

Decision 07-05-031 May 3, 2007

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the 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, and American Water Works Company, Inc. for an Order Authorizing the Sale by Thames GmbH of up to 100% of the Common Stock of American Water Works Company, 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 06-05-025
(Filed May 22, 2006)

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OPINION APPROVING A CHANGE OF CONTROL

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OPINION APPROVING A CHANGE OF CONTROL

I. Summary

By this decision, we approve the proposed transaction as described in the application, which involves: (1) a transfer of indirect control of California-American Water Company (Cal-Am), wholly owned by American Water Works Company, Inc. (American Water), through the sale of up to 100% of the shares of common stock of American Water through an Initial Public Offering (IPO), and any subsequent public offerings to be listed on the New York Stock Exchange by American Water's parent company, Thames Water Aqua Holdings GmbH (Thames GmbH); and (2) prior to the closing of the IPO, the merger of Thames Water Aqua U.S. Holdings, Inc. (TWAUSHI), the intermediate holding company for all of RWE's water and wastewater businesses in the United States and a wholly owned subsidiary of Thames GmbH, with and into American Water. This approval is subject to the conditions set forth in Appendix A of this order.

II. Jurisdiction

This application was filed pursuant to Pub. Util. Code §§ 851 through 854.¹ Section 851 requires Commission approval before a public utility may sell the whole or any part of its system. Section 852 requires a public utility to secure Commission authority before acquiring any capital stock of any other public utility. Section 854 requires Commission approval for a transfer of indirect control of a utility. There are several subsections of Section 854 that must be

¹ All statutory references are to the Public Utilities Code unless otherwise stated.

considered to determine whether applicants proposed transfer of indirect control is in the public interest.

A. Section 854(a)

Section 854(a) requires Commission approval before any person or corporation merges, acquires, or controls any public utility organized and doing business in this state without first securing authorization to do so from this Commission. The Commission has broad discretion to determine if it is in the public interest to authorize a transaction pursuant to § 854(a).² The primary standard used by the Commission to determine if a transaction should be authorized under § 854(a) is whether the transaction will adversely affect the public interest.³ The Commission may also consider if the transaction will serve the public interest. When necessary and appropriate, the Commission may attach conditions to a transaction in order to protect and promote the public interest.⁴

In regards to whether the proposed transaction is in the public interest, the parties differ on whether the “ratepayer indifference standard” (a showing that no negative effects result from the change of control), or a ratepayer benefit standard should apply to this application. We are not using the ratepayer benefit standard for this application and pursuant to the October 6, 2006 assigned Commissioner Scoping Memo and Ruling. Irrespective of the ratepayer

² See Decision (D.) 95-10-045, 62 CPUC 2d 160 at 167 and, D.91-05-026, 40 CPUC 2d 159 at 171.

³ See D.00-06-079, 7 CPUC 3d 101 at 107.

⁴ See D.02-12-068, *mimeo.*, p. 11.

indifference standard, we do find that the transaction will result in benefits to the ratepayers.

B. Section 854(b) and (c)

The additional criteria needed for authority to transfer control of a utility set forth in subsections (b) and (c) of § 854 are not applicable in this instance because those subsections do not pertain to water companies like Cal-Am. Those subsections pertain to electric, gas, and telephone utilities having gross annual California revenues in excess of five hundred million dollars.

C. Section 854(d)

Section 854(d) requires that when reviewing a merger, acquisition, or control proposal, the Commission shall consider reasonable options to the proposal recommended by other parties 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 San Lorenzo Valley Water District (SLVWD) and County of Santa Cruz (County) cited § 854(d) as its authority to request that any approval of this application be conditioned upon the divestiture of the Cal-Am Felton district to a public agency. Applicants disputed whether § 854(d) is applicable in this instance and disputed whether this proceeding should address any divestiture of their property, which they believe should be addressed only in a condemnation proceeding. Pursuant to the October 6, 2006 Scoping Memo, the SLVWD and County's proposed divestiture condition was specifically excluded from this proceeding. In the December 12, 2006 Ruling denying a motion to modify the scope of the proceeding, we encouraged the parties interested in public acquisition of the Felton District to pursue that interest and we invited them to use our alternative dispute resolution program. We would also like to take

official notice of the Condemnation filing by the San Lorenzo Valley Water District in the Superior Court of Santa Cruz County on February 21, 2007, Case Number CISCV156413.

Although applicants are seeking a transfer of indirect control of all the water and wastewater systems of American Water and its subsidiaries providing service in 29 states and Canada, this proceeding involves American Water only as it relates to its California subsidiary, Cal-Am and its seven districts. Of the 18 million customers involved in this transaction, Cal-Am provides water service to approximately 170,000 connections. This amounts to a very small percentage of all customers that will be impacted by the proposed transfer of indirect control. The Felton District has 1,300 connections, which represents less than 1% of all California customers impacted by the proposed transaction.

A reasonable option for consideration in this proceeding under § 854(d) would be a proposal that puts forth short-term and long-term economic savings for the seven districts of Cal-Am *as a whole*, not the minuscule portion of the proposed transaction as sought by SLVWD and County. No party offered to submit such a proposal for consideration in this proceeding. Hence, § 854(d) is not applicable in this proceeding.

We affirm the October 6, 2006 Scoping Memo, which specifically excluded from considering in this proceeding whether approval of a transfer of indirect control should be conditioned upon the divestiture of the Cal-Am Felton district to a public agency pursuant to § 854(d).

III. Parties

Joint applicants Cal-Am, American Water, Thames GmbH, and RWE Aktiengesellschaft (RWE) are the primary parties involved in this application.

A. Cal-Am

Cal-Am, a California corporation, is a Class A water utility authorized to provide water service within its service territory under its U-210-W Certificate of Public Convenience and Necessity. Cal-Am currently serves approximately 170,000 customers in portions of the counties of Los Angeles, Ventura, San Diego, Monterey, Sacramento, Placer, Santa Cruz, and Sonoma. Those customers are served through seven districts: Coronado, Felton, Larkfield, Los Angeles, Monterey, Sacramento, and Village. Its principal office is located in Chula Vista, California. Cal-Am is a wholly owned subsidiary of American Water, consisting of less than 5% of American Water's regulated operations.

B. American Water

American Water, a Delaware corporation headquartered in New Jersey, provides water, wastewater, and other water resource management services, both regulated and non-regulated, to a population of approximately 18 million people in 29 states and Canada. American Water provides professional and staff services to its utility subsidiaries, including Cal-Am, through its wholly owned subsidiary American Water Works Service Company. American Water also provides cash management and debt funding to its subsidiaries through its wholly owned subsidiary American Water Capital Corporation (AWCC). Its principal office is located in Voorhees, New Jersey. American Water is a wholly owned subsidiary of Thames GmbH.

