

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

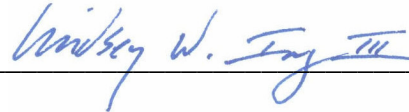
**In the Matter of:**

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

**JOINT PETITIONERS' POST-HEARING BRIEF**

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## INTRODUCTION

Kentucky-American Water Company (“KAWC”), Thames Water Aqua Holdings GmbH (“Thames”), RWE Aktiengesellschaft (“RWE”), Thames Water Aqua US Holdings, Inc. (“TWAUSHI”) and American Water Works Company, Inc. (“American Water”) (collectively the “Joint Petitioners”) filed an Application/Petition (“Joint Petition”) pursuant to KRS 278.020 seeking an order from the Kentucky Public Service Commission (“Commission”) approving the change of control of KAWC which will result from the merger of TWAUSHI and American Water and the sale of up to 100% of the shares of American Water through an initial public offering (“IPO”) and subsequent public offerings (the “Proposed Transaction”). Thereafter, RWE will no longer be the ultimate owner of all of the stock of American Water; instead, the stock will be held by a broad group of investors, including institutional and retail investors, who will buy the stock through the initial and any subsequent public offerings.

On August 14, 2006, the Commission issued an order in which it held that approval of the Proposed Transaction is governed by the provisions of KRS 278.020(5), which provides, “The commission **shall** grant its approval if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service.” (Emphasis added). It went on to advise the parties that it had the implied power to consider whether the proposed transfer is consistent with the public interest and whether conditions should be imposed. The evidence before the Commission establishes that the requirements of KRS 278.020(5) and the public interest standard are met. The Joint Petition should, accordingly, be approved without the imposition of any conditions.

It is beyond dispute that KAWC, supported by American Water, has the financial, technical and managerial abilities to provide reasonable service to KAWC customers. In addition, by virtue of being a publicly traded company, American Water will have access to the United States capital markets and be subject to the provisions of the federal securities laws, including the Sarbanes-Oxley legislation, which will provide for transparency and the assurance of continued skillful management of American Water. Therefore, KAWC's already excellent service record will continue.

### **OVERVIEW OF THE PROPOSED TRANSACTION**

The Joint Petition describes in detail the particulars of the Proposed Transaction that prompted the initiation of this proceeding. In general, the sale of the common stock of the parent corporation of KAWC constitutes an indirect change of control of KAWC which requires Commission approval in accordance with KRS 278.020(5).

The Joint Petitioners are familiar to the Commission. RWE is a foreign corporation organized and existing under the laws of the Federal Republic of Germany.<sup>1</sup> Thames is a foreign corporation organized and existing under the laws of the Federal Republic of Germany. It is a wholly-owned subsidiary of RWE and is the holding company for most of RWE's water companies, both in the United States and in several foreign countries.<sup>2</sup> TWAUSHI is a Delaware corporation. It is a wholly-owned subsidiary of Thames and the direct parent of American Water.<sup>3</sup> American Water is a Delaware corporation with its principal office located in Voorhees, New Jersey. It owns regulated operating subsidiaries in 18 states, including KAWC.<sup>4</sup>

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<sup>1</sup> Joint Petition, ¶ 11.

<sup>2</sup> Joint Petition, ¶ 12.

<sup>3</sup> Joint Petition, ¶ 13.

<sup>4</sup> Joint Petition, ¶ 14.

KAWC is a wholly-owned subsidiary of American Water. It is a Kentucky corporation with its principal office and place of business located in Lexington, Kentucky. It is engaged in the distribution and sale of water in Bourbon, Clark, Fayette, Harrison, Jessamine, Scott, Woodford, Gallatin, Grant and Owen Counties. KAWC owns, operates and maintains potable water production, treatment, storage, transmission and distribution systems for the purpose of furnishing potable water for residential, commercial, industrial and governmental users in its service territory. It also owns, operates and maintains collection, pumping and/or treatment systems for the purpose of furnishing wastewater service for residential, commercial, industrial and governmental users in its service territory.<sup>5</sup>

The Proposed Transaction consists of (i) the sale by Thames of up to 100% of the shares of common stock of American Water and (ii) prior to the IPO, the merger of TWAUSHI with and into American Water. The shares will be sold through one or more underwritten public offerings to a broad group of investors, including institutional and retail investors. Thames seeks to sell 100% of the shares in the IPO, but, depending on market conditions, all of the shares may not be sold and the unsold shares will be sold in a subsequent offering or offerings. The IPO and any subsequent offerings will be made in accordance with the rules for underwritten public offerings mandated by the Securities and Exchange Commission (“SEC”).<sup>6</sup> The SEC’s function in this process is not to approve the transaction,<sup>7</sup> but rather to provide guidance on the manner and scope of the disclosure that is presented to potential purchasers of American Water stock.

