COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE JOINT PETITION OF KENTUCKY-AMERICAN WATER COMPANY, THAMES WATER AQUA HOLDINGS GMBH, RWE AKTIENGESELLSCHAFT, THAMES WATER AQUA US HOLDINGS, INC., AND AMERICAN WATER WORKS COMPANY, INC. FOR APPROVAL OF A CHANGE IN CONTROL OF KENTUCKY-AMERICAN WATER COMPANY	) CASE NO. 2006-00197

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O R D E R

Joint Petitioners[1] have applied to the Commission for approval of Thames Water Aqua Holdings GmbH's ("Thames GmbH") sale of the common stock of American Water Works Company ("AWWC") to the public. The proposed transaction will effectively transfer indirect control of Kentucky-American Water Company ("Kentucky-American") from its current owner to unknown persons. At issue is whether the proposed transaction meets the requirements of KRS 278.020(5). Finding that, with the imposition of conditions to protect the public interest, the proposed transaction meets these requirements, the Commission approves the proposed transfer subject to certain conditions.

PROCEDURE

On May 10, 2006, Joint Petitioners advised the Commission of their intent to apply for Commission approval of Thames GmbH's sale of its common stock of AWWC

[1] The "Joint Petitioners" are: Kentucky-American Water Company; American Water Works Company; Thames Water Aqua US Holdings, Inc.; Thames Water Aqua Holdings GmbH; and RWE Aktiengesellschaft.

and the merger of Thames Water Aqua US Holdings, Inc. ("TWAUSHI") with AWWC. On May 11, 2006, the Commission established a docket to review the proposed transaction and further established procedures for the electronic filing of documents and pleadings in this docket. On June 5, 2006, Joint Petitioners filed their application.

On June 19, 2006, the Commission established a procedural schedule for this docket and directed the submission of memoranda upon the applicability of KRS 278.020(5) and (6) to the proposed transaction. On August 14, 2006, after all parties had submitted written memoranda, the Commission held that only KRS 278.020(5) was applicable to the proposed transaction.

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

Following extensive discovery by the parties in this matter, the Commission held a public hearing on August 16, 2006, at its offices in Frankfort, Kentucky. Testifying at this hearing were: Nick O. Rowe, president of Kentucky-American; Jens Gemmecke, Senior Project Manager in the RWE Mergers and Acquisitions Department; John S. Young, Jr., Chief Operations Officer, AWWC; Ellen C. Wolf, AWWC Senior Vice President and Chief Financial Officer; Michael A. Miller, Kentucky-American Treasurer/Comptroller; J. Randall Woolridge, consultant; and Scott J. Rubin, attorney and consultant.[2] Following the hearing, all parties submitted written briefs.

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[2] Although the Commission provided an opportunity for public comment at this hearing, no members of the public appeared and presented comments.

THE PROPOSED TRANSACTION: AN OVERVIEW

Kentucky-American, a Kentucky corporation, owns and operates facilities that are used in the distribution of water to the public in Bourbon, Clark, Fayette, Gallatin, Grant, Harrison, Jessamine, Owen, Scott and Woodford counties. It also owns and operates facilities for the collection and treatment of sewage for the public in Clark and Owen counties. It is a utility subject to Commission jurisdiction and regulation.[3]

AWWC, a Delaware corporation, and its operating subsidiaries employ approximately 6,000 persons and provide water, wastewater and other water resource management services to approximately 18 million persons in 29 states and Canada. From 1947 until 2003, it was one of the largest publicly-traded water companies in the United States and was listed on the New York Stock Exchange. It currently owns all outstanding shares of Kentucky-American stock. It neither conducts nor is authorized to conduct business within the Commonwealth.

TWAUSHI, a Delaware corporation, is AWWC's direct parent company. It neither conducts nor is authorized to conduct business within the Commonwealth. It owns subsidiaries that provide water, wastewater services and other water resource management services to approximately 18 million customers in 29 states and Canada.

Thames GmbH is a foreign corporation that is organized and exists under the laws of the Federal Republic of Germany. It is a wholly-owned subsidiary of RWE Aktiengesellschaft ("RWE") and is the holding company for most of RWE's water operations throughout the world. Thames GmbH owns all of the outstanding stock of

[3] KRS 278.010(3)(d) and (3)(e); KRS 278.040(1).

TWAUSHI. It neither conducts nor is authorized to conduct business within the Commonwealth.

In February 2003, after obtaining Commission approval, RWE and Thames GmbH acquired AWWC's outstanding stock and effectively obtained control of Kentucky-American and all of AWWC's other operating companies. Two years after acquiring AWWC and its operating subsidiaries, however, RWE chose to focus upon its electric and natural gas operations and to divest itself of its water operations. One of AWWC's witnesses testified as to RWE's reasoning:

> RWE has revised its core business focus to be on the European power and energy markets, where historically its roots lie. In the last two years, in order to become a more market-oriented and focused company, RWE had already divested non-core activities such as its environmental business. In order to maintain its position among Europe's leading integrated electricity and gas companies, in response to fierce competition, growing customer needs, and rising costs both for energy production facilities and many other energy production inputs, RWE is forced to concentrate on its power and energy markets. As a result of these developments, RWE's ability to maintain its competitiveness in its core European businesses is proving far more capital intensive than RWE could have predicted when it acquired American Water. Consequently, RWE decided that it intends to sell the water operations of Thames Water in the U.K. and to return American Water to its status as a U.S. publicly-traded company. The Proposed Transaction will allow RWE to focus on its core businesses in its home region . . . .[4]

RWE's planned divesture of its North American water operations involves two steps. First, TWAUSHI will merge with and into AWWC. AWWC will be the surviving corporation. This merger will consolidate all of RWE's water-related assets in the

[4] Direct Testimony of Ellen C. Wolf at 10.

United States into one entity.[5] Thereafter, Thames GmbH will sell up to 100 percent of the common stock of AWWC. These shares will be sold through one or more public offerings to a broad group of investors, including institutional and retail investors. If less than 100 percent of the AWWC stock is sold in the initial offering, then subsequent pubic offerings of AWWC stock will be conducted. The identities of the stock purchasers will not be known until the public offerings are complete.

An initial step in the proposed transaction is the preparation and filing of a registration statement with the U.S. Securities and Exchange Commission ("SEC"). This statement will contain AWWC's "audited financial statements, descriptions of its business, financial performance, management and risk factors that investors may consider in deciding to buy the shares."[6] This statement will also set forth the principal risks in investing in AWWC. The SEC will review and comment upon this statement. AWWC must address these comments with amendments to the initial registration statement.

Upon submission of a registration statement that is acceptable to the SEC, AWWC, Thames GmbH, and the underwriters will market the stock issuance. Once this marketing process is completed, AWWC will request the SEC to declare the registration statement effective. The underwriters and Thames GmbH will then agree upon a price per share at which the shares will be sold to the public.