C. Thames GmbH

Thames GmbH, a Republic of Germany corporation headquartered in Essen, Germany, is a holding company for most of the water and wastewater operations of RWE. As such, Thames GmbH is the parent company of American Water which in turn, is the parent company of Cal-Am. Its principal office is

located in Essen, Germany. Thames GmbH is a wholly owned subsidiary of RWE.

D. RWE

RWE, a Republic of Germany corporation headquartered in Essen, Germany, is an international multi-service parent company of a group of companies principally engaged in the business of electric power generation, trading, transmission and distribution of electric power; natural gas and crude oil exploration and production as well as natural gas transmission and distribution; and environmental and water related services. Its region focus stretches mainly from the United Kingdom to Eastern Europe.

IV. The Proposed Transaction

Joint applicants seek Commission approval for a transfer of indirect control of Cal-Am. The proposed transaction is intended to return American Water to a publicly traded company, as it was for nearly 60 years before being acquired by RWE in 2003.

RWE requested Commission authority to acquired control of American Water and, in turn, Cal-Am by Application 02-01-036 so that RWE could expand its water and wastewater services to the United States. At that time, RWE was providing water and wastewater services to approximately 43 million people worldwide.

Although that original application was protested, joint applicants entered into a settlement agreement with their affiliate Apollo Acquisition Company, Division of Ratepayer Advocates (DRA), the Utility Workers Union of America, and the AFL-CIO. That settlement agreement incorporated several conditions which were to benefit Cal-Am's ratepayers. Those benefits included a sharing of RWE's best practices; a lowering of Cal-Am's cost of debt; a deferral of rate

increases; implementation of two public assistance programs; and adoption of affiliate transaction rules. All of the agreed-upon conditions are attached to this order as Appendix C. The Commission adopted the proposed settlement agreement and authorized RWE to acquire indirect control of American Water, pursuant to D.02-12-068 on December 19, 2002.

Since the 1960s, until its acquisition by RWE, American Water was the ultimate parent of Cal-Am and throughout that period and thereafter, American Water has provided the necessary capital and operating assistance to Cal-Am to ensure that Cal-Am provides safe and reliable service to its customers.

Due to changed circumstances, RWE has refocused its core business on the rapidly changing European energy markets that are experiencing increased competition, growing customer needs, and rising costs. To do so, RWE made a business decision to withdraw from its non-core businesses.⁵ RWE had already divested itself of its non-core environmental business and now seeks to divest itself of its non-core water services business.

This proposed transaction involves only a change of control at the holding company level and will not change the relationship between Cal-Am and American Water, nor will it change Cal-Am's day-to-day operations. Applicants seek to accomplish this transfer of indirect control through the sale of up to 100% of the shares of common stock of American Water through an IPO to be listed on the New York Stock Exchange by American Water's parent company, Thames

⁵ Although DRA has inferred reasons that RWE seeks to divest itself of American Water from a review of the RWE Supervisory Board of the Board of Director's meeting minutes, RWE nevertheless made a business decision to classify its water operations as a non-core businesses and to divest itself of its non-core businesses.

GmbH. The first step of the proposed transaction is the merger of TWAUSHI with and into American Water, so that American Water is the servicing corporation. The merger will result in the consolidation of RWE's American Water related U.S. water assets (including U.S. water assets acquired by RWE through its acquisition of Thames Water plc) into American Water. Upon completion of the merger, Thames GmbH will sell up to 100% of the common stock of American Water through one or more public offerings. The proposed transaction is expected to be completed within two years. The IPO prospectus will include a clear statement that no investor is permitted to acquire control of American Water without obtaining any necessary regulatory approval pursuant to applicable state laws.

Although Thames GmbH will sell all of the shares of American Water, it may initially sell less than 100% of the shares in the IPO. That decision will be dependent upon market conditions at the time the IPO is issued. To the extent all shares are not sold as part of the IPO, the remainder of the shares would then be sold in a subsequent offering or offerings as soon as reasonably practicable. The IPO and any subsequent public offerings will be conducted according to the rules for underwritten public offerings mandated by the United States Securities and Exchange Commission (SEC).

V. Public Interest and Ratepayer Benefit

The primary question to be determined in this proceeding is whether the proposed transaction is in the public interest and is beneficial to ratepayers. While applicants identified several ratepayer benefits they believe to be significant, DRA has proposed several conditions to ensure that ratepayers do benefit from the proposed transaction.

A. Applicants' Position

Applicants contend that their proposed transaction meets the requirements of § 854(a) because it will result in a company with sound financial structure focusing on the water and wastewater business in the United States that will be well managed and will provide benefits to ratepayers. Although applicants cannot quantify the benefits from the proposed transaction, they identify them as significant. Those ratepayer benefits include a solid capital structure; ability to raise capital on a going forward basis; becoming a United States publicly traded company; local control; enhancement of employee relations; and transparency to Cal-Am's ratepayers.

1. Capital Structure

Applicants are committed to providing American Water with a sound capital structure at the time of the proposed IPO. At the time of the proposed IPO, RWE will infuse capital necessary to reach 45% common equity, with a potential of equity or other equity-like components up to 55%.⁶

This intended capital structure is within the 45% to 55% debt to equity ratio of publicly traded water utilities within the United States and supports the utility's creditworthiness. Applicants do not expect the current cost of American Water's capital to change as a result of the proposed transaction except due to changes in interest rates. The cost of debt that American Water will incur is expected to be in line with the costs it would incur as a non-core operation of RWE.

⁶ The capital structure of American Water as of December 31, 2005 consisted of 53% debt and 47% preferred and common stock.

2. Access to Capital

Applicants contend that approval of the proposed transaction will enhance American Water's ability to access capital in the United States debt and equity markets, access which is not currently available under the private ownership of RWE. American Water must currently compete for capital with the core energy operations of RWE, whose capital requirements are greater than were anticipated at the time RWE acquired American Water.

Applicants do not expect that approval of the proposed transaction will alter the current investment and capital programs of Cal-Am, which include the Coastal Water Project on the Monterey Peninsula and the retrofit of the San Clemente Dam in Carmel. Access to the United States debt and equity markets will enable American Water to continue providing quality water service throughout its operating subsidiaries in a cost-effective manner.

3. Publicly Traded Company

Applicants contend that the increased transparency of American Water as a publicly traded company is a significant benefit to American Water, to the customers of American Water's operating subsidiaries, and to the public. The proposed transaction will require American Water to be subject to federal securities laws and regulations, as well as New York Stock Exchange rules where American Water's common shares will be listed.

As a publicly traded company, American Water will be required to comply with extensive requirements imposed by the Sarbanes-Oxley legislation, including internal controls over financial reporting and external audit of such controls, corporate officer certification of financial and other information, corporate governance requirements, and enhanced and expedited disclosure,

particularly with respect to financial information. None of those requirements is currently applicable to American Water since all of its shares are privately held.