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<sup>5</sup> Joint Petition, ¶ 15.

<sup>6</sup> Joint Petition, ¶ 16.

<sup>7</sup> Transcript of Evidence for Hearing dated August 16, 2006 (“TE”) at 70.

After completion of the Proposed Transaction, American Water will be a publicly traded company and will no longer be an indirect subsidiary of RWE. It is anticipated that American Water's shares will be traded on the New York Stock Exchange.<sup>8</sup> The board of directors of American Water will meet the requirements of boards of publicly traded companies. It will consist of experienced individuals who, in the aggregate, possess the capabilities and experience appropriate for the board of a large, publicly-owned multi-state water utility holding company. In accordance with the federal securities laws and stock exchange rules, the board of directors will have a majority of independent directors and the audit, compensation and nominating committees will consist entirely of independent directors.<sup>9</sup> American Water's board of directors and management team will take it through the IPO process and assure continued provision of safe and reliable utility service during and after the IPO process. The highly qualified KAWC management team will continue to operate the local business.<sup>10</sup>

### **PROCEDURE**

On May 10, 2006, the Joint Petitioners advised the Commission of their intent to apply for Commission approval of the Proposed Transaction. On May 11, 2006, the Commission acknowledged receipt of the notice of intent and established this docket. On May 17, 2006, the Office of the Attorney General of the Commonwealth of Kentucky ("AG") filed his Motion for Intervention. The Joint Petition was filed on June 5, 2006, along with the direct testimony of Ellen C. Wolf, Michael A. Miller and Nick O. Rowe. The Commission entered an order on the same day providing for electronic filing procedures in this case. On June 7, 2006, the Lexington-Fayette Urban County

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<sup>8</sup> Joint Petition, ¶ 23; Wolf Direct at 9.

<sup>9</sup> Joint Petition, ¶ 31; Wolf Direct at 18.

<sup>10</sup> Wolf Direct at 18.

Government (“LFUCG”) filed its Motion to Intervene. On June 19, 2006, the Commission entered an order granting intervention to the AG and the LFUCG and an order setting forth a procedural schedule for the case. On the same day, the Commission entered an order directing the parties to brief the issue of whether KRS 278.020(5) and/or KRS 278.020(6) should apply to the Commission’s consideration of the Proposed Transaction. On June 26, 2006, the parties submitted their briefs on the subject and submitted responses to the briefs on July 3, 2006. In the meantime, extensive discovery was conducted by the Commission Staff and the Intervenors. On August 14, 2006, the Commission entered an order that advised all parties that KRS 278.020(5), and not KRS 278.020(6), is applicable to the Proposed Transaction.

In the meantime, on August 10, 2006, an informal conference was held for the purpose of exploring the possibility of settling this case. The parties were unable to agree to a settlement. On August 14, 2006, the AG filed the direct testimony of Scott J. Rubin and J. Randall Woolridge.

The public hearing was held on August 16, 2006. The Commission provided an opportunity for public comment, but none was offered. The following persons testified at the public hearing: Nick O. Rowe, President of KAWC; Jens Gemmecke, Senior Project Manager in the RWE Mergers and Acquisitions Department; John S. Young, Jr., Chief Operating Officer of American Water; Ellen C. Wolf, Senior Vice President and Chief Financial Officer of American Water; Michael A. Miller, Treasurer/Comptroller of KAWC; Scott J. Rubin, attorney and consultant to the AG; and J. Randall Woolridge, consultant to the AG. Following the hearing, the Joint Petitioners submitted responses to the hearing data requests.

