to the Affiliate Transaction Rules. As mitigated by the settlement and additional conditions, the transaction preserves the Commission's jurisdiction.

L. § 854(c)(8) – Provide Mitigation Measures to Prevent Significant Adverse Consequences

We have discussed above certain additional conditions we impose in order to mitigate adverse consequences. (See also our discussion concerning § 854(d) below.)

VI. Review of Reasonable Alternative Options

Pursuant to § 854(d), the Commission shall consider reasonable alternative options to the proposed transaction which are recommended by other parties, including no acquisition, to determine whether comparable short-term or long-term economic savings can be achieved through other means while avoiding the possible adverse consequences of the proposal.

MSD believes that public acquisition of its district is a superior alternative to this transaction because of the unique nature of the MSD. Cal-Am's Montara District has had serious water service deficiencies for over 25 years, and since 1981, there has been a moratorium on new connections in the district. According to the revised 2000 Master Plan approved in D.01-09-055, Montara needs significant capital investment over the next few years for system improvements.

MSD argues that because of these factors, rates are high and are certain to escalate in the future. According to MSD, the four factors driving rates higher

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corporation and any subsidiary or affiliate of, or corporation holding a controlling interest in, the electrical, gas, or telephone corporation, as otherwise permitted or required by law.

are (1) the cost of capital improvements authorized in D.01-09-055, which are expected to cost between $4.5 to $5.5 million and would more than double the current rate base in the Montara District within the next seven years;[28] (2) the cost of additional capital improvements, such as redrilling a recently failed well, which are not included in the master plan; (3) the potential significant rate increase from Cal-Am's expected general rate case; and (4) the fact that Cal-Am has failed to take advantage of opportunities to obtain grants and low-cost tax-exempt financing, such as could be obtained through joint participation with MSD in capital improvements.

MSD argues that the causes of the problems of the Montara District are many, but in part result from long-time neglect from Citizens Utilities' management, which has not improved under Cal-Am's purview. MSD argues that the settlement does nothing to address Montara District's unique problems, which MSD believes it can alleviate by increased responsiveness and its access to low-cost tax-exempt financing. MSD submitted evidence showing that if it refinanced 100% of its rate base using tax-exempt financing, the benefits for the Montara District are 165 times greater than the estimated benefits from the instant transaction. Because of this, MSD argues that if other equally qualified, financially capable, and willing alternative providers are capable of serving the Montara District's customers, and can provide ratepayer benefits superior to those that can be provided by the proposed acquiring entity, the Commission should condition approval of the transaction on Cal-Am's divestiture of the Montara District to the alternative provider.

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[28] According to MSD, if financed by Cal-Am in its usual manner, Montara District rates would increase by 41.93% over the same period.

Applicants and ORA disagree, arguing that Montara District's water problems are not related to this transaction, and that the Commission is addressing them through other means, such as by the Master Plan discussed above. Applicants also point out that MSD has filed a condemnation case, and that MSD will be able to acquire the district after a jury verdict in that action.

The Montara District is in a unique position vis-a-vis other Cal-Am districts, because the Montara District has had, and continues to have, persistent critical water problems as to quality, service, capacity, and rates. Furthermore, for a number of reasons, water development in and around the Montara area has historically been very difficult. As we found in D.01-09-055, "[w]ater resources are limited, water development can be competitive, and anti-growth sentiment is significant." (2001 Cal. PUC LEXIX 777 *11.)

Private companies (first Citizens and now Cal-Am) have been unable to solve these problems to date. However, in November 2001, over 80% of the Montara District voters approved a bond measure for the acquisition of Cal-Am's Montara District facilities by MSD. As a result of this vote, the MSD has recently filed a condemnation action in Superior Court.

