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May 8, 2007

CERTIFICATE OF SERVICE

RE: Case No. 2007-00104
Kentucky-American Water Company aka Kentucky American Water

I, Beth O'Donnell, Executive Director of the Public Service Commission, hereby certify that the enclosed attested copy of the Commission's Order in the above case was served upon the addressee by U.S. Mail on May 8, 2007.

A handwritten signature in black ink, appearing to read "Beth O'Donnell", written over a horizontal line.

Executive Director

BOD/sh
Enclosure

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY-AMERICAN)	
WATER COMPANY FOR APPROVAL OF)	CASE NO. 2007-00104
DEBT ISSUANCE)	

ORDER

Kentucky-American Water Company ("Kentucky-American") has applied for approval of a \$14 million promissory note for long-term borrowing issued to American Water Capital Corporation ("AWCC") on March 1, 2004. At issue is whether the Commission may retroactively approve the issuance of evidences of indebtedness that were issued without prior Commission authorization. Finding in the negative, we deny the application.

Kentucky-American is a Kentucky corporation that owns and operates facilities that treat and distribute water to the public for compensation in Bourbon, Clark, Fayette, Gallatin, Grant, Harrison, Jessamine, Owen, Scott, and Woodford counties, Kentucky. It provides wholesale water service to Harrison County Water Association, Jessamine-South Elkhorn Water District, and the cities of Georgetown, Midway, North Middletown, Nicholasville, Versailles, and Winchester. It is a utility subject to Commission jurisdiction.¹

¹ KRS 278.010(3)(d).

In Case No. 2000-00189,² Kentucky-American sought Commission authorization to participate in a borrowing program that American Water Works Company (“American Water”) made available to each of its subsidiaries. Under this program, each American Water subsidiary entered into an agreement with AWCC, a wholly owned subsidiary of American Water, for financial services. AWCC would arrange for a syndicated bank credit line to provide for short-term loans and register its own debt securities for sale in the public market by filing shelf registration with the Securities and Exchange Commission. Each participant would provide AWCC with an estimate of its future borrowing requirements. AWCC would arrange borrowing commitments and programs to meet these commitments. The liability of each participant in the program was limited to its individual debt. All loans to the program participants were unsecured.

In support of its application, Kentucky-American asserted that pooling the borrowing requirements of American Water and its subsidiaries would result in lower capital costs. Because the issuance costs associated with debt instruments will generally remain constant regardless of the size of the issuance, the pooling of long-term debt requirements would produce a reduced pro rata share of issuance costs for the program participants. Kentucky-American further asserted that larger sized debt issuances in the public market produced more favorable terms because lenders of larger loans are able to share their risk with others.

After considering Kentucky-American’s application, the Commission on July 21, 2001 found that Kentucky-American’s entry into the proposed Financial Services

² Case No. 2000-00189, The Application of Kentucky-American Water Company for Approval of Participation in the Borrowing Program (Ky. PSC July 21, 2000).

Agreement (“Agreement”) was appropriate for its provision of utility service and authorized Kentucky-American to enter into the Agreement and to issue securities in the form of notes or debentures in the amount of \$41.5 million prior to December 31, 2005.

On March 9, 2007, Kentucky-American applied to the Commission for approval of the issuance of a promissory note to AWCC for \$14 million. Kentucky-American issued this note on March 1, 2004 under the auspices of the Agreement. The note was for a term of 10 years. Kentucky-American used the proceeds of this note to refund and refinance then existing short- and long-term debt.³

This note represented the third promissory note issued under the auspices of the Agreement. Kentucky-American had previously issued promissory notes to AWCC for \$15.5 million on March 29, 2001 and for \$24 million on June 12, 2002.⁴ Although the \$14 million promissory note exceeded the \$41.5 million limit that the Commission placed on borrowing from AWCC under the Agreement, Kentucky-American asserts that the issuance did not exceed “the authorization of the Commission in Case No. 2000-00189.”⁵

The Commission finds little merit in Kentucky-American’s position. As we specifically limited our authorization to a total debt issuance of \$41.5 million and expressly directed Kentucky-American to seek prior Commission approval for any debt issuance that would result in a cumulative debt exceeding that amount, Kentucky-American’s characterization of its action as consistent with our Order of July 21, 2000 is

³ Application at 5.