## STANDARD OF REVIEW

KRS 278.020 requires Commission review and approval of any change in or transfer of control of a utility.<sup>11</sup> The issue of whether subsection 5 or subsection 6 of KRS 278.020 or both apply to the Proposed Transaction arose early in the proceeding. In its Order of August 14, 2006, the Commission decided that only subsection 5 applies and, in so doing, stated:

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). Upon its completion, RWE, the entity that currently controls American Water and KAWC, will no longer control either entity. As the proposed transaction results in the transfer of RWE’s ability to control American Water and KAWC, Subsection 5 is applicable. As there is no evidence that at the proposed transaction’s completion any entity will possess a sufficient quantity of American Water stock to control American Water and thus KAWC, Section 6 is not applicable at this time.<sup>12</sup>

KRS 278.020(5) provides, in pertinent part, as follows, “The commission shall grant its approval if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service.”

In its determination of the standard of review to be utilized in this proceeding, the Commission considered and specifically rejected the contention of the LFUCG that the filing of the Joint Petition herein was premature because the identity of the purchasers of the American Water stock had not been established. In so ruling, the Commission said:

The Commission further finds no merit to LFUCG’s argument that Commission review of the proposed transaction is premature. Given the nature of the proposed transaction, the identity of those persons acquiring

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<sup>11</sup> *In the Matter of: Application for Approval of the Transfer of Control of KAWC Water Company to RWE Aktiengesellschaft and Thames Water Aqua Holdings GmbH*, Case No. 2002-00018, Order of May 30, 2002, at 6.

<sup>12</sup> Order of August 14, 2006 at 8-9.



American Water stock will not be known until completion of the transaction. As the transfer of American Water stock can lawfully occur only if the Commission grants its prior approval to transfer, identification of the acquiring parties before the Commission considers the proposed transaction is not possible. Acceptance of LFUCG's argument requires us to hold that KRS 278.020(5) and KRS 278.020(6) prohibit initial public offerings. LFUCG has offered no argument or evidence to support the proposition that the General Assembly intended this result when enacting either section of KRS 278.020. (Footnote omitted.)<sup>13</sup>

Thus, in this case, the Commission must determine whether the party acquiring control has the requisite abilities to provide reasonable utility service.<sup>14</sup> Absent from subsection 5 of KRS 278.020 is the explicit requirement in subsection 6 that, in order to be approved, the Proposed Transaction must be "consistent with the public interest." The Commission has noted its implied power to determine if the Proposed Transaction is in the public interest and to impose conditions on the Proposed Transaction to ensure that it will not adversely affect utility service.<sup>15</sup> However, to the extent that such implied power may exist, it is clear that the Proposed Transaction is both in the public interest and will not adversely affect utility service. Therefore, the imposition of conditions is not necessary nor is it required by statute.

### **PROVISION OF REASONABLE UTILITY SERVICE**

During the public hearing in this matter, Ellen C. Wolf, American Water Senior Vice President and Chief Financial Officer, was asked the following question:

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<sup>13</sup> Id. at 9-10.

<sup>14</sup> Case No. 2002-00018, Order of May 20, 2002, at 7.

<sup>15</sup> The Commission addressed its implied powers under subsection 5 in its Order of August 14, 2006, by stating that the Commission has always had the implied power to review and hear evidence on utility transfers and went on to say, "[t]his implied power includes 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 adequately affect utility service." Order of August 14, 2006 at 9, n. 14.

Is it your opinion that, after the IPO for the Proposed Transaction as described in this Application, Kentucky-American Water Company will still have the financial, technical and managerial ability to provide reasonable service in its territory?<sup>16</sup>

She answered unequivocally, “Yes, it is.”<sup>17</sup> As set forth below, the evidence in this case demonstrates beyond question that Ms. Wolf’s sworn testimony is correct.

The financial ability of American Water and KAWC is clearly sufficient to enable KAWC to provide reasonable utility service and the consummation of the Proposed Transaction will not diminish that ability. KAWC can finance its expenditures through equity or debt financing. After the Proposed Transaction, American Water will remain the source of common equity capital for KAWC. As such, KAWC will benefit from American Water becoming a Sarbanes-Oxley compliant and publicly traded company which will be able to access the United States equity markets.<sup>18</sup> KAWC can also finance part of its investments in the debt markets. KAWC has in the past, and can in the future, issue debt instruments to third parties in the private debt markets.<sup>19</sup> KAWC will also be able to access the public debt markets through American Water Capital Corp. (“AWCC”).<sup>20</sup> AWCC borrows money for the benefit of American Water and its regulated operating subsidiaries and then loans it to those companies at cost.<sup>21</sup> This financing vehicle allows the operating subsidiaries, including KAWC, to benefit from economies of scale associated with group-wide debt financing and lower administrative

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<sup>16</sup> TE at 97.

