COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION FOR APPROVAL OF THE TRANSFER OF CONTROL OF KENTUCKY-AMERICAN WATER COMPANY TO RWE AKTIENGESELLSCHAFT AND THAMES WATER AQUA HOLDINGS GMBH	)	CASE NO. 2002-00018

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O R D E R

Kentucky-American Water Company (KAWC) and Thames Water Aqua Holdings GmbH (Thames) (collectively Joint Applicants) have applied for Commission approval of the transfer of control of KAWC to Thames and to RWE Aktiengesellschaft (RWE), Thames corporate parent. At issue is whether Thames and RWE have the managerial, technical and financial ability to provide reasonable utility service and whether the proposed transfer of control is in the public interest. We find in the affirmative on the former issue, but conclude that a finding in the affirmative on the latter issue is dependent upon the acceptance of certain conditions by the Joint Applicants, RWE and American Water Works Company (AWWC).

PROCEDURE

On January 14, 2002, the Joint Applicants advised the Commission of their intent to apply for Commission approval of the transfer of control of KAWC to Thames and to RWE and requested that electronic filing procedures be used in our review of that application. On January 30, 2002, we established this docket to review the proposed transaction and further established procedures for the electronic filing of documents and pleadings in this docket. The next day the Joint Applicants filed their application.

Shortly thereafter, they moved for the establishment of a procedural schedule that allowed for a 120-day review period.[1]

On February 15, 2002, the Commission established a procedural schedule for this docket. Recognizing this case s complexity and its significance to the economy of central Kentucky, we found that good cause existed to extend the review period to 90 days and established a procedural schedule to meet this time requirement. Because of disputes between the parties over the production of documents and the level of public access to certain documents, the Commission subsequently extended the review period to 120 days.

The following parties have been granted leave to intervene in this proceeding: Attorney General s Office of Rate Intervention (AG); Lexington-Fayette Urban County Government (LFUCG); and, Bluegrass FLOW, Inc. (Bluegrass FLOW).

Following extensive discovery by the parties in this matter, the Commission held a public hearing on April 2 and 10, 2002 and May 1-2, 2002, at our offices in Frankfort, Kentucky. The following persons testified at these hearings: James McGivern, Managing Director, Thames Water Plc; Roy W. Mundy II, president of KAWC; Charles F. Haywood, consultant; Linda C. Bridwell, Director of Engineering, KAWC; Daniel L. Kelleher, Vice President, AWWC; Michael Carmedy, Senior Vice President and Commercial Director, Thames Water Americas; and Scott J. Rubin, attorney and consultant. The Commission also solicited and heard public comments on the proposed

[1] KRS 278.020(5) requires the Commission to complete its review of any application for transfer of control of a utility within 60 days of the application s filing. The Commission may if it is necessary, for good cause shown, . . . continue the application for up to sixty (60) additional days.

transaction at these hearings.[2] Following the hearing, all parties submitted written briefs.

THE PROPOSED TRANSACTION: AN OVERVIEW

KAWC is a Kentucky corporation that serves approximately 100,000 water customers in Fayette, Bourbon, Clark, Harrison, Owen, Scott, and Woodford counties, Kentucky. It provides wholesale water service to the cities of Midway, North Middleton, Georgetown, and Versailles, Kentucky; Jessamine-South Elkhorn Water District; and Spears Water Company. KAWC also owns and operates wastewater collection and treatment facilities that serve approximately 80 customers in Clark County, Kentucky. KAWC was originally incorporated in 1882 as Lexington Water Company and has provided continuous service to Lexington, Kentucky and its surrounding area since shortly after its incorporation.

AWWC, a Delaware corporation, owns all of KAWC s common stock. AWWC is a publicly traded water and wastewater services company. It owns and operates regulated utility subsidiaries that provide water or wastewater service to approximately 10 million persons in 23 states. It also owns subsidiaries that provide water and wastewater management services to municipal and other governmental entities. Through these subsidiaries, it manages and operates 1,000 water or wastewater facilities that serve approximately 5 million persons in 18 states and three Canadian provinces.

[2] The following persons made public comments: Joanne Bell; Chetan Talwalkar; James Peck; Andy Slone; Governor Edward T. Breathitt; Thomas P. Dupree; Emma Tibbs; Joe Graves; Richard Moloney; William L. Quisenberry; Mayor Foster Pettit; Don Slagel; Joan Crowe; Don Pratt; and Don Dampier. No KAWC employee spoke at these hearings or submitted written comment against the proposed merger.

RWE, a corporation formed under the laws of the Federal Republic of Germany, is a management holding company. It is Germany s fifth largest industrial group and is a leading international multi-utility provider with core businesses in electricity, water, gas and waste management and utility-related services. RWE has 12 major operating subsidiaries in more than 120 countries on six continents and employs 170,000 persons worldwide, of which 16,000 are based in the United States. It reported $43.7 billion in sales for the fiscal year ending June 30, 2000.[3] Moody s Investors Service reported in 2001 that RWE has a strong financial profile.[4] Standard & Poor s and Moody s Investors Service currently give RWE credit ratings of AA- and A1, respectively.[5]

Thames, a corporation formed under the laws of the Federal Republic of Germany, is a wholly-owned subsidiary of RWE and serves as the holding company for RWE s water and wastewater operations. As of December 31, 2000, it had assets with a book value of $6.4 billion.[6] For the fiscal year ending June 30, 2001, Thames reported external net sales of 1,690 million euros, generating 821 million euros in earnings before interest, taxes, depreciation, and amortization and 563 million euros in operating results. As of December 31, 2002, Standard & Poor s and Moody s Investors Service give Thames credit ratings of AA- and A1, respectively.[7]

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[3] Joint Applicants Response to the Commission s Order of January 30, 2002, Item 1(a) at 1.

[4] Joint Applicants Brief at 6.

[5] Id.

[6] Joint Applicants Response to the Commission s Order of January 30, 2002, Item 7 at 17.

[7] Joint Applicants Response to the Commission s Order of January 30, 2002, Item 7 at 18.

Thames has delegated the full power and authority to operate Thames subsidiaries, including its current and future subsidiaries in America, to Thames Water Plc (Thames Water). Thames Water, a public limited corporation organized under the laws of the United Kingdom, is the largest water and wastewater utility in the United Kingdom and one of the three largest water/wastewater services companies in the world. It provides water-related services to over 43 million people by managing and operating over 540 water/wastewater facilities in 44 countries. Thames holds all of Thames Water s stock.[8]

On September 16, 2001, RWE, Thames, AWWC and Apollo Acquisition Company (Apollo), a wholly-owned subsidiary of Thames, executed an Agreement and Plan of Merger (Acquisition Agreement). This agreement provides that AWWC will merge into Apollo and, upon completion of the merger, become the surviving corporate entity. At the merger closing, Thames will pay $46 for each share of outstanding AWWC common stock that is not owned either by Thames or AWWC.[9] Based upon the number of outstanding shares of AWWC common stock as of December 31, 2001, Thames total payment for this stock will be $4,600,661,572. RWE intends to finance this payment through the issuance of bonded debt.

The redemption price specified in the Acquisition Agreement represents a significant increase over the market price of AWWC stock at the time of the Acquisition Agreement s execution. The market price of AWWC stock at the close of 2000 was

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[8] Because of their close corporate relationship, any reference in this Order to Thames water operations refers to the activities of Thames and Thames Water.

[9] The Acquisition Agreement requires AWWC to redeem all outstanding shares of preferred and preference stock for $25 and $35, respectively, prior to the closing date.

$29.38 per share. Prior to the merger announcement, AWWC s share price was $34.12. In the two-week to three-week period prior to the first public revelation of negotiations between RWE and AWWC, AWWC s share price ranged from $33.68 to $33.29.

A special meeting was held on January 17, 2002, asking the stockholders of AWWC to consider and vote upon a proposal to adopt the Acquisition Agreement and plan of merger between AWWC and Thames.[10] At the special meeting, the AWWC stockholders voted to approve the Acquisition Agreement.[11]

The proposed merger has no immediate or direct effect upon KAWC. None of its stock or debt is involved. The Acquisition Agreement requires no change in KAWC s financial or management structure. As AWWC owns all of KAWC s outstanding common stock, however, RWE and Thames will effectively acquire control of KAWC when the proposed merger is completed.

