

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

**IN THE MATTER OF:**

|                                             |   |                   |
|---------------------------------------------|---|-------------------|
| <b>COMPLIANCE OF KENTUCKY-AMERICAN</b>      | ) |                   |
| <b>WATER COMPANY, AMERICAN WATER WORKS</b>  | ) |                   |
| <b>COMPANY, RWE AKTIENGESELLSCHAFT AND</b>  | ) |                   |
| <b>THAMES WATER AQUA HOLDINGS GMBH WITH</b> | ) |                   |
| <b>THE PROVISIONS OF THE ORDERS</b>         | ) | <b>CASE NO.</b>   |
| <b>APPROVING THE TRANSFER OF CONTROL OF</b> | ) | <b>2002-00277</b> |
| <b>KENTUCKY-AMERICAN WATER COMPANY TO</b>   | ) |                   |
| <b>RWE AKTIENGESELLSCHAFT AND THAMES</b>    | ) |                   |
| <b>WATER AQUA HOLDINGS GMBH</b>             | ) |                   |

**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 attached.

Respectfully submitted,

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BY: 

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Thames Water Aqua Holdings GmbH, Thames  
Water Aqua US Holdings, Inc., RWE AG and  
American Water Works Company, Inc.

**CERTIFICATION**

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. 2002-00317 by electronic mail on March 31, 2006 that the electronic version of this pleading has been transmitted to the Commission, and that a paper copy has been served by mail upon:

Foster Ockerman, Jr., Esq.  
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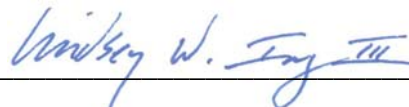
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and that the original and three paper copies have been filed with the Public Service Commission on the 31st day of March, 2006.

BY:   
Counsel for Kentucky-American Water Company,  
Thames Water Aqua Holdings GmbH, Thames  
Water Aqua US Holdings, Inc., RWE AG and  
American Water Works Company, Inc.

**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 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 was implemented and new purchasing contracts were 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 \$10,400 of the total 2003 procurement savings. Kentucky American Water's annual procurement cost savings were \$279,000 in 2004 and \$302,000 in 2005. 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 \$416,828 was realized in 2004 and \$446,249 in 2005. 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 reflected (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 a single contractual agreement to design and build projects in exchange for appropriate incentives designed to ensure timely 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 and risk management.

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. No individual projects greater than \$1.5 million were initiated in 2005.

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 is incorporated into the overall savings shown on Table 1.

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 testimony in Case 2004-0103 has demonstrated gross savings of approximately \$281,000 as part of its forecasted test-year filing. The Company has also demonstrated 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. The customer care center transactional accounting shared services center savings were embedded into the current rates of the Company in the order establishing approved tariffs in case number 2004-00103.

**TABLE 1 OF 2005 REPORT  
KENTUCKY-AMERICAN WATER COMPANY  
RWE MERGER COSTS/SAVINGS INFORMATION**

**OP EX COSTS/SAVINGS FROM PROCUREMENT INITIATIVE**

|                                                  | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>TOTAL</u> |
|--------------------------------------------------|-------------|-------------|-------------|--------------|
| Operating Expense Savings as shown on Table 1.1. | \$10,400    | \$279,000   | \$302,000   | \$591,400    |
| Revenue Requirement Reduction                    | \$10,400    | \$279,000   | \$302,000   | \$591,400    |

**CAP EX COSTS/SAVINGS FROM PROCUREMENT INITIATIVE**

|                                                 |          |           |          |          |
|-------------------------------------------------|----------|-----------|----------|----------|
| Capital Expense Savings as shown on Table 1.2   | \$17,500 | \$106,000 | \$70,000 |          |
| Less: allocated Portion of Implementation costs | \$0      | \$0       | \$0      |          |
| Net Capital Expense (Rate Base) Savings         | \$17,500 | \$106,000 | \$70,000 |          |
| Rate of Return                                  | 8.25%    | 8.25%     | 8.25%    |          |
| Reduction in Utility Operating Income           | \$1,444  | \$8,745   | \$5,775  |          |
| Revenue Requirement Reduction (At 1.4 times)    | \$2,021  | \$14,264  | \$22,349 | \$22,349 |