Given the Montara District's unique position, a heightened corporate focus on issues affecting this district may be necessary, and the proposed transaction may have possible adverse consequences in diminishing this focus. While our record does not permit us to make a finding that the Montara District will be better off under public management than under Cal-Am's, we can find that they will not be worse off. MSD demonstrated that if it acquires the Montara District, it can obtain access to lower cost financing for its entire rate base, and local control and accountability, which is quite critical to resolve the Montara District's problems, will be enhanced. We are also influenced by the Montara District voters overwhelming selection of the MSD to operate the water district. Under

these circumstances, pursuant to § 854(d), we condition this transaction upon Cal-Am's divestiture of the Montara District at fair market value to MSD or another public agency. Ratepayers shall not bear any costs of this divestiture. (See e.g., *Re Pacific Enterprises, Enova Corp. et al.* (D.98-03-073, 79 CPUC2d 343, 394-396.) Divestiture of the Montara District is not a condition precedent to closing the transaction which is the subject of this application.

The divestiture of the Montara District to a public agency with access to tax exempt financing should result in short-term and long-term economic savings in excess of that resulting from the proposed transaction while avoiding the possible adverse consequences to the Montara District of the proposed transaction. We do not anticipate that this divestiture should be difficult to accomplish, since MSD has a condemnation action pending, and the only issue between the parties is the amount of just compensation.

No later than 90 days after the effective date of this decision, Cal-Am shall submit an advice letter to the Commission for approval of the divestiture pursuant to Pub. Util. Code § 851. We intend that all other aspects of the divestiture be completed within these 90 days. This time may be extended upon joint motion by applicants and MSD to the Commission, the Assigned Commissioner, or assigned ALJ. If Cal-Am makes financial expenditures for capital improvement projects on the Montara system prior to the divestiture, it shall comply with Ordering Paragraph 3 of D.01-09-055 in financing these expenditures. The fact that MSD may be an owner of the capital improvement project shall not be grounds for Cal-Am to fail to comply with Ordering Paragraph 3.

In their comments to the proposed decision, applicants voiced concern over their ability to comply with this condition, for example, if the MSD were unable to obtain financing for the transaction. Applicants, as well as other

parties, have the ability to request that the Commission modify its decision if conditions warrant. (See Rule 47 of the Commission's Rules of Practice and Procedure.)

Thousand Oaks also argues against this transaction, in part, because public acquisition would be superior for its district. We believe the transaction, as conditioned by this decision, is in the public interest for the balance of Cal-Am's districts. Thousand Oak's arguments were of a general nature, and did not set forth the specificity that MSD did. For instance, Thousand Oaks at one point argues that the majority of its district does not need immediate capital improvements. The Montara District's water persistent water problems are unique and are not common to Cal-Am's other districts. We therefore limit this divestiture condition to the Montara District.

VII. Other Matters

A. Environmental Review

The Commission's staff has determined that the transfer of control proposed by applicants constitutes "a project" under the California Environmental Quality Act (CEQA), Pub. Resources Code § 21000 et seq. However, since it can be seen with certainty that no significant effect on the environment could result from our granting the authorization, the proposed project itself qualifies for an exemption from CEQA pursuant to § 15061(b)(3) of the CEQA guidelines. Therefore, no further Commission environmental review is required.

B. Pub. Util. Code § 704 Does Not Bar This Transaction

At the first prehearing conference, the ALJ requested that the applicants and any other interested parties address how Pub. Util. Code § 704 applies to this

transaction.[29] Applicants do not believe § 704 bars this transaction, whereas Thousand Oaks does. The other parties are silent on this issue.

Section 171 of the California Corporations Code defines a "foreign corporation" as "any corporation other than a domestic corporation," and § 167 of that same code defines a "domestic corporation" as a "corporation formed under the laws of this State." Within the meaning of these statutes, Cal-Am is a domestic corporation, while its parent American, as well as Thames and RWE, are foreign corporations that are not qualified to conduct business in California.

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[29] Pub. Util. Code § 704 states:

"Except as otherwise provided in this section, no foreign corporation, other than those which by compliance with the laws of this State are entitled to transact a public utility business within this State, shall henceforth transact within this State any public utility business, nor shall any foreign corporation which is at present lawfully transacting business within this State henceforth transact within this State any public utility business of a character different from that which it is at present authorized by its charter or articles of incorporation to transact. No license, permit, or franchise to own, control, operate, or manage any public utility business or any part or incident thereof shall be henceforth granted or transferred, directly or indirectly, to any foreign corporation which is not at present lawfully transacting within this State a public utility business of like character.