STANDARD OF REVIEW

KRS 278.020 requires Commission review and approval of any change in or transfer of control[12] of a utility. KRS 278.020(4) provides:

> No person shall acquire or transfer ownership of, or control, or the right to control, any utility under the jurisdiction of the

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[10] Proxy Statement for the Special Meeting of Stockholders January 17, 2002 at 5.

[11] Press Release, AWWC, American Water Works Stockholders Give Resounding Approval to RWE AG Merger Agreement (Jan. 17, 2002) *available at* http://www.amwater .com / awpr /news/news1317.html.

[12] KRS 278.020(5) defines control as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a utility, whether through the ownership of voting securities, by effecting a change in the composition of the board of directors, by contract or otherwise. Clearly the proposed merger represents a transfer of control of KAWC.

> commission by sale of assets, transfer of stock, or otherwise, or abandon the same, without prior approval by the commission. The commission shall grant its approval if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service.

KRS 278.020(5) provides in part:

> No individual, group, syndicate, general or limited partnership, association, corporation, joint stock company, trust, or other entity (an "acquirer"), whether or not organized under the laws of this state, shall acquire control, either directly or indirectly, of any utility furnishing utility service in this state, without having first obtained the approval of the commission. Any acquisition of control without prior authorization shall be void and of no effect. . . . The commission shall approve any proposed acquisition when it finds that the same is to be made in accordance with law, for a proper purpose and is consistent with the public interest.

Our review of the proposed transaction must address two issues. First, we must determine whether the party acquiring control has the requisite abilities to provide reasonable utility service. Second, we must determine whether the proposed transfer is consistent with the public interest.

KRS 278.020 does not define public interest. The parties agree that a proposed transfer of control is in the public interest when the proposed transfer produces some benefits for the public and does not adversely affect the utility or the quality of its service. They disagree over whether the benefits resulting from the proposed transfer must be immediate and readily quantifiable.

The Commission finds that any party seeking approval of a transfer of control must show that the proposed transfer will not adversely affect the existing level of utility service or rates <u>or</u> that any potentially adverse effects can be avoided through the Commission s imposition of reasonable conditions on the acquiring party. The acquiring party should also demonstrate that the proposed transfer is likely to benefit the public through improved service quality, enhanced service reliability, the availability of additional services, lower rates, or a reduction in utility expenses to provide present services.[13] Such benefits, however, need not be immediate or readily quantifiable.[14]

Bluegrass FLOW and LFUCG assert that any determination of the public interest must consider the possibility of public ownership of the utility facilities and the efforts of local governments to acquire such facilities. In some circumstances, these considerations may be relevant.[15] Generally, however, the Commission s focus must be upon the qualifications of the acquiring party and the potential effects of the proposed transfer. We find no legal authority to support Bluegrass FLOW s assertion that the presence of a local government s willingness to acquire a utility s facilities is sufficient basis for the Commission to delay or deny a private entity s application for approval of transfer of control. To the extent that a local government may wish to acquire a public utility s facilities, the Legislature has provided the necessary means for accomplishing such acquisition without any Commission involvement. See KRS 106.220.

LFUCG asserts that a determination of the public interest also requires a comparison of benefits that the proposed transaction produces for AWWC s

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[13] Potential benefits that fall within these categories include improved security of utility facilities, increased availability of capital for infrastructure improvement, and greater employee training opportunities, and enhanced research and development opportunities.

[14] See, e.g., Case No. 2000-00129, Joint Application of NiSource, Inc., New NiSource, Inc., Columbia Energy Group, and Columbia Gas of Kentucky for Approval of a Merger (Ky. P.S.C. June 30, 2000).

[15] For example, the transfer of control of utility facilities to a person or persons with marginal ability to provide reasonable service, which might not otherwise be in the public interest, may be in the public interest if no local government is willing to acquire the facilities and the only alternative to the transfer is the abandonment of utility service. Clearly, in ruling upon an application for such transfer, we must carefully weigh the lack of any local government effort.

shareholders with those produced for KAWC s ratepayers. It further suggests that the public interest requires AWWC s shareholders to share the enormous cash benefits created by the proposed transaction with KAWC shareholders. LFUCG Brief at 8.

We find no legal support for this proposition. Courts have long recognized that ratepayers are not entitled to a share of a proportion of the proceeds of the sale of capital stock simply because they are the users of the service furnished by the utility. Democratic Central Committee of D.C. v. Washington Metropolitan Area Transit Comm n, 485 F.2d 786, 805 (D.C. Cir. 1973).[16] To the extent that KAWC s ratepayers bore no risk as to fluctuations in the price of AWWC s shares, we find no basis to support any claim to entitlement to any share of the increase in that stock s price as a result of the merger.[17] Any sharing of benefits must be based upon reductions in costs or savings resulting from the proposed merger transaction.

JURISDICTION OVER THE PROPOSED TRANSACTION

Contending that the real parties in interest are not before the Commission Bluegrass FLOW has moved to dismiss the Joint Application for lack of jurisdiction. It asserts that, as AWWC currently owns all of KAWC s stock and as RWE is the owner of all of Thames voting stock, AWWC currently controls KAWC and that RWE will control KAWC upon completion of the proposed transaction. Neither entity is a party to the

[16] See also Board of Public Utility Commissioners v. New York Telephone Co., 271 U.S. 23, 32 (1926) (Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company just as does that purchased out of proceeds of its bonds and stock.).

[17] Democratic Central Committee of D.C., 485 F.2d at 806 (the right to capital gains on utility assets is tied to the risk of capital losses).

current proceeding or has applied to the Commission for approval. KRS 278.020(4) and (5), Bluegrass FLOW asserts, require them to take such action. That corporate subsidiaries of each entity have applied to the Commission for approval of the transaction, Bluegrass FLOW argues, is insufficient. They are not real parties in interest.

Bluegrass FLOW suggests that the absence of RWE and AWWC renders the Commission powerless to impose conditions to our approval of the proposed transaction that related to AWWC or RWE. See Bluegrass FLOW s Motion at 11 (It is not legally possible to bind AWWC and RWE to any condition, restriction, covenant or commitment if they are not parties).

Supporting this motion, the AG argues that the most obvious of parties is absent and that their absence is a jurisdiction flaw. AG s Brief at 3. He states that KRS 278.020 reflects a clear legislative intent for the party with ultimate authority to seek Commission approval and that RWE and AWWC s absences violate the fundamental principle . . . that a party that is the focus or the subject of the Commission s power or jurisdiction is the party that has the obligation and responsibility to appear and participate in the proceedings in front of the Commission. Id. at 4 - 5.

Echoing the AG s position, LFUCG asserts that KRS 278.020(4) expressly requires the entities transferring or acquiring control of a utility, AWWC and RWE, to apply to the Commission for approval of such transfer or acquisition. They cannot . . . be given approval to acquire or transfer ownership when they are not properly before the Commission. LFUCG s Response to Motion to Dismiss at 1 2.

Our review of KRS 278.020 fails to disclose this filing requirement. KRS 278.020 clearly confers jurisdiction upon the Commission over any transfer of control of a utility.

It requires an application for Commission approval and Commission review of the proposed transfer and the acquirer s ability to provide reasonable utility service. KRS 278.020 further provides that the lack of Commission approval, as well as any failure to apply for Commission approval, will render a transfer void. It, however, does not expressly require that a transferor or acquirer apply for Commission approval nor does it prohibit a corporate subsidiary from doing so on behalf of a corporate parent.

We find no legal authority to support the Intervenors contention that the absence of RWE and AWWC deprives the Commission of jurisdiction over the proposed transfer of control or the Joint Application and therefore deny the Motion to Dismiss. The Commission has acted previously upon applications for transfer of control in which an acquirer or transferor was absent from the proceeding.[18] KRS 278.020 confers jurisdiction over the transaction regardless of the parties. This jurisdiction is based upon KAWC s status as a utility and the nature of the proposed transaction. Commission approval of the transaction must be obtained. Regardless of whether an entity associated with the transaction personally appears before us, the failure of that entity to accept reasonable conditions that we attach to our approval will deprive the transaction of our approval.

