

**COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION**

IN THE MATTER OF:

**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)**

**CASE NO.
2002-00277**

**NOTICE OF BEST PRACTICES IMPLEMENTATION –
ORDERING PARAGRAPH 8 AND CONDITION 19**

Come Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, American Water Works Company, Inc., Thames Water Aqua U.S. Holdings, Inc. and Kentucky-American Water Company, and pursuant to ordering paragraph 8 and Condition 19 of the Commission’s Order dated December 20, 2002, in Case No. 2002-00317, herewith give notice of the filing of a Report on Compliance related to the implementation of best practices for Kentucky-American Water Company, a copy of which is filed herewith electronically.

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CERTIFICATION

In conformity with paragraph 7 of the Commission's Order dated January 30, 2002, in Case No. 2002-00018, this is to certify that the electronic version of this pleading is a true and accurate copy of the pleading filed in paper medium; that the Petitioners have notified the Commission and the parties in Case No. 2002-00018 by electronic mail on March 31, 2004, that the electronic version of this pleading has been transmitted to the Commission, and that a copy has been served by mail upon:

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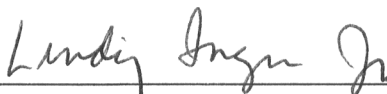
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and that the original and three copies have been filed with the Public Service Commission in paper medium on the 31st day of March, 2004.



Counsel for Thames Water Aqua Holdings GmbH,
RWE AG, American Water Works Company, Inc.,
Thames Water Aqua U.S. Holdings, Inc. and
Kentucky-American Water Company

REPORT ON COMPLIANCE WITH CONDITIONS IN THE RWE APPROVAL ORDER
RELATED TO THE IMPLEMENTATION OF BEST PRACTICES
KENTUCKY-AMERICAN WATER COMPANY

COMPLIANCE WITH BEST PRACTICES COST/SAVINGS TRACKING

BACKGROUND

On December 20, 2002 the Kentucky Public Service Commission (KYPSC) issued its decision in the matter docketed as Case No. 2002-00317. That order authorized a subsidiary of RWE AG (Apollo Acquisition Company) to purchase all the common stock of American Water Works Company, Inc. (AWW). The authorized transaction was completed on January 10, 2003. On that date RWE assumed control of Kentucky-American Water Company (Kentucky American Water). Kentucky American Water remains a wholly owned subsidiary AWW.

Conditions and ordering paragraphs were included in the KYPSC's December 20, 2002 Order requiring Kentucky American Water to track, identify and annually report on the customer benefits resulting from the planned implementation of "best practices". Those conditions and ordering paragraphs are:

Ordering Paragraph 8 – Beginning with calendar year 2003, Thames GmbH and Kentucky American Water shall file annually* with the Commission a report that details the adoption and implementation of best practices at Kentucky American Water.

Condition 19 – Following the consummation of the proposed merger, RWE, Thames GmbH, TWUS, AWW and Kentucky American Water will submit written reports to the Commission annually* on the adoption and implementation of best practices at Kentucky American Water.

* The deadline for filing reports on an annual basis is March 31 as set forth by the KPSC in Ordering Paragraph 12.

Expense Tracking

Since information regarding the anticipated cost/savings tracking system was filed on March 14, 2003, the tracking system generally described in that report has been utilized. Savings produced from implementation of those best practices can be, and are identified in this report.

A more detailed tracking system is currently used to identify savings created by the implementation of "best practices" for the procurement of goods and services. This system tracks costs and savings for Kentucky American Water and other AWW subsidiaries that benefit from implementation of that particular initiative.

Costs to implement the procurement initiative are segregated from other expenses incurred by the American Water Works Service Company (Service Company) in special accounts labeled "authorizations". Expenses charged to those authorizations are accumulated by the Service Company and periodically charged out to participating subsidiaries to the extent of procurement cost savings realized and documented by that subsidiary.

This method of allocating implementation costs is consistent with Kentucky American Water's objective to implement best practices when savings exceed implementation costs.