<sup>17</sup> Id.

<sup>18</sup> Joint Petition, ¶ 38.

<sup>19</sup> Joint Petition, ¶ 25.

<sup>20</sup> Id.

<sup>21</sup> Joint Petition, ¶ 26.

costs.<sup>22</sup> American Water has used AWCC as a financing vehicle for several years, predating the 2003 acquisition of American Water by RWE.<sup>23</sup>

While all inter-company financial relationships between RWE and American Water and its subsidiaries will be terminated in connection with the Proposed Transaction,<sup>24</sup> KAWC, supported by American Water, will still have the financial ability to provide reasonable service to its customers.<sup>25</sup> For example, as a publicly traded company, American Water will have access to public debt and equity markets in the United States,<sup>26</sup> whereas RWE did not have access to such markets in the United States.<sup>27</sup> Moreover, American Water will no longer have to compete with RWE's other affiliates for management attention and financial support.<sup>28</sup>

American Water's goal for its debt to equity ratio is 45-55% debt and 55-45% equity and equity-like components.<sup>29</sup> Thus, given American Water's plan for debt to equity levels, and assuming a rate of return similar to the average in the industry, Ms. Wolf does not expect a change in American Water's cost of capital, other than due to changes in the interest rate environment.<sup>30</sup> More broadly, no material changes to American Water's financial characteristics are anticipated as a result of the Proposed

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<sup>22</sup> Id.

<sup>23</sup> Id.

<sup>24</sup> The vast amount of any refinancing that will become necessary as a result of the Proposed Transaction is for loans that have or will become due under ordinary course of business terms and conditions between June 2006 and June 2007. Wolf Direct at 15.

<sup>25</sup> KAWC has filed a Verified Application with the Commission (Case No. 2006-00418) in which it seeks approval for a continued relationship with AWCC and for contemplated long term financings through December 31, 2007. The Verified Application states, in Paragraph 11, that the post-IPO short term debt costs to AWCC will be less than they are currently.

<sup>26</sup> Wolf Direct at 13; TE at 113. It is anticipated that AWCC will replace debt from RWE with debt from public and private debt markets in the United States. Wolf Direct at 15-16.

<sup>27</sup> TE at 108, 137.

<sup>28</sup> Wolf Direct at 14.

<sup>29</sup> Wolf Direct at 16.

<sup>30</sup> Wolf Direct at 17.

Transaction.<sup>31</sup> American Water's commitment to investing the capital required to appropriately maintain operations will continue.<sup>32</sup>

The KAWC financial profile will continue to be similar to that which currently exists.<sup>33</sup> AWCC will continue to support KAWC under the present arrangement.<sup>34</sup> American Water and AWCC will continue to support the financing needs of KAWC.<sup>35</sup> Of course, any changes to the inter-company debt between KAWC and AWCC will, if required, be subject to the approval of the Commission.<sup>36</sup>

KAWC's Treasurer and Comptroller, Michael A. Miller, testified that KAWC will require major debt and equity investment over the next five years.<sup>37</sup> While this investment requirement is unrelated to the Proposed Transaction, it will need to be met. As indicated above, American Water and AWCC will have the financial strength and commitment to meet these requirements and KAWC's customers' service will not suffer as a result of the Proposed Transaction.

After the consummation of the Proposed Transaction, KAWC will continue to have skilled technical employees on its staff and access to additional skilled employees at American Water Works Service Company, Inc. ("the Service Company"), with whom it has a contract that has been approved by the Commission. KAWC's President, Nick O. Rowe, testified that he does not anticipate that there will be any changes to the day-to-day operations of KAWC as a result of the Proposed Transaction.<sup>38</sup>

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<sup>31</sup> Id.

<sup>32</sup> Id.

<sup>33</sup> Wolf Direct at 18.

<sup>34</sup> Wolf Direct at 19.

<sup>35</sup> Wolf Direct at 129-20.

<sup>36</sup> Joint Petition, ¶ 30.

<sup>37</sup> Direct Testimony of Michael A. Miller ("Miller Direct") at 3-4.

<sup>38</sup> Direct Testimony of Nick O. Rowe ("Rowe Direct") at 4.