Of course, the better practice is for all corporate entities to jointly apply for Commission approval. In other cases involving transfers or acquisitions of a similar nature and complexity, the corporate parents applied to the Commission for approval of

[18] See, e.g., Case No. 2001-00399, Petition by Alltel Corporation to Acquire the Kentucky Assets of Verizon South, Incorporated (Ky. PSC Feb. 13, 2002); Case No. 1999-00496, The Application of Covered Bridge Utilities, Inc. For Approval of the Transfer of the Covered Bridge Wastewater Treatment Plant to the Oldham County Sanitation District (Ky. PSC Mar. 13, 2000); Case No. 1997-00300, Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for Approval of Merger (Ky. PSC Sep. 12, 1997).

the transaction and participated as parties.[19] AWWC s and RWE s failure to appear have led us to craft carefully the conditions to our acceptance of the proposed merger to ensure that all appropriate parties are bound.

We find that the absence of AWWC and RWE neither interfered with nor impeded our review nor deprived any party of its right to due process. Although RWE and AWWC failed to appear as parties to this proceeding, the Intervenors and Commission Staff questioned the Joint Applicants extensively about each entity s operations. The Joint Applicants made available AWWC and RWE officials to respond to questions regarding these operations. No intervenor requested the appearance or testimony of any AWWC or RWE employee or official. No intervenor identified any area of inquiry that it was prevented from pursuing by AWWC s and RWE s absence.

While not a party, RWE actively participated in this proceeding. Thames filed the Joint Application on RWE s behalf. RWE conferred authority upon Thames representative to make commitments on its behalf, and this representative has made such commitments. RWE, moreover, has directly made commitments on several issues to the Commission.[20]

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[19] See, e.g., Case No. 2001-00104, Joint Application for Transfer of Louisville Gas and Electric Company and Kentucky Utilities Company in Accordance with E.On AG s Planned Acquisition of Powergen Plc (Ky. PSC Aug. 6, 2001); Case No. 2000-00129, Joint Application of NiSource, Inc., New NiSource, Inc., Columbia Energy Group, and Columbia Gas of Kentucky for Approval of a Merger (Ky. P.S.C. June 30, 2000).

[20] See, e.g., Joint Applicants Response to the Commission s Order of January 30, 2002, Item 44.

ANALYSIS

Provision of Reasonable Utility Service

The proposed merger will not impair or have any immediate effect upon KAWC s ability to provide reasonable utility service to its customers. The Acquisition Agreement requires no change in KAWC s management, labor force, operating practices, or financial structure. Thames Managing Director testified that no changes in KAWC s operations were immediately planned in any of these areas.

The proposed merger will enhance KAWC s ability to provide reasonable utility service at reasonable rates. Upon completion of the transaction, KAWC will have access to Thames resources and expertise. It will allow KAWC to share best operating practices, increase KAWC s access to technical resources, enhance KAWC s access to capital markets, and derive the benefits of Thames research and development programs.

The proposed merger will allow KAWC to draw upon RWE s extensive borrowing power. It will permit KAWC to access world capital markets. As RWE has higher bond ratings than AWWC, capital will likely be available to KAWC at a cost lower than AWWC s. Given the increasing capital expenditures needed to replace aging water infrastructure,[21] access to capital at the lowest possible cost will be critical to KAWC maintaining its present system at the lowest possible rates.

[21] The U.S. Environmental Protection Agency estimates that the total cost to replace and repair water infrastructure needs in the United States for the next 20 years is $150.9 billion. Kentucky s share of this amount was $283 million. See Office of Water, U.S. EPA, Drinking Water Infrastructure Needs Survey: Second Report to Congress 12 and 71 (2001).

Both RWE and Thames have a strong commitment to research and development (R&D). In 2001 RWE spent over $400 million on R&D. Thames has an annual budget of $13 million.[22] Thames has developed cutting-edge technologies in the area of water distribution and transmission. These technologies include alternative water treatment solutions, burst pipe prediction methodology, and trenchless technologies.[23]

Of some significance, given current concerns of terrorist attacks against water infrastructure sites, the proposed merger will permit KAWC to access Thames experience in the area of security. Thames Water has operated water facilities in regions of the world that have heightened security concerns. As a result, it has developed an expertise in these matters. Having operated in a relatively risk free environment in the United States, AWWC and KAWC, in contrast, have little experience in this area.

<u>Merger Savings/Synergies</u>

The AG is highly critical of the Joint Application because of its silence on potential savings and synergies resulting from the proposed merger. He notes that, while the Joint Applicants have emphasized that the merger s purpose is to provide a platform for RWE and Thames growth in the water utility sector, RWE has recognized the potential for savings from the merger of AWWC s and Thames operations.[24] He

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[22] Joint Applicants Brief at 19.

[23] Direct Testimony of James McGivern at 9.

[24] <u>See</u> Joint Applicants Response to AG s Initial Requests for Information, Item 98 at 3; Joint Applicants Response to AG s Initial Requests for Information, Item 69 at 4 (a Transition Implement Plan that identifies two broad categories of efficiencies and synergies between Thames and AWWC, [b]est practice where process improvements can be achieved from combining the strengths of the two business and [i]mplementation of new process to improve efficiency, effectiveness and business performance).

asserts that RWE and Thames have deliberately chosen to minimize this potential to avoid attracting the attention of utility regulators.[25] The AG argues that, if the transaction is to be in the public interest, these synergy savings should be calculated and then shared with ratepayers.

AG witness Scott Rubin presented five methods for allocating synergy savings of the transaction to KAWC. While conceding that these methods are imprecise, he contends that they produce a reasonable estimate of savings from merger synergies. Mr. Rubin estimates a range of expected savings to KAWC of $0.9 million to $3.5 million. To ensure KAWC s ratepayers benefit from the merger, Rubin proposes that the Commission require KAWC to reduce its base rates by $1.5 million within 5 business days of the merger closing and prohibit KAWC from applying for an increase in its base rates for 17 months from the transaction closing date.[26]

The Joint Applicants dismiss the AG s calculations of merger savings as speculative. They assert that a 2-year moratorium on any rate increase when combined with a required revenue reduction of $3 million over the 2 years following the merger,

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[25] AG Brief at 28. The AG specifically refers to statements of RWE and Thames officials during conference calls with investor analysts. For example, during a conference call on September 17, 2001, RWE s Chief Financial Officer, Dr. Klaus Sturany, indicated his reluctance to comment upon any merger synergies because [a]s you may know, if there are synergies they would be clawed back by the Regulator, so obviously there could be good cooperation but it is not time now. Joint Applicants Response to AG s Initial Requests for Information, Item 98 at 14. At the same conference call, Thames Group Finance Director, Chris Bunker, stated in response to a question regarding synergies: The important thing to understand which you will appreciate these are highly regulated businesses, therefore we are not doing this from the point of view of synergies. In a sense, if we were to do that the Regulator would then seek to claw back those benefits. But what we clearly will be trying to do is ensure we share best practice from our world-wide operations (I m speaking for Thames in that regard) which hopefully will improve the quality and the service for American s customers base. Id. at 19.

[26] Testimony of Scott J. Rubin at 46-47.

the cost of required capital improvements and investments, and increased security costs would severely damage KAWC s financial integrity and would, in fact, constitute confiscation.[27]

The Joint Applicants further contend that the AG s proposal is unlawful on two grounds. First, they argue that speculative savings predicated on uncertain events that may occur in the future and are not known and measurable, fail to meet the legal standard that all pro forma adjustments must meet. Second, they argue that the proposed reduction constitutes retroactive rate-making.[28]

The Joint Applicants have proposed two alternatives to the AG s proposals. First, they state their willingness to accept a 2-year moratorium on any rate increase intended to recover any increased costs except those necessary to recover the mandated capital investment to increase water storage facilities and the capital investment and operating expenses associated with enhanced security measures.[29] Alternatively, the Joint Applicants propose that KAWC be required to file for a rate adjustment within 2 years following the merger closing to provide an opportunity to examine any merger savings/synergies and to adjust KAWC s rates to reflect such savings.[30]

Based upon our review of the record, we find that neither party s proposal is reasonable. The record clearly shows that the proposed merger will result in benefits and savings to KAWC. Most of these benefits cannot be readily quantified or will not

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[27] Joint Applicants Brief at 43-44.