Cost Savings Tracking

As a result of implementing best practices in the area of procurement, reductions in operating expenses and capital expenditures of approximately \$3.7 million were realized throughout the American Water system during 2003. A portion of the procurement initiatives were implemented and new purchasing contracts executed during the latter part of 2003. As a result of creating a lower expense base in 2004 than would have otherwise resulted, savings will continue in later years. Kentucky American Water realized approximately \$ 14,800 of the total 2003 procurement savings. Kentucky American Water's annual cost savings are expected to increase to \$150,750 in 2004. As discussed above, only realized savings provide a basis for allocating a portion of the implementation costs accumulated on the Service Company's books to Kentucky American Water and other participating subsidiaries.

Flow-Back Of Savings

As shown on schedules included with this report, a reduction in Kentucky American Water's revenue requirement of \$173,730, net of implementation costs will be realized in 2004. This is shown on Table 1. Operating expense savings

resulting from implementation of procurement best practices are shown on Table 1.1 and capital project expense savings are shown on Table 1.2.

By implementing design/build processes for capital projects, Kentucky American Water has been able to reduce its planned construction expenditures. Cost reductions that have been, or in the near future are anticipated to be reflected, in Kentucky American Water's Utility Plant in Service and Rate Base are shown on Table 1 attached to this report.

The design/build construction initiative includes review of the governance, asset management, and project delivery of the capital investment program. One component of that initiative involves a change from the process formerly used in the American Water system to complete large and/or complex construction projects.

Subsequent to completion of the RWE transaction, the traditional design, build, permit and construction process was shifted to a design/build process. In the design/build process, bidders enter into single contractual agreement to design and build projects in exchange for appropriate incentives designed to ensure on time and at or below targeted completion costs. Thames Water has extensive experience and successful use of this best practice. The process also provides additional benefits such as simplified dispute resolution, risk management, etc.

Savings on projects of \$1,500,000 or more are estimated at 3% in 2004. Savings on construction projects of less than \$1,500,000 will also be realized, but the level of those savings to use for this report is difficult to estimate.

RWE has a stronger credit rating than American Water Capital Corp (AWCC). AWCC is the source of short-term and long-term capital for Kentucky American Water. As a result of the completion of the RWE transaction, AWCC and Kentucky American Water have been able to borrow money at a lower cost than the cost of borrowings that would otherwise have been available. The impact of these savings on the cost of long-term debt is shown on Table 1.3 attached to this report and are incorporated into the overall savings shown on Table 1.

The 2005 column of Table 1 reflects the savings, net of implementation cost, that will be embedded in the forecasted test-year of a rate case to be filed no sooner than four weeks from March 26, 2004. In addition, the Company has now completed its transition to the National Customer Care Center and Transactional Accounting Shared Services Center as part of its ongoing "Best Practice" initiatives. The rate case testimony will demonstrate gross savings of approximately \$281,000 (\$169,000 net of requested amortization of transition costs) as part of its forecasted test-year filing. The Company will also demonstrate savings from "Best Practices" regarding on-going security costs as part of its case, subject to the "confidentiality" agreements that are contemplated for review of this sensitive data.

**TABLE 1 OF 2003 REPORT
KENTUCKY-AMERICAN WATER COMPANY
RWE MERGER COSTS/SAVINGS INFORMATION**

OP EX COSTS/SAVINGS FROM PROCUREMENT INITIATIVE

	2003	2004	2005	Total
Operating Expense Savings as shown on Table 1.1	\$14,800	\$150,750	\$168,857	\$334,407
Revenue Requirement Reduction	\$14,800	\$150,750	\$168,857	\$334,407

CAP EX COSTS/SAVINGS FROM PROCUREMENT INITIATIVE

	2003	2004	2005	
Capital Expense Savings as shown on Table 1.2	\$17,500	\$44,150	\$45,033	
Less: Allocated Portion of Implementation Costs	0	0	0	
Net Capital Expense (Rate Base) Savings	\$17,500	\$44,150	\$45,033	
Rate of Return	8.25%	8.25%	8.25%	
Reduction in Utility Operating Income	\$1,444	\$3,642	\$3,715	
Revenue Requirement Reduction (At 1.4 times)	\$2,021	\$5,099	\$5,201	\$12,322

COSTS/SAVINGS FROM DESIGN AND BUILD CONSTRUCTION INITIATIVE

Capital Projects Over \$1,500,000 With Design/Build Expenditures in 2004, 2005 or 2006