4. Local Control

The proposed transaction will shield Cal-Am from the potential risks of remaining a fourth tier subsidiary of a foreign corporation, now refocusing its core business on the European energy markets. There will be no change in the management of Cal-Am or American Water in the ordinary course of business. Local management will be able to make appropriate business decisions, unencumbered by RWE's competing goals.

5. Employee Relations

Employee relations will not be adversely impacted because Cal-Am contemplates no change in employment, employment levels, or compensation. Cal-Am employees will continue to be managed by the same management team, under supervision of its American Water board of directors. Cal-Am will also continue to honor its collective bargaining agreements. In addition, American Water may create an employee stock purchase program following the proposed transaction and employees may invest in American Water. Applicants contend that stable employee relations, coupled with employee ability to purchase stock in their company, will enable Cal-Am to attract and retain qualified employees.

6. Ratepayer Transparency

The proposed transaction will be transparent to Cal-Am's ratepayers because there will be no change in the name, management, employees, terms or condition of service. The only change will be an indirect transfer of control from the foreign ownership by RWE to a United States publicly traded company. Ratepayers will have the ability to invest in American Water and obtain ownership interest in the parent of their water supplier.

B. DRA's Position

DRA reviewed the proposed transaction to determine what impact it would have on Cal-Am's ratepayers if applicants' request is approved. DRA concluded that ratepayers will not benefit if this application is denied because RWE has already decided to divest itself of its non-core businesses. DRA finds it not in the public interest to require a foreign entity that does not wish to have ownership to continue to have a controlling interest in Cal-Am.⁷ DRA also concluded that, if the application is approved, ratepayers will experience an increase in rates and will not receive any quantifiable benefits because applicants themselves could not quantify any benefits.

DRA recommends that 17 conditions be imposed upon American Water and Cal-Am to ensure that Cal-Am's ratepayers benefit from the proposed transaction. Those conditions, along with applicants' position on each condition, are detailed in Appendix B to this order.

C. Discussion

Applicants do not believe that DRA's conditions need to be imposed as part of the approval process because the conditions merely restate applicants' commitments as part of the proposed transaction. However, applicants do not object to the specific imposition of the conditions if they assure the Commission that the proposed transaction will not harm ratepayers.

With no general opposition to the proposed transfer or conditions, we consider and review each of the conditions that DRA seeks to impose upon approval of the transfer of indirect control of Cal-Am.

⁷ Exhibit 14, p. 10-2.

1. Undisputed Conditions

Applicants concur with Condition Numbers 1 through 7, and 12 recommended by DRA, with minor modifications to Condition Numbers 4, 7, and 12. These conditions pertain to maintaining adequate capital, current policies and service quality, a business headquarters and operational field offices in California, employee collective bargaining agreements, notification of any bond downgrading, and adherence to the Commission's affiliate transaction rules.

DRA concurs with the minor modifications that applicants made to Condition Numbers 4 and 7.⁸ Although DRA did not specifically address applicants' proposed modification to Condition Number 12, which requires RWE to continue to abide by the Commission's affiliate transaction rules as long as RWE has a controlling interest in American Water, that modification merely clarifies the condition. However, that condition is silent on what constitutes a controlling interest. Based on applicants' and DRA's testimony, a controlling interest as set forth in Condition Number 12 shall be defined as 10% or more.⁹

Given that no party disputes Condition Numbers 1 through 7 and 12, approval of the proposed transaction should be subject to those conditions, as modified by applicants. We now address DRA's remaining nine conditions, all of which applicants oppose.¹⁰

⁸ Reporter's Transcript Vol. 5, pp. 312 and 313.

⁹ Reporter's Transcript Vol. 4, p. 216 and Vol. 5, p. 313.

¹⁰ The following recommended conditions are paraphrased. Specific language of each condition can be found in Appendix B to this order.

2. Condition Number 8

This condition will preclude American Water, Cal-Am, and its ratepayers from incurring any costs or obligations that may arise from the proposed transaction, whether direct or indirect. It also requires RWE to reimburse American Water for all direct and indirect transaction costs that have already been paid by American Water.

DRA seeks to impose this condition on the basis that such costs would not occur but for the desire of RWE to divest itself of American Water.¹¹ As to the reimbursement requirement from RWE to American Water, DRA is concerned that any payment of transaction costs by American Water will reduce the amount of money American Water will have available for Cal-Am and other water affiliates.¹²

Applicants affirm that they do not seek recovery of the costs of the proposed transaction. Hence, there is no opposition to this aspect of the condition. Applicants do oppose RWE being required to reimburse American Water for already incurred costs applicable to the proposed transfer. Applicants also oppose being precluded in future general rate proceedings from seeking the recovery of ongoing, non-startup costs American Water incurs as a publicly traded company. Applicants seek to modify this condition so that RWE need not reimburse American Water for cost it has incurred related to the proposed transaction and to allow Cal-Am to seek recovery of ongoing costs it incurs as a publicly traded company in future rate proceedings.

¹¹ Reporter's Transcript Vol. 5, p. 290.

¹² *Id.*

To the extent that American Water has paid for costs related to the proposed transaction with its own funds, such funds will effectively be repaid when RWE infuses capital into American Water upon the issuance of the IPO. This position was affirmed by a DRA witness, who testified that although American Water may pick up costs attributed to the proposed transaction, such costs will be repaid to American Water when RWE capitalizes American Water prior to going to the IPO market.¹³ Hence, this aspect of the condition is moot.

In regards to seeking recovery of ongoing costs as a result of being a publicly traded company, applicants estimate that American Water's annual ongoing cost, which includes Sarbanes-Oxley compliance and additional audit fees, will be approximately \$2 million in the first year and \$1 million a year thereafter. Less than 5% of those ongoing annual costs will be allocated to Cal-Am. That equates to approximately \$96,000 the first year and \$48,000 annually thereafter. To the extent that Cal-Am would be authorized to recover those costs, the bills of ratepayers would increase four cents per month more for the first year and half that amount, or two cents per month, thereafter, based on a \$40 monthly bill.¹⁴

As privately owned companies, American Water's and Cal-Am's operational practices and financial positions are confidential, not available to ratepayers or the general public. As a publicly traded company, ratepayers will benefit through public disclosure of American Water's and Cal-Am's financial reporting, accounting, internal controls, general business practices, corporate

¹³ Reporter's Transcript Vol. 6, p. 326.

¹⁴ Exhibit 10, p. 4.

governance, executive compensation reporting, issuance of securities, and related financial business matters. Ratepayers will benefit from public disclosure and openness of the operations of American Water and Cal-Am.

Similarly situated regulated water companies are able to obtain recovery of reasonable ongoing costs in general rate proceedings. Cal-Am should be treated no differently. Cal-Am should be given an opportunity to justify its ongoing costs of being a publicly traded company and seek recovery of those costs in future general rate proceedings, as do other publicly traded companies.

Applicants' proposed modification to Condition Number 8 is adopted.