**COSTS/SAVING FROM DESIGN AND BUILD CONSTRUCTION INITIATIVE  
Capital projects Over \$1,500,000 With Design/Build Expenditures in 2004, 2005 or 2006**

|                                                                     | <u>Total Expenditures</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> |         |
|---------------------------------------------------------------------|---------------------------|-------------|-------------|-------------|---------|
| IP 03-01 Elevated storage Tank - 2.0 MG                             | \$3,000,000               |             | \$480,216   |             |         |
| Total Capital Expenditures From Qualifying Projects                 | \$3,000,000               |             | \$480,216   | \$0         |         |
| Forecasted Percent of Saving From Changes in Design/Build Practices |                           |             | 3.00%       |             |         |
| Forecasted Rate Base Savings                                        |                           |             | \$14,406    |             |         |
| Rate of Return                                                      |                           |             | 8.25%       |             |         |
| Reduction in Utility Operating Income                               |                           |             | \$1,189     |             |         |
| Revenue Requirement Reduction (At 1.4. times0                       |                           |             | \$1,664     |             | \$1,664 |

**COSTS/SAVINGS FROM IMPROVED DEBT RATING**

|                                                |          |           |           |           |
|------------------------------------------------|----------|-----------|-----------|-----------|
| Interest and Issuance Cost Savings (Table 1.3) | \$83,400 | \$121,900 | \$121,900 |           |
| Total Kentucky-American Interest Savings       | \$83,400 | \$121,900 | \$121,900 | \$327,200 |
| <b>NET COST/SAVINGS</b>                        |          |           |           |           |
| Total Savings - Best Practices Implementation  | \$95,821 | \$416,828 | \$446,249 | \$958,899 |

**TABLE 1.1 OF 2005 REPORT KENTUCKY-AMERICAN WATER COMPANY  
OPERATING EXPENSE SAVINGS FROM RWE PROCUREMENT INITIATIVE**

|                                        | 2003            | 2004             | 2005             | TOTAL            |
|----------------------------------------|-----------------|------------------|------------------|------------------|
| Accounts Payable Audit Advertising     |                 | 1,000            |                  | 1,000            |
| Bill inserts & CCR Chemicals           |                 | 9,000            |                  | 9,000            |
| Field Op's Equipment Facility          |                 | 30,000           |                  | 30,000           |
| Plumbing Supplies/ Plumbing Supplies   |                 | 72,000           | 121,000          | 193,000          |
| Courier Services                       |                 | 2,000            | 2,000            | 4,000            |
| Fleet                                  |                 | 1,000            |                  | 1,000            |
| Freight/Transportation Fuel            |                 |                  |                  | 0                |
| Instrumentation 7 process Control      |                 |                  |                  | 0                |
| Information Technology (IT)            |                 | 7,000            | 2,000            | 9,000            |
| Laboratory supplies                    |                 | 12,000           | 20,000           | 32,000           |
| Maintenance, Repair & Operations (MRO) | 200             | 13,000           | 17,000           | 30,200           |
| Equipment                              |                 | 3,000            |                  | 3,000            |
| Office Supplies                        | 2,400           | 7,000            | 6,000            | 15,400           |
| P-Card Rebate                          | 7,000           | 3,000            |                  | 10,000           |
| Professional Services                  |                 | 7,000            | 6,000            | 13,000           |
| Professional Services - Lock box       |                 | 40,000           | 29,000           | 69,000           |
| Tank Rehabilitation                    |                 |                  |                  | 0                |
| Telecommunications                     |                 | 20,000           | 36,000           | 56,000           |
| Temporary Labor                        |                 | 31,000           | 40,000           | 71,000           |
| Tires                                  | 800             | 9,000            | 8,000            | 17,800           |
| Travel                                 |                 | 7,000            | 12,000           | 19,000           |
| Uniforms                               |                 | 5,000            | 3,000            | 8,000            |
| <b>TOTAL</b>                           | <b>\$10,400</b> | <b>\$279,000</b> | <b>\$302,000</b> | <b>\$591,400</b> |

