

**BEFORE THE TENNESSEE REGULATORY AUTHORITY  
NASHVILLE, TENNESSEE**

**IN RE:**

**PETITION OF TENNESSEE AMERICAN WATER  
COMPANY TO CHANGE AND INCREASE CERTAIN  
RATES AND CHARGES SO AS TO PERMIT IT TO  
EARN FAIR AND ADEQUATE RATE OF RETURN  
ON ITS PROPERTY USED AND USEFUL IN FURNISHING  
WATER SERVICE TO ITS CUSTOMERS**

**DOCKET NO.  
06-00290**

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**CITY OF CHATTANOOGA'S SECOND DISCOVERY REQUESTS TO PETITIONER  
TENNESSEE AMERICAN WATER COMPANY**

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Intervenor, the City of Chattanooga ("Chattanooga"), by and through counsel, hereby submits the following Second Discovery Requests (the "Supplemental Requests") to Petitioner, Tennessee American Water Company ("TAWC"). The responses to the Requests shall be delivered to the offices of the City Attorney, 400 Pioneer Bank Building, Chattanooga, Tennessee, 37402, in accordance with the Scheduling Order.

**INSTRUCTIONS AND DEFINITIONS**

A. These Supplemental Requests are to be deemed as continuing, and you are requested to provide, by way of supplemental responses, such additional information as may be hereafter obtained by you or any person on your behalf which augment, supplement, or otherwise modify responses to these Supplemental Requests.

B. The word "**Document**" shall include and mean, without limitation, the original and each draft and copy of any kind of written, printed, typed, recorded, or graphic matter, however produced or reproduced, of any kind or description, whether sent or received or neither. The term shall further include, without limitation, originals, all copies, all images, all backup or archived copies, and all drafts of: papers, books, writings, memoranda, letters, electronic

messages, electronic files, computer files, emails, correspondence, telegraphs, notes, book entries, accounts, statements of accounts, checks, cancelled checks, minutes of meetings, contracts, cables, telex messages, intra-office communications, intra-departmental communications, recordings or notes of telephone conversations, recordings or notes of other conversations, or meetings, affidavits, schedules, tabulations, calculations, computer files, and all other written or electronic records. The term "**Document**" includes the term "**Communication**".

C. The term "**Communication**" means any oral or written statement conveyed by one person or entity to another person or entity by whatever means, including electronic **Communications**, emails, and computer files.

D. If any **Document** called for by any request herein is to be withheld pursuant to any purported privilege or immunity:

(a) State the basis for such claim of privilege or immunity (e.g., attorney-client privilege, work product doctrine);

(b) Identify the **Document** being withheld by stating the name or title of the **Document**; the type of **Document**; its date, author, addressee, and copyee(s); a general description of its subject matter; its present location(s) and custodian(s); and each person who, to your knowledge, has seen it; and

(c) State the number and/or portion of the request to which each such **Document** would be responsive.

E. "**TAWC**" means the Petitioner, Tennessee-American Water Company.

F. "**TAWC Parent or Affiliate**" means (i) American Water Works Co., Inc. ("**AWWC**"); (ii) American Water Works Service Company, Inc. ("**AWWSC**"); (iii) American Water Capital Corp. ("**AWCC**"); (iv) Thames Water Aqua Holdings GmbH ("**Thames GmbH**");

(v) Thames Water Aqua US Holdings, Inc. ("**TWAUSHI**"); (vi) RWE Aktiengesellschaft ("**RWE**"); (vii) American Water Services AAET, LP ("**AWC LP**"); (viii) American Water Services Corp. ("**AWSCorp**"); (ix) American Water Resources ("**AWR**"); (x) American Anglian Environmental ("**AAE**"); (xi) American Carbon Services ("**ACS**"); (xii) all successors of any entity identified in items (i) through (xi); and (xii) all affiliates, subsidiaries, and parents of any entity identified in items (i) through (xi).

G. "**Operating Company**" means **TAWC** and any other company providing water service to the public, the majority of the capital stock of which is owned by **AWWC** or any **TAWC Parent or Affiliate**.

H. "**Explain**" means to provide a detailed explanation of the specified subject matter and to provide all **Documents** reflecting, recording, referring to, reporting, or relating to the subject matter or the response.

I. "**Identify**" means: (i) when used with reference to an individual person, to state his/her full name, employer, job title, present or last known residence address and telephone number, and present or last known business address and telephone number; and (ii) when used with reference to a **Document**, means to state the type of the document, its date, author, addressee, any other recipient(s), general subject matter, present location, and custodian. If any document to be identified was, but no longer is, in your possession, state the disposition that was made of it and the reasons, facts, or circumstances associated with its disposition.

J. "**Native Format**" means the electronic versions or copies of all **Documents** in their original formats, including all metadata, formulas, and format information.

## DISCOVERY REQUESTS

1. Provide copies of all monthly, quarterly, and annual period income statements, or other ***Documents*** reporting income and expenses for such periods, for AWWSC, AWCC, and ACS for the periods since January, 2001. If electronic copies of ***Documents*** responsive to this request exist, provide all such ***Documents*** in ***native format***.

RESPONSE:

2. Provide copies of all monthly, quarterly, and annual period balance sheets, or other ***Documents*** reporting assets and liabilities for such periods, for AWWSC, AWCC, and ACS for the periods since January, 2001. If electronic copies of ***Documents*** responsive to this request exist, provide all such ***Documents*** in ***native format***.

RESPONSE:

3. Provide copies of all monthly, quarterly, and annual period statements of sources and uses of cash, or other ***Documents*** reporting sources and uses of cash for such periods, for AWWSC, AWCC, and ACS for the periods since January, 2001. If electronic copies of ***Documents*** responsive to this request exist, provide all such ***Documents*** in ***native format***.

RESPONSE:

4. For each month, quarter, and annual period since January, 2001, state the income contributed to AWWC by each of the following entities: AWWSC, AWCC, and ACS. If electronic copies of ***Documents*** responsive to this request exist, provide all such ***Documents*** in *native format*.

RESPONSE:

5. For each month, quarter, and annual period since January, 2001, state all financial transfers to AWWC by each of the following entities: AWWSC, AWCC, and ACS. If electronic copies of ***Documents*** responsive to this request exist, provide all such ***Documents*** in *native format*.

RESPONSE:

6. Identify all ***Documents***, ***Communications*** or other items of information withheld based upon objections asserted in your responses to Chattanooga's First Discovery Requests, stating as to each ***Document***, ***Communication***, or other item of information the definition or instruction upon which you relied in withholding it.

RESPONSE:

7. Provide all ***Documents*** identified in the previous request. If electronic copies of ***Documents*** responsive to this request exist, provide all such ***Documents*** in *native format*.

RESPONSE:

8. For each annual period since January, 2001, provide a complete description and the total amount of each item of expense included in the (a) Labor Benefits Overhead and (b) General Overhead reported in "TN-COC-01-Q18&Q19 supplemental attachment 3.xls". If electronic copies of *Documents* responsive to this request exist, provide all such *Documents* in *native format*.