[28] Id. at 44.

[29] Transcript of May 1, 2002 Hearing, Vol. I at 185-189.

[30] Id. at 189.

result in immediate savings. Because of RWE s strong credit ratings, for example, KAWC will have access to capital at interest rates that are substantially lower than those currently available from AWWC. These savings, however, will not be realized until KAWC refinances its current debt obligations or funds new capital construction. The proposed rate reduction, which is based upon the assumption of immediate savings as of the closing date of the merger, is not reasonable.

The Commission strongly believes that KAWC s ratepayers should receive their fair share of any savings that the proposed merger produces. Any adjustment in rates based upon these savings must be supported by the evidence, not mere speculation. Recognizing the difficulties in projecting merger savings and synergies, the Commission finds that as a condition for approval of the proposed merger, the Joint Applicants should be required to develop a mechanism to track the merger savings and costs, as well as a methodology to allocate a proportionate share of those savings and costs to KAWC s ratepayers.

The Commission also recognizes that, given the organization changes that the proposed merger is likely to produce, any adjustment in KAWC s base rates until the merger transition is completed is inappropriate. Changes in operating practices are likely to produce changes in the cost of service. Maintaining the status quo, therefore, is in the best interests of KAWC and its ratepayers. Accordingly, we find that the public interest requires that as a condition to our approval of the proposed merger, KAWC should forego any right to apply for any rate adjustment from the date of this Order until March 16, 2004, or one year following the date of the merger closing, whichever occurs later. This moratorium will provide the Joint Applicants with adequate time to identify and implement any merger savings/synergies.[31]

The Joint Applicants have asserted that a significant benefit of the proposed merger will be in the area of infrastructure security. Thames is already assisting and will be providing more assistance in this area. The record strongly suggests that the merger is likely to affect significantly KAWC s security costs. Accordingly, we further find that the introduction of any new rate mechanism regarding security costs at this time is inappropriate and that KAWC s proposal for such mechanism, which is currently under review in Case No. 2001-00440,[32] should be withdrawn until KAWC s integration within Thames is complete. We conditioned our approval of the proposed merger upon such action by KAWC.

Changes in KAWC Management/Labor Force

The AG argues that the proposed merger threatens KAWC s current level of service because of potential changes in its current management team. He notes that Thames may make such changes or that existing managers may choose to leave KAWC. He suggests that approval of the proposed merger be conditioned upon the inclusion of current KAWC managers in any retention bonus program and upon Thames commitment to notify the Commission of any change in officers, managers, or other key employees.

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[31] The Commission recognizes that certain unforeseen circumstances or events (e.g., significant revisions in federal taxation laws, a natural disaster) may require KAWC to request a rate adjustment before the moratorium ends. If such circumstances occur, we will consider a request to modify this condition.

[32] Case No. 2001-00440, Proposed Revisions to the Filed Rate Schedules of Kentucky-American Water Company to Permit the Assessment of an Asset Protection Charge.

The Commission shares the AG s concerns on this issue. KAWC has achieved a high level of service due to the efforts of its current management team. While Thames and RWE cannot compel these persons to remain in their positions, it should take appropriate actions to encourage their retention. Thames has acknowledged the high level of expertise that exists in KAWC s technical staff and agreed that such expertise should be retained. It has agreed to retain existing management in place through March 2004. AWWC has agreed to modify its retention bonus program to include KAWC s officers. [33]

We find that the public interest requires that all reasonable efforts be made to keep present management in place at least through the transition. We therefore condition our approval of the proposed merger upon the Joint Applicants making efforts to retain existing management and initiating a retention bonus program. We further find that, as a condition to our approval of the proposed merger, the Joint Applicants, RWE and AWWC should provide us with written notification of any changes in management personnel for the first year following consummation of the merger.

LFUCG has expressed concerns about the reductions in KAWC s non-management and union work force. It notes that 12 to 13 positions will be lost when certain KAWC customer service functions are transferred to AWWC s national call center. It suggests that efforts be made to protect the jobs of KAWC employees.

[33] Joint Applicants May 17, 2002 Supplemental Response to Item 3(d) of the Commission Staff Second Set of Interrogatories and requests for Production of Documents of March 11, 2002.

The Commission notes that the labor union representing KAWC s union employees has expressed support for the merger.[34] While we recognize that cost savings measures should be implemented when possible, we also recognize the need to retain a skilled and highly motivated work force. To this end, we find that, at least during the transition period following the consummation of the merger, KAWC should be required to maintain its present work force at existing levels. We condition our approval of the proposed merger on this point. As changes related to customer service employees were planned before any merger discussions, and as these personnel were hired with the knowledge that their positions would be transferred, we have excluded these positions from the terms of the condition.[35]

Risks to KAWC s Financial Condition

Maintaining KAWC s financial condition is of critical importance when considering the effects of a proposed acquisition. Both the AG and LFUCG have raised concerns about the possible detrimental effects on KAWC of the proposed merger. Both assert that pressures created by RWE s increased debt burden to finance the proposed merger could require KAWC to take measures to generate sufficient cash flow. These measures may include a reduction in preventive maintenance, the transfer of funds from KAWC to Thames and other RWE subsidiaries, and the failure to adequately fund KAWC s necessary capital expenditures.

[34] Letter from Donald E. Wightman, President, Utility Workers Union of America, to Thomas M. Dorman, Executive Director, Kentucky Public Service Commission (May 17, 2002).

[35] This condition also does not include retention of the positions that were planned for elimination as a result of the nationwide consolidation of AWWC accounting functions.

The Commission shares these concerns. We have previously noted that these concerns take on a heightened level of importance when a foreign company with international operations acquires a U.S. utility. [36] To address these concerns, we have imposed several conditions upon the proposed merger addressing financial resource issues of balanced capital structures, dividend policy, provision of capital resources, and debt guarantees.

The Joint Applicants have represented that KAWC and its ratepayers will not directly or indirectly incur any additional costs, liabilities, or obligations in conjunction with the proposed acquisition by, and transfer of ownership and control of AWWC to Thames. They further represented that no costs associated with the acquisition will be recorded on KAWC s books and that KAWC will not incur any additional debt, issue any additional securities, or pledge any assets to finance Thames purchase of AWWC stock. We have incorporated these representations into our conditions for approving the proposed merger.

The Commission also has concerns regarding RWE, Thames and AWWC s potential use of push down accounting. Push down accounting would require KAWC to record a portion of the goodwill resulting from the premium that Thames paid for the AWWC stock. We find that, due to its potential adverse financial effect on KAWC and KAWC ratepayers, the use of this accounting treatment to record such transactions as that currently before us is contrary to the public interest. We find that the proposed merger, therefore, should be conditioned upon RWE, Thames, AWWC and KAWC not using this accounting method.

[36] Case 2001-104, Joint Application for Transfer of Louisville Gas and Electric Company and Kentucky Utilities Company in Accordance with E.ON AG s Planned Acquisition of Powergen PLC Order (Aug. 6, 2001) at 15.

We further find that approval of the proposed merger should be conditioned upon RWE, Thames, AWWC and KAWC adequately funding and maintaining KAWC s treatment, transmission and distribution systems.[37] Based upon the number of customers, KAWC represents only 5 percent of the AWWC system. Upon consummation of the proposed merger, it will represent a much smaller percentage of the Thames system. As its relative size is reduced, we are concerned that the capital needs of KAWC may not receive the proper priority in Thames capital budgeting and capital investment allocation processes. To monitor RWE, Thames, AWWC and KAWC s commitment in this area, the Commission finds that KAWC should on or before March 31 of each year submit to us its current 2-year capital and operations and maintenance budgets and an explanation of each reduction of a capital budget item that exceeds a 10 percent change from the prior year.