3. Condition Number 9

This condition will require the cost of any new debt for Cal-Am from the present time to five years after RWE and its affiliates no longer retain a controlling interest of American Water to be based on a Standard & Poor's (S&P) credit rating of A for secured debt and a Moody's Investment Services (Moody's) credit rating of Baa1 for senior unsecured debt.¹⁵

DRA proposed this condition to protect ratepayers from higher debt costs which DRA expects to result from a downgrade of American Water's credit rating to an A- from an A rating by S&P at the time RWE announced that it was going to divest itself of American Water.

Applicants contend that the credit ratios of American Water will improve in the future because RWE is going to inject common equity capital to replace

¹⁵ The S&P range of investment grade credit rating consists of nine steps with BBB being the lowest and AAA the highest rating. A credit rating of A- is two steps above and a credit rating of A is three steps above a credit rating of BBB. Moody's also has nine steps in its range of investment grade credit ratings with Baa2 being the lowest and Aaa the highest step. A credit rating of Baa1 is one step above a credit rating of Baa2.

some of American Water's debt.¹⁶ Applicants oppose freezing American Water's cost of debt for any period of time into the future. They believe Cal-Am should be allowed to recover its actual market-based cost of capital in future general rate proceedings and thusly earn a reasonable rate of return.

A credit rating, which impacts how much debt will cost, is the opinion of credit rating agencies on the overall general creditworthiness of a company based on their individual analysis of relevant risks, considering both qualitative and quantitative factors.¹⁷ Two such credit rating agencies are S&P and Moody's. Qualitative factors used by rating agencies, not measurable, are based on their informed judgment and include factors such as competitiveness and growth prospects, caliber of management, and regulatory framework. Quantitative factors are measurable. The three primary quantitative measurements used by rating agencies are funds from operations to total debt, pretax coverage ratios, and total debt to total capital.¹⁸

Prior to the acquisition of American Water by RWE in 2003, American Water had an S&P credit rating of A- and a Moody's credit rating of Baa1. Upon RWE acquiring American Water in 2003, the S&P credit rating improved one step to a credit rating of A but lowered to a credit rating of A- upon the 2005

¹⁶ Reporter's Transcript Vol. 4, pp. 218 and 219.

¹⁷ Exhibit 5, p. 13.

¹⁸ Funds from operations to total debt is a measurement of how many years it will take for a company to repay all of its debt with internally generated cash flows, pretax coverage is an earnings measurement, and total debt to total capital is a financial leverage indicator.

announcement of RWE that it will divest itself of American Water.¹⁹ S&P also placed American Water on a negative credit watch as part of the recent downgrade to an A-. In issuing that negative credit watch, S&P stated that it was waiting to see what American Water's business plan will be, to understand the debt refinancing that will occur, and to see what conditions will be placed on the proposed transaction by the various regulatory agencies.²⁰

There is no assurance that the credit ratings of American Water, or even RWE, will remain unchanged for at least five years into the future. Credit ratings are based on future conditions, some of which are under the control of an individual company and some of which are not. DRA acknowledges that debt ratings can change anytime due to factors not under the control of a company such as regulatory environment, market structure, competition, environmental conditions, litigation, geographic location, and customer demographics.²¹

To impute the cost of debt based on a specific S&P credit rating for at least five years into the future ignores the qualitative and quantitative factors not under the control of American Water and Cal-Am, and could only harm Cal-Am and its ratepayers through a disparity between regulatory and actual earnings. To ignore these conditions can only weaken the financial condition of Cal-Am

¹⁹ There is no direct evidence on what impact the acquisition and subsequent divestiture announcement of divestiture had on American Water's credit rating from Moody's. However, a comparison of the proposed conditions set forth in Appendix B and prior conditions in Appendix C shows that American Water currently has the same Baa1 credit rating from Moody's.

²⁰ Reporter's Transcript Vol. 4, pp. 174 and 175.

²¹ Reporter's Transcript Vol. 6, p. 351 and p. 352.

and American Water and thus result in higher costs of future debt and equity and lead to non-investment grade credit ratings. Even though DRA estimated that a one-step downgrade in an S&P credit rating would increase the cost of new debt by 0.15%, it acknowledges that a credit rating is not the sole criteria for determining the cost of new debt.²²

General rate proceedings are the proper forum to address recovery of reasonable and prudent business costs. We decline to impose an S&P credit rating of A for secured debt and a Moody's credit rating of Baa1 for senior unsecured debt from now until five years after RWE and its affiliates no longer retain a controlling interest in American Water. Condition Number 9 is not adopted.

4. Condition Number 10

This condition will require RWE to provide an equity investment of 50% to American Water at the date of divestiture, resulting in a capital structure of 50% equity and 50% debt.²³

DRA believes that its proposed capital structure is necessary to ensure that the IPO is not detrimental to Cal-Am's ratepayers.²⁴ DRA also believes that Cal-Am's ratepayers will benefit though lower debt cost because its proposal will strengthen the capital structure and credit ratings for American Water and AWCC, an affiliate which will provide debt financing to Cal-Am.

²² Reporter's Transcript Vol. 6, p. 327 and Vol. 5, p. 291 and p. 292.

²³ American Water's capital structure at December 31, 2005 consisted of 47% preferred and common stock and 53% debt.

²⁴ Reporter's Transcript Vol. 6, p. 343.

Applicants state that they are committed to providing a strong capital structure to American Water. They oppose a strict 50% equity ratio on the basis that it is too rigid and will preclude them from taking advantage of market conditions at the time of divestiture.²⁵ Applicants seek to modify this condition to a range of 45% to 55% equity and agree to infuse equity as needed to maintain this proposed equity range.²⁶

The equity ratio in a capital structure must be sufficient to maintain a reasonable credit rating and attract capital, as addressed in our discussion of Condition Number 9. It also must be sufficient to provide a margin of safety for payment of interest, reasonable dividends, and to retain some money in the business to fulfill public utility service obligations. Although neither DRA nor applicants provided analytical data supporting their individual proposals, we observe that both proposals are comparable with other water utilities.

We are reluctant to adopt a specific equity ratio for a proposed transaction that may occur more than two years in the future.²⁷ Consistent with D.89-11-068, we decline to micro-manage the capital structure of a public utility. We instead give American Water and Cal-Am discretion to manage their capital structures with a view towards a balance between shareholders' interest, regulatory requirements, and ratepayers' interests.²⁸ Such discretion will provide applicants the flexibility to take advantage of market conditions at the time the IPO is

²⁵ Exhibit 6, p. 15.

²⁶ *Id.*

²⁷ Reporter's Transcript, Vol. 4, p. 214.

²⁸ 33 CPUC 2d 495 at 541 to 545 (1989).

issued, the reasonableness of which will be addressed in Cal-Am's general rate or cost of capital proceeding.

Applicants' proposed modification to Condition Number 10 is adopted.