RESPONSE:

9. For each individual employee listed in "Static Summaries with employee rates – CONFIDENTIAL.xls", describe how time charged to TAWC was calculated, stating for each time entry whether the time charged was based on actual time entered on time sheets or was based on something other than actual time, and, if entered on some basis other than actual time, describe that other basis for each such employee time entry reflected on the referenced spreadsheet. If electronic copies of *Documents* responsive to this request exist, provide all such *Documents* in *native format*.

RESPONSE:

10. Provide all timesheets or other *Documents* reflecting original time entries for each employee identified in "Static Summaries with employee rates – CONFIDENTIAL.xls". If electronic copies of *Documents* responsive to this request exist, provide all such *Documents* in *native format*.

RESPONSE:

11. For each employee listed in "Static Summaries with employee rates – CONFIDENTIAL.xls", and for each month reported in that spreadsheet, provide a complete description and the total amount of each item of expense included in the overhead applied to the employee's direct personnel cost. If electronic copies of *Documents* responsive to this request exist, provide all such *Documents* in *native format*.

RESPONSE:

12. *Explain* fully the differences from month to month in the overhead percentages applied to direct personnel costs reported in "Static Summaries with employee rates – CONFIDENTIAL.xls". If electronic copies of *Documents* responsive to this request exist, provide all such *Documents* in *native format*.

RESPONSE:

13. Admit that the unredacted portions of the document attached as Exhibit A are true and correct copies of excerpts of the minutes of the September 16, 2005, November 4, 2005, and February 21, 2006 meetings of the Supervisory Board of *RWE*.

RESPONSE:

14. Identify by full name and title during the period of September, 2005 through February, 2006, the individual identified as "Mr. Roels" in the Supervisory Board minutes attached as Exhibit A.

RESPONSE:

15. ***Explain*** in detail the constituents of and justification for the "Gross Revenue Deficiency Factor" used on Exhibit 1, Schedule 1 to the TAWC Petition and provide all ***Documents*** supporting its calculation. If electronic copies of ***Documents*** responsive to this request exist, provide all such ***Documents*** in *native format*.

RESPONSE:

16. ***Explain*** in detail the nature and justification of each expense entry in the column headed "Expenses" in the billing statements contained in "TN-COC-01-Q18&Q19 Supplemental SCB2004.pdf" and "TN-COC-01-Q18&Q19 Supplemental SCB2005.pdf". If any individual entry reflects the total of more than one expense, state the nature and justification of each expense included in the line item total. If electronic copies of ***Documents*** responsive to this request exist, provide all such ***Documents*** in *native format*.

RESPONSE:



17. Provide all **Documents** referring to, relating to, recording, or reporting each expense included in the column headed "Expenses" in the billing statements contained in "TN-COC-01-Q18&Q19 Supplemental SCB2004.pdf" and "TN-COC-01-Q18&Q19 Supplemental SCB2005.pdf". If any individual entry reflects the total of more than one expense, provide all **Documents** referring to, relating to, recording, or reporting each expense included in the line item total. If electronic copies of **Documents** responsive to this request exist, provide all such **Documents** in *native format*.

RESPONSE:

18. For each expense included in the column headed "Expenses" in the billing statements contained in "TN-COC-01-Q18&Q19 Supplemental SCB2004.pdf" and "TN-COC-01-Q18&Q19 Supplemental SCB2005.pdf", **identify** the specific service in Article 1 of the 1989 Agreement identified as "TN-TRA-01-Q032-ATTACHMENT.pdf" which was purchased or financed by the expense. If any expense entry did not purchase or finance a specific service identified in Article 1 of the 1989 Agreement identified as "TN-TRA-01-Q032-ATTACHMENT.pdf", state the detailed purpose of the expense, and provide a copy of the agreement between TAWC and AWWSC that authorized the expense. If electronic copies of **Documents** responsive to this request exist, provide all such **Documents** in *native format*.

RESPONSE:

19. For each employee time entry listed in "Static Summaries with employee rates – CONFIDENTIAL.xls", **identify** the task or service completed by such employee.

RESPONSE:

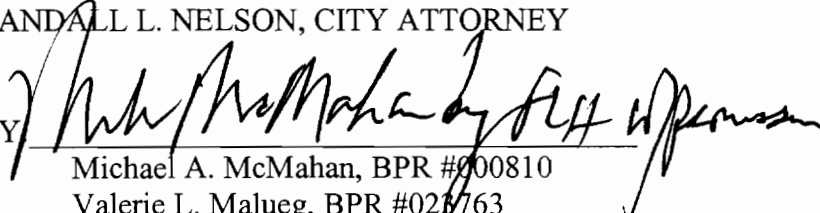
20. For each employee time entry listed in "Static Summaries with employee rates – CONFIDENTIAL.xls", **identify** the specific service in Article 1 of the 1989 Agreement identified as "TN-TRA-01-Q032-ATTACHMENT.pdf" that was provided by the employee. If any employee time entry did not fulfill a specific service identified in Article 1 of the 1989 Agreement identified as "TN-TRA-01-Q032-ATTACHMENT.pdf", provide a copy of the agreement between TAWC and AWWSC that authorized the work. If electronic copies of **Documents** responsive to this request exist, provide all such **Documents in native format.**

RESPONSE:

Respectfully submitted,

CITY OF CHATTANOOGA, TENNESSEE  
RANDALL L. NELSON, CITY ATTORNEY

BY

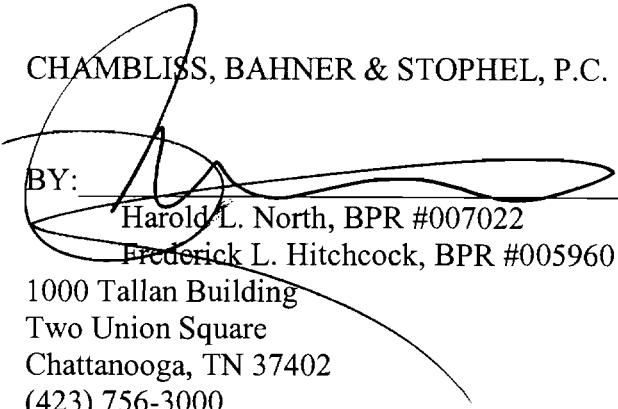
  
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CERTIFICATE OF SERVICE

This is to certify that the undersigned has this day served a true and correct copy of the foregoing pleading by electronic mail and by depositing same in the United States mail, postage prepaid, and addressed to the following:

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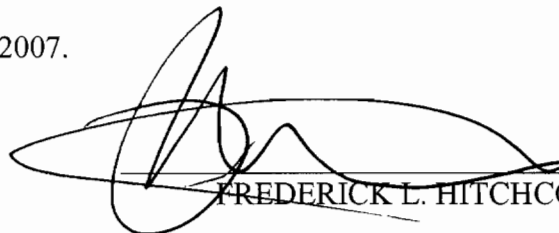
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This the 14th day of March, 2007.