When the public sale occurs, Thames will sell its shares of AWWC stock to the underwriters who will then resell these shares to the subscribed purchasers. Both sales

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[5] Joint Petition at ¶ 16.

[6] Direct Testimony of Ellen C. Wolf at 7.

should occur within the same day. The closing of the stock offering will occur at the settlement of purchases, which is expected to occur within 3 or 4 days of the pricing. At settlement, shares are transferred directly to the investors. On the date of closing, AWWC's stock will begin regular trading on the New York Stock Exchange.

The proposed transaction will have no immediate or direct effect upon Kentucky-American. None of its stock or debt is involved. No change in Kentucky-American's financial or management structure will occur.[7] As AWWC owns all of Kentucky-American's outstanding common stock, however, the initial public offering ("IPO") of AWWC stock will effectively transfer control of Kentucky-American when the IPO is completed.

STANDARD OF REVIEW

KRS 278.020 requires Commission review and approval of any change in or transfer of control of a utility. KRS 278.020(5) provides:

> No person shall acquire or transfer ownership of, or control, or the right to control, any utility under the jurisdiction of the 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(6) 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

[7] Joint Petitioners' Post-Hearing Brief at 13; Direct Testimony of Nick O. Rowe at 4-5.

> 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.

Subsections 5 and 6 are not dependent. Subsection 5 represents the codification of the holding of Public Service Commission v. Cities of Southgate, Highland Heights, 268 S.W.2d 19, 21 (Ky. 1954),[8] and addresses the transfer of ownership or control of a utility. Subsection 6 focuses more narrowly on the "acquisition of control" of a utility. While a transaction that results in a transfer of control may trigger both subsections, it does not necessarily do so.

The proposed transaction will result in a transfer of control, but as presently described will not result in an "acquisition of control" for purposes of KRS 278.020(6).[9] Upon its completion, RWE, the entity that currently controls AWWC and Kentucky-American, will no longer control either entity. As the proposed transaction results in the transfer of RWE's ability to control AWWC and Kentucky-American, Subsection 5 is applicable. As there is no evidence that at the proposed transaction's completion any entity will possess a sufficient quantity of AWWC stock to control AWWC, and thereby Kentucky-American, Subsection 6 is not applicable at this time.

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[8] See also Public Service Commission v. City of Paris, 299 S.W.2d 811 (Ky. 1957); South Central Rural Tel. Co-op. Corp. v. Public Service Commission of Ky., 453 S.W.2d 257 (Ky. 1970).

[9]
> Control shall be presumed to exist if any individual or entity, directly or indirectly, owns ten percent (10%) or more of the voting securities of the utility. This presumption may be rebutted by a showing that ownership does not in fact confer control. . . .

KRS 278.020(6).

While Subsection 6 is not applicable, the Commission's review in this case is not limited merely to the examination of the acquirer's financial, technical, and managerial abilities to provide utility service. As Kentucky's highest court noted in Southgate, the Commission has always possessed the implied power to review and hear evidence on utility transfers, including the authority to examine the effects of the proposed transfer on the adequacy of utility service, to determine if the proposed transfer is in the public interest, and to impose conditions upon the proposed transfer to ensure that it will not adversely affect utility service.[10] KRS 278.020(5) codified this implied power.[11]

In reviewing Joint Petitioners' application, the Commission must first determine if the persons who are acquiring control of Kentucky-American have the requisite abilities to provide reasonable utility service. Next, we must determine whether the proposed transfer is consistent with the "public interest."

The Commission has previously held that a proposed transfer is in the public interest if it will not adversely affect the existing level of utility service or rates or that any potentially adverse effects can be avoided through the Commission's imposition of

[10] Southgate at 21 ("[W]here an existing utility proposes to sell its system, the [C]ommission, in order to carry out its responsibility, must have the opportunity to determine whether the purchaser is ready, willing and able to continue providing adequate service."). See, e.g., Blue Grass State Tel. Co. v. Public Service Commission, 382 S.W.2d. 81, 82 (Ky. 1964) ("The sole issue for [the Commission] to decide was whether the operation of this system by Blue Grass was in the public interest.")

[11] See also KRS 278.280 (permitting the Commission to determine and fix the just, proper, adequate, reasonable or sufficient practices, services and methods to ensure the proper delivery of utility service).

reasonable conditions on the acquiring party.[12] The Commission has further required a showing 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]

ACQUIRING PARTIES' ABILITY TO PROVIDE REASONABLE UTILITY SERVICE

Joint Petitioners argue that, upon completion of the proposed transaction, no material changes will occur in Kentucky-American's operation and that the provision of service will be unaffected. They note that after the IPO, Kentucky-American will continue to operate with its current employees and will continue to contract with American Water Works Service Company ("AWWSC") for additional services. Kentucky-American currently employs directly or through AWWSC an experienced engineering staff that has been nationally recognized.[15]

They further note that AWWC will remain a source of equity capital for Kentucky-American and that Kentucky-American will continue to be able to access the debt

[12] Case No. 2002-00018, Application for Approval of the Transfer of Control of Kentucky-American Water Company to RWE Aktiengesellschaft and Thames Water Aqua Holdings GmbH (Ky. PSC May 30, 2002) at 7.

[13] Case No. 2002-00317, The Joint Petition of Kentucky-American Water Company, Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, Thames Water Aqua US Holdings, Inc., Apollo Acquisition Company and American Water Works Company, Inc. for Approval of a Change of Control of Kentucky-American Water Company (Ky. PSC Dec. 20, 2002) at 10.

[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. PSC June 30, 2000).

[15] Direct Testimony of Nick O. Rowe at 4-6.

market through American Water Capital Company ("AWCC"). Acting as the financing arm of AWWC since 2000,[16] AWCC borrows money for AWWC and its operating subsidiaries and then loans those monies to the operating subsidiaries at cost. This arrangement enables each operating subsidiary to share any benefits from a greater economy of scale.

Finally, Joint Petitioners assert that the management that is currently operating Kentucky-American will continue to remain in place after the IPO of AWWC stock. They further note that upon completion of the IPO, a majority of AWWC's directors, and all members of the audit, compensation and nominating committees of AWWC's board of directors will be independent directors.[17] "The seasoned management team at American Water will continue to have the background necessary to run a large, publicly traded water company."[18]

LFUCG argues that, as the identity of those persons acquiring AWWC stock through the IPO is currently unknown, the record is devoid of any evidence of their ability to provide reasonable utility service.[19] Given that the Commission lacks any ability to assess and determine an unknown entity's ability to provide reasonable utility service, LFUCG argues, the General Assembly through its enactment of KRS

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

[17] Direct Testimony of Ellen C. Wolf at 18.

[18] Joint Petitioners' Post-Hearing Brief at 13.