5. Condition Number 11

This condition will require all costs of the proposed transaction, for a period of five years, to be absorbed by American Water using the RWE equity infusion and will preclude these costs from being passed on to Cal-Am's ratepayers. Transaction costs include increases in directors and officers liability insurance, audit fees, annual stock exchange fees, employee stock purchase program costs, and Sarbanes-Oxley compliance costs.

This condition is an extension of Condition Number 8 and differs only to the extent that it imposes a five-year moratorium for seeking recovery of costs directly and indirectly attributed to the proposed transaction. We have already addressed when Cal-Am may seek recovery of such costs in our discussion of Condition Number 8.

6. Condition Number 13

This condition will require Cal-Am to make capital expenditures of not less than \$62.2 million in 2007, \$126.9 million in 2008, \$181.0 million in 2008, and \$97.6 million in 2010.²⁹ If capital expenditures in any of these years are projected to be below the minimum by 10% or more, then Cal-Am must notify the Commission and explain why.

²⁹ DRA indicated that these amounts appear in applicants' CA-DRA-02-Q020 response to a DRA data request, which was not submitted into the record of this proceeding.

DRA proposes this condition out of its concern that the new owners and new management may change how Cal-Am operates and how capital expenditures are made.³⁰ DRA acknowledges that the capital investments, customer service, and water quality of Cal-Am are adequate.³¹

No one disputes that Cal-Am will need to make future capital investments. If this condition is adopted, Cal-Am need only satisfy the minimum capital expenditure amounts, regardless of the actual plant investment needs of each of its seven districts.

Applicants are already committed to providing Cal-Am with adequate capital to fulfill all of its service obligations and to ensure that there is no adverse impact on the quality of customer service, water quality, and reliability of service as a result of this transaction.³² One such project requiring new capital is the Coastal Water Project in Monterey (Application 04-09-019).

Ongoing reviews and approval of capital budgets for each of the seven districts of Cal-Am are undertaken through general rate proceedings. That ongoing review considers capital expenditures needed to meet customer needs, source of supply development, and economic conditions. It also considers capital project delays due to changing circumstances such as weather, shortage of materials, and environmental and local permitting issues.

This condition is not necessary because the review and approval process undertaken in general rate proceedings, along with Condition Numbers 1, 2,

³⁰ Reporter's Transcript Vol. 5, p. 293.

³¹ Reporter's Transcript Vol. 6, p. 354.

³² Condition Numbers 1, 2, and 3.

and 3 being adopted in this order, provides sufficient assurance that Cal-Am will have adequate capital to fulfill its capital improvement obligations in each of its seven districts.

7. Condition Number 14

This condition will require that all of the conditions set forth in a 2002 settlement agreement that authorized RWE to acquire an indirect control of Cal-Am to remain in place until RWE no longer holds a controlling interest in American Water.

No one disputes that RWE should continue to comply with the conditions set forth in D.02-12-068 until RWE no longer holds a controlling interest in American Water.³³ There is a dispute over when RWE will no longer have that controlling interest in American Water. Is it when RWE owns less than a 10% interest in American Water or less than 50%?

DRA asserts that RWE will continue to retain a controlling interest in American Water until it has less than a 10% interest in American Water.³⁴ That percentage is identical to the Financial Accounting Standards Board (FASB) Opinion 57 definition of controlling interest, which addresses related party disclosures in financial statements.³⁵ FASB Opinion 57 indicates that principal owners remain in control if they have more than 10% of the voting interest.

³³ This is consistent with Rule 12.5 of the Commission's Rules of Practice and Procedure which prohibits the adoption of a settlement agreement to constitute approval of, or precedent regarding, any principle or issue in the proceeding or in any future proceeding.

³⁴ Reporter's Transcript Vol. 5, p. 313.

³⁵ FASB is an authoritative body which establishes a common set of accounting concepts, standards, procedures, and conventions, commonly known as "Generally

Footnote continued on next page

Applicants assert that they will lose their ability to control American Water when they have less than a 50% voting interest in American Water because they will no longer be able to control American Water at that level.³⁶

This controlling interest question is moot as long as applicants satisfy their stated intent of offering 100% of the shares in American Water through the IPO and offering any unsubscribed shares in subsequent offerings as soon as reasonably practical following the IPO. However, applicants' modification to this proposal conflicts with their intent to preclude buyers of the IPO from acquiring control of American Water. Applicants seek to preclude individual buyers or a group of buyers from obtaining a controlling interest in American Water by instructing their investment bankers not to allocate 10% or more of the stock to any individual buyer or group of buyers.³⁷

The less than 10% condition is consistent with the FASB 57 controlling interest definition, which applicants propose to preclude any individual buyer or group of buyers from gaining control of American Water by acquiring 10% or more of the IPO, and consistent with applicants' stated intent to divest itself of all interest in American Water. The condition proposed by DRA is adopted. If applicants and their affiliates cumulatively have more than a 10%, but less than 50% interest in American Water and find themselves in a minority position and unable to comply with any of the conditions set forth in Appendix C, Cal-Am

Accepted Accounting Principles" (GAAP). GAAP, in turn, is recognized by the accounting profession as a whole, and is used by most enterprises as a basis for their external financial statements and reports.

³⁶ Reporter's Transcript Vol. 4, p. 223.

³⁷ Reporter's Transcript Vol. 4, p. 216.

should file an application explaining why applicants cannot comply and request an exemption from the condition.

8. Condition Number 15

This condition will require a one-year deferral of Cal-Am rate increases, escalation year step increases, and the next general rate case in each of its jurisdictions.

DRA seeks to impose this condition to ensure that ratepayers receive some benefit from the proposed transaction by deferring a rate increase. DRA provides no analysis to substantiate that its proposed condition will actually benefit ratepayers.

Applicants oppose this condition on the basis that it will impose a significant financial hardship on Cal-Am because Cal-Am would expect to lose \$26.8 million of authorized revenue under DRA's proposal, approximately 24% of its 2011 projected revenues and more than eliminate its authorized earnings for one entire year.³⁸ Applicants also oppose this condition because it will preclude Cal-Am from earning a reasonable return on its investment and adversely impact the quantitative measurements used by rating agencies.

This condition may appear to provide a short-term benefit to ratepayers. However, the evidence in this proceeding shows that any short-term benefit will be offset by long-term harm. The revenue loss will have a negative impact on the cash flow of Cal-Am, making it difficult for Cal-Am to fund capital projects and to attract investors in the capital market, thereby driving up the cost of debt. Even DRA acknowledges that its proposed deferral of rate changes may impact

³⁸ Exhibit 10, p. 2 and p. 3.

the credit rating of American Water, may result in rate shock to the ratepayers of Cal-Am when the authorized but delayed rates go into effect, and may adversely affect the ability of Cal-Am to continue paying its operating costs.³⁹

This condition will also unfairly preclude Cal-Am from earning a reasonable return on its investment. The legal standard for setting a fair rate of return has been established by the United States Supreme Court in the *Bluefield* and *Hope* cases.⁴⁰ The *Bluefield* decision states that a public utility is entitled to earn a return upon its property employed for the convenience of the public and sets forth parameters to assess a reasonable return. The *Hope* decision reinforces the *Bluefield* decision and emphasizes that such returns should be sufficient to cover operating expenses and capital costs of the business.