FREDERICK L. HITCHCOCK

Excerpt from the Supervisory Board minutes dated September 16, 2005

On item 3 of the agenda – Strategic alignment of the Group,

the Chairman made reference to the fact that the presentation on this item had been slightly shortened in view of the in-depth preparations by the Presidium.

Mr. Roels stressed that his aim was an in-depth dialog with the Supervisory Board on the strategy. He recalled that regular reports had been submitted on the strategy developments in the various RWE segments since the end of 2003. In view of constantly changing markets, there is a need for adjustments in the water strategy. The thinking on a possible strategy change in water business announced today merely constituted an interim report. Before any decision on a strategy change, a range of questions still had to be clarified. He pointed out that this subject was extremely sensitive and secrecy regarding such thinking had to be maintained at all costs.

Mr. Roels then explained the historical developments which, after the merger of RWE/VEW in 1999, had led to the development of a multi-utility concept for the RWE Group with water as a fourth pillar. After the acquisition of Thames Water in 2001 and of American Water in 2002 and after the integration of these companies, experience has now shown that the expectations that had attached to these acquisitions at that time had not been fulfilled. The coming years were likely to bring rising capital requirements in the Water division along with lower outperformance chances. While at the turn of the millennium the capital market had still believed in the theory that utilities would have to evolve into global players, it now seemed that, in effect, there could no longer be any talk of globalization of the water market. Instead, the development to be observed was toward a regional focus of the water companies. Such developments, it was said, had already been taken into account by major competitors of RWE, who had either withdrawn from this business field or were concentrating on their various home markets.

Viewed against this background, the Executive Board had to face a number of questions. The chief issues were:

- Does an isolated presence in the US create value for RWE?
- In view of the risks and the resources required, is maintenance of this presence justified?
- Is RWE the optimal owner of a business that brings no optimal synergies for the core business, energy?
- Does the limited capital return, while accompanied by relative stability, justify the maintenance of a position in water business?
- Does more financial flexibility improve RWE's starting position with regard to the consolidation of Europe's energy sector?

In the Executive Board's opinion, the first four questions must be answered with a 'no', and the fifth with a definite 'yes'.

Mr. Roels then recalled the reasons that had originally tipped the scales in favor of pursuing the multi-utility strategy. The aim of this strategy had been to reduce the dependence on electricity business in Germany, in which losses were being



posted at the end of the last century. At the time it was assumed that customers would demand multiple-play, energy-related services and solutions on a one-stop basis. The success factors assumed had been value creation from cross-selling and the bundling of products, a broadening of the customer base and the achievement of cost leadership in all segments thanks to scale effects. In those days, focusing on the water market had seemed sensible owing to the poor future perspectives for the core market Germany, substantial erosion of electricity prices and plummeting market share. At that time, RWE had water know-how in Germany only. The global water market appeared to be a utility segment with max. growth potential. The multi-utility strategy was also suggested by the possibility of risk spreading across different utilities and regions.

The acquisitions in the water sector pursued a number of goals. By purchasing Thames Water and American Water, RWE had risen to slot 3 on the global water market. Water was set to become "the most profitable and fastest growing corporate division" and make a contribution of about one third to the 2003 EBITDA. Acquisition of Thames Water was to achieve a significant position in the UK water market and to gain control of the "best positioned" company in global water business. The object of the acquisition of American Water was, in addition, to obtain market leadership in the US. Another consideration behind these acquisitions was the idea that the customer base in the water business field could be used for multi-utility services. The expansion and integration of Thames Water, in particular, was expected to help internationalize the Group.

The acquisitions were to be an investment in a global growth market. In fact, it had been assumed that sales revenue from global water business would quintuple from USD 80 billion in 2000 to USD 400 billion in 2010. For Thames Water, revenue from non-regulated UK water business was expected to at least double by 2005, viz. from 15% to 30 or 40% revenue share. Similar growth assumptions had also been made in respect of the US water market, the world's largest regional market.

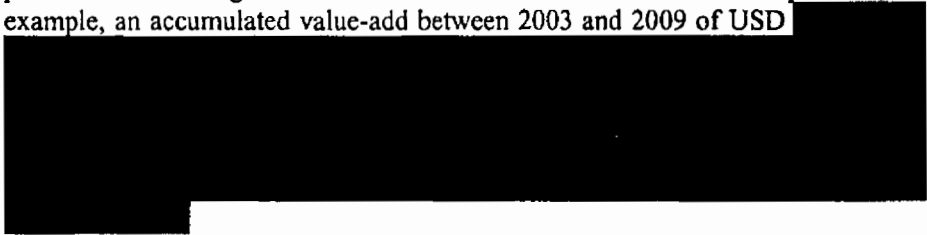
In view of these growth assumptions, high premiums had been paid for the purchase of Thames Water and American Water. For instance, relative to the 3-month average for the Thames Water share before the acquisition, the premium stood at 47%. The corresponding value for the American Water common stock had been 46%.

In the sequel, a number of adverse exogenous developments emerged. Due to a slower course taken by liberalization and to what was in places considerable political resistance to privatization of the water sector, the achievable overall market footprint was much smaller than expected. At the same time, risks in water business had been underestimated. This was true in particular of international water business. Here, unreliable regulatory authorities, in China or Indonesia, say, had not kept promises given. Highly political decision-taking processes and frequent resistance to foreign ownership had done the rest. But there had also been technical risks, like substantial distribution losses. It could be said today that the risk spread in this business field was definitely asymmetrical. High risks in the non-achievement of output targets had to be juxtaposed with only slight outperformance chances. Specifically in international water business, the obtainable return in many cases had not justified the higher risks.

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Finally, it should also be noted that there had been a significant increase in the efficiency pressure on saturated markets. Although short-term improvements could quite easily be achieved, outperforming the set targets on a time axis had become more difficult.

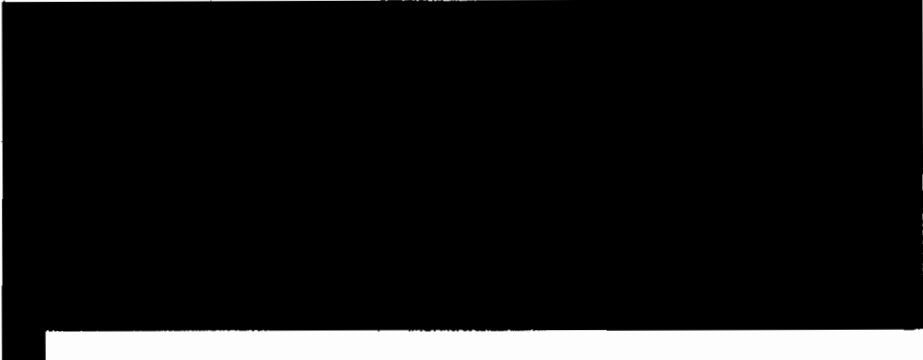
Mr. Roels then dealt with endogenous developments that had led to performance problems and weak growth at American Water. At the time of the acquisition, for example, an accumulated value-add between 2003 and 2009 of USD



While growth in regulated basic business was largely on track (growth from investment), growth in non-regulated business was well below expectations due to the weak distribution team.