Transaction Costs

As of January 30, 2002, Thames and AWWC had costs related to the proposed merger of $8.5 million[38] and $10 million, respectively.[39] The Joint Applicants have represented to the Commission that all transaction-related costs, including the cost of purchase and the premium paid for AWWC, should be excluded for rate-making purposes from KAWC rates.[40] We find that the public interest requires that, as a condition of approving the proposed merger, RWE, Thames, AWWC and KAWC waive

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[37] For additional discussion of this issue, see Service Quality and Customer Service supra p. 27.

[38] Joint Applicants Response to the Commission s Order of January 30, 2002, Item 18(a).

[39] Id. at Item 18(b).

[40] Id. at Item 44(k).

any right to recover these costs through KAWC rates and that they file information sufficient to allow adequate monitoring of the costs associated with the proposed merger.

To permit reasonable monitoring of transaction costs, we find that Thames should file a schedule of its actual cumulative acquisition costs in the same level of detail set forth in its response to discovery requests.[41] Thames should specifically identify any costs that have been allocated to AWWC. We further find that AWWC should file a schedule of its actual cumulative transaction costs, including any costs that Thames has allocated to it, in the same level of detail set forth in its response to discovery requests.[42] AWWC should identify any costs allocated to a subsidiary or affiliate, provide the name of the subsidiary or affiliate and the accounting entries made on its books, and identify the basis for the allocation. These reports should be filed semi-annually for the periods ending June 30 and December 31. Any costs that are allocated to KAWC should be fully documented and described in detail in KAWC s next rate adjustment filing.

Most Favored Nations Clause

The Commission finds that since AWWC has operating subsidiaries in numerous jurisdictions, a most favored nations clause would ensure that KAWC ratepayers receive all of the merger benefits that RWE, Thames, and AWWC make available to other jurisdictions. We find that the public interest requires our approval of the proposed merger be conditioned upon RWE, Thames, AWWC, and KAWC extending to

[41] See Joint Applicants Response to Commission Staff s First Set of Interrogatories and Requests for Production of Documents, Item 12.

[42] Id. at Item 11.

KAWC ratepayers proportionate net benefits of each condition imposed by another state regulatory commission that will benefit ratepayers in another jurisdiction. Recognizing that unique circumstances may exist in those jurisdictions in which both Thames and AWWC are located, we have excluded those jurisdictions from the required commitment.

Local Control/Local Concerns

The Intervenors have raised several concerns about the proposed merger s effect on local control and responsiveness of KAWC after the merger. LFUCG has requested assurances that KAWC s local management will have the necessary authority and autonomy to make decisions on a local level. It proposes that a majority of KAWC s Board of Directors be comprised of local residents and selected by a process that ensures that local control is a top priority for KAWC. LFUCG has proposed that KAWC be required to maintain its current level of involvement in local charitable and civic organizations upon completion of the proposed merger. Bluegrass FLOW has expressed concerns that the proposed merger, by creating another layer of corporate review, will stifle local autonomy and reduce KAWC s responsiveness to local issues.

The Commission is also concerned about the potential effects of the proposed merger on KAWC s responsiveness to local needs. To ensure that KAWC remains responsive and retains some measure of local autonomy, we have, as a condition to our approval of the proposed merger, crafted several protections to ensure local control. These protections include requiring KAWC to:

- Actively support economic development and social and charitable activities throughout the areas in which KAWC serves.
- Maintain a substantial level of involvement in community activities, through annual charitable and other contributions, on a level

comparable to or greater than the participation levels experienced prior to the merger.

- Ensure that at least 40 percent of the members of its board of directors are persons who reside within the area that KAWC serves and are not employees or officers of RWE, Thames, AWWC or any RWE affiliated entity.

Recognizing LFUCG s concerns about the future of Jacobson Park, we condition our approval of the proposed merger on KAWC s agreement that no transfer of ownership or control of Jacobson Park will occur without prior Commission approval.

The Commission further finds that the public interest requires as a condition to our approval of the proposed merger that, if RWE establishes a headquarters for its North American operations, such headquarters will be located in Kentucky. The location of such headquarters in this state will ensure appropriate attention to KAWC needs and the communities that KAWC serves.

Bluegrass FLOW urges the Commission to void those provisions of the Acquisition Agreement that prohibit KAWC and AWWC from negotiating with LFUCG for the sale of KAWC s assets. We respectfully decline this request. Given the complexity and scale of the proposed merger, we find nothing about these provisions that is unlawful or unreasonable or contrary to public policy. Moreover, Kentucky law provides adequate means for LFUCG to pursue the acquisition of KAWC s assets if it chooses to do so. <u>See</u> KRS 106.220.

Bluegrass FLOW suggests that the proposed merger is contrary to the public interest because it places Central Kentucky s water supply at risk from foreign manipulation.[43] We find no evidence in the record to support such concern. The Commission is troubled by this argument particularly in light of the Commonwealth s

[43] Bluegrass FLOW Brief at 4.

efforts over the last two decades to encourage foreign development and investment in this state. This concern ignores that, while KAWC s ultimate owners may be citizens of a foreign nation, KAWC will remain subject to the laws of this Commonwealth.

Finally, the Commission takes no position on the issue of public ownership of water utilities. The Joint Applicants application does not present that issue. As of this date, we have no knowledge of any public entity offering to purchase KAWC s facilities or wishing to negotiate for such purchase.

Best Practices

The Joint Applicants state that, following the consummation of the proposed merger, an ongoing review will be conducted of their operations using various methods of benchmarking, all of which are designed to improve and increase the efficiency of their operational processes. By applying best practices, the utility seeks out other companies who perform similar types of functions or tasks to ascertain how the process operates and whether there are techniques that can be adopted or modified and applied to its own processes. This process is likely to lead to cost savings, more competitive customer prices, improved customer service and greater customer satisfaction.

While the Commission encourages the Joint Applicants efforts to apply best practices to their operations, we caution them to do so in a judicious manner. When the savings or increased revenues that will result from the implementation of such practices do not exceed the cost of such practices, they should not be implemented without a compelling justification. We find that the public interest requires that the application of best practices and their results should be closely monitored and tracked.

We therefore require as a condition of our approval of the proposed merger that the Joint Applicants submit annual progress reports on these efforts to us. For each area reviewed for application of best practices at KAWC or an affiliate whose costs are charged to KAWC, these reports should document the investigating team, its mission and area of investigation, current status, estimated costs, expected results including savings, and all results actually achieved.

Service Quality and Customer Service

One of the Commission s principal concerns is the possible degradation of service quality after consummation of the proposed merger. The Joint Applicants have pledged to maintain the high quality of KAWC service for the ratepayers of KAWC.[44] RWE and Thames have further pledged that AWWC s and KAWC s work force levels will be maintained at their current levels until March 2004. Despite these pledges, we find additional protections are necessary. A common theme throughout the public comment on the proposed transaction was the perceived decline in the level of customer service that can occur upon the merger of utilities.

We find that the public interest requires as a condition for approving the proposed merger that KAWC report annually on its water quality standard, the number of water service interruptions, the average employee response time to water service interruptions, the number of customer complaints, and the customer inquiry response time for each calendar year from 2000. We intend to use these reports as one tool to monitor the quality of KAWC s service and to discover any decline in that quality. We further find that approval of the proposed merger should be conditioned upon RWE, Thames, AWWC and KAWC allocating adequate resources to Kentucky operations to maintain and improve the existing high level of service quality and safety.

[44] Joint Applicants Response to the Commission s Order of January 30, 2002, Item 44.

Research and Development

As mentioned previously, Thames places a high emphasis on its R&D by developing cutting-edge technologies. The Commission encourages Thames to continue its efforts in the R&D area because such efforts produce a myriad of benefits to KAWC ratepayers. We recognize, however, that most new technologies require several years to develop and successfully implement. We are concerned that as a result of economic pressures, Thames may implement cost cutting that adversely affects R&D spending. As reducing R&D spending may be shortsighted and adverse to ratepayers long-term interests, we urge Thames to act cautiously when considering any reduction to R&D spending.