Recently, both of KAWC's water treatment plants received national recognition in the form of 5-year EPA Director Awards.<sup>39</sup> KAWC's Production Superintendent, Dillard Griffin, has over 35 years of experience in managing the day-to-day operation of its water and wastewater facilities, including oversight of water quality standards.<sup>40</sup> Mr. Griffin was instrumental in the EPA awards described above.<sup>41</sup> KAWC's Network/Distribution Superintendent, Fred White, has 30 years' experience ranging from the installation of new construction to managing distribution facilities.<sup>42</sup> KAWC's Manager of Capital Project Delivery, Linda Bridwell, has 16 years' experience in managing capital programs and planning processes for infrastructure replacement.<sup>43</sup>

The Commission is well aware of the long-standing relationship between the Service Company and KAWC and the technical expertise that the relationship provides for the benefit of KAWC's customers. The Service Company provides high quality customer service, accounting, administration, engineering, financial, human resources, information systems, operations, risk management, water quality and other services to KAWC.<sup>44</sup> That relationship will not change as a result of the Proposed Transaction.

One of the reasons that the Commission found that RWE and Thames would have the technical ability to provide reasonable service for the benefit of KAWC's customers was the sharing of Thames' best practices with American Water and its affiliates.<sup>45</sup> That sharing has, in fact, occurred. KAWC has instituted security procedures based on

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<sup>39</sup> Rowe Direct at 7.

<sup>40</sup> Rowe Direct at 10.

<sup>41</sup> Id.

<sup>42</sup> Id.

<sup>43</sup> Id.

<sup>44</sup> Joint Petition, ¶ 39.

<sup>45</sup> Case No. 2002-00018, Order of may 30, 2002, at 13.

Thames' experience.<sup>46</sup> KAWC has adopted Event Management procedures that allow it to anticipate and react to events, such as large main breaks, weather related incidents and safety and security incidents, which may materially affect its business.<sup>47</sup> KAWC has also adopted the concepts of Tiered Safety policies, Comprehensive Health and Safety Programs and Self-Certification which have contributed to improving health and safety performance.<sup>48</sup> While KAWC will no longer be a part of the RWE/Thames family of companies after the consummation of the Proposed Transaction, the benefits gained from having been a member of that corporate family will not disappear.<sup>49</sup> That relationship has helped KAWC enhance its technical ability to provide reasonable service. Those enhancements have been added to the corporate knowledge base and that increased knowledge will not disappear after the Proposed Transaction is consummated.

The Proposed Transaction will have no adverse impact on the managerial ability of KAWC, supported by American Water, to provide reasonable service to KAWC's customers. In fact, once American Water becomes a publicly traded company, the federal securities laws, including the Sarbanes-Oxley legislation, will enhance the transparency of the management of American Water and enable regulators to assure themselves that American Water's management is complying with SEC and Sarbanes-Oxley requirements. Those requirements are not currently applicable to American Water since its shares are all currently held by RWE/Thames/TWAUSHI. As indicated above, after completion of the IPO, a majority of the members of American Water's board will be independent directors and all members of the audit, compensation and nominating

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<sup>46</sup> Rowe Direct at 7.

<sup>47</sup> Id.

<sup>48</sup> Id.

<sup>49</sup> Rowe Direct at 8.

committees will be independent directors.<sup>50</sup> The board will consist of experienced individuals who, in the aggregate, possess the capabilities and experience appropriate for the board of a large, publicly-owned multi-state utility company.<sup>51</sup> The seasoned management team at American Water will continue to have the background necessary to run a large, publicly-traded water company.<sup>52</sup>

KAWC will continue to be a subsidiary of American Water and will be operated by KAWC's skilled management under the supervision of KAWC's board of directors.<sup>53</sup> The experienced management of KAWC will continue to serve the customers and the communities in which they live.<sup>54</sup>

American Water is more than 100 years old. It and its subsidiaries have approximately 6,000 employees and provide water, wastewater and other water resource management services to approximately 18 million persons in 29 states and in Canada.<sup>55</sup> For nearly 60 years, American Water was one of the largest publicly-traded water companies in the United States. After the Proposed Transaction, American Water is expected to be the largest publicly-traded water company in the United States.<sup>56</sup> The focus of the management and the owners of American Water will be totally devoted to the water, wastewater and other water resource management services in the United States and Canada after the consummation of the Proposed Transaction.<sup>57</sup> As the Commission is aware, American Water had the financial, technical and managerial ability to provide reasonable service for years prior to its acquisition by RWE. It has had such ability while

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<sup>50</sup> Joint Petition, ¶ 31; Wolf Direct at 18.