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Mr. Roels then explained in detail the underlying regulatory framework for the activities of Thames Water in the UK and American Water in the US. On the one hand, Thames Water had a ring-fencing duty to maintain its substance and to adhere to agreed output and all environmental standards. On the other hand, the associated costs could not always be passed on to customers in full. The extra investment alone that Thames Water would incur under the planned EU Water Directive was put at some [REDACTED]. On the one hand, Thames Water was subject to stringent liability rules for services performed while, on the other, even those customers must be supplied who do not pay. The level of bad debts for all water companies in Britain was estimated to be GBP 800 million; it might not be possible to pass on these costs to customers in full. Owing to the asymmetric risk profile that had emerged, however, an offset between poor performance in drinking water and better performance in wastewater was not possible.

The situation in the US was also difficult. There, public resistance to privatization schemes of companies was growing. Some of the infrastructure of the water companies in the United States was outdated. Nevertheless, the regulatory requirements as regards reduction in contamination from the pipe network with the heavy metals arsenic and lead were steadily growing in severity. Here, too, the extra costs incurred could not always be passed on to customers. Specifically, it had been shown that customers responded to big rate hikes by substantially lowering their demand (rate shocks). To this must be added the fact that the regulatory environment, e.g. in Kentucky, Arizona and Virginia, was extremely difficult. What the two markets had in common was the fact that the guaranteed return is limited to approx. 6% in all after taxes, and that the leeway for outperformance is restricted. Tougher environmental standards, it was said, would require ever higher capital spending.

Mr. Roels then explained in depth the risks that arise for Thames Water and American Water from distribution losses. In Thames Water's case, for example, the distribution losses, due to London's obsolete pipe system, currently amounted to some 30% of production. This was equivalent to 915 million liters a day. The corresponding value at American Water was about 19%. London's pipe network has a total length of about 30,000 km, 50% of which is older than 100 years. Based on the 1,200 km of approved replacement in the current regulation period AMP4, replacing the entire pipe system would take more than 100 years. The regulator's aim in the current regulation periods was to obtain a significant reduction in such distribution losses. However, this would only be possible at the price of a considerable rise in investment in new networks.



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[REDACTED]

[REDACTED]

The chief challenges in the US concerned an increase in efficiency and growth. Management complexity was very high. This became clear when it was realized that the company operates in 28 states, with a breakdown by 4 regions.

[REDACTED]

Mr. Roels then went on to explain the corresponding situation in the United States. There, it had become clear that the highest growth in demand was expected in the West region. However, a negative value-add was reckoned with for the years 2005 to 2009.

In addition, it had to be noted that both American Water and Thames Water in their relations with each other and with other companies in the RWE Group had only limited synergy potential. Hence, American Water – other than originally planned – had no synergies with the energy area because the scheduled entry into the US electricity market had not happened. Only at Thames Water were there limited synergies with RWE npower, most of which are likely to benefit RWE npower, however. Procurement and IT benefits, too, as part of the RWE Group, were negligible.

Using a comparison of the strategies of many utilities in the European area, Mr. Roels explained that important competitors of RWE who had likewise pursued a multi-utility approach until 2002 had been concentrating on their core business fields. Thus, Scottish Power, Centrica, Enel, E.on, Endesa, Nuon and Scottish & Southern had now withdrawn from water business. Merely Suez and Véolia were still systematically pursuing their multi-utility strategy.

If the questions asked at the beginning were asked once more against this background, it would have to be said that RWE's isolated presence in the US creates no value. In view of the risks and the required resources, maintenance of

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this presence could not be justified. Also to be answered in the negative was the question as to whether RWE is the optimal owner of a business that offers no significant synergies to its core business, energy. Much the same is true of the question of whether the limited capital return justifies maintaining a position in water business. Yet this still did not answer the issue of whether the financial flexibility gained from an abandonment of the water business would improve RWE's basic position in the consolidation of the European energy sector. This would require further thinking on consolidation in energy business.

A look at the capital-market assessment of water business shows that most analysts view RWE as a pure-play energy company. Specifically, the US water activities were being undervalued as part of the RWE portfolio. Among companies that operate water as a separate business, it can be noted that pure-play, regionally focused water suppliers are currently highly rated.

Against this backdrop, a number of options for action by American Water could be identified. If a decision were taken in favor of retaining the holding in American Water, it would be essential to install a new management in the US. The restructuring of the American Water group would then have to be pursued with special urgency. It might also be necessary to have stronger links between American Water and the Group Center.

Also conceivable might be an IPO with a placement of American Water at an American stock exchange in one or more steps. One alternative would be a private placement of 100% of the shares with at least 11 institutional investors each receiving fewer than 10% of the stocks. The background for such a scatter involved regulatory obstacles. Mixed forms of IPO and private placement could also be considered in principle. In addition, the regulated water business is also very attractive for individual financial investors, like infrastructure funds, insurance companies and pension funds. By contrast, there were, it is true, only few strategic investors on the market. Looking at the risks of the various options, it can be noted that the hold option is associated with the exposure of a further worsening in the performance. There was then also the risk that the currently favorable market environment would cease to exist. But a disposal option would entail risks as well. Here, the risk of rising interest rates in the US must be cited first with correspondingly adverse implications for the achievable disposal proceeds. To this must be added the general price risk in any IPO, although this could be reduced in any private placement by fixing the purchase price in advance. There were also performance risks as regards the level and the sustainability of the company's US-GAAP result. On top of this came an implementation risk, which was marked by the high complexity of the transaction and the limited management resources in the US.



temptation of reckoning yourself rich.

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[REDACTED]

[REDACTED]

Finally, Mr. Roels explained that, regarding American Water, the internal preparations for a possible transaction were to be completed by the end of October 2005. Extraordinary meetings of the Executive Board and the Supervisory Board were envisaged for early November 2005. A possible kick-off for a selling process could then take place after the Supervisory Board meeting. Should the Company decide in favor of the hold option, a restructuring process might then have to be implemented.

Debate:

Mr. XXX pointed out that it was not intended at today's meeting to adopt any resolution on a possible strategy change. Instead, the Executive Board was to be given a mandate to press ahead with thinking on a strategy change and, possibly, to arrange for measures needed to implement the strategy. What mattered most was to make an ACTUAL-BUDGET comparison for water business. It might then be necessary to consider the shape that could be given to the exit from water business. In future, the Company would increasingly be competing for the ever-scarcer resource "capital". It was also important, in his view, that the capital tie-up at Thames Water in the UK was growing faster than expected.

Mr. XXX welcomed the Executive Board's thinking. For him, the impact on the free cash flow was crucial. If the Executive Board opted for a continuation of activities in the water business field, this would have far-reaching consequences for the Group's other business.