The evidence in this proceeding does not substantiate that ratepayers will benefit from this condition. Condition Number 15 is not adopted.

9. Condition Number 16

This condition will require American Water to provide \$100,000 of shareholders funds annually for a five-year period to develop, promote or otherwise obtain a low-income assistance program underway in cooperation with the Commission. Cal-Am will be precluded from recovering those funds from its ratepayers.

DRA acknowledged that Cal-Am already provides low-income assistance funding pursuant to § 739.7 and that Cal-Am currently recovers prudently

³⁹ Reporter's Transcript Vol. 5, p. 295 and p. 296.

⁴⁰ *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944) and *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia*, 262 U.S. 679 (1923).

incurred low-income assistance program costs from ratepayers. Although DRA sees this proposal as a ratepayer benefit, it nevertheless acknowledges that approval will adversely impact the ability of Cal-Am to earn its authorized rate of return because Cal-Am will not be allowed to recover the \$100,000 annually for a five-year period applicable to low-income ratepayers.⁴¹

Consistent with our discussion of Condition Number 15, Cal-Am should be afforded a reasonable opportunity to recover its cost of doing business. Condition Number 16 is not adopted.

10. Condition Number 17

This condition will require American Water to provide shareholder funds of \$100,000 annually for a five-year period to assist small troubled water systems. Cal-Am would not seek to recover these funds.

While small troubled water companies may benefit from this proposed condition, DRA has not substantiated that Cal-Am ratepayers will receive any benefit. Approval of this condition is expected to provide a benefit to small troubled water companies not parties to the proposed transaction and to their ratepayers. With the funds going to other regulated entities, Cal-Am's ratepayers will receive no benefit from this condition.

This condition is not adopted because it does not benefit Cal-Am's shareholders or ratepayers. Other California regulated entities obtaining similar approval are not required to assist small troubled water companies at shareholder expense.

⁴¹ Reporter's Transcript Vol. 5, p. 309.

D. Conclusion

The proposed transaction is in the public interest. Cal-Am and its parent American Water will return to a United States publicly traded company from private ownership by a foreign company which no longer considers American Water to be a part of its core business and which seeks to divest itself of its water operations.

Ratepayers of Cal-Am will benefit from the replacement of ownership no longer interested in providing service to them. Ratepayers will also benefit from a transparent corporate structure but with no change in the name of the companies, management, terms of condition of service, or employees. The proposed transaction will also benefit ratepayers through the ability of Cal-Am and American Water to obtain new capital without competing against the capital needs of RWE's core companies. The adoption of the conditions set forth in Appendix A to this order helps ensure that ratepayers will be protected and benefited.

VI. Environmental Assessment

The transfer of control proposed by applicants constitutes a "project" under California Environmental Quality Act (CEQA), Pub. Resources Code §§ 21000 et seq. 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. No further Commission environmental review is required.

VII. Confidential Information

Applicants and DRA tendered portions of their testimony under seal. DRA also tendered portions of its briefs under seal. This information was

deemed sensitive to applicants proposed public offering of common stock and, if disclosed prematurely, would violate the SEC disclosure rules related to a proposed public offering of stock.

All sealed information should remain sealed for a period of two years after the effective date of this order. If applicants believe that further protection of sealed information is needed beyond the two years, they shall comply with the procedure set forth in Ordering Paragraph 6.

VIII. Categorization and Need for Hearings

Joint applicants requested that this matter be categorized as ratesetting. By Resolution ALJ 176-3174, dated June 15, 2006, the Commission preliminarily determined that this was a ratesetting proceeding and that hearings may be necessary. There was no objection to the ratesetting categorization.

Notice of the application appeared in the Commission's Daily Calendar of May 26, 2006. Public participation hearings were held in Burbank on September 6, 2006, Santa Rosa on September 18, 2006, and Felton on September 27, 2006. An evidentiary hearing was held on December 14, 15, and 18, 2006. This proceeding was submitted upon receipt of reply briefs on January 25, 2007.

IX. Comments on the Proposed Decision

The proposed decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with Pub. Util. Code § 311 and Rule 14.2(a) of the Commission's Rules of Practice and Procedure. Comments were filed on April 17, 2007, and reply comments were filed on April 23, 2007. Those comments did not result in any major changes to the proposed decision. To the extent comments and reply comments required changes in the proposed decision, those changes were incorporated into the body of this order.

X. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Michael J. Galvin is the assigned ALJ in this proceeding.

Findings of Fact

1. Applicants seek to transfer indirect control of Cal-Am through the sale of up to 100% of the shares of common stock of American Water through an IPO to be listed on the New York Stock Exchange by American Water's parent company, Thames GmbH.

2. The primary standard used by the Commission to determine if a transaction should be authorized under § 854(a) is the ratepayer indifference standard.

3. Section 854(b) and (c) are applicable to electric, gas, and telephone utilities organized and doing business in this state having gross annual California revenues exceeding \$500,000.

4. Section 854(d) requires the Commission to consider reasonable options to the proposal recommended by other parties 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.

5. There was no proposal put forth by any party to consider short-term and long-term economic savings for the seven districts of Cal-Am as a whole in comparison to the indirect change of control before us.

6. Official notice is taken of Case Number CISCV156413 filed in the Superior Court of Santa Cruz County by the San Lorenzo Valley Water District, an action to condemn the Felton District.

7. The parties differ on whether the ratepayer indifference standard or a ratepayer benefit standard should apply to this application.

8. Applicants assert that the proposed transaction will produce benefits for the ratepayers of Cal-Am.

9. Cal-Am serves approximately 170,000 customers in portions of the counties of Los Angeles, Ventura, San Diego, Monterey, Sacramento, Placer, Santa Cruz, and Sonoma.

10. Cal-Am is a wholly owned subsidiary of American Water, consisting of less than 5% of American Water's regulated operations.

11. American Water is a wholly owned subsidiary of Thames GmbH which, in turn, is wholly owned by RWE, a Republic of Germany corporation.

12. RWE obtained Commission authority to acquire control of American Water and, in turn, Cal-Am in 2002 so that it might expand its water and wastewater services in the United States, pursuant to a settlement agreement with its affiliate Apollo Acquisition Company, DRA, the Utility Workers Union of America, and the AFL-CIO which incorporated several conditions to benefit ratepayers.

13. RWE seeks to transfer its indirect control of Cal-Am because it has refocused its core business on the rapidly changing European energy market and has made a business decision to withdraw from the water business.

14. This proposed transaction involves only a change of control at the holding company level and will not change the relationship between Cal-Am and American Water, nor will the proposed transaction change the day-to-day operations of Cal-Am.

15. To the extent that all of the shares of American Water are not sold as part of the IPO, the remainder of the shares will be sold in a subsequent offering or offerings as soon as reasonably practicable following the IPO.

16. The IPO and any subsequent offerings will be conducted according to the rules for underwritten public offerings mandated by the SEC.

17. Ratepayer benefits identified by applicants include a solid capital structure, ability to raise capital on a going forward basis, becoming a United States publicly traded company, local control, enhancement of employee relations, and transparency to Cal-Am ratepayers.

18. DRA finds it not in the public interest to require a foreign entity that does not wish to have ownership in American Water to continue to have a controlling interest in Cal-Am.

19. DRA recommends that 17 conditions be imposed upon Cal-Am and American Water to ensure that ratepayers of Cal-Am are unharmed by the proposed transaction.

20. Applicants do not object to the imposition of conditions as part of approving the proposed transaction to the extent those conditions provide additional assurances that the proposed transaction will not harm ratepayers.

21. Applicants concur with Condition Numbers 1 through 7, and 12, with minor modifications to Condition Numbers 4, 7, and 12.

22. DRA concurs with applicants' modifications to Condition Numbers 4 and 7.

23. Although DRA did not define what constitutes a controlling interest in American Water as it pertains to Condition Number 12, DRA and applicants have defined a controlling interest to be a 10% or more ownership.

24. Applicants do not seek recovery of the costs of the proposed transaction.

25. Although American Water may pay costs attributed to the proposed transaction, such costs will be repaid to American Water when RWE capitalizes American Water prior to the IPO.

26. If Cal-Am is authorized to recover ongoing costs of being a publicly traded company, the bills of ratepayers are estimated to increase approximately four cents per month during the first year and two cents per month thereafter.

27. Ratepayers benefit from a publicly traded company through public disclosure of the operations and practices of American Water and Cal-Am.

28. S&P lowered the credit rating of American Water by one step to an A- from an A and placed American Water on a negative credit watch upon the announcement that RWE was divesting itself of American Water.

29. S&P placed American Water on a negative credit watch pending a review of American Water's business plan, an understanding of the refinancing of debt that is to occur, and an understanding of what conditions will be placed on the proposed transaction by the various regulatory agencies.

30. Debt ratings can change anytime because of factors not under the control of a company such as regulatory environment, market structure, competition, environmental conditions, litigation, geographic location, and customer demographics.

31. The proposed transaction is expected to be completed within two years of the date the SEC declares the Registration Statement effective.

32. DRA's recommended capital structure, with a fixed equity of 50%, and applicants' proposed capital structure, with an equity range of 45% to 55% and an intent to infuse equity as needed, are comparable with other water utilities.

33. Ongoing reviews and approval of capital budgets for each of the seven districts of Cal-Am are undertaken through general rate proceedings.

34. Applicants are committed to providing Cal-Am with adequate capital to fulfill all of its service obligations and to ensure that the quality of customer

service, water quality, and reliability of service do not deteriorate as a result of this transaction.

35. RWE should continue to comply with the conditions set forth in D.02-12-068 until RWE no longer holds a controlling interest in American Water.

36. DRA defines a controlling interest in American Water to exist until RWE has less than a 10% interest in American Water.

37. FASB Opinion 57 also defines a controlling interest to be more than 10% of the voting interest in an entity.

38. DRA's Condition Number 15 deferral of rate increases may result in rate shock to Cal-Am's ratepayers when the requested delays go into effect and adversely affect the ability of Cal-Am to continue paying its operating costs.

39. Cal-Am expects to lose \$26.8 million of authorized revenue, approximately 24% of its 2011 projected revenues, and more than eliminate its authorized earnings for one entire year if Condition Number 15 is adopted.

40. The *Bluefield* decision states that a public utility is entitled to earn a return upon its property employed for the convenience of the public and sets forth parameters to assess a reasonable return.

41. The *Hope* decision reinforces the *Bluefield* decision and emphasizes that such returns should be sufficient to cover operating expenses and capital costs of the business.

42. Cal-Am currently provides low-income assistance funding pursuant to § 739.7 and is allowed to recover prudently incurred low-income assistance program costs from ratepayers.

43. DRA concurs that Cal-Am would not be allowed to recover the \$100,000 annually for a five-year period applicable to low-income ratepayers if its Condition Number 16 is adopted.

44. DRA has not substantiated that Cal-Am's ratepayers will receive any benefit from the condition of requiring American Water to provide and Cal-Am to not seek ratepayer recovery of shareholder funds of \$100,000 annually for a five-year period to assist small troubled water systems.

Conclusions of Law

1. The ratepayer indifference standard should be used to determine whether the proposed transaction should be approved.

2. 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 in Commission proceedings.

3. Section 854(b) and (c) are not applicable in this proceeding because they pertain only to electric, gas, and telephone utilities.

4. Section 854(d) is not applicable in this proceeding because no party offered any alternative option which could provide short-term and long-term economic savings for the seven districts of Cal-Am as a whole in comparison to the indirect change of control before us.

5. Condition Numbers 1 through 7 should be adopted as modified by applicants.

6. Condition Number 12 should be adopted with a definition of a controlling interest to be 10% or more.

7. Condition Number 8 should be adopted as modified by applicants because ratepayers will benefit from public disclosure and openness of the operations of American Water and Cal-Am.

8. Condition Number 9 should not be adopted because the freezing of the cost of debt for at least five years into the future can only harm Cal-Am and its ratepayers through a disparity between regulatory and actual earnings and ignores qualitative and quantitative factors not under the control of American Water and Cal-Am.

9. Applicants' proposed modification to Condition Number 10 should be adopted because it provides American Water and Cal-Am the flexibility to take advantage of market conditions at the time of the IPO. The reasonableness of the capital structure of Cal-Am should be addressed in the next general rate or cost of capital proceeding.

10. Condition Number 11 is addressed as part of Condition Number 8.

11. Condition Number 13 is unnecessary and should not be adopted because the review and approval process undertaken in general rate proceedings, along with Condition Numbers 1, 2, and 3 being adopted in this order, provides sufficient assurance that Cal-Am will have adequate capital to fulfill its capital improvement obligations in each of its seven districts.

12. Condition Number 14 as proposed by DRA should be adopted. If at a future time, applicants and their affiliates cumulatively have more than 10%, but less than 50% interest in American Water and find themselves in a minority position and unable to comply with any of the conditions set forth in Appendix C to this order, Cal-Am should file an application seeking an exemption from the condition(s).

13. Condition Number 15 should not be adopted because it will unfairly preclude Cal-Am from earning a reasonable return on its investment.

14. Condition Number 16 should not be adopted because it will preclude Cal-Am from recovering prudently incurred costs of doing business.

15. Condition Number 17 should not be adopted because it benefits neither the shareholders nor ratepayers of Cal-Am.

16. The requested acquisition and transfer of control are a “project” that qualifies for an exemption from CEQA pursuant to § 15061(b)(3) of the CEQA Guidelines.

17. The proposed transaction should be approved subject to the conditions imposed by this order, as set forth in Appendix A.

18. The proposed transaction is in the public interest.

19. Ratepayers of Cal-Am will benefit from the replacement of ownership no longer interested in providing service to them; from a transparency of the proposed change in ownership which will not change the name of the companies, management, terms of condition of service, or employees; and from the ability of Cal-Am and American Water to obtain new capital without competing against the capital needs of RWE’s core companies.

20. All sealed information should remain sealed for a period of two years.

21. Public convenience and necessity require the granting of this application be effective on the date signed.

22. The application should be granted to the extent provided in the following order.

O R D E R

IT IS ORDERED that:

1. Joint applicants California-American Water Company (Cal-Am), American Water Works Company, Inc. (American Water), Thames Water Aqua Holdings GmbH (Thames GmbH), and RWE Aktiengesellschaft (RWE) are authorized pursuant to Pub. Util. Code § 854 to transfer indirect control of Cal-Am, wholly owned by American Water. This is to be accomplished through the sale of up to 100% of the shares of common stock of American Water through an Initial Public Offering and subsequent public offerings to be listed on the New York Stock Exchange by American Water's parent company, Thames GmbH. Joint applicants are also authorized to merge Thames Water Aqua U.S. Holdings, Inc. (TWAUSHI), the intermediate holding company for all of RWE's water and wastewater businesses in the United States and a wholly owned subsidiary of Thames GmbH, with and into American Water.

2. The authority granted by Ordering Paragraph 1 is subject to complying with the 11 conditions set forth in Appendix A to this order.

3. None of the acquisition conditions from Decision 02-12-068 should be removed until RWE (or its subsidiaries or affiliates) has sold more than 90% of its interest in American Water. If RWE or its affiliates cumulatively have more than a 10%, but less than 50% interest in American Water and find themselves in a minority position and unable to comply with any of the conditions set forth in Appendix C, Cal-Am should file an application explaining why RWE or its subsidiaries cannot comply with the condition(s) and request an exemption from the condition(s).

4. Joint applicants shall notify the Director of the Commission's Water Division in writing of the transfer of control, as authorized herein, within 10 days of the date of consummation of such transfer.

5. The corporate identification number U-210-W assigned to Cal-Am shall continue to be used by Cal-Am and shall be included in all original filings with the Commission and in the titles and other pleadings filed in existing cases.

6. All sealed information shall remain sealed for a period of two years after the effective date of this order. After two years, all such information shall be made public. If applicants believe that further protection of sealed information is needed beyond two years, applicants may file a motion stating the justification for further withholding of the sealed information from public inspection. This motion shall be filed no later than 30 days before the expiration of the two-year period granted by this order.

7. The application is granted as set forth above and the authority granted shall expire if not exercised within two years from the date the Securities and Exchange Commission Registration Statement becomes effective.

8. Application 06-05-025 is closed.

This order is effective today.

Dated May 3, 2007, at San Francisco, California.

MICHAEL R. PEEVEY

President

DIAN M. GRUENEICH

JOHN A. BOHN

RACHELLE B. CHONG

TIMOTHY ALAN SIMON

Commissioners

APPENDIX A

ADOPTED CALIFORNIA-AMERICAN WATER COMPANY CONDITIONS ON TRANSFER OF INDIRECT CONTROL

1. California-American Water Company (Cal-Am) will be provided with adequate capital from American Water Works Company, Inc. (American Water) to fulfill all of its service obligations prescribed by the Commission and Cal-Am.

2. American Water and Cal-Am shall ensure the transaction will not result in any adverse changes in Cal-Am policies with respect to service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest of utility operations.

3. American Water and Cal-Am will ensure that there is no adverse impact on the quality of customer service, water quality, and reliability as a result of the transaction.

4. Cal-Am will continue to maintain its business headquarters in California together with field offices as appropriate to maintain the quality of service. Cal-Am will not close any of its local offices as a result of his transaction. However, Cal-Am is not precluded from making local operational changes in connection with integrating water and wastewater systems acquired in other transactions or which would have occurred absent the transaction.

5. The transaction will have no adverse impact on Cal-Am employees and there will be no changes in any existing union agreements as a result of the transaction. All collective bargaining agreements will continue to be honored.

6. Cal-Am will not allow the transaction to diminish staffing that would result in service degradation. However, Cal-Am may make local staffing and other operating changes which would have occurred absent the transaction.

7. American Water and American Water Capital Corporation (AWCC) will notify the Commission in writing within 30 days of public notification to American Water or AWCC of any downgrading to the bonds of American Water or AWCC and will include with such notice the complete report from the issuing bonding rating agency.

8. American Water will make no attempt to recover through Cal-Am's rates any of the transaction costs arising from the divestiture by RWE Aktiengesellschaft (RWE) and Thames Water Aqua Holdings GmbH (Thames GmbH) of American Water, including the Securities and Exchange registration fee, the National Association of Securities Dealer filing fee, the stock exchange listing fee, legal fees and costs of the proposed transaction, accounting fees and expenses of the proposed transaction, printing and engraving fees and expenses for the registration statement, Blue Sky fees and expenses, transfer agent fees and expenses, legal fees for the state regulatory approval process, and the costs of implementing the initial process and controls for compliance with the Sarbanes-Oxley Act of 2002. Cal-Am will not at any time seek to recover from its ratepayers costs directly incurred as a result of the proposed transaction from ratepayers of Cal-Am; however, Cal-Am may seek recovery of legitimate ongoing, non-startup costs of being a publicly traded company in future general rate proceedings.

9. RWE will provide an equity investment to American Water at the time of the proposed initial public offering to ensure that American Water has a capital structure in the range of 45% to 55%, with a minimum of 45% common equity.

10. All affiliated interest agreements approved by the Commission to which Cal-Am is a party will remain in effect. Additionally, the Affiliate Transaction Rules that were agreed to as part of the Settlement Conditions in Decision

(D.) 02-12-068 will continue. The references to RWE and RWE Group will be removed once RWE no longer has a 10% controlling interest in American Water.

11. None of the acquisition conditions from D.02-12-068 should be removed until RWE (or its subsidiaries or affiliates) has sold more than 90% of its interest in American Water. Where RWE and its affiliates cumulatively have more than 10% but less than 50% interest in American Water and find themselves in a minority position and unable to comply with any of the conditions set forth in Appendix C, Cal-Am should file an application explaining why RWE or its subsidiaries cannot comply with the condition and request an exemption from the condition.

(END OF APPENDIX A)