"Foreign corporations engaging in commerce with foreign nations or commerce among the several states may transact within this State such commerce and intrastate commerce of a like character; provided, however, that no such foreign corporation shall be permitted to engage in interstate commerce within this State until it shall have first complied with the laws of this State respecting foreign corporations. Any foreign corporation which complies with the laws of this State respecting foreign corporations, and which owns at least 90 percent of the outstanding capital stock of any other foreign corporation transacting a public utility business in this State, may succeed to the public utility business, franchises, and rights of such latter corporation and, thereafter continue and carry on such public utility business."

RWE, Thames, and American do not propose to conduct any utility business in California as a result of this transaction.[30]

In D.99-06-049, 1999 Cal. PUC LEXIS 421, the Commission approved a transaction where Scottish Power, a company incorporated in Scotland, acquired ownership of PacifiCorp. The transaction in PacifiCorp, similar to the one at issue in this proceeding, involved a change in control of the utility at the holding company level. The Scottish Power/PacifiCorp transaction did not involve a transfer of a certificate or utility property, and PacifiCorp, a corporation providing electric utility service in five states, including California, would continue to operate its electric utility property in California. In D.99-06-049, the Commission considered § 704 and found that the statute was not a bar to the Commission approving the transaction.

The transaction at issue in this application also involves a change of control at the holding company level, and Cal-Am will continue to provide water utility service in parts of California. No certificate or utility property is being transferred. Similar to our conclusion in the PacifiCorp matter, we find § 704 does not bar this transaction.[31]

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[30] A subsidiary of American, the Service Company, is a Delaware Corporation qualified to conduct business in California.

[31] The Commission has also held that the fact that the capital stock of a domestic corporation is wholly owned by a foreign corporation does not prevent the Commission from authorizing the domestic corporation to engage in public utility business. (See *Application of Southern Pacific Motor Transport Co. for a Certificate of Public Convenience and Necessity* (1928) 32 CRC 331, 335-336.) American has owned Cal-Am for a number of years, and American is a foreign corporation within the meaning of § 704, and is not qualified to conduct business in California. RWE and Thames Holdings are no different than American in this respect.

VIII. Conclusion

Because the transaction, with the conditions agreed to in the settlement and the additional conditions we impose, (1) provides both quantifiable and unquantifiable benefits; (2) does not adversely affect competition; (3) maintains and in some instances, improves the status quo regarding financial condition, service quality, and management; (4) is fair and reasonable to affected public utility employees and shareholders and to state and local economies; and (5) preserves the Commission's jurisdiction, we find it to be in the public interest. For these reasons, the settlement, as conditioned herein, is also reasonable in light of the whole record and is consistent with the law. Accordingly, we adopt the settlement as further conditioned, and authorize the transfer of control requested by applicants as conditioned herein.

IX. Comments on the Proposed Decision

The proposed decision of ALJ Econome in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. The following parties filed timely comments and replies to the proposed decision: Applicants, ORA, MSD, and Thousand Oaks. On December 12, 2002, the Commission held final oral argument, and the above-mentioned parties, as well as the Union, participated in the oral argument. We make the following changes:

- Confirm applicants' assurance made at the final oral argument that the Commission can enforce the settlement and additional conditions, including but not limited to the capital commitment, at the Commission in Commission proceedings (Section V.A);
- Confirm applicants' assurance made at the final oral argument that, in enforcing the capital condition, the Commission will have recourse to any capital (as broadly defined in this decision) in the possession of any of the parents, including the ability to recapture any past dividends paid by the utility (Section V.E);