<sup>51</sup> Id.

<sup>52</sup> Joint Petition, ¶ 40.

<sup>53</sup> Joint Petition, ¶ 39.

<sup>54</sup> Id.

<sup>55</sup> Wolf Direct at 6.

<sup>56</sup> Joint Petition, ¶ 35.

<sup>57</sup> Joint Petition, ¶ 34.

a member of the RWE family of companies. When American Water again becomes a publicly-traded company, it will continue to have those abilities and KAWC will as well.

The LFUCG has offered no testimony in this proceeding, so at this stage, it is impossible to know its position on whether reasonable utility service will be provided. The AG has offered testimony that contains some criticism of American Water, but it is not offered for the purpose of denying the Joint Petition. It is offered to support the AG's argument that the Commission should impose conditions on the approval of the Joint Petition in order for it to be consistent with the public interest.

Thus, the evidence fully supports the conclusion that American Water and KAWC will have the financial, technical and managerial ability to provide reasonable service to KAWC's customers after the consummation of the Proposed Transaction.

### **PUBLIC INTEREST**

As indicated above, the Commission ruled in its August 14, 2006, Order herein that it has the implied power to determine if the Proposed Transaction is in the public interest even though KRS 278.020(5) does not give it the explicit power to make such determination. In 2002, when the Commission approved the transfer of control of American Water and KAWC to RWE/Thames, it set forth the standard of proof necessary to demonstrate that a transfer of control is in the public interest:

The Commission finds that any party seeking approval of a transfer of control must show that the proposed transfer will not adversely affect the existing level of utility service or rates or that any potentially adverse effects can be avoided through the Commission's imposition of reasonable conditions on the acquiring party. The acquiring party should also demonstrate that the proposed transfer is likely to benefit the public through improved service quality, enhanced service reliability, the availability of additional services, lower rates, or a reduction in utility



expenses to provide the present services. Such benefits, however, need not be immediate or readily quantifiable.<sup>58</sup> (Emphasis in original).

An examination of the evidence in this case and discussed herein demonstrates that the Proposed Transaction is consistent with the public interest, is likely to benefit the public, and, therefore, the Commission need not impose any conditions.

After the consummation of the Proposed Transaction, American Water will be a company with a sound financial structure that is focused on the water and wastewater business in the United States and Canada. It will be well-managed and will provide benefits to both the customers and employees of KAWC.<sup>59</sup> American Water will be subject to the laws and regulations of the SEC and the stock exchange on which its shares will be traded. Its operating subsidiaries will be subject to regulation by state utility regulatory agencies, like the Commission, as well as state and federal environmental, safety and employment regulatory agencies. Thus, not only will American Water and KAWC and the other operating subsidiaries operate in a manner consistent with the public interest, they are subject to the jurisdiction of regulatory agencies that will assure such conduct.

There are several immediate benefits that the public will realize as a result of the consummation of the Proposed Transaction. First, American Water will have access to the public debt and equity capital markets in the United States.<sup>60</sup> Currently, RWE does not have access to such markets, as the AG's witnesses acknowledged during the public

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<sup>58</sup> Case No. 2002-00018, Order of May 30, 2002, at 7; Case No. 2002-00018, Order of July 10, 2002, at 9; Affirmed in *In the Matter of: The Joint Petition of KAWC Water Company; Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, Apollo Acquisition Company and American Water Works Company, Inc. for Approval of a Change of Control of KAWC Water Company*, Case No. 2002-00317, Order of December 20, 2002, at 13.

<sup>59</sup> Joint Petition, ¶ 34.

<sup>60</sup> Joint Petition, ¶ 38.

hearing.<sup>61</sup> Moreover, American Water's access to the United States public debt and equity capital markets is a significant benefit when compared to what American Water 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.

Absent divestiture, RWE will be in the position of having to fund two highly capital intensive industries (water and energy), including the European energy industry, where rapidly evolving regulatory and market conditions will result in capital requirements that are greater than anticipated at the time RWE acquired American Water. Indeed, the AG's witness, Mr. Scott J. Rubin, stated, "I do not like the idea of keeping an owner in place that does not want to be there and is not willing to devote further capital to the enterprise."<sup>62</sup> While RWE would, of course, continue to provide capital necessary to assure safe and reliable service, there would clearly be increased competition for scarce capital funds which would increase constraints on the availability of capital for discretionary purposes, such as growth, earlier implementation of efficiency improvements, the rate of infrastructure replacement and the like. In addition, RWE's risk profile could change depending on developments in the European energy markets. All of these challenges could adversely impact the cost of available capital.