⁴ Id. at 3.

⁵ Id. at 6.

disingenuous. Kentucky-American's issuance of the promissory note in question was clearly contrary to the express provisions of that Order.⁶

Moreover, Kentucky-American's actions are contrary to KRS 278.300(1), which provides:

No utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized so to do by order of the commission.

This statute required Kentucky-American to seek our authorization prior to its issuance of the promissory note to AWCC for \$14 million.

The relief that Kentucky-American seeks is retroactive authorization to issue evidences of indebtedness. The Commission has consistently held that such authorization is not permissible. In Case No. 2005-00058,⁷ when rejecting a similar request for retroactive authorization to issue evidences of indebtedness, we stated:

KRS 278.300 makes no provision for the Commission to retroactively approve a utility's issuance of evidences of indebtedness. Moreover, to engage in such practice would encourage utilities to enter into unauthorized transactions without obtaining the necessary regulatory approval and then present the transaction to the Commission as a fait accompli. Utilities that have failed to observe the law should not be excused from its requirements. For these reasons,

⁶ Kentucky-American's action represents the second known instance in the last two years in which the water utility has failed to comply with a Commission Order requiring prior Commission authorization. See Case No. 2002-00277, Compliance of Kentucky-American Water Company, American Water Works Company, RWE Aktiengesellschaft and Thames Water Aqua Holdings GmbH with the Provisions of the Orders Approving the Transfer of Control of Kentucky-American Water Company To RWE Aktiengesellschaft and Thames Water Aqua Holdings GmbH (Ky. PSC May 19, 2006).

⁷ Case No. 2005-00058, Kentucky Infrastructure Authority's Joint Application on Behalf of Certain Water Districts for Authority to Borrow Funds to Refinance Certain Indebtedness to the Kentucky Infrastructure Authority (Ky. PSC Aug. 26, 2005) at 4.

the Commission has historically refused to retroactively approve a utility's issuance of evidences of indebtedness. See, e.g., Kenton County Water District No. 1, Case No. 91-046 (Ky. PSC Nov. 8, 1991) at 4 ("As no purpose will be served by the post-execution approval of these documents, the Commission will not stamp its imprimatur upon these documents.")

The same reasoning applies here.

Kentucky-American's failure to comply with the requirements of KRS 278.300(1) represents a serious breach of its statutory obligations as a public utility. Whether such breach mandates administrative sanctions, to possibly include the imposition of a civil penalty, will be the subject of a forthcoming proceeding. In the interim, we have determined that additional controls should be imposed over Kentucky-American's issuance of evidences of indebtedness in conjunction with the AWCC Borrowing Program to ensure compliance with our Orders and KRS 278.300. In approving Kentucky-American's continued participation in that program, we have conditioned our approval upon Kentucky-American providing 15 days prior written notice to the Commission of each issuance of any long-term debt in conjunction with the AWCC Borrowing Program and the sworn written certification of Kentucky-American's President and Treasurer of the amount of the issuance and the debt issuance's compliance with our Orders and KRS 278.300.⁸

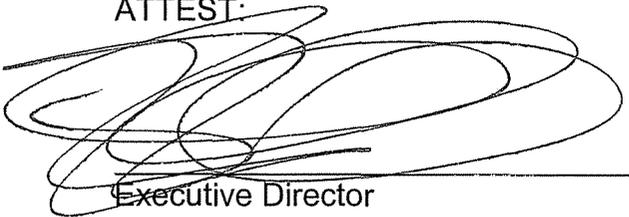
IT IS THEREFORE ORDERED that Kentucky-American's application for approval of a \$14 million promissory note for long-term borrowing issued to AWCC on March 1, 2004 is denied.

⁸ Case No. 2006-00418, Application of Kentucky-American Water Company for Continued Participation with American Water Capital Corp. (Ky. PSC May 8, 2007).

Done at Frankfort, Kentucky, this 8th day of May, 2007.

By the Commission

ATTEST:



Executive Director