- Clarify that the Commission has final authority to approve the public assistance programs, and direct that the fully allocated sum for these programs be spent, even if it is not expended during the five-year period (Section V.B.5);
- Clarify that Cal-Am's requirement to answer all calls within 30 seconds means an answer by a live person and not a recording (Section V.F);
- Clarify that applicants seek to be treated like any other American-owned water company and will not assert in any tribunal or forum that the Commission's exercise of its obligation to regulate is preempted by federal or international law or treaty, except to the extent a water company owned entirely by American companies (i.e., where all parents, etc. are incorporated as American companies in the United States), operating in California, could assert such preemption (Section V.K. and condition 3);
- Provide a timeframe by which applicants shall divest themselves of the Montara District, clarify that this divestiture shall be at fair market value, and clarify that this divestiture is not a condition precedent to applicants closing the transaction which is the subject of this application (Section VII); and
- Make the timing of Cal-Am's next general rate case filing for its Sacramento, Felton, Montara and Larkfield districts consistent with the filing date set forth in D.01-09-057 (Condition 1).

In addition, we make other changes to the text and findings of fact, conclusions of law, and ordering paragraphs to incorporate these changes. We also make changes to strengthen the discussion, improve the flow of the decision, and to correct typographical errors.

X. Assignment of Proceeding

Henry Duque is the Assigned Commissioner and Janet Econome is the assigned ALJ in this proceeding.

Findings of Fact

1. Under the proposed transaction, RWE will purchase all of the stock of Cal-Am's parent, American, pursuant to the Agreement and Plan of Merger

dated September 16, 2001 between American and Thames. Under the agreement, American will merge into a corporate shell entity, the Apollo Acquisition Company, that is a subsidiary of Thames Holdings created solely to accommodate the acquisition of American. After the transaction, American will become the wholly owned subsidiary of Thames USA, which is organized in the United States and is a wholly owned subsidiary of Thames Holdings, which is a wholly owned subsidiary of RWE.

2. Thames Holdings will purchase all outstanding American common stock at $46/share and will assume American's existing debt. The total purchase price is $7.6 billion, consisting of $4.6 billion in cash and the assumption of $3.0 billion in debt. The purchase price includes a $2.8 billion acquisition premium, which is about 2.6 times American's book value of about $1.8 billion.

3. After the proposed transaction is completed, Cal-Am will continue to be the operating public utility providing water utility service under the Commission's jurisdiction in the areas where it is authorized to do so.

4. According to their respective annual reports for 2001, American's total revenues for 2001 were $1,438,887,000, while Cal-Am's were $76,639,907.80. Thus, Cal-Am's total operating revenues are about 5% of American's. Cal-Am's customer base comprises about 6.4% of American's.

5. On July 31, 2002, ORA, applicants, and the Union signed a settlement agreement. San Diego, which had opposed the application, withdrew its opposition and supported the settlement. MSD and Thousand Oaks continue to oppose the application and settlement.

6. The Cal-Am/Citizens and CWS/Dominguez transactions involved the merger of California water utilities and applicants in those proceedings projected operational and administrative synergies from the merger of the affected entities. This case, in contrast, involves an acquisition at the holding company level. For

that reason, applicants do not demonstrate that the transaction will eliminate redundancies; rather, they project that Cal-Am will operate its business as usual, and will achieve benefits from operating practices, etc., over time. Also, the Cal-Am/Citizens and CWS/Dominguez mergers both involved recovery of the acquisition premium authorized by Pub. Util. Code § 2720, where in this case applicants are not seeking to increase Cal-Am's rate base.

7. Cal-Am's enhanced access to Thames' additional security protections, although monetarily unquantifiable at this time, is a benefit of this transaction.

8. Cal-Am's use of Thames Water's design/build process is a short-term benefit to ratepayers, because reducing capital costs by about $2.2 million should translate into lower rates than would have occurred if the improved construction methods were not used.

9. Cal-Am's access to Thames Water's R&D is a substantial, albeit an unquantifiable benefit of this transaction, because Thames Water will share its embedded R&D with American at no cost, and Thames Water has had a substantially higher R&D budget than has American.

10. Since 1998, Thames Water has invested in excess of $6 billion to enhance service quality, including constructing an advanced water treatment system and major renovations of water mains and sewage treatment works. This background should be beneficial in enhancing Cal-Am's future service quality.