Mr. XXX remarked that a quarter of the Group's result came from the water business field. Against this background, the Executive Board must consider what implications the planned strategy change would have for result planning and the Company's balance sheet. In the event that the Executive Board opted to sell the water business field, thought would have to go into how the associated developments in the result would be communicated to the market. It must also be anticipated that the focus on the power and gas business fields then expected by the capital market and the re-investment risk resulting from this would lead to unrest there, all the more so since new acquisitions would probably not be possible at favorable prices. This might give rise to future goodwill problems. In his view, Thames Water would probably be easier to sell than American Water. This was due to the fact that, in the US, any sale is subject to the consent of a number of regulators. In addition, the company's management was not yet complete either. For an acquisition of American Water there were not many strategic partners. In the case of financial investors, it must be asked whether the regulators would be willing to accept such a buyer. Experience had shown that it is easier to resolve a change of strategy than to actually implement it.

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Mr. Roels pointed out that the market was quite interested in acquiring holdings in water companies. The investors concerned were pension funds and infrastructure funds with an investment horizon of at least 30 years. He shared the view that financial investors in the form of private-equity companies would, as viewed from the regulators' angle, be less suitable as buyers. American Water currently operates in 28 US states. In about half of the states, regulator approval would have to be obtained. The regulators were expected to welcome any acquisition by American buyers.

The fact was that the Executive Board was aware of the problems associated with implementing the strategy change, so that special care was being applied to planning the implementation process. He again pointed out that today's Supervisory Board meeting would not adopt any resolution on the strategy change. For the rest, this would also trigger immediate *ad-hoc* duties under Germany's Securities Trading Act (*WpHG*).

Mr. XXX was of the opinion that the strategy change indicated here was wrong. He believed that water was in fact part of the Company's core business. Although he was able to replicate the Executive Board's thinking on the intensive capital tie-up in the water business field, it must also be considered that substantial premium losses had to be expected in any sale. Also, the opportunities from water business were not being sufficiently considered. Confining the discussion to a mere look at the segment itself was wrong-headed, he felt. Not enough heed was being paid to the risk spreading argument, in particular. He felt that it was crucial that the certainty associated with regulated business had a favorable effect on the Group in the medium to long term. It was also important to retain competence in water business. Abandoning the water business was destroying value, he said.

Mr. Roels replied that he respected Mr. XXX's doubts as regards the correctness of the strategy change. He stressed that planning did not provide for an exit from water business in Germany. Here, there were synergies to be had with other business fields. Such synergies did not exist in the case of American Water. The planned entry into the US electricity market after 2001 had failed to materialize. Before a final discussion of any strategy change by the Supervisory Board, the advantages and disadvantages as well as the financial consequences of such a strategy change would be investigated and described.

Mr. XXX emphasized that, for him, an in-depth discussion of the long-term perspectives for water business and the associated risk and return expectations, on the one hand, and early involvement of the Supervisory Board, on the other, were very positive. He wished to ask the Executive Board to clarify the following 6 points before a final debate in the Supervisory Board on a possible strategy change:

- a) a clear, figures-backed statement on the future of the water market;
- b) stand-alone perspectives for American Water and Thames Water;
- c) the financial implications of the planned transactions, taking special account of any write-downs, and submission of pro-forma balance sheets;
- d) the implications for key ratios, specifically the free cash flow, in planning, and an account of the capital flows;

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- e) specific statements on the exit strategy, including the requirements to be met in communicating any changes;
- f) expectations on growth and risk diversification in the future.

Here too, it was important to realize that nobody has ever grown by adopting a shrinking processes.

In the preparations for a final discussion of a possible strategy change, Mr. XXX requested that adequate heed be taken of Mr. XXX's misgivings. In this connection, he expected submission of facts on the opportunities and perspectives for the water business field.

The XXX pointed out that the conduct of the competition could not in itself be an argument. After all, there were too many examples in various industries of collective wrong decision-making. Answering a question from the XXX as to whether the Executive Board would receive a mandate for further exploration of a possible strategy change, the Supervisory Board members gave their assent.

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Excerpt from the Supervisory Board minutes dated November 4, 2005

On item 1 of the agenda – Strategic alignment of the Group,

Mr. Roels, on the basis of the many Presidium discussions during the previous six weeks and the advance discussions in the Supervisory Board, started by explaining the thinking of the Executive Board on water business.

The main objects of the acquisition of the water business five years previously had been to establish a water-business line and reach an international size, and to obtain profitable growth and spread risks by having a global multi-utility portfolio. Actual goal achievement presented a more differentiated picture overall, however. Building up an international presence by acquiring Thames Water and American Water had been associated with a high entry price, Mr. Roels said. The water market as a whole had evolved otherwise than expected. It was now clear that size no longer matters. The underlying political conditions for the water market had tended to worsen. These adverse developments on the water market had also had an impact on performance. It had been particularly disappointing, Mr. Roels said, that the Water division had not achieved its growth targets. The risk-reward ratio had clearly evolved at RWE's expense. At international level, unkept promises by government authorities, and in particular faulty market assessments, had led to considerable losses. In some countries, the outperformance chances had grown steadily smaller than the penalization risk in any non-achievement of the agreed output targets. An offset between the business fields "Water" and "Wastewater" was inadmissible in the UK. A look at the budget figures for Thames Water and American Water clearly showed that the previously announced targets had been chronically too optimistic.

[REDACTED]. At the time of the acquisition, it had still been assumed that the value-add would be positive after 2005. The fall in the operating result was mainly due to cost increases and too-optimistic assumptions about growth and efficiency.

[REDACTED] Thames Water, too, has had to scale back its targets. Crucial here had been higher costs and overly optimistic efficiency assumptions.

[REDACTED] The new budget, which is based on much more realistic suppositions, showed many more downsides than upsides for the water area.

All in all, it was said, a strategic assessment of the two acquisitions after five years tended to be rather negative, even looking beyond the ratios. There were only limited synergies with other areas, and no material synergy effects between American Water and Thames Water either. Characteristic of water business is high capital intensity. As soon as agreement is reached with the regulator, the Company has to meet its investment duty if it is not to lose its operating license. In the next decade, significant additional capital spending is expected in order to meet the regulator's requirements. This would also reduce the available funds for investing in electricity and gas business, e.g. in power plants and grid renewals. After five years, it must now be said that horizontal integration as the core idea of a multi-utility concept has failed. This was now widely recognized, so that most competitors had taken leave of this strategy. Another reason for this was that

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water business had a disproportionately high need for capital without offering correspondingly high return.

This being so, there were a number of arguments in favor of selling American Water and Thames Water. The risk-reward balance, for instance, was poorer than in the energy area. The trend toward under-performance compared with electricity and gas was ongoing. The options for increasing performance had to be regarded as limited. To this had to be added a considerable rise in capital needs with all the adverse implications for the free cash flow. Mr. Roels made reference to the fact that the Supervisory Board in recent weeks had held in-depth discussions about the regulatory duties of the Group's water companies. The output parameters were crucial variables for the regulator. While American Water and Thames Water were liable for any missed targets, there was the simultaneous risk that certain costs could not be passed on to customers at all or not in full. A sale of American Water would also mean that RWE in future need not fear any exposure as regards the jurisdiction of American courts in the event of any class actions. All of these arguments meant that the capital market placed a relatively low value on the RWE Group's water activities. Hence, a sale would have a positive effect on the ratios and would also enable the Group to grow in electricity and gas. In the Executive Board's opinion, it would be possible to largely manage any inherent risks from the power and gas market by vertical integration and extensions to the geographic focus. What is more, it was said, the valuation of pure-play water companies is favorable at present.