[19] Although he devotes little attention to it, the AG also makes this argument. See Office of Attorney General Post-Hearing Brief at 4 ("Given the identification of any actual owner that will succeed RWE, there is no basis in the record for the premise that the new owners will supply any financial, technical, or managerial expertise.")

278.020(5) clearly intended to prohibit the use of IPOs of stock to transfer ownership or control of a utility.[20] Accordingly, it argues, Joint Petitioners' application should be denied or, in the alternative, be held in abeyance until such time as AWWC files its registration statement with the SEC.

The plain language of KRS 278.020(5) does not support LFUCG's position. The statute addresses transfers of control or ownership "by sale of assets, transfer of stock, **or otherwise,** [emphasis added] . . . ." The use of the phrase "or otherwise" suggests an intent on the General Assembly's part to include all means of transfer of ownership or control. The statute does not exclude IPOs.[21]

The Commission acknowledges that lack of the acquiring party's identity renders any determination of that party's abilities more difficult and less reliable. The proposed transaction, however, assumes the issuance of stock to a broad range of the public and does not envision any of the purchasing parties acquiring sufficient stock to direct the utility's management and activities. As a practical matter, these purchasers are acquiring the stock as a passive investment and will rely upon the management already

[20] LFUCG's Brief at 8-9. See also LFUCG's Memorandum in Response to the Commission's June 19, 2006 Order at 3.

[21] We find no support for LFUCG's assertion that the acquiring party must personally demonstrate its ability to provide reasonable service. LFUCG's Brief at 9 ("The express language of this statute is that the **acquirer** (and not AWW, for instance) **must demonstrate the abilities** that the Kentucky legislature has determined are required for such a transfer of ownership [emphasis added].") KRS 278.020(5) merely requires the Commission to determine if the acquirer has such abilities and, if it does, to approve the transfer. See also Case No. 2002-00018, Order of May 30, 2002 at 11 (holding that KRS 278.020 "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").

in place to operate the utility. Should this change and one or more investors seek to acquire "control" of AWWC, the requirements of KRS 278.020(6) would be triggered.

The Commission finds that an accurate assessment of the acquiring parties' ability to provide utility service can be made through an examination of the abilities of the management that is currently in place and will remain in place after the transaction is completed.[22] Based upon this examination, the Commission finds that, the acquiring parties using the current management of AWWC and Kentucky-American, will have the requisite abilities to provide reasonable utility service.

PUBLIC INTEREST ANALYSIS

Joint Petitioners argue that the proposed transaction will result in several benefits for Kentucky-American's ratepayers and the public at large. First, they point to AWWC's enhanced access to public debt and equity capital markets in the United States. They note that RWE currently does not have access to such markets. This access, they further note, "is a significant benefit when compared to what . . . [AWWC] could face if it were forced to remain a fourth tier subsidiary of a foreign corporation which has refocused its core business on the European energy market" and subject to "increased competition for scarce capital funds which would increase constraints on the availability of capital for discretionary purposes."[23]

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[22] An acquirer's reliance upon existing management is not unusual and has previously served as the basis for a determination of the acquiring party's ability to provide utility service. See, e.g., Case No. 2005-00433, The Joint Application of Nuon Global Solutions USA, BV, Nuon Global Solutions USA, Inc., AIG Highstar Capital II, LP, Hydro Star, LLC, Utilities, Inc. and Water Service Corporation of Kentucky for Approval of an Indirect Change in Control of a Certain Kentucky Utility Pursuant to the Provisions of KRS 278.020(5) and (6) and 807 KAR 5:001, Section 8 (Ky. PSC Mar. 8, 2006).

[23] Joint Petitioners' Post-Hearing Brief at 16.

Second, Joint Petitioners note that, upon completion of the transaction, AWWC will be "subject to the SEC laws and regulations, including the Sarbanes-Oxley legislation, and the rules of the stock exchange on which it is traded."[24] They further note that RWE is not currently subject to these laws. Joint Petitioners suggest that the application of these laws will create investor confidence in AWWC and will better enable it to attract capital at reasonable rates.

Third, Joint Petitioners assert that the proposed transaction will enable Kentucky-American customers and Kentucky-American employees to invest in AWWC and thus have an ownership interest in their water supplier or employer. Kentucky-American officials testified that employee ownership of AWWC stock would strengthen employee-employer relations and potentially improve employee productivity.[25]

Joint Petitioners assert that there are no known potential adverse effects on Kentucky-American from the proposed transaction.[26] They note that none of the proposed transaction costs will be recovered from Kentucky-American ratepayers;[27] that Kentucky-American will continue to honor its collective bargaining agreements;[28] that Kentucky-American's rates, operating policies, and current investment and capital programs will not change;[29] and that Kentucky-American will continue its contributions

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[24] Id.

[25] Joint Petition at ¶ 23.

[26] Direct Testimony of Nick O. Rowe at 8.

[27] Joint Petition at ¶ 46.

[28] Direct Testimony of Nick O. Rowe at 8.

[29] Id.

and commitment to local communities.[30] They expect no adverse change in either AWWC or Kentucky-American's cost of capital.[31]

The AG and LFUCG do not share this view. They find no significant benefits resulting from the proposed transaction. LFUCG argues that the proposed transaction will eliminate all purported benefits from RWE's acquisition of AWWC, which included access to Thames GmbH resources and expertise, a sharing of Thames GmbH's best operating practices, and greater availability to technical resources, capital markets, and Thames GmbH's research and development programs.[32]

The AG argues that the proposed transaction will increase AWWC's capital costs. He notes 3 factors in support of his position: (1) Standard and Poor's downgrading its rating of AWWC's debt to A- after the announcement of the proposed transaction; (2) AWWC's need to refinance $2.65 billion of existing debt that RWE currently holds; and (3) the effective conversion of $1.75 billion of AWWC preferred stock, which RWE holds, to common equity.[33]

The AG further argues that the proposed transaction will expose AWWC to significant auditing and reporting costs associated with the Sarbanes-Oxley Act of 2002.[34] Upon completion of the proposed transaction, AWWC will be a publicly traded corporation and will be subject to the requirements of the Sarbanes-Oxley Act.

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[30] Id.

[31] Direct Testimony of Ellen C. Wolf at 17.

[32] LFUCG's Brief at 12-13.

[33] Direct Testimony of J. Randall Woolridge at 12.

[34] Pub.L. No. 107-204, 116 Stat. 745.

Although AWWC estimates these costs at one million dollars annually after the first year following the proposed transaction, the AG asserts that the financial cost of compliance will be much greater. These costs, the AG suggests, will be pushed down to Kentucky-American and its ratepayers.

The AG expresses great concern that the AWWC which RWE and Thames GmbH leave behind will be a significantly weakened entity that faces major financial challenges. He notes that AWWC's pension fund and other post-employment benefit plans are currently underfunded by $277 million and $177 million respectively.[35] As compared to an industry average of 90 percent, AWWC's funding ratio was only 60 percent. Under a recently enacted federal law,[36] this funding shortfall must be corrected by 2015. The AG asserts that such a shortfall can only be corrected through higher rates or delay of needed capital and maintenance expenditures.