**TABLE 1.2 OF 2005 REPORT KENTUCKY-AMERICAN WATER COMPANY  
CAPITAL EXPENSE SAVINGS FROM RWE PROCUREMENT INITIATIVE**

|                                    | <b>2003</b>     | <b>2004</b>      | <b>2005</b>     | <b>TOTAL</b>     |
|------------------------------------|-----------------|------------------|-----------------|------------------|
| Construction Equipment             |                 | 34,000           | 7,000           | 41,000           |
| Copper Tubing                      |                 | 28,000           | 1,000           | 29,000           |
| Fleet                              |                 | 4,000            | 57,000          | 61,000           |
| Instrumentation & Process Control  | 200             | 11,000           |                 | 11,200           |
| Information Technology (IT)        | 17,300          | 24,000           | 4,000           | 45,300           |
| Lab Supplies                       |                 | 3,000            |                 | 3,000            |
| Meters                             |                 |                  | 1,000           | 1,000            |
| Package Pump Stations & Well Rehab |                 | 2,000            |                 | 2,000            |
| <b>TOTAL</b>                       | <b>\$17,500</b> | <b>\$106,000</b> | <b>\$70,000</b> | <b>\$193,500</b> |

**TABLE 1.3 OF 2005 REPORT  
 KENTUCKY-AMERICAN WATER COMPANY  
 RWE MERGER CONSTS/SAVINGS INFORMATION  
 SAVINGS ON THE COST OF LONG-TERM DEBT**

| <b>Debt Security</b>        | <b>Date Issued</b> | <b>Amount Issued</b> | <b>Term of the Loan</b> | <b>Basis Point Savings</b> | <b>Annual Interest Savings</b> | <b>Avoided Issuance Costs</b> | <b>Avoided Annual Issuance Costs</b> | <b>Net Annual Savings</b> |
|-----------------------------|--------------------|----------------------|-------------------------|----------------------------|--------------------------------|-------------------------------|--------------------------------------|---------------------------|
| 2002                        | 06/12/2002         | \$24,000,000         | 5 Years                 | 20                         | \$48,000                       | \$177,000                     | \$35,400                             | \$83,400                  |
| <b>Total Savings - 2002</b> |                    |                      |                         |                            | <b>\$48,000</b>                |                               | <b>\$35,400</b>                      | <b>\$83,400</b>           |
|                             |                    |                      |                         |                            |                                |                               |                                      |                           |
| 2003                        |                    |                      |                         |                            | \$48,000                       |                               | \$35,400                             | \$83,400                  |
| <b>Total Savings - 2003</b> |                    |                      |                         |                            | <b>\$48,000</b>                |                               | <b>\$35,400</b>                      | <b>\$83,400</b>           |
|                             |                    |                      |                         |                            |                                |                               |                                      |                           |
| 2004                        | 3/1/2004           | 14000000             | 10 Years                | 20                         | \$28,000                       | \$105,000                     | \$10,500                             | \$38,500                  |
| <b>Total Savings - 2004</b> |                    |                      |                         |                            | <b>\$76,000</b>                |                               | <b>\$45,900</b>                      | <b>\$121,900</b>          |
|                             |                    |                      |                         |                            |                                |                               |                                      |                           |
| 2005                        |                    |                      |                         |                            | \$76,000                       |                               | \$45,900                             | \$121,900                 |
| <b>Total Savings - 2005</b> |                    |                      |                         |                            | <b>\$76,000</b>                |                               | <b>\$45,900</b>                      | <b>\$121,900</b>          |

Note: No New Permanent Financings in 2005