	Total Expenditures	2004	2005	
IP 03-01 Elevated Storage Tank - 2.0 MG	\$3,000,000	\$2,150,000	\$850,000	
Total Capital Expenditures From Qualifying Projects	\$3,000,000	\$2,150,000	\$850,000	
Forecasted Percent of Savings From Changes in Design/Build Practices		3.00%	4.00%	
Forecasted Rate Base Savings		64,500	34,000	
Rate of Return		8.25%	8.25%	
Reduction in Utility Operating Income		\$5,321	\$2,805	
Revenue Requirement Reduction (At 1.4 times)		\$7,450	\$3,927	\$11,377

COSTS/SAVINGS FROM IMPROVED DEBT RATING

	2003	2004	2005	
Interest and Issuance Cost Savings (Table 1.3)	\$83,400	\$121,900	\$134,275	
Total KY-AM Interest Savings	\$83,400	\$121,900	\$134,275	\$339,575

NET COST/SAVINGS

Total Savings - Best Practices Implementation	\$100,221	\$285,199	\$312,260	\$697,681
Total Costs to Implement Best Practices - Charged to Subsidiaries (3-year Amortization of KY-AM Procurement Initiative Savings)		\$111,469	\$111,469	222,938
Net Savings in Revenue Requirement Resulting From RWE Transaction	\$100,221	\$173,730	\$200,791	\$474,743

**TABLE 1.1 OF 2003 REPORT
KENTUCKY - AMERICAN WATER COMPANY
OPERATING EXPENSE SAVINGS FROM RWE PROCUREMENT INITIATIVE**

	2003	2004	Inflation Factor	2005
Chemicals		54,000	1.02	55,080
Commercial Printing & Finishing		6,100	1.02	6,222
Field Op's Equipment		700	1.02	714
Fleet		15,400	2.00	30,800
Freight/Transportation		1,100	1.02	1,122
Fuel		2,500	1.02	2,550
Instrumentation & Process Control		200	1.02	204
Information Technology (IT)		7,900	1.02	8,058
Laboratory Supplies	2,400	8,000	1.02	8,160
Maintenance, Repair & Operations (MRO)	200	250	1.02	255
Office Equipment		3,600	1.02	3,672
Office Supplies	7,000	14,300	1.02	14,586
Professional Services		6,900	1.02	7,038
PVC Pipe		0	1.02	0
Tank Rehabilitation		0	1.02	0
Telecommunications		14,400	1.02	14,688
Temporary Labor		8,000	1.02	8,160
Tires	800	500	1.02	510
Travel		6,900	1.02	7,038
	<u>\$10,400</u>	<u>\$150,750</u>		<u>\$168,857</u>

**TABLE 1.2 OF 2003 REPORT
 KENTUCKY - AMERICAN WATER COMPANY
 CAPITAL EXPENSE SAVINGS FROM RWE PROCUREMENT INITIATIVE**

	2003	2004	Inflation Factor	2005
Construction Equipment		4,500	1.02	4,590
Fleet		11,600	1.02	11,832
Instrumentation & Process Control	200	250	1.02	255
Information Technology (IT)	17,300	11,300	1.02	11,526
Package Pump Stations & Well Rehab		16,500	1.02	16,830
	\$17,500	\$44,150		\$45,033

**TABLE 1.3 OF 2003 REPORT
 KENTUCKY-AMERICAN WATER COMPANY
 RWE MERGER COSTS/SAVINGS INFORMATION
 SAVINGS ON THE COST OF LONG-TERM DEBT**

Debt Security	Date Issued	Amount Issued	Term of the Loan	Basis Point Savings	Annual Interest Savings	Avoided Issuance Costs	Avoided Annual Issuance Costs	Net Annual Savings
2002	6/12/2002	\$24,000,000	5 Years	20	\$48,000	\$177,000	\$35,400	\$83,400
Total Savings - 2002					\$48,000		\$35,400	\$83,400
2003								
Total Savings - 2003					\$48,000		\$35,400	\$83,400
2004	3/1/2004	\$14,000,000	10 Years	20	\$28,000	\$105,000	\$10,500	\$38,500
Total Savings - 2004					\$76,000		\$45,900	\$121,900
2005	10/1/2005	\$5,500,000	30 Years	20	\$11,000	\$41,250	\$1,375	\$12,375
Total Savings - 2005					\$87,000		\$47,275	\$134,275