In addition to addressing its pension fund shortages, AWWC will need to maintain a high level of capital expenditure spending to upgrade and maintain its existing utility plant to meet present and expected regulatory standards. The AG notes that AWWC expects capital expenditures for maintenance to increase at a rate of 15 percent annually from 2011 through 2020. He further notes that AWWC's capital expenditure averaged close to $500 million over the past 3 years and its capital spending is expected to markedly increase in the next 5 years.[37]

[35] Direct Testimony of Scott J. Rubin at 12.

[36] Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780.

[37] Direct Testimony of Scott J. Rubin at 10-12.

Based upon our review of the record, we find few benefits from the proposed transaction that will accrue to Kentucky-American ratepayers. We agree with the AG and LFUCG that the proposed transaction will eliminate virtually all benefits that were to have resulted from RWE's acquisition of AWWC. It will eliminate Kentucky-American's access to world capital markets through Thames GmbH and RWE.[38] It will end Kentucky-American's ability to draw upon Thames GmbH's research and development programs and its resources and expertise, including those in the critical area of infrastructure security.[39]

While the proposed transaction provides some benefits, these are of limited value. Any benefit resulting from AWWC's access to public debt and equity capital markets in the United States occurs at the expense of AWWC's access to foreign debt and equity capital markets. Joint Petitioners, moreover, have failed to provide

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[38] The result is likely to be higher capital costs. See Case No. 2002-00018, Petitioners' Post-Hearing Brief at 19-20 (citations omitted) ("[S]ince RWE's bond ratings are higher than American's, capital will be available at a cost lower than American's cost. No longer confined to domestic markets, Kentucky-American will have access to capital markets from around the world. This expansion of financial sources should bring down Kentucky-American's cost of capital and position the Company to both grow and enhance services.").

[39] In his direct testimony, Mr. Rowe insists that Kentucky-American has benefited greatly from its current relationship with Thames GmbH and that these benefits will remain with the utility. Direct Testimony of Nick O. Rowe at 8-9. While nothing in the record indicates that these benefits will disappear, the transfer of ideas, practices, and experiences between AWWC and Thames GmbH will cease. In Case No. 2002-00018, Kentucky-American asserted that this constant sharing of ideas would provide future benefits long after the transaction had been consummated. See Case No. 2002-00018, Joint Applicants' Response to Attorney General's Initial Requests for Information, Item 118 ("Through the potential exchange of personnel and information that will result from the merger, the management of KAWC will have access to this increased breadth of experience. Over time, this exchange of information will result in more rapid application of new methods and technologies to KAWC than KAWC would be able to effect without the transaction.")

convincing evidence that access to domestic public debt and equity capital markets will result in lower capital costs.

We find very limited value in the ability of Kentucky-American customers and employees to invest in AWWC. While such ability may have a positive effect on the utility's relations with labor and the public, the record is devoid of any specific evidence that it will produce greater employee productivity, reduce management-labor disputes, or otherwise benefit the public or Kentucky-American's ratepayers who do not choose to invest in AWWC.

The Commission recognizes that enhanced regulatory review and scrutiny of AWWC results from the proposed transaction. The SEC will again exercise regulatory oversight of certain aspects of AWWC's operations. Moreover, the reporting requirements of federal securities laws and SEC regulations provide greater and timelier access to information about AWWC's operations to this Commission and the general public. For Kentucky-American ratepayers, the benefit of such requirements is much less significant. As this Commission and other state utility regulatory commissions have imposed significant reporting requirements as a condition to RWE's acquisition of AWWC, most of the relevant information necessary for review and supervision of AWWC's regulated subsidiaries and AWWC's interactions with those subsidiaries is already available. [40]

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[40] Joint Petitioners contend that the applicability of the Sarbanes-Oxley Act and the regulations of the New York Stock Exchange will enable AWWC to attract capital at reasonable rates. While the Commission does not dispute this assertion, we find no compelling evidence on this point. Moreover, while the overall effect of the Sarbanes-Oxley Act on domestic public debt and equity capital markets may be a reduction in the cost of capital, it is unclear whether this reduction would produce a lower cost of capital for AWWC than remaining as a subsidiary of RWE.

The most compelling benefit from the proposed transaction is AWWC's removal from a large, multi-national entity that has operations in several different business sectors and is no longer interested in the water industry. RWE has clearly chosen to focus its resources and attention upon the European energy market. If Kentucky-American and AWWC were to remain in such an organization, their capital and resource requirements would likely be given lower priority than those sectors upon which RWE has chosen to focus.[41] At a minimum, Kentucky-American would be less likely to improve the quality of its service and meet the growing demand for water. At worst, it might experience deterioration in the quality of its service and lack the resources to make important infrastructure replacements. With AWWC as an independent entity, Kentucky-American would be much better positioned to address its capital requirements and to take the necessary actions to maintain and improve the quality of its service.

The record indicates that, upon completion of the proposed transaction, AWWC will face significant capital expenditures to replace and improve the infrastructure of its regulated subsidiaries. It also apparently faces a significant shortfall in its pension funding. Concurrent with the proposed transaction, it must refinance its existing debt as RWE and Thames GmbH divest themselves of any interest in AWWC. Prior to completion of the proposed transaction, AWWC will undergo significant management changes as the composition of its Board of Directors changes with the addition of several independent members.[42] Accordingly, we find that, in light of the lack of any significant benefit that the proposed transaction will bring to Kentucky-American

[41] The AG and LFUCG share this view. <u>See, e.g.</u>, Direct Testimony of Scott J. Rubin at 21; LFUCG Brief at 19.

[42] Joint Petitioners' Post-Hearing Brief at 4.

ratepayers and the significant risk and uncertainty that it will create, the proposed transaction is in the public interest only under the conditions described below and more fully set forth in Appendix A to this Order.

CONDITIONS TO APPROVAL OF PROPOSED TRANSACTION

Based upon our review of the proposed transaction, we find that our approval must be conditioned upon the inclusion of certain protections for Kentucky-American ratepayers. Many of these conditions are similar to those placed upon our approval of RWE's acquisition of AWWC and merely restate AWWC and Kentucky-American's existing obligations.