The Commission strongly supports R&D and commends the Applicants for their commitments to such programs. Benefits can be realized whether research is sponsored solely by one utility or through a larger organization funded by multiple utilities or stakeholders. The benefits of R&D may well help the Applicants in fulfilling their commitments to ensure rate stability and high quality service.

To assist the Commission in its efforts to monitor this commitment, the Applicants should provide written notice of any material changes in their level of participation or funding for R&D 30 days prior to the proposed change. This includes any change in R&D funding equal to or greater than 5 percent of the previous year s budget. The written notice should include an explanation and justification for the change in policy.

Intervenor Proposed Conditions

The Intervenors have proposed that several conditions be placed upon our approval of the proposed merger. Many of these conditions have been discussed previously in this Order and have been incorporated into those set forth in Appendix A.

Of the 20 conditions that the AG proposed, we have declined to accept only two.[45] The remaining proposals have been accepted in toto or with modifications. Similarly, LFUCG submitted 14 proposed conditions, of which 10 were accepted in some form.[46] For the reasons previously stated in this Order, we have rejected the three conditions that Bluegrass FLOW proposed.

PUBLIC INTEREST

Our review of the record leads us to conclude that, if the Joint Applicants, AWWC and RWE accept the conditions and commitments set forth in Appendix A, the proposed merger is in the public interest. It will not result in any increase in utility rates or reduction in the quality of water service. By placing KAWC into a larger company system, the proposed merger will increase KAWC s access to capital, cutting edge technologies, and enhanced R&D. It will allow KAWC to draw upon Thames experience in the area of security practices and to better protect its facilities at lower cost. It will permit greater employee training opportunities and should result in a better-trained work force.

[45] We find that AG Conditions No. 3 and No. 11 are too restrictive and too intrusive on management and would add little protection for KAWC ratepayers. For a listing of the AG s conditions, see Testimony of Scott J. Rubin at 30-32.

[46] We find that LFUCG Conditions No. 4 and 5, which related to the relocation of KAWC employees due to the creation of AWWC s national call center and the consolidation of its accounting functions, were planned well before any merger discussions and are unrelated to the proposed merger. We decline to accept LFUCG Condition No. 11 because we find no legal basis for conditioning ratepayer benefits upon the compensation that AWWC shareholders will receive for their stock. We chose not to accept LFUCG Condition No. 10, because this commitment merely restates existing federal and state law.

SUMMARY OF FINDINGS

After considering the evidence of the record and being other sufficiently advised, the Commission finds that:

1. RWE, Thames, AWWC and KAWC will, after the consummation of the proposed merger, have the financial, technical, and managerial abilities to provide reasonable utility service.

2. RWE s and Thames proposed acquisition of AWWC and the proposed transfer of control of KAWC from AWWC to Thames are in accordance with law and for a proper purpose; they will, however, be consistent with the public interest only if the Joint Applicants, AWWC, and RWE accept and agree to the commitments and conditions set forth in Appendix A to this Order.

3. RWE will not, by reason of its ownership of all outstanding shares of common stock of Thames, be a utility as defined in KRS 278.010(3).

4. Thames will not, by reason of its ownership of all outstanding shares of common stock of AWWC, be a utility as defined in KRS 278.010(3).

5. AWWC will not, by reason of its ownership of all outstanding shares of common stock of KAWC, be a utility as defined in KRS 278.010(3).

IT IS THEREFORE ORDERED that:

1. Bluegrass FLOW s Motion to Dismiss is denied.

2. The transfer of control of KAWC from AWWC to RWE and Thames through Thames acquisition of ownership and control of AWWC is approved, subject to the filing, within 7 days of the date of this Order, of the written acknowledgements on behalf of RWE, Thames, AWWC, and KAWC by each entity s chief executive officer that

these entities each accept and agree to be bound by the commitments set forth in Appendix A to this Order.

3. Neither RWE nor Thames nor AWWC shall impair KAWC s capacity to meet its obligations to provide adequate, efficient, and reasonable utility service.

4. KAWC is prohibited from guaranteeing the debt of RWE, Thames, AWWC, or any of their affiliates or subsidiaries without the prior approval of the Commission.

5. The Joint Applicants shall file with the Commission a copy of the final decision or order or other forms of regulatory notification regarding the proposed merger that each state regulatory authority with jurisdiction over the proposed merger issues within 20 days of the issuance of such order or notification.

6. The Joint Applicants shall notify the Commission in writing of any material change in KAWC s participation in, or funding for, research and development 30 days prior to any proposed change.

7. KAWC shall, for calendar year 2002 and for the next five years thereafter, include with its annual report to the Commission a table that shows each water quality standard imposed by law, the number of water service interruptions, the average employee response time to water service interruptions, the number of customer complaints, and the customer inquiry response time for each calendar year from 2000.

8. Beginning with calendar year 2003, the Joint Applicants shall file annually with the Commission a report that details the adoption and implementation of best practices at KAWC.

9. Within 30 days of the date of this Order, KAWC shall file with the Commission a report that states its actual expenditure levels for economic development activities and civic and charitable activities for the past 3 calendar years.

10. KAWC shall report annually to the Commission its economic development activities and its actual expenditures for economic development activities and civic and charitable activities.

11. KAWC shall annually file with the Commission its current 2-year capital and operation and maintenance budgets and an explanation for any reduction in a budgeted item.

12. Thames and AWWC shall at 6-month intervals submit to the Commission written reports on the actual cumulative costs of the proposed merger until all transaction costs have been incurred. These reports shall be for the periods ending June 30 and December 31, with the first report submitted no later than August 15, 2002 and all subsequent reports submitted within 45 days of the end of the reporting period.

13. RWE, Thames, AWWC and KAWC shall comply with all reporting and filing requirements described herein. Unless otherwise noted, all quarterly reports shall be filed within 45 days of the close of the reporting quarter, while all annual reports shall be filed by March 31 of the year following the reporting period.

14. Within 5 days of the consummation of the merger, KAWC shall file a written notice setting forth the date of merger.

Done at Frankfort, Kentucky, this 30th day of May, 2002.

By the Commission

DISSENT OF COMMISSIONER ROBERT E. SPURLIN

Kentucky-American is a family-owned corporation that has historically valued its employees and provided outstanding service to its customers. As a Richmond, Kentucky native, a former Kentucky-American customer, and a twice-appointed Public Service Commissioner, I have both personal and professional knowledge of the company s stellar service record. Nowhere was Kentucky-American s record of employee and customer satisfaction more evident than at the public hearing held on April 2, 2002.

It has long been the policy of the Commission to allow individuals who are not parties to a proceeding to offer public comment before the hearing. In this case, 15 citizens traveled to Frankfort and offered their opinions on the proposed acquisition.[1] While these individuals came from very different walks of life, all spoke highly of Kentucky-American. They expressed deep concerns about a possible decline in management and service quality if the Commission decided to approve the acquisition. They bestowed glowing compliments upon the management and boasted about the superior service they had received over the years. Overall, I was very impressed with the support Kentucky-American received from its customers. I was also impressed with the statements made by Roy Mundy II, President of Kentucky-American. I have never heard stronger testimony for the benefit of a company. Mr. Mundy is truly a company man and, given that he had no guarantees of his future with Kentucky-American at the

[1] Joanne Bell; Chetan Talwalkar; James Peck; Andy Slone; Governor Edward T. Breathitt; Thomas P. Dupree; Emma Tibbs; Joe Graves; Richard Moloney; William L. Quisenberry; Foster Pettit; Don Slagel; Joan Crowe; Don Pratt; and Don Dampier all provided public comment.

time of his testimony, I admire his loyalty. His statements, along with the statements offered by private citizens, clearly demonstrate Kentucky-American s commitment to employee and customer satisfaction.

Prior to these proceedings, I had no personal knowledge of the reputation of Thames or RWE, and had to rely upon the record. The companies began this case with a request that this Commission keep volumes of documents confidential rather than disclose them to the public. From the beginning, I viewed this excessive request for confidentiality as a warning sign. Due to the financial scandals involving companies like Enron, Arthur Andersen and Firestone, I am sensitive to the fact that many members of the public no longer trust large corporations. Because this case involved the control of water, a commodity basic to the lives of Kentuckians, it was important to me that all parties and citizens had access to key information. The Applicants passion for secrecy, in contravention of the public s need to know, cast a pall over the entire proceeding. I believe that the Applicants initial reluctance to divulge important information goes directly to the question of the Applicants credibility and is one of the many facts the Commission must consider in determining whether the public interest is served by this acquisition.