In addition, divestments would increase the Group's financial flexibility. In the European energy environment, there would be more attractive growth options in future. Selling American Water and Thames Water would boost the leeway for acquisitions, which was currently some € 5 billion, to about € 15 billion.

This being so, the Executive Board proposed the following change of strategy: In future, the Group would focus mainly on electricity and gas in the European core area. RWE would remain engaged in water business in the regions, however, wherever this is compatible with RWE Energy's regional strategy. The Company's presence in most or all of the links in the value-add chain would help reduce volatility. In this way, there would be the possibility of generating stable cash flows from the regulated grid business for electricity and gas. It was the aim of RWE to gain significant market shares in those countries where the Company operates. Also, the Company proposed to raise additional value potentials. The extra financial flexibility obtainable by selling American Water and Thames Water would permit the Company to utilize the possibilities offered by the next consolidation wave in the energy sector.

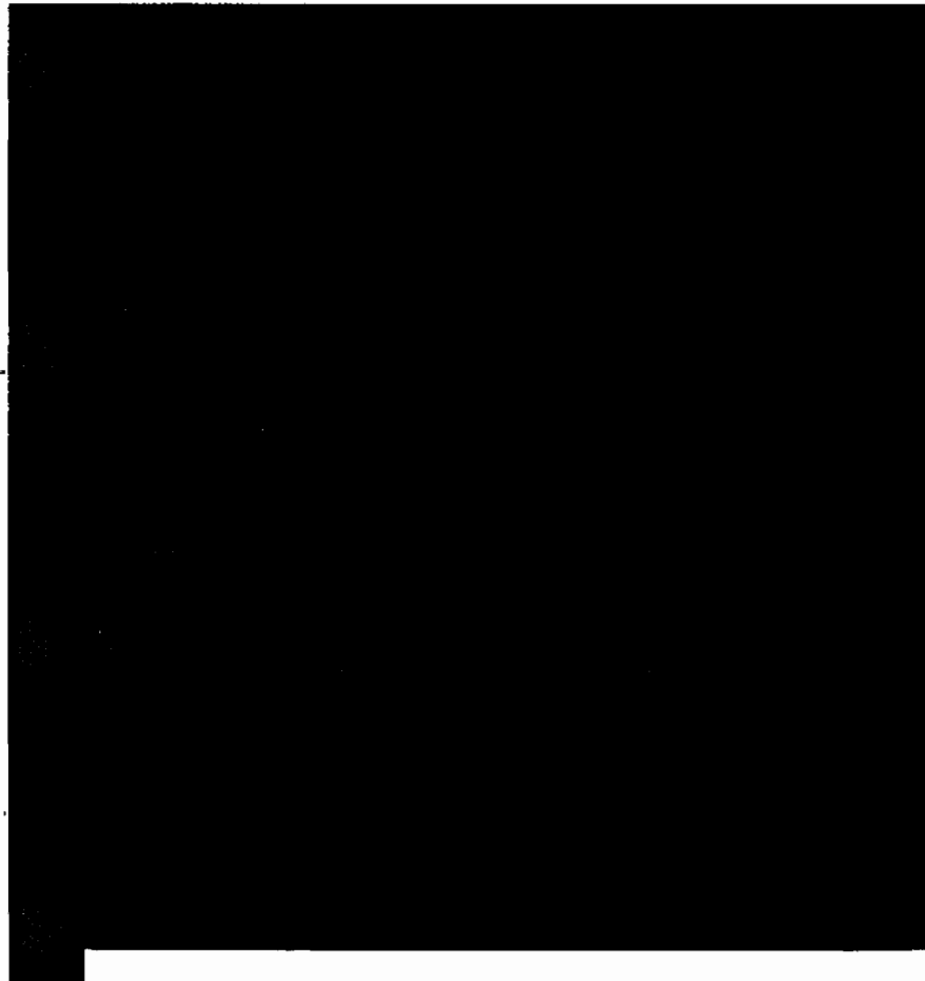
In any future acquisitions, stringent criteria would be set. In strategic terms, what mattered here, first and foremost, was a strengthening of RWE's market position. Any takeover targets would have to be attractive as regards growth potential, risk profiles, market position and regulations. The quality of the target companies' business would be of special importance in this respect. At any event, synergy potential with other RWE companies and the potential for stand-alone efficiency increases would have to be present. On the financial side, the return on capital employed would have to be above the pre-tax capital costs no later than the third full year of consolidation. What was required was additional value-add. The assessment would take account of the operating assets, including any goodwill.



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The internal rate of return would have to be above the yield stipulations. In this respect, the Executive Board would be very disciplined in making use of the financial leeway gained from the sale. The Group's healthy financial position after American Water and Thames Water are sold would offer a guarantee that there is no need to be forced to act.

Mr. Roels then went on to illustrate the time frame for the planned implementation of the various measures. The intention was to start with the sale of American Water, because the process in its case – due to there being regulators' approval rules in at least 14 states – would be much more complicated in the United States than in Britain, where only Ofwat's consent would be required. In both markets, several sales options were being investigated. In the light of today's knowledge, the best marketing options were likely to be an IPO – be it in one or more steps – or a private placement. Also conceivable was a mixed form (hybrid) of the two transactions. The aim was to complete the two transactions in the 2007 financial year. Before the Thames Water transaction would be initiated, planning called for a retransfer of the interest-securing instruments that had been concluded when Thames Water was bought and which are currently in the money, in order to obtain the market value.



Debate:

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Mr. XXX explained that the planned strategy change must be closely scrutinized. The Supervisory Board had supported the multi-utility strategy when American Water and Thames Water were bought. [REDACTED]

[REDACTED] In view of the interest of 5-6% on the capital employed in the water area and interest of 8 to 12% of the capital employed in the energy area, it had to be asked whether – in the light of the upcoming liberalization of the gas market – there might not be a danger that the margin in this business field would come under pressure. To this must be added the fact that the energy utilities would increasingly be entering into direct gas acquisitions. Here, it was conceivable that a 60% share of sales revenue might be jeopardized. Nor should it be ignored that energy prices were increasingly becoming a focus of politics and that the margin could come under pressure for that reason as well. Mr. XXX went on to explain that he felt uneasy hearing the water business being identified as a supplementary business. This implied that water was no longer a core business.

Mr. XXX also asked why the pay-out of a special dividend was envisaged from the inflow of funds from the sale of American Water and Thames Water. In his view, this contradicted the argument of high capital tie-up in these companies. The readiness of the Executive Board to propose the payment of a special dividend, he felt, was a sign that RWE's willingness to make acquisitions was not high. His impression was that what seemed to matter was a downsizing of the Company.