Service Quality

Our principal concern is the possible degradation of service quality after the public offering. To ensure that the proposed transaction will not unduly disrupt Kentucky-American's operations or adversely affect the quality of its service, we have expressly conditioned our approval upon Kentucky-American customers experiencing no material adverse change in utility service as a result of the proposed transaction.[43]

To guard against immediate and drastic changes in Kentucky-American's management after the public offering of AWWC common stock, we have further conditioned our approval upon retention of the current Kentucky-American management for one year following completion of the IPO and required AWWC and Kentucky-American to provide us with written notification of any changes in management

[43] Appendix A, Condition No. 22.

personnel.[44] Similar conditions have been placed on reductions of non-management employee positions.[45]

The Commission has further imposed several conditions that restate and emphasize Kentucky-American's primary duty to provide reasonable utility service. The provision of utility service must be Kentucky-American's highest priority.[46] Kentucky-American will not be used as an employer or purchaser of last resort for employees, assets, and products associated with any failed or troubled AWWC affiliated venture.[47] Kentucky-American and AWWC must adequately fund and maintain Kentucky-American's facilities to ensure their compliance with all state and federal requirements and their ability to meet the current and future demands of Kentucky-American customers.[48]

We have also extended the requirement that we imposed in Cases No. 2002-00018 and No. 2002-00317 for an annual report on Kentucky-American's water quality standards, number of water service interruptions, average employee response time to water service interruptions, number of customer complaints, and customer inquiry time.[49] We will continue to use these reports as a tool to monitor the quality of Kentucky-American's service and detect any decline in that quality.

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[44] Appendix A, Conditions No. 12 and No. 13.

[45] Appendix A, Condition No. 41.

[46] Appendix A, Condition No. 18.

[47] Appendix A, Condition No. 17.

[48] Appendix A, Condition No. 24.

[49] Appendix A, Condition No. 23.

Transaction Costs

Thames GmbH and AWWC expect to incur costs related to the proposed transaction of $12 million and $11 million, respectively.[50] The Commission finds that Kentucky-American should not bear any of these costs. Joint Petitioners have represented that none of the costs of the proposed transaction will be recovered from Kentucky-American.[51] We have incorporated their representations into our conditions for approving the proposed transaction[52] and have further required that no costs related to early termination costs, retention bonuses or change in control payments resulting from the proposed transaction will be allocated to Kentucky-American.[53] We have further prohibited the payment for the redemption of AWWC's preferred stock to be recorded on Kentucky-American's books.[54]

Local Control/Local Concerns

While the Commission recognizes that the proposed transaction is likely to reduce the distance between Kentucky-American's operations and its ultimate owners, we are of the opinion that the public interest requires that Kentucky-American's local management have the necessary authority and autonomy to make decisions on a local level. To ensure that Kentucky-American remains responsive and retains some measure of local autonomy, we have required Kentucky-American to:

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[50] Joint Petitioners' Response to Commission Staff's First Information Request, Item 10(c) and (d).

[51] Joint Petition at ¶ 46.

[52] Appendix A, Condition No. 3.

[53] Appendix A, Condition No. 7.

[54] Appendix A, Condition No. 5.

- Actively support economic development and social and charitable activities throughout the areas in which it 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 proposed transaction.

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

We have further conditioned our approval upon Kentucky-American's headquarters remaining in Lexington and the utility's books and records remaining within the state.[55] We have also conditioned our approval upon Kentucky-American honoring all existing contracts and agreements with local governments and negotiating renewal of those agreements in good faith.[56]

Sarbanes-Oxley Act of 2002 Compliance Costs

AWWC estimates that it will incur approximately $2 million to comply with the Sarbanes-Oxley Act in the year following the proposed transaction and $1 million annually thereafter.[57] A portion of these costs will be apportioned to Kentucky-American in accordance with its agreement with AWWSC. The AG proposes that Kentucky-

[55] Appendix A, Condition No. 1.

[56] Appendix A, Condition No. 36.

[57] Joint Petitioners' Response to Commission Staff's First Information Request, Item 3.

American's recovery of these costs through general rates be limited to an amount no greater than Kentucky-American's pro rata share of $1.0 million of such costs.[58]

While we find few benefits accruing to Kentucky-American's ratepayers as a result of AWWC being subject to the requirements of the Sarbanes-Oxley Act, we will not place any specific restriction on Kentucky-American's recovery of those costs through the rate-making process. Such compliance costs may be a reasonable and a necessary cost of providing utility service. We place Kentucky-American on notice, however, that in any general rate proceeding in which it seeks recovery of <u>any</u> Sarbanes-Oxley Act compliance costs, it must clearly demonstrate not only that these costs were reasonably incurred but that Kentucky-American ratepayers receive a specific and definite benefit from these costs. Generalities without specific empirical support will not suffice.

<u>Increased Capital Costs</u>

Asserting that the proposed transaction will increase Kentucky-American's capital costs, the AG urges the Commission to condition our approval of the proposed transaction on Joint Petitioners' agreement that AWWC and Kentucky-American hold Kentucky-American's ratepayers harmless for 5 years for the proposed transaction's adverse effects on AWWC's cost of capital.[59]

In light of our general rate-making powers that permit the disallowance of any unreasonable expenses, we find such condition to be unnecessary. In any general rate-making proceeding in which substantial evidence is presented to demonstrate that

[58] AG Post-Hearing Brief at 10.

[59] Direct Testimony of Scott J. Rubin at 26.

Kentucky-American is experiencing higher capital costs as a result of the proposed transaction, the Commission may disallow the portion of such costs that are due solely to the proposed transaction.[60] The party seeking disallowance of any capital costs for this reason must clearly demonstrate that the increased costs result directly from the proposed transaction.

Capital Contribution

In light of AWWC's significant need for capital in the upcoming years, the AG and LFUCG urge that the proposed transaction be conditioned upon requiring Thames GmbH to contribute to AWWC 20 percent of the proceeds of the public stock offering. This required contribution, they argue, would improve AWWC's credit rating, make funds available for necessary capital expenditures, reduce the total amount of debt that must be issued, and cover some of the initial costs associated with compliance with the Sarbanes-Oxley Act. It would force Thames GmbH to "make good on some of the commitments it [and RWE] made when it acquired AWW[C]."[61]

Characterizing this proposal as the assessment of an "exit fee," Joint Petitioners voice strong policy and legal objections. First, they contend that the purpose of the proposed condition is improper as it seeks to penalize Thames GmbH and RWE for their alleged failure to meet certain commitments made at the time of their acquisition of AWWC.[62] Conditions should only be used, they argue, "to mitigate any adverse effect

[60] The Commission places all parties on notice that our approval of the transfer of control with conditions does not constitute a finding that all costs related to the proposed transaction or that ultimately result from the proposed transaction are reasonable.

[61] Joint Petitioners' Post-Hearing Brief at 22.

[62] Joint Petitioners' Brief at 26.

of the proposed transfer of control, not as a means to assess punitive damages for alleged past actions by a shareholder."[63] The proposed condition, the Joint Petitioners assert, is unrelated to the provision of service. They further deny that Thames GmbH or RWE have failed to meet any of their commitments.