I also question the Applicants commitment to Kentucky-American employees. In any merger, the most important document is obviously the merger agreement. During my initial review of the merger agreement it became apparent that the contract was extremely one-sided. While the agreement reads as if highly competent counsel skillfully represented the interests of Thames and RWE, it reflects no concern for the interests of other parties affected by the agreement. This is the first merger contract I have reviewed that does not have a section to protect management or retain key employees.

In the section of the merger agreement that follows Section 5.07 are the words intentionally omitted. The omitted section is the general area of the agreement that addresses employee retention issues. Omissions in a contract often speak louder than inclusions, and, in my opinion, this glaring omission speaks volumes about Thames and RWE. The Applicants could have cured the omission by extending management contracts to key employees but, as the record reflects, management contracts were never offered to Kentucky-American staff.[2] Even more disturbing, while the Applicants offered retention bonuses totaling $10,414,000 to employees *outside* of Kentucky-American,[3] it was only after rigorous cross-examination by the Office of the Attorney General and Commission staff attorneys that the Applicants chose to offer similar bonuses to certain Kentucky-American employees.[4] I predict that the Applicants belated attempt to assure these employees of their future with Kentucky-American will dramatically decrease morale and quality of service.

I am also disappointed with the Applicants failure to honor all existing agreements with Kentucky-American employees. Thames and RWE have decided not to honor a provision concerning equity-based plans. The Applicants claim that they will replace the current equity agreement with a comparable one, but, to date, they have not done so. In fact, the Applicants are not committed to retaining any Kentucky-American employee past March 2004.[5] The omissions in the merger agreement, together with the

[2] Transcript of May 1, 2002 Hearing, Vol. 1 at 212.

[3] Joint Applicants Response to Commission Staff s Second Set of Interrogatories and Requests for Production of Documents, Item 3(d).

[4] Joint Applicants Supplemental Response to Commission s Second Set of Interrogatories and Requests for Production of Documents, Item 3(d).

[5] Transcript of May 1, 2002 Hearing, Vol. 1 at 127.

Applicants failure to honor existing agreements, force me to conclude that this merger will negatively impact employee morale and, subsequently, will lower the quality of service provided to Kentucky-American customers.

In addition to the Applicants apparent indifference to Kentucky-American employees, I have serious concerns about RWE s future financial stability. The intervenors presented testimony regarding the uncertainty of RWE s future liability for the disposal of nuclear waste, the decommissioning of nuclear power plants, and the reclamation of coal mines. The level or cost of capital could be adversely impacted if RWE fails to set aside funds for these future liabilities or if the laws governing these industries are revised. In my opinion, RWE and Thames failed to adequately address the impact that these future liabilities could have on RWE s ability to adequately fund the capital requirements of American Water Works and Kentucky-American.

I am also concerned that central Kentuckians will have little or no input in forming the policies that will affect Kentucky-American customers. Stockholders in Germany elect RWE s board. RWE s board appoints the Director of Thames who will appoint the Director for American Water Works, who will appoint the Director of Kentucky-American. These multiple layers of company control will inevitably result in Kentucky-American directors who place the strategic goals of Thames and RWE above the interests and concerns of Kentucky-American customers. I fear that this lack of local control will shift Kentucky-American s focus from employees and service to shareholders and profit.

The demonstration of some net positive benefit to the public is a necessary predicate for a determination that the proposed acquisition is in the public interest. In my opinion, Kentucky-American has not demonstrated that this proposed acquisition would result in any benefits to Kentucky customers that they would not otherwise receive. For the foregoing reasons, it is abundantly and painfully clear to me that this merger is not consistent with the public interest. I cannot agree with my colleagues decision to approve this merger. Therefore, I respectfully dissent.

Robert E. Spurlin

Robert E. Spurlin, Commissioner

ATTEST:

Thomas McDon

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2002-00018 DATED MAY 30, 2002

The approval of the proposed merger agreement between RWE, Thames, AWWC, and Apollo and the transfer of control of KAWC from AWWC to Thames and RWE is conditioned upon the written acceptance by RWE, Thames, AWWC, and KAWC of the commitments and assurances listed below:

OPERATIONS AND FINANCIAL

1. From the date of this Order until March 16, 2004, or one year following the date of the consummation of the proposed merger, whichever is later, KAWC will not apply to the Commission for a rate adjustment or make any other filing that has the effect of increasing its rates for water service.

2. KAWC will, within 10 days of the date of this Order, withdraw its proposed Asset Protection Charge Tariff that is currently the subject of review in Case No. 2001-00440[1] and will not for 5 years from the date of this Order apply to the Commission for recovery of costs associated with the protection of water utility assets except through adjustments in its general rates for water service.

3. KAWC s books and records will be maintained and housed in Kentucky.

4. RWE, Thames, AWWC, and KAWC will not assert in any Commission proceeding that Commission review of the reasonableness of any cost has been or is

[1] Case No. 2001-00440, Proposed Revisions to the Filed Rate Schedules of Kentucky-American Water Company to Permit the Assessment of an Asset Protection Charge.

preempted by a United Kingdom, Federal Republic of Germany, European Community, or other foreign regulator.

5. RWE, Thames, AWWC, and KAWC will not assert in any judicial or administrative proceeding that the Commission lacks for rate-making purposes jurisdiction over KAWC s capital structure, financing, and cost of capital.

6. RWE, Thames, AWWC, and KAWC will obtain Commission approval prior to the transfer of any KAWC asset with an original book value in excess of $1 million or real property or real estate with a net original book value in excess of $200,000.

7. KAWC will obtain Commission approval prior to any transfer of control or ownership of the land upon which Jacobson Park is located.

8. Neither KAWC nor its ratepayers, directly or indirectly, will incur any additional costs, liabilities, or obligations in conjunction with Thames and RWE s acquisition of AWWC.

9. KAWC will not incur any additional indebtedness, issue any additional securities, or pledge any assets to finance any part of the purchase price paid by Thames for AWWC stock.

10. The payment for AWWC stock will be recorded on Thames books, not those of KAWC.

11. The premium that Thames pays for AWWC stock, as well as all transaction-related costs, will not be pushed down to KAWC and will not be recovered from KAWC s ratepayers.

12. Thames acquisition of AWWC will not affect the accounting and rate-making treatments of KAWC s excess deferred income taxes.

13. No early termination costs, change in control payments, or retention bonuses paid to a KAWC or AWWC employee as a result of the proposed transaction will be allocated to KAWC or recovered from KAWC s ratepayers.

14. KAWC will not bear any costs incurred to comply with any law, regulation, standard or practice of the United Kingdom, Federal Republic of Germany, or European Community necessary to complete the proposed transaction.

15. For at least one year from the date of the consummation of the merger or until March 16, 2004, whichever occurs later, each of KAWC s current corporate officers will continue in his current position and perform his current duties unless he requests reassignment or retirement, is unable to continue to perform the duties of that position due to some physical, mental or civil disability, or has engaged in some misconduct that requires his removal or reassignment.

16. For at least one year from the date of the consummation of the merger or until March 16, 2004, whichever occurs later, RWE, Thames, AWWC or KAWC will notify the Commission in writing within 10 days of any changes in KAWC s corporate officers and management personnel.

17. RWE and Thames will take an active and ongoing role in managing and operating KAWC in the interests of customers, employees, and the Commonwealth of Kentucky, and will take the lead in enhancing KAWC s relationship with the Commission, with state and local governments, and with other community interests, and to advance these goals shall, among other things, arrange for meetings between RWE s and/or Thames chief executive and the Commission and/or its Staff at least twice a year.

18. No later than March 16, 2003, RWE, Thames, AWWC, and KAWC will develop and implement a mechanism to track the savings and costs resulting from the proposed merger and a methodology to allocate such savings and costs and will submit to the Commission in writing a detailed description of that methodology.