11. Cal-Am's customers can benefit from Thames Water's technology providing a direct, real-time link between the Customer Service Center and the field technicians by having customer problems ascertained, analyzed, and addressed by field personnel in a more accurate, timely, and efficient manner.

12. Cal-Am ratepayers will benefit from this transaction because Cal-Am will have a lower cost of debt and cost of capital as a result of the transaction. RWE has an A+ credit and bond rating from S&P and an A1 credit rating from

Moody's. AWCC's comparable ratings from S&P are A- and BB+, and Baa1 from Moody's. This means that RWE will be able to borrow money at a lower cost than AWCC under the current ratings.

13. Cal-Am's ratepayers have already benefited from RWE's higher credit rating in receiving a lower cost of debt as a result of the pending transaction. The savings, or benefit, to Cal-Am's ratepayers is about $300,000 per year, or about $1.5 million over a five-year period, which is the length of the bond.

14. Condition 19 of the settlement, as clarified, means that for the five-year period described in that condition, Cal-Am will not seek a cost of debt greater than A- for secured debt and Baa1 for senior unsecured debt.

15. We want to ensure condition 1 of the settlement provides sufficient ratepayer benefit and also to guard against the possibility of "rate shock," or a large rate increase occurring at one time.

16. The stay out provision, as conditioned, will benefit ratepayers to the extent the Commission orders a rate increase for Cal-Am. However, we cannot quantify on this record the likelihood of our ordering a rate increase in the future, or the amount of such increase, and therefore cannot quantify the benefits associated with condition 1 at this time.

17. The public purpose programs set out in conditions 23 and 24 should benefit ratepayers if properly implemented.

18. The Affiliate Transaction Rules attached to the settlement should benefit ratepayers because there are currently no standardized, Commission approved affiliate transaction rules that apply to all transactions between Cal-Am and its parent and affiliates.

19. Through condition 20, the applicants are committed to pass through 100% of the future benefits of this transaction to Cal-Am's ratepayers.

20. Because D.01-09-057 approving the Cal-Am/Citizens merger permits future benefits of that merger to largely accrue to shareholders in future rate cases, there exists an incentive for applicants in the future to find savings attributable to the Cal-Am/Citizens merger rather than to this transaction.

21. In settlement conditions 17 and 18, applicants have agreed not to pass on to Cal-Am ratepayers any transaction-related costs, and to forego the step up in rate base they believe is authorized by Pub. Util. Code §§ 2118 – 2120.

22. This acquisition should not adversely affect competition.

23. Condition 2 requires RWE, Thames, and American to provide Cal-Am with all necessary capital to fulfill all of its obligations prescribed by this Commission.

24. The term "capital" as used in condition 2 is broader than just investment in plant and facilities; rather, the definition of "capital" in condition 2 is the same definition of capital used in by the Commission in D.02-01-039, *Investigation into Pacific Gas and Electric Company, Southern California Edison Company and San Diego Gas and Electric Company and their respective holding companies*, Findings of Fact 5 and 6, 2002 Cal. PUC LEXIS 5 *57.

25. Having Cal-Am's representatives available locally is an important aspect of customer service.

26. Cal-Am should be, at the very least, meeting its own internal service quality targets.

27. Conditions 8, 9, and 10 are binding on RWE, Thames, American and Cal-Am.

28. Applicants have committed that they will not change operational control, nor the management or officers as a result of this transaction. However, no settlement condition addresses the makeup of Cal-Am's board of directors.

29. As mitigated by the settlement and further conditions we impose, this transaction should not adversely affect Cal-Am's service quality.

30. The conditions discussed in Section V.E, as interpreted by the Commission, sufficiently mitigate the transaction's business and financial risk.

31. Because Cal-Am's board of directors sets the policy and direction for Cal-Am, it is important to ensure that the board is responsive to local concerns.

32. For the reasons set forth in Section V.H, the transaction should be fair and reasonable to employees.

33. Because American's shareholders approved the acquisition, we infer that the transaction is fair and reasonable to these shareholders.