Joint Petitioners also contend that the proposal constitutes an improper and inappropriate taking of Thames GmbH's proceeds. Citing previous legal precedent, they assert that RWE and Thames GmbH solely bore the risk of their investment and should not be required to share a portion of the proceeds with others. As AWWC did not bear any risk with the value of its stock, they argue, it is not entitled to share in any proceeds from the sale of its stock.

Joint Petitioners argue that the AG's proposal constitutes an exaction, a concession made in order to receive a governmental permit or approval. In effect, the proposal, if accepted, would require RWE and Thames GmbH to surrender 20 percent of the stock sale proceeds to obtain Commission approval for the proposed transaction. Such conditioning, they argue, may result in a regulatory taking and be prohibited by the Federal Constitution.

While Joint Petitioners object to the AG's assertion that AWWC's capital needs are the result of poor planning or neglect, they acknowledge that "all [water] systems in the United States face high levels of capital expenditure now and in the future to replace aging infrastructure."[64] They further note that this need alone is not a sufficient basis to impose any conditions on the proposed transaction.

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[63] Id. at 26.

[64] Joint Petitioners' Post-Hearing Brief at 23.

While the Commission agrees that AWWC must have adequate capital if its regulated subsidiaries are to provide adequate service, neither the AG nor LFUCG has provided any legal authority to support this proposal nor have they explained how this required level of capitalization was determined or identified RWE and Thames GmbH's responsibility to provide it. Accordingly, we decline to accept this proposal.

The Commission is not unmindful of AWWC and Kentucky-American's significant capital needs. To the extent that RWE and Thames GmbH during their ownership of AWWC failed to ensure adequate funding of AWWC's pension fund and other post-employment benefit plans to prevent increases in the level of unfunded liabilities, they must bear responsibility for such increases and should not be allowed to foist that responsibility onto the shoulders of AWWC's new owners and ultimately on the ratepayers of AWWC's regulated utilities. As they divest themselves of their interests in AWWC, RWE and Thames GmbH should be required to make the equity capital infusions necessary to render AWWC's current pension funding ratio at the same level that existed when they acquired AWWC.[65] This condition is not an exaction but merely eliminates the effects of a departing owner's budgetary decisions, and is consistent with that departing owner's commitments to this Commission at the time of the acquisition.

[65] Mr. Rubin testified that AWWC's pension funding ratio was 77 percent as of December 31, 2001 and was only 60 percent as of December 31, 2004. The record does not contain any information regarding this level for the past 2 years. Any contribution to restore AWWC's pension ratio to the December 31, 2002 level should be computed using the pension funding ratios that existed on December 31, 2002 and December 31, 2006.

Avoiding Unauthorized Acquisitions of Control

While Joint Petitioners represent that they have no intention of permitting any person to acquire control[66] of AWWC through the proposed transaction,[67] the Commission remains concerned that the proposed transaction could result in such acquisition. KRS 278.020(6) requires that such acquisition be made only with prior Commission approval. To prevent any violation of this statute, we condition our approval of the proposed transaction upon AWWC's filing of a registration statement with the SEC in connection with the proposed transaction that contains a clear disclosure that no person may acquire control of AWWC without obtaining necessary regulatory approvals pursuant to applicable state laws, including KRS 278.020. We have further required that any agreements that Thames GmbH or AWWC have with the transaction's underwriters require the underwriters to report to AWWC and the Commission all instances in which a person or entity has acquired directly or indirectly 10 percent or more of AWWC stock through the IPO.

Most Favored Nations Clause

The Commission finds that since AWWC has operating subsidiaries in numerous jurisdictions, a "most favored nations clause" would ensure that Kentucky-American ratepayers receive all of the benefits that RWE, Thames GmbH, 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 GmbH, AWWC, and Kentucky-American extending to Kentucky-American ratepayers proportionate net

[66] For a definition of "control," see supra note 9.

[67] Joint Petition at ¶ 50.

benefits of each condition imposed by another state regulatory commission that will benefit ratepayers in another jurisdiction.

Intervenor Proposed Conditions

The AG has proposed 47 conditions to be placed upon any approval of the proposed transaction. Many of these conditions are similar to those that we placed upon RWE and Thames GmbH's acquisition of AWWC.[68] Some of these have been discussed previously in this Order and have been incorporated into those set forth in Appendix A. Of the 47 conditions that the AG proposed, we have accepted 35 conditions in toto or with modifications.

The AG proposes that the Commission require Kentucky-American to adopt new procedures to closely monitor lost water and to file quarterly water loss reports with the Commission.[69] He argues that such procedures would address one of the reasons for Thames GmbH's divesture of AWWC and would assist in resolving Kentucky-American's source of supply concerns. As Kentucky-American already must file a report of its water loss with its annual report and as Kentucky-American's current water losses do not appear excessive,[70] we decline to impose this condition. We will,

[68] LFUCG also urges the Commission to apply the same conditions that we attached to RWE's acquisition of AWWC. LFUCG Brief at 1 and 18.

[69] Direct Testimony of Scott J. Rubin at 26.

[70] For the calendar year ending December 31, 2005, Kentucky-American has a water loss percentage of 13.1399 percent. See Annual Report of Kentucky-American Water Company to the Public Service Commission of Kentucky for the Calendar Year Ended December 31, 2005 at 35. The Commission's regulations consider any water loss in excess of 15 percent as unreasonable for rate-making purposes. See 807 KAR 5:066, Section 6.

however, continue to monitor Kentucky-American's water losses. If they worsen, we will consider additional remedies.[71]

The AG further requests that all AWWC or Kentucky-American unregulated activities[72] be conducted through a separate corporate entity and that any services that Kentucky-American provides be charged at no less than Kentucky-American's fully embedded cost.[73] In light of existing statutory restrictions on non-regulated utility transacations,[74] we find no need for this condition. We, however, continue to insist that AWWC and Kentucky-American retain separate books for each corporate entity operating within Kentucky and follow appropriate state cost allocation guidelines.[75]

The AG proposes that AWWC report to the Commission in writing on several aspects of its operations.[76] The Commission declines to accept these proposals. The requested information will be available through filings that AWWC must make to the SEC or easily obtained through the use of publicly available documents.

The AG also proposes that AWWC be required to appoint an agent in Kentucky for the limited purpose of accepting service of process of any enforcement action that

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[71] Our authority to order remedial action is independent of any condition to the proposed transfer of control. See KRS 278.280(1).

[72] The AG's reference to unregulated activities presumably refers to Kentucky-American's operation of non-public utilities. Kentucky-American has previously operated water treatment and production facilities for several Kentucky municipalities. These operations are not subject to Commission jurisdiction.

[73] Direct Testimony of Scott J. Rubin at 26.

[74] See KRS 278.2201-.2219.

[75] Appendix A, Condition No. 14.

[76] These proposals are virtually identical to Conditions No. 31 and No. 34 that we imposed in Case No. 2002-00317.

the Commission may bring and to consent to the personal jurisdiction of Franklin Circuit Court to hear and consider any legal action or proceeding that the Commission may bring against AWWC to enforce the provisions of this Order.