Second, American Water 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.<sup>63</sup> RWE is currently not subject to such laws, regulations and stock exchange rules. The AG's witness, J. Randall Woolridge, testified that, to the extent compliance

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<sup>61</sup> TE at 108, 137.

<sup>62</sup> Direct testimony of Scott J. Rubin ("Rubin Direct") at 21.

<sup>63</sup> Joint Petition, ¶ 37.

with Sarbanes-Oxley enables American Water to attract capital at reasonable rates, it “may be” beneficial to ratepayers.<sup>64</sup>

Third, KAWC’s customers will be able to invest in American Water and, thus, have an ownership interest in the parent of their water supplier.<sup>65</sup>

Fourth, KAWC’s and American Water’s employees will be able to invest in American Water.<sup>66</sup> Mr. Rowe testified at the public hearing as follows on that subject:

The employees are excited – I can tell you they are – by that opportunity to purchase stock and, again, you know, it’s something for a meter reader or someone in the field to say, “You know, I’m part owner of this company.” Whether it be large or small in nature, it really does, in my mind, really changes the culture of the business, and that’s what has made American Water strong over the years.<sup>67</sup>

Thus, the change in the ownership of American Water from private to public will have at least four identifiable immediate benefits for the public.

In other areas, there will be no material adverse impact to KAWC’s customers as a result of the Proposed Transaction. The Joint Petitioners will not recover the costs of the Proposed Transaction from KAWC’s (or any operating subsidiary of American Water) customers.<sup>68</sup> KAWC will continue to honor its collective bargaining agreements and there will be no adverse impact on KAWC’s employees or the employment level in Kentucky as a result of the Proposed Transaction.<sup>69</sup> There will be no adverse impact on KAWC’s rates or its policies with respect to customers, employees, operations, financing or other similar matters. There will be no adverse impact on KAWC’s current investment

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<sup>64</sup> TE at 137.

<sup>65</sup> Joint Petition, ¶ 42.

<sup>66</sup> Joint Petition, ¶ 43.

<sup>67</sup> TE at 36.

<sup>68</sup> Joint Petition, ¶ 46; Rowe Direct at 6.

<sup>69</sup> Joint Petition, ¶ 44; Rowe Direct at 5.

and capital programs.<sup>70</sup> KAWC does not contemplate any material changes in its income statement, balance sheet, or financial position as a result of the Proposed Transaction. There are no foreseeable adjustments to the book value of any of KAWC's assets.<sup>71</sup> KAWC will continue to provide safe, adequate and reliable service as it is obligated to do under state and federal law.<sup>72</sup>

American Water and KAWC will continue their contributions to state and local economies and KAWC's commitment to its local communities.<sup>73</sup> This will include KAWC's significant contributions to civic, charitable and economic development stewardship, including sponsorship in such programs as Bluegrass Pride, McConnell Springs, the Audubon Society and Reforest the Bluegrass.<sup>74</sup>

KAWC's customers will benefit from the Proposed Transaction because American Water will no longer be a subsidiary of a multi-national energy-focused corporation that has now decided to be primarily focused on a rapidly evolving European energy market.<sup>75</sup> While American Water's association with RWE has always been a positive one, the Proposed Transaction will alleviate any lingering concerns some may have about the foreign ownership of American Water.<sup>76</sup> In fact, it is the intention of the Joint Petitioners that no person or entity will obtain a controlling interest in American Water through the Proposed Transaction.<sup>77</sup> Specific disclosures are planned for the registration statement for the IPO to ensure that potential purchasers are aware that any

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<sup>70</sup> Joint Petition, ¶ 45.

<sup>71</sup> Joint Petition, ¶ 46.

<sup>72</sup> Joint Petition, ¶ 47.

<sup>73</sup> Joint Petition, ¶ 48.

<sup>74</sup> Rowe Direct at 6-7.

<sup>75</sup> Rowe Direct at 3-4.

<sup>76</sup> Wolf Direct at 14; Rowe Direct at 6.