34. For the reasons set forth in Section V.J, the transaction should be beneficial to the state and local economies and communities in the area served.

35. The Commission will have access to Cal-Am and its affiliated companies' books and records as necessary in the Commission's judgment to facilitate the Commission's obligation to regulate.

36. The Montara District is in a unique position vis-a-vis other Cal-Am districts, because the Montara District has had, and continues to have, persistent critical water problems, as to quality, service, capacity, and rates.

37. Private companies (first Citizens and now Cal-Am) have been unable to solve these problems to date.

38. In November 2001, over 80% of the Montara District voters approved a bond measure for the acquisition of Cal-Am's Montara District facilities by MSD.

39. Given the Montara District's unique position, a heightened corporate focus on issues affecting this district may be necessary, and the proposed transaction may have possible adverse consequences in diminishing this focus.

40. While our record does not permit us to make a finding that the Montara District will be better off under public management than under Cal-Am's, we can find that they will not be worse off.

41. The divestiture of the Montara District to a public agency with access to tax exempt financing should result in short-term and long-term economic savings in excess of that resulting from the proposed transaction while avoiding the possible adverse consequences to the Montara District of the proposed transaction.

Conclusions of Law

1. Pursuant to Rule 51.1(e) which provides that, prior to approval, the Commission must find a settlement "reasonable in light of the whole record, consistent with the law, and in the public interest."

2. Although this acquisition differs significantly from the CWS/Dominguez and Cal-Am/Citizens mergers, the Commission does not have to determine whether some other standard should apply because we find the settlement, as modified by the conditions we impose in today's decision, meets the higher standard adopted in D.01-09-057 that ratepayers receive an equitable share of the benefits of the transaction.

3. Pursuant to § 854, the Commission has broad authority to approve or deny applications for transfers of utility ownership or control. Implicit in this authority is the right to place reasonable conditions upon the transferor or transferee, should the need for conditions arise. The right to impose these conditions carries with it the right to enforce the conditions at the Commission in Commission proceedings.

4. It is reasonable to modify condition 1 of the settlement to ensure sufficient ratepayer benefit and to guard against the possibility of "rate shock," or a large rate increase occurring at one time.

5. The proposed transaction, with the conditions agreed to in the settlement as further conditioned by this decision, provides ratepayers an equitable share of both quantifiable and unquantifiable short-term and long-term benefits.

6. The Director of the Water Division should immediately designate Commission personnel to participate with applicants in developing the programs set forth in settlement conditions 23 and 24, and Commission personnel and applicants should hold their first meeting on these programs no later than 15 days from the effective date of this decision. The Director of the Water Division shall thereafter submit a program plan to the Commission for its consideration. The Director should also explore whether existing programs comparable to each proposal exist, and whether these monies can be more effectively used directed toward these existing programs. We intend that applicants spend the fully allocated annual sum for these two programs even if the funds are not expended during the five-year period, and require applicants to file annual reports with the Director of the Water Division and ORA no later than January 31 during the five year duration of these programs with an accounting of monies spent on each of these public purpose programs.

7. Rules 1, 7 and 14 of the Affiliate Transaction Rules appended to the settlement mistakenly refer to "affiliate sister companies" instead of "affiliated companies", and we adopt the settlement as so corrected.

8. In future rate cases, applicants have the burden of establishing from which transaction (this transaction or the Cal-Am/Citizens merger) the benefits accrue. If applicants do not meet this burden, the Commission will attribute the benefits

to this transaction rather than to the Cal-Am/Citizens merger, to assure ratepayers that they receive 100% of the benefits of this transaction.

9. Applicants are not entitled to recover either the acquisition premium or any transaction-related costs in current or future rates.

10. Although a small part of RWE's business is comprised of riskier ventures, this business and financial risk is mitigated by RWE's diverse portfolio, as well as by certain settlement conditions.

11. To mitigate customer concerns about the potential for Cal-Am's lack of responsiveness due to foreign ownership, reasonable requirements should be imposed on any potential closure of Cal-Am's existing field offices, and reasonable performance targets should be imposed on Cal-Am's customer call center.