We find these proposals unworkable and unnecessary. Kentucky law makes no provisions for the appointment of an agent for the sole purpose of accepting service of process for a Commission enforcement action. As AWWC is a party to this proceeding and has sought relief from this Commission, it has already consented to the jurisdiction of the courts of this Commonwealth for any action to enforce the provisions of this Order.

MONITORING THE PROPOSED TRANSACTION

The AG urges the Commission to continue monitoring the proposed transaction until its completion to ensure that ratepayers "will not be harmed by a change in the transaction after any approval under this proceeding but subsequent to the actual implementation of the plan."[77] The Commission concurs with this proposal and has in this Order directed Joint Petitioners to submit monthly written reports on the progress of the proposed transaction and to file simultaneously with the Commission any documents that they file with the SEC in connection with the proposed transaction. These requirements will ensure that the Commission remains abreast of all developments and can take any necessary actions to protect Kentucky-American's ratepayers.

[77] AG Post-Hearing Brief at 15.

RELEASE OF RWE AND THAMES GmbH FROM PRIOR CONDITIONS

Joint Petitioners have requested that RWE and Thames GmbH be released from all conditions set forth in our Orders of December 19, 2002 and January 21, 2003 in Case No. 2002-00317 in which we approved RWE and Thames GmbH's acquisition of indirect control over Kentucky-American. These conditions were intended to protect Kentucky-American ratepayers and the public interest. Upon the completion of the proposed transaction, at which time RWE and Thames GmbH will cease to hold any beneficial interest, direct or indirect, in any class of securities of AWWC, these conditions will no longer serve that purpose. At that time, RWE and Thames GmbH should be released from the conditions set forth in those Orders.

SUMMARY

Having considered the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. Kentucky-American owns and operates facilities that are used in the distribution of water to the public in Bourbon, Clark, Fayette, Gallatin, Grant, Harrison, Jessamine, Owen, Scott and Woodford counties and owns and operates facilities for the collection and treatment of sewage for the public in Clark and Owen counties. Kentucky-American is a utility subject to the Commission's jurisdiction.

2. AWWC owns and controls Kentucky-American.

3. TWAUSHI currently owns all of AWWC's common stock.

4. Thames GmbH currently owns all of TWAUSHI's common stock.

5. By virtue of its ownership of TWAUSHI, Thames GmbH possesses indirect control of Kentucky-American.

6. Joint Petitioners propose to merge TWAUSHI and AWWC and then to conduct a public offering of AWWC's common stock. Upon completion of the proposed transaction, Thames GmbH will possess less than 10 percent of AWWC's common stock and will no longer exercise direct control over AWWC or indirect control of Kentucky-American.

7. The proposed transaction will result in a transfer of indirect control of Kentucky-American and will require Commission approval.

8. The identities of those persons who will acquire AWWC's common stock are currently unknown and will not be known until completion of the public offering of AWWC common stock.

9. Upon completion of the public offering and transfer of AWWC's common stock, the management that currently manages AWWC and Kentucky-American will continue to be in place and will continue to manage those entities' day-to-day operations.

10. The current management has the managerial, technical and financial abilities to provide reasonable utility service.

11. As those persons who are acquiring AWWC common stock will continue to use AWWC's management immediately following the public offering, these persons will possess the managerial, technical and financial abilities to provide reasonable utility service.

12. The proposed transaction may have potentially adverse effects on the quality of service that Kentucky-American provides and will be consistent with the public interest only under the conditions set forth in Appendix A to this Order.

IT IS THEREFORE ORDERED that:

1. The transfer of control of Kentucky-American resulting from the merger of AWWC and TWAUSHI and the proposed public offering of AWWC common stock is approved, subject to the conditions set forth in Appendix A of this Order.

2. The proposed transfer of control shall not proceed unless, within 20 days of the date of this Order, the written acknowledgements on behalf of RWE, Thames GmbH, TWAUSHI, AWWC, and Kentucky-American 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 are filed with the Commission.

3. Within 10 days of the date of this Order, Joint Petitioners shall advise the Commission in writing of the following:

a. AWWC's total liability for pension and other post-retirement benefit plans as of December 31, 2002;

b. The fair value of AWWC's plan assets for pension and other post-retirement benefit plans as of December 31, 2001;

c. The percentage of AWWC's pension and other post-retirement benefit plans that was funded as of December 31, 2002;

d. AWWC's total liability for pension and other post-retirement benefit plans as of December 31, 2006;

e. The fair value of AWWC's plan assets for pension and other post-retirement benefit plans as of December 31, 2006;

f. The percentage of AWWC's pension and other post-retirement benefit plans that was funded as of December 31, 2006;

g. The amount of capital necessary to bring AWWC's plan assets for pension and other post-retirement benefit plans as of December 31, 2006 to the same percentage level of funding that existed for AWWC's plan assets and other post-retirement benefits as of December 31, 2002.

4. Within 10 days of the date of this Order, Joint Petitioners shall file with the Commission the financial statements of AWWC for the calendar years ending December 31, 2002 and December 31, 2006.

5. AWWC shall not impair Kentucky-American's capacity to meet its obligations to provide adequate, efficient, and reasonable utility service.

6. Kentucky-American is prohibited from guaranteeing the debt of RWE, Thames GmbH, TWAUSHI, AWWC, or any of their affiliates or subsidiaries without the prior approval of the Commission.

7. Joint Petitioners shall file with the Commission a copy of the final decision or order or other forms of regulatory notification regarding the proposed transfer of control that each state regulatory authority with jurisdiction over the proposed IPO of AWWC stock issues within 20 days of the issuance of such order or notification.

8. Kentucky-American shall include with its annual report to the Commission a report in table format 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 that year.

9. Kentucky-American shall report with its annual report to the Commission its actual expenditure levels for economic development activities and civic and charitable activities for the past calendar year.

10. AWWC and Kentucky-American shall comply with all reporting and filing requirements set forth herein. Unless otherwise noted, all quarterly reports shall be filed within 45 days of the close of the reporting quarter, and all annual reports shall be filed by March 31 of the year following the reporting period.

11. AWWC shall, at 6-month intervals, submit to the Commission written reports on the actual cumulative costs of the proposed IPO of AWWC common stock until all transaction costs have been incurred. These reports shall be for periods ending June 30 and December 31 and shall be submitted within 45 days of the end of the reporting period.

12. On the last day of each month following the issuance of this Order and continuing until the proposed transaction is completed, Joint Petitioners shall submit a written report of current status of the proposed transaction. This report shall, at a minimum, address Joint Petitioners' progress in obtaining the approval of all state utility regulatory commissions that must review the proposed transaction and the status of all filings with the SEC.