<sup>77</sup> Joint Petition, ¶ 50; Wolf Direct at 9.

attempt to obtain a controlling interest in American Water will require compliance with any applicable state law, including provisions related to changes of control.<sup>78</sup>

A significant benefit that will result from the Proposed Transaction is the creation of a greater degree of transparency of the operations of American Water and its subsidiaries.<sup>79</sup> Transparency of operations and management decisions was shown in the wake of Enron to be one of the most important characteristics of publicly traded companies and is now required by federal legislation of corporate governance. During the public hearing, Dr. Woolridge, testifying on behalf of the AG, acknowledged the importance of this transparency and its resulting enhancement of the credibility of management and that it may benefit both the shareholders of American Water and the customers of its subsidiaries.<sup>80</sup>

When asked in his direct testimony if he believed that the Proposed Transaction is consistent with the public interest under the Commission's standard of proof set forth in the 2002 cases, Mr. Rowe responded, "As I have stated, and am absolutely convinced, the Proposed Transaction will not adversely affect the existing level of water and wastewater services and rates provided by KAWC. There are no known potential adverse affects on KAWC from the Proposed Transaction."<sup>81</sup> (Emphasis in original). Ms. Wolf echoed Mr. Rowe when she testified:

The primary benefit of the Proposed Transaction will be to return American Water to its status as a United States publicly-traded company, with all the transparency and ready access to the U.S. public equity and debt capital markets that such a status entails.<sup>82</sup>

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<sup>78</sup> Wolf Direct at 9-10.

<sup>79</sup> Rowe Direct at 8.

<sup>80</sup> TE at 138-139.

<sup>81</sup> Rowe Direct at 9-10.

<sup>82</sup> Wolf Direct at 11.

## CONDITIONS

The Joint Petitioners have requested the Commission to withdraw the conditions and obligations imposed in Case No. 2002-00317.<sup>83</sup> In his direct testimony, Mr. Rowe gave one of the reasons for the withdrawal of the conditions: neither RWE nor Thames will have any affiliation with American Water or KAWC.<sup>84</sup> At the public hearing, Mr. Rowe was asked if KAWC would continue its level of community activities even if no condition requiring it to do so were imposed. He said:

Well, remember KAWC has been in existence for a number of years and we were absolutely – we were, well before conditions, we were supporting the community and we see no change in that going forward.<sup>85</sup>

Later during the public hearing, Mr. Rowe was asked how the Commission could enforce the Joint Petitioners' statement that no transaction costs would be passed along to ratepayers in the absence of a condition prohibiting such pass-through. He responded:

Well, I mean, let's face it; after this hearing, or whenever, we're still regulated by this Commission. So, if we come to agreement with this regulatory body that those conditions are not necessary, then we'll honor the direction of the Commission, with or without a condition. I mean, the regulatory oversight of this Commission doesn't change, in my mindset, whether we have a condition or do not have a condition.<sup>86</sup>

Mr. Rowe addressed the condition issue further as follows at the public hearing:

. . . I think the company's position has been, we don't think they [conditions] were necessary. We were operating under the guides [sic] of this Commission and many other regulatory agencies well before the conditions, and, you know, the one thing I'd like to remind the parties here is that, you know, we're sitting in Frankfort, Kentucky.

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<sup>83</sup> Joint Petition, ¶ 52.

<sup>84</sup> Rowe Direct at 9.

<sup>85</sup> TE at 29.

<sup>86</sup> TE at 32.

We're regulated by the Public Service Commission. Right down the road here, we're regulated by the Kentucky River Authority and the Department of Environmental Protection. None of those agencies go away. So, with or without conditions, I believe our company's viewpoint is we're a regulated entity and those entities have always had those authorities, and this Commission does have, we recognize, the ability to impose those conditions. We just don't feel they're necessary.<sup>87</sup>

Certainly, no one questions the Commission's jurisdiction over KAWC. Nor does anyone question the Commission's authority to regulate KAWC's rates and to investigate KAWC's methods and practices to require it to "conform to the laws of [Kentucky], and to all reasonable rules, regulations and orders of the commission not contrary to law."<sup>88</sup> Those oversight and enforcement powers obviate the need for any conditions.

An examination of the Commission's standard for the public interest inquiry in light of the evidence in this proceeding confirms Mr. Rowe's conclusion. The party seeking approval of the transfer of control must show that the proposed transfer will not adversely affect the existing level of utility service or rates.<sup>89</sup> If that showing is made, then there is neither a need nor legal grounds for conditions, according to the second part of that standard. Here, the proof is overwhelming that the Proposed Transaction will not adversely affect the existing