12. To ensure that Cal-Am's corporate governance is reasonably responsive to local concerns, reasonable requirements should be imposed regarding the make-up of Cal-Am's board of directors as a condition to approval of this transaction.

13. We adopt the following condition as agreed to by applicants and San Diego. The management of Cal-Am has and will continue to have full authority with regard to any decisions concerning Cal-Am's relationship with the City of San Diego including, but not limited to, any water supply and franchise agreements. This condition is the functional equivalent of condition 9.

14. To ensure applicants are complying with the Affiliate Transaction Rules, and to preserve the Commission's capacity to effectively regulate and audit public utility operations in the State, approval of this transaction should be conditioned on RWE, Thames, American, and Cal-Am being subject to Pub. Util. Code § 797.

15. As mitigated by the settlement and the further conditions we impose, the transaction preserves the Commission's jurisdiction.

16. Under the unique circumstances set forth in this decision, pursuant to § 854(d), approval of this transaction should be conditioned upon Cal-Am's divestiture of the Montara District at fair market value to MSD or another public agency under the timeframe set forth in this decision. Ratepayers should not bear any costs of this divestiture. Divestiture of the Montara District is not a condition precedent to closing the transaction which is the subject of this application.

17. If Cal-Am makes financial expenditures for capital improvement projects on the Montara system prior to the divestiture, it shall comply with Ordering Paragraph 3 of D.01-09-055 in financing these expenditures. The fact that MSD may be an owner of the capital improvement project shall not be grounds for Cal-Am to fail to comply with Ordering Paragraph 3.

18. The requested acquisition and transfer of control is a "project" that qualifies for an exemption from CEQA pursuant to § 15061(b)(3) of the CEQA guidelines.

19. Pub. Util. Code § 704 does not bar this transaction.

20. Appendix B sets forth the settlement as annotated by the Commission's specific understanding of its terms where appropriate, and we approve the settlement based on that understanding and as further described and conditioned in this decision.

21. The settlement agreement, as interpreted by the Commission in this decision and Appendix B, as further conditioned by this decision, is reasonable in light of the whole record, consistent with the law, and in the public interest, and we approve it.

22. The transaction should be approved subject to the conditions imposed by the settlement condition and the additional conditions imposed by this decision.

23. In order to provide certainty to the parties in their business dealings, this decision should be effective immediately.

O R D E R

IT IS ORDERED that:

1. The joint application of California-American Water Company (Cal-Am), RWE Aktiengesellschaft (RWE), Thames Water Aqua Holdings GmbH (Thames Holdings), Thames Water Plc (Thames refers to the Thames entities), and Apollo Acquisition Company (applicants) for authority pursuant to Pub. Util. Code § 854 authorizing Thames Holdings, RWE and Thames Water Aqua U.S. Holdings, Inc. to acquire control of American Water Works (American) is granted, subject to the conditions set forth in the August 1, 2001 settlement agreement and attached Affiliate Transaction Rules, as interpreted by the Commission in Appendix B, which we approve, as well as to the further conditions set forth in the ordering paragraphs that follow.

2. Conditions 1 and 3 of the settlement shall be modified as set forth in the Commission comment on the attached settlement.

3. During the five years following the completion of this transaction, applicants shall not close any of Cal-Am's existing filed offices for any reason without first receiving this Commission's permission to do so through filing an application.

4. Cal-Am's customer call center shall meet the targets for each of the categories listed in Section V.F of this decision, averaged on a quarterly basis. For five full years following the effective date of this decision, Cal-Am shall make quarterly filings listing the service quality targets, as well as the rates actually achieved. Cal-Am shall file these reports with the Director of the Water Division and the Office of Ratepayer Advocates (ORA) on January 15, April 15,

July 15, and October 15, commencing on the first quarter following the effective date of this decision. The reports shall be for the preceding three months (the January filing will be for the October—December, etc.).