13. Should the Joint Petitioners receive any information or notice that a person or persons have purchased or otherwise acquired 10 percent or more of AWWC's common stock through the IPO, they shall advise the Commission in writing of this information or notice within 72 hours of its receipt.

14. Thames GmbH and AWWC shall in their agreements with all persons that are underwriting the IPO of AWWC common stock require that those persons report to AWWC and the Commission all instances in which a person or entity has acquired directly or indirectly 10 percent or more of AWWC stock through the IPO and to identify such persons or entities.

15. Joint Petitioners shall simultaneously with each filing made to the SEC in connection with the proposed transaction file with the Commission a copy of such filing.

16. At such time as RWE and Thames GmbH cease to have any beneficial interest, direct or indirect, in any class of securities of AWWC, all terms and conditions set forth in the Commission's Orders of December 19, 2002 and January 21, 2003 in Case No. 2002-00317 shall terminate.

17. Within 10 days of completion of RWE and Thames GmbH's transfer of all interests in AWWC, they shall notify the Commission is writing that such transfer has occurred.

Done at Frankfort, Kentucky, this 16th day of April, 2007.

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2006-00197 DATED April 16, 2007

The proposed IPO of AWWC common stock and the transfer of indirect control of Kentucky-American from TWAUSHI, Thames GmbH and RWE to unknown persons are approved upon the following conditions:

1. Kentucky-American's books and records will be maintained and housed in Kentucky.

2. AWWC and Kentucky-American will not assert in any judicial or administrative proceeding that the Commission lacks for rate-making purposes jurisdiction over Kentucky-American's capital structure, financing, and cost of capital.

3. Neither Kentucky-American nor its ratepayers, directly or indirectly, will incur any additional costs, liabilities, or obligations in conjunction with Thames GmbH and RWE's divesture of AWWC.

4. AWWC and Kentucky-American will obtain Commission approval prior to the transfer of any Kentucky-American 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.

5. The payment for redemption of AWWC's preferred stock will not be recorded on Kentucky-American's books.

6. RWE and Thames GmbH's divesture of AWWC will not affect the accounting and rate-making treatments of Kentucky-American's excess deferred income taxes.

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

8. Kentucky-American 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.

9. AWWC and Kentucky-American will not assert in any Commission proceeding that Commission review of the reasonableness of any cost has been or is preempted by any other governmental regulator.

10. The prospectus within the registration statement to be filed with the Commission in connection with the proposed transaction will include a clear statement that no person may acquire control of AWWC without obtaining necessary regulatory approvals pursuant to applicable state laws, including KRS 278.020.

11. Thames GmbH and AWWC will require in their agreements with the underwriters of the IPO of AWWC stock that the underwriters report to AWWC and the Commission all instances in which a person or entity has acquired directly or indirectly 10 percent or more of AWWC stock through the IPO and to identify such persons or entities.

12. RWE and/or Thames GmbH will infuse equity capital into AWWC prior to the proposed transaction sufficient to render AWWC's pension funding ratio on December 31, 2006 at the same level that existed on December 31, 2002.

13. For at least one year from the date of the IPO of AWWC stock, each of Kentucky-American's current corporate officers will continue in his or her current position and perform his or her current duties unless he or she requests reassignment or retirement, resigns on his or her own volition, 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 or her removal or reassignment.

14. For at least one year from the date of the IPO of AWWC stock, AWWC or Kentucky-American will notify the Commission in writing within 10 days of any changes in Kentucky-American's corporate officers and management personnel.

15. AWWC and Kentucky-American 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.

16. Kentucky-American's equity-to-capital ratio will be maintained between 35 to 45 percent. If the equity-to-capital ratio falls outside this range, AWWC and Kentucky-American 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 Kentucky-American's equity-to-capital ratio to this range.

17. AWWC and Kentucky-American will notify the Commission in writing within 30 days of any downgrading of the bonds of AWWC or any AWWC subsidiary and will include with such notice the complete report of the issuing bonding agency.

18. Kentucky-American will not be the employer or purchaser of last resort for employees, assets, and products associated with any failed or troubled AWWC affiliate or venture.

19. Kentucky-American's utility operations will be Kentucky-American's highest priority and will not be used to solely benefit non-utility affiliates.

20. 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.

21. Kentucky-American will file with its annual report to the Commission a report of its dividend payments and other funds transfers to AWWC. This report will list the date of each dividend payment or other funds transfer made to AWWC during the calendar year, the amount of each payment, and the amount of net income available at the time of each payment.

22. AWWC will semi-annually submit written reports to the Commission on the actual cumulative costs of the proposed divesture. 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.

23. Kentucky-American customers will experience no material adverse change in utility service due to the divesture.

24. Beginning for calendar year 2007 and for the next 5 years thereafter, Kentucky-American will include in its annual report to the Commission in table format a report 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 that calendar year.

25. AWWC and Kentucky-American will adequately fund and maintain Kentucky-American's treatment, transmission, and distribution systems; comply with all

applicable Kentucky statutes and administrative regulations; and supply the service needs of Kentucky-American customers.

26. At least 30 days prior to any planned reduction of 5 percent or more in Kentucky-American's workforce, AWWC or Kentucky-American 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 Kentucky-American's plan for maintaining service quality at the reduced workforce level.

27. AWWC will maintain Kentucky-American's levels of commitment to high quality utility service and will fully support maintaining Kentucky-American's record for service quality.

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

29. AWWC and Kentucky-American will actively support economic development and social and charitable activities throughout the areas in which Kentucky-American serves for as long as Kentucky-American continues to serve those areas.

30. Kentucky-American 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 IPO of AWWC stock.

31. AWWC will maintain and support the relationship between Kentucky-American and the communities that it serves.

32. At least 40 percent of the members of Kentucky-American's Board of Directors will be persons who reside within the area that Kentucky-American serves and who are not employees or officers of AWWC or any AWWC affiliated entity.

33. AWWC will hold all of Kentucky-American's common stock and will 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(7)(b).

34. If any state regulatory commission imposes conditions on RWE, Thames GmbH, TWAUSHI, or AWWC as a condition for its approval of the proposed divesture and IPO of AWWC common stock and those conditions would benefit ratepayers in any other jurisdiction, proportionate net benefits and conditions will be extended to Kentucky-American ratepayers.

35. Kentucky-American will retain its current name and will continue as a corporation organized under Kentucky law.

36. Kentucky-American's headquarters will remain in Lexington, Kentucky.

37. AWWC and Kentucky-American will honor all existing Kentucky-American contracts, easements, or other agreements with local governments, and will negotiate with those local governments in good faith regarding the renewal of those agreements.

38. Kentucky-American will not, for at least one year from the date of the IPO of AWWC common stock, eliminate any non-management or union employee positions.

39. AWWC and Kentucky-American will maintain a sound and constructive relationship with those labor organizations that may represent certain AWWC or Kentucky-American 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 Kentucky-American, and will honor any agreements with those unions.