Regarding the negative value-add by American Water until 2010, Mr. Roels explained that none of the expectations that had attached to American Water had been fulfilled. To this must be added, he said, that the interest rate had fallen significantly in the US since the acquisition. Besides this external factor, there had also been a range of endogenous factors. For instance, American Water had had to face considerable cost hikes. Rises in efficiency were not implemented as planned. Regarding Mr. XXX's remarks on the gas market, Mr. Roels explained that an absolute return for this business field could not be guaranteed, of course. However, a comparison of energy markets with the water market showed that, in the water business field, lower return was earned across the entire business cycle than in the energy area. Both the electricity and the gas market did in fact carry risks, although these are manageable in the Executive Board's opinion.

[REDACTED]

[REDACTED]

- 5 -

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- 6 -

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- 7 -

[REDACTED]

[REDACTED]

[REDACTED]

On the planned strategy change, Mr. XXX noted that the Executive Board had submitted convincing arguments at the time when Thames Water and American Water had been bought. Today, the Executive Board would submit a new concept which, for him, had the same convincing reasons as the previous concept. Regarding a study by Goldman Sachs on water business, Mr. XXX then pointed out that the study was of the opinion that water business would become the oil business of the decade from 2020 to 2030. Investment in such a business field required stamina, therefore. In view of the fact that the Executive Board knew best what was happening on the water market, he would nevertheless follow the Executive Board's proposal. In this respect, he was also aware that any rejection of the planned strategy change by the Supervisory Board would lead to a problem for the Supervisory Board with the Executive Board as a whole.

Mr. Sturany in this connection recalled that the Group's electricity and gas business had been suffering considerably from the consequences of the beginning liberalization of the electricity market at the time when Thames Water and American Water were bought. Back then, much-reduced investment in new power plants, too, had been planned. He went on to explain that the actual problem was due to developments in the free cash flow. When the stakes in American Water and Thames Water were acquired, the electricity price had been € 17/MWh. Today, the corresponding forward price for the year 2006 stands at € 40/MWh.

On this, Mr. XXX remarked that the Executive Board knew at the time of its decision what would be upcoming for RWE in the way of new investment. At the time, the Executive Board had mounted a DM 20 billion program in connection with the development of the Garzweiler II lignite deposit, so that there could be no talk of much-reduced scheduled investment in new power plants.

Mr. XXX pointed out that reference to a supposedly faulty market assessment at the time American Water and Thames Water were bought was problematical. It could be observed in general that capital markets are guided by short-term assessments. In this case, however, a long-term view is called for. With reference to the Goldman Sachs market study quoted by Mr. XXX, Mr. XXX remarked that this was obvious to him as well. From an analysis by the Executive Board, it had become clear that the regional approach was quite correct. Still, this only meant that selling the holding in American Water was justified. In its water business, RWE must focus on Europe. To the extent that this concerns the

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holding in Thames Water, he had serious doubts about the viability of the arguments presented.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]. In connection with the discussions about the most recent planning by American Water's management, it had become clear to him that leakage problems in the US would tend to worsen in future. For instance, the share of water production in New Jersey that is lost by leakage had risen from 15% to currently 18%. The comparable value for Pennsylvania stood at 30%. While replacing Thames Water's entire pipe system would take 125 years at the current renewal rate, the corresponding figure for American Water was over 200 years. The reason for this extraordinarily high value was that American Water, across a period of several years, had not met regulatory stipulations in various US states. In part, this was due to insufficient investment by American Water in the previous 10 years prior to RWE acquiring its holding. In view of this renewal backlog, there ought to be no investment restraint in dealing with these defects. The elimination of major deviations from regulators' stipulations is likely to last into the year 2008.

[REDACTED]

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[REDACTED]

[REDACTED]

Mr. Sturany added that, in this respect, the issue of the free cash flow was of special significance. As regards planning at American Water, he explained that planning on free cash flow I submitted by American Water's management was unrealistic due to delayed investment. For him, it had become apparent that RWE would be unable to optimally develop its water business with an increased capex.

[REDACTED]

[REDACTED]

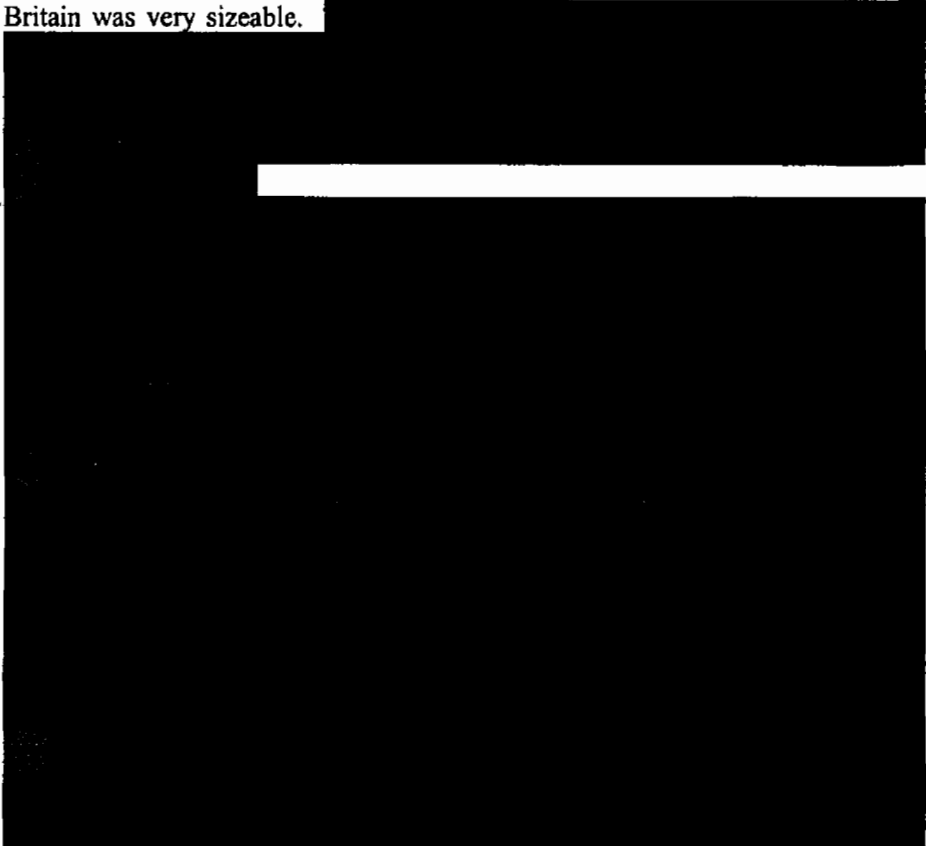
Mr. XXX pointed out that he had no problem with the planned strategy change and the associated focusing, wherever this concerns American Water. However, he did have trouble comprehending the scheduled measures in the UK. He requested an explanation of the main differences in medium-term planning at American Water and Thames Water. Mr. Roels then explained the chief reasons for the deterioration in the planning of Thames Water and American Water. These largely involved reduced quantity effects, the non-materialization of planned growth and non-achievement of targets under efficiency programs. This was true of both American Water and Thames Water. Mr. Sturany added that, owing to the price regulation, the underlying data would largely be fixed for Thames Water in respect of the period AMP4. By contrast, America's regulation was less efficiency-driven.