5. Cal-Am shall provide the Commission with the notice required by condition 26 no later than 30 days prior to Cal-Am's payment of a dividend or transfer of such funds to its parent. Cal-Am shall provide this notice to the Director of the Water Division, the Commission's Executive Director, and ORA.

6. The management of Cal-Am has and will continue to have full authority with regard to any decisions concerning Cal-Am's relationship with the City of San Diego including, but not limited to, any water supply and franchise agreements.

7. For a minimum of five years from the effective date of this order, a majority of the individuals appointed to serve on the board shall be United States citizens. Additionally, in order to ensure local input, if applicants make any changes to the current composition of Cal-Am's board, we require that in the future, at least 30% of the members of Cal-Am's board be California residents, as well as United States citizens, and further, be persons who are not employees of RWE, Thames, American, Cal-Am, or any RWE affiliated entity. Familiarity with interests and concerns in Cal-Am's service territory also shall be an important consideration in appointing directors to serve on the board.

8. For at least one year from the date of the consummation of the transaction or until March 31, 2004, whichever is later, applicants shall notify the Commission in writing within 10 days of any changes in Cal-Am's board of directors, corporate officers, or management personnel. Such notification shall be sent to the Director of the Water Division, the Commission's Executive Director, and ORA.

9. RWE, Thames, American, and Cal-Am shall be subject to Pub. Util. Code § 797.

10. Approval of this transaction is conditioned on Cal-Am divesting itself of the Montara District at fair market value to the Montara Sanitary District (MSD) or another public agency. Ratepayers shall not bear any costs of this divestiture. No later than 90 days after the effective date of this decision, Cal-Am shall submit an advice letter to the Commission for approval of the divestiture pursuant to Pub. Util. Code § 851. We intend that all other aspects of the divestiture be completed within these 90 days. This time may be extended upon joint motion by applicants and MSD to the Commission, the Assigned Commissioner, or assigned Administrative Law Judge.

11. Applicants shall file annual reports with the Director of the Water Division and ORA no later than January 31 during the five year duration of the public purpose programs set forth in conditions 23 and 24 of the settlement with an accounting of monies spent on each of the public purpose programs.

12. In future Cal-Am rate cases, applicants have the burden of establishing from which transaction (this transaction or the Cal-Am/Citizens merger) the benefits accrue. If applicants do not meet this burden, the Commission will attribute the benefits to this transaction rather than to the Cal-Am/Citizens merger, to assure ratepayers that they receive 100% of the benefits of this transaction.

13. Applicants shall track the (1) savings and increased revenues, and (2) the costs of implementing best practices in separate memorandum accounts.

14. Applicants shall tender the notice required by settlement condition 16 to the Director of the Commission's Water Division, the Commission's Executive Director, and ORA.

15. The Director of the Water Division shall immediately designate Commission personnel to participate with applicants in developing the programs set forth in settlement conditions 23 and 24, and Commission personnel and applicants shall hold their first meeting on these programs no later than 15 days from the effective date of this decision. The Director shall thereafter submit a program plan to the Commission for its consideration. The Director shall also explore whether existing programs comparable to each proposal exist, and whether these monies can more effectively be used directed toward these existing programs.

16. RWE, Thames Holdings, Thames Water Aqua U.S. Holdings, Inc., Apollo Acquisition Company, American, and Cal-Am shall file a written notice with the Commission, served on all parties to this proceeding, of their agreement, evidenced by a resolution of their respective boards of directors duly authenticated by a secretary or assistant secretary of these entities, as the case may be, to the conditions adopted in decision as set forth in the settlement agreement as interpreted by the Commission, as well as the additional conditions adopted in this decision. Failure to file such notice within 60 days of the effective date of this decision shall result in the lapse of authority granted by this decision.

17. This proceeding is closed.

This order is effective today.

Dated December 19, 2002, at San Francisco, California.

HENRY M. DUQUE
CARL W. WOOD
GEOFFREY F. BROWN
MICHAEL R. PEEVEY
Commissioners

I abstain.

/s/ LORETTA M. LYNCH
President

Appendix A

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(END OF APPENDIX A)

Appendix B
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To Be Attached.