19. Following the consummation of the proposed merger, RWE, Thames, AWWC, and KAWC will submit written reports to the Commission annually on the adoption and implementation of best practices at KAWC.

20. RWE, Thames, AWWC, and KAWC will retain separate books for each corporate entity operating within Kentucky and will follow state cost allocation guidelines, as well as all applicable codes of conduct.

21. KAWC s equity to capital ratio will be maintained between 35 to 45 percent. If the equity to capital ratio exceeds this range, RWE, Thames, AWWC, and KAWC will notify the Commission in writing within 30 days of this development and will submit to the Commission a detailed plan of action to return KAWC s equity to capital ratio to this range.

22. AWWC will implement the revisions to its Retention Bonus Plan as set forth in Joint Applicants Supplemental Response to Item 3(d) of the Commission Staff s Second Set of Interrogatories and Requests for Production of Documents.

23. RWE, Thames, AWWC, and KAWC will notify the Commission in writing within 30 days of any downgrading of the bonds of RWE, Thames, AWWC, or any AWWC subsidiary and will include with such notice the complete report of the issuing bonding agency.

24. KAWC will match in its future rate proceedings the cost of any best practices that are implemented with a reasonable estimate of the savings or increased revenues that will result from the implementation of such practices and will not implement the practices if the increased revenues or decreased expenses do not exceed the cost of such practices.

25. KAWC will not be the employer or purchaser of last resort for employees, assets, and products associated with any failed or troubled RWE, Thames, or AWWC affiliate venture.

26. KAWC s utility operations will continue to be a priority and will not be used to solely benefit non-utility affiliates.

REPORTING

27. Unless the Commission requests otherwise, all documents filed with the Commission on behalf of RWE or any RWE subsidiary or affiliate will be in English and all financial statements will be stated in their original currency and in U.S. dollars (converted as on the date of the financial statement).

28. If RWE or Thames issues new debt or equity in excess of $100 million, it will notify the Commission in writing as soon as practicable prior to such issuance.

29. If AWWC issues new debt or equity in excess of $100 million, it will notify the Commission in writing 30 days prior to such issuance.

30. No later than 30 days after the public announcement of any acquisition of a regulated or non-regulated business representing 5 percent or more of Thames total capitalization, RWE and Thames will notify the Commission in writing of such acquisition.

31. No later than March 31 of each year following the consummation of the proposed merger, RWE and Thames will report in writing to the Commission on KAWC s proportionate share of RWE s total assets, total operating revenues, operating and maintenance expenses, and number of employees for the most recently completed fiscal year. If AWWC remains a subsidiary of Thames and KAWC remains a subsidiary of AWWC, this report will also reflect KAWC s proportionate share of Thames total assets, total operating revenues, operating and maintenance expenses, and the number of employees for the most recently completed fiscal year.

32. RWE, Thames, AWWC and KAWC will obtain Commission approval prior to KAWC s payment of any dividend or transfer of any funds representing more than 5 percent of KAWC s retained earnings to RWE, Thames or any other entity related to RWE.

33. RWE and Thames will notify the Commission in writing at least 30 days prior to AWWC s payment of any dividend or transfer of any funds representing more than 5 percent of AWWC s retained earnings to RWE, Thames or any other entity related to RWE.

34. RWE, Thames, AWWC or KAWC will file the following reports with the Commission: RWE s quarterly interim reports to its shareholders; RWE s annual reports to its shareholders; and, RWE s, Thames , AWWC s, and KAWC s annual audit reports.

35. Beginning for calendar year 2002 and for the next 5 years thereafter, KAWC will include in its annual report to the Commission a table that shows each water quality standard, the number of water service interruptions, the average employee

response time to water service interruptions, the number of customer complaints, and the customer inquiry response time for each calendar year from 2000.

36. Beginning August 15, 2002 and continuing until all transaction costs have been incurred, Thames and AWWC will semi-annually submit written reports to the Commission on the actual cumulative costs of the proposed merger. The reports should be for reporting periods ending June 30 and December 31 and submitted within 45 days of the end of the reporting period.

37. RWE, Thames, AWWC, and KAWC will file with the Commission, no later than March 31 of each year, a detailed organization chart showing all subsidiaries and affiliates of RWE as of the end of the previous calendar year.

SERVICE QUALITY AND RELIABILITY

38. KAWC customers will experience no material adverse change in utility service due to the merger.

39. RWE, Thames, AWWC and KAWC will adequately fund and maintain KAWC s treatment, transmission, and distribution systems; comply with all applicable Kentucky statutes and administrative regulations; and supply the service needs of KAWC customers.

40. When implementing best practices, RWE, Thames, AWWC and KAWC will take into full consideration the related impacts on the levels of customer service and customer satisfaction, including any negative impacts resulting from any future work force reductions.

41. At least 30 days prior to any planned reduction of 5 percent or more in KAWC s work force, RWE, Thames, AWWC or KAWC will notify the Commission in

writing of the planned reduction and will include with such notice a written study of the reduction s expected effects on service and KAWC s plan for maintaining service quality at the reduced work force level.

42. RWE and Thames will maintain AWWC s and KAWC s levels of commitment to high quality utility service and will fully support maintaining KAWC s record for service quality.

43. KAWC will continue to protect and safeguard the condition of all of its watershed land holdings surrounding its reservoirs and well fields in Kentucky.

OTHER COMMITMENTS AND ASSURANCES

44. If, during the 10 years following the consummation of the proposed merger RWE establishes a headquarters for its operations in the United States, RWE will locate such headquarters in the Commonwealth of Kentucky, will include in that headquarters the corporate management personnel of those operations, and will require the chief executive officer and subordinate officers of these operations to reside in Kentucky.

45. RWE, Thames, AWWC and KAWC will actively support economic development and social and charitable activities throughout the areas in which KAWC serves for as long as KAWC continues to serve those areas.

46. KAWC will maintain a substantial level of involvement in community activities, through annual charitable and other contributions, on a level comparable to or greater than the participation levels experienced prior to the date of the merger.

47. RWE and Thames will maintain and support the relationship between KAWC and the communities that it serves.

48. RWE, Thames, AWWC and KAWC will file annually with the Commission a formal analysis of any potential synergies and benefits from any water or wastewater utility merger or acquisition in the United States that occurred in the previous calendar year and that is exempted from Commission review, together with and a proposed methodology for allotting an appropriate share of the potential synergies and benefits to KAWC s ratepayers.

49. At least 40 percent of the members of KAWC s Board of Directors will be persons who are not employees or officers of RWE, Thames, AWWC, or any other RWE affiliated entity, and who reside within the area in which KAWC serves.

50. AWWC will hold all of KAWC s common stock and shall not transfer any of that stock without prior Commission approval even if the transfer is pursuant to a corporate reorganization as defined in KRS 278.020(6)(b).

51. If any state regulatory commission, except for a commission that presently exercises jurisdiction over both AWWC and Thames operating subsidiaries, imposes conditions on RWE, Thames or AWWC as a condition for its approval of the proposed merger and those conditions would benefit ratepayers in any other jurisdiction, proportionate net benefits and conditions will be extended to KAWC ratepayers.

52. KAWC will retain its current name and will continue as a corporation organized under Kentucky law.

53. KAWC s headquarters will remain in Lexington, Kentucky.

54. RWE, Thames, AWWC and KAWC will honor all existing KAWC contracts, easements or other agreements with the LFUCG, and will negotiate with the LFUCG in good faith regarding the renewal of those agreements.

55. KAWC will not, for at least one year from the date of the consummation of the merger or until March 16, 2004, whichever occurs later, eliminate any non-management or union employee positions, except for those positions related to the transfer of accounting and call center functions to AWWC Service Company that were planned prior to the announcement of the Acquisition Agreement.

56. RWE, Thames, AWWC and KAWC will maintain a sound and constructive relationship with those labor organizations that may represent certain AWWC or KAWC employees, will remain neutral respecting an individual s right to choose to be a trade union member, will continue to recognize the unions that currently have collective bargaining agreements with KAWC, and will honor any agreements with those unions.