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Mr. XXX pointed out that, in his assessment, the problems at American Water were greater than those at Thames Water, so that he would back the planned sale of American Water without further ado. By contrast, he, too, had problems with following the planned strategy change as regards Thames Water. Mr. Sturany replied that the problems from the bottleneck in the free cash flow were much greater in the British business than in the American business, so that it was necessary to shed this business as well.

Mr. XXX referred to the fact that, in connection with the purchase of Thames Water and American Water, acquisition premiums of 45% had been paid. There was a considerable risk that these acquisition premiums would be lost in any sale of American Water and Thames Water. He still believed the three-pillar strategy pursued by RWE was correct. As regards RWE's future activities in continental European water business, he expected the Executive Board to declare that RWE's water business would remain a core business. He would back the envisaged sale of American Water, though this by no means applied to the sale of Thames Water.

Mr. Roels remarked that he could quite easily imagine that the water business would remain in the Group as part of RWE Energy's business as an additional business field. Still, it would be hard to convey to others the logic of shedding American Water while retaining the holding in Thames Water. The staggered sequence of the planned sale was due to the fact that the transactions concerned – owing to the requirements of regulatory approvals in a number of US states – could not be handled by a certain cut-off date. In this connection, Mr. Sturany again explained that the bottleneck from the free cash flow of Thames Water in Britain was very sizeable.





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[REDACTED]

[REDACTED]

[REDACTED]

Mr. XXX then asked Mr. Sturany whether business secrets would be safeguarded also in dealings with analysts. Mr. Sturany confirmed this. Mr. XXX recalled that he had on various occasions in the past already demanded that a strategy discussion be held. The Supervisory Board must, in its view, say from time to time in which direction the Company should be evolving. Basically, he agreed with Mr. XXX's opinion. The selling process for American Water could be initiated immediately. By contrast, the decision on whether Thames Water should be sold could not be taken until the Executive Board was able to name specific acquisition projects on the markets for power and gas.

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In reply to a question addressed to Mr. Roels from XXX as to whether it would be conceivable to split the water business in such a way that American Water would be sold and the stake in Thames Water retained, Mr. Roels said that the Executive Board had checked very carefully whether this option existed. The logic of such a decision would be hard to convey, however. For Thames Water, the point was that the risks and rewards from this participation were not in balance, so that the Executive Board had found no arguments in favor of this variant. If the Company took a decision in favor of this variant, he feared that the capital market would reject this strategic decision on account of its inconsistency. Critical questioning of Thames Water's planning had shown that no improvement of the situation is probable in the next two years.

[REDACTED]

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Excerpt from the Supervisory Board minutes dated February, 21 2006

Mr. Roels then went into the progress made by the various M&A projects. He started by reporting on the current position of the divestment process at American Water. As agreed in the meeting held on November 4, 2005, the most attractive marketing options – IPO and/or private placement – were being scrutinized in depth. In the run-up to the planned disposal activities, the investment bank acting as consultancy had informally contacted a number of potential buyers. This had yielded follow-up talks with [REDACTED]

[REDACTED]. As things stood today, however, an IPO of American Water would be the most probable route.

In parallel to the disposal talks, the most important legal and organizational steps required by the planned sale had been taken. Project teams were working on the models for re-financing inter-company receivables and on the optimal transaction structure. Also, the launch of a risk-management and control system had started which would meet the SOX requirements. Besides this, the applications for the disposal approvals of the various regulatory authorities were being prepared. What mattered here, among other things, was to provide evidence of the advantages of a sale for American Water and its customers in the various states.

[REDACTED]

[REDACTED]

Debate:

[REDACTED]

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[REDACTED]

[REDACTED]

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Excerpt from the Supervisory Board minutes dated April 13, 2006

Mr. Roels then reported on current M&A projects and started with the planned sale of American Water. At the time of the most recent meeting, RWE had been submitted an indicative offer from [REDACTED]

As notified, RWE had again scrutinized this offer under price and risk aspects and re-negotiated it with the investor. Still, no satisfactory agreement could be reached. Mr. Roels reminded those present that the examination by the regulatory authorities would take much longer in a sale to an infrastructure fund and constitute a higher risk than an IPO. [REDACTED]

[REDACTED] RWE's lawyers were convinced – a conviction shared by its legal department – [REDACTED]

RWE was now concentrating on an IPO. In the next few weeks, RWE would be selecting the banking syndicate that is to back the IPO. Probably in the second half of the year, a due-diligence check would be made and the stock exchange admission prospectus drafted.

Besides this, RWE had triggered the regulatory approval procedure in a total of 15 US states that require approval. In addition, RWE had continued its work on launching a risk-management and control system that meets the SOX requirements. Depending on the outcome of these two procedures, American Water could be listed in the second half of 2007.

The re-financing of the inter-company receivables of American Water was making headway. At the start of the month, a bidding procedure for a short-term credit facility had been launched. Successful negotiations provided, it could be available to American Water as early as the end of the second quarter. Thereafter, American Water would issue a commercial-paper program and in the sequel ensure medium- and long-term financing by issuing bonds and, possibly, hybrid capital. The re-financing process would at any rate be completed before title passes.

In this connection, Mr. Roels briefly dealt with three personnel matters. As of April 17, 2006, Donald L. Correll had been appointed American Water's CEO and President. With this move, the US manager with experience in IPOs and the water sector would replace George MacKenzie who had performed the function of CEO on an interim basis only and had now returned to the Board of American Water, initially as an ordinary member. The plan was that he take over the position of Chairman of the Board from Jeremy Pelczer who is now CEO at RWE Thames Water. Some weeks ago already, RWE had been able to win again the former CFO, Ms Ellen Wolf, for this function. At RWE Thames Water, too, there had been changes. Within the scope of preparing for the sale, RWE had parted with Tim Weller, CFO. The finance portfolio is currently being managed by Ralph Lindackers on an interim basis. The search for an experienced British CFO had been started.

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Answering a question from Mr. XXX as to the resistance of American local governments to an IPO of American Water, Mr. Roels explained that this concerned a few isolated cases. About half a dozen US local governments had advocated a re-transfer of their various water-supply systems. To that extent, it was only natural that these local governments were now attempting to acquire their water supply within the scope of the upcoming IPO. Such acquisition offers would be very carefully vetted in each case. Wherever occasional attempts had been made in the past to take American Water's stakes in local water suppliers within the scope of expropriation proceedings, such proceedings had been regularly won. In view of American Water's multitude of water holdings, such attempts are day-to-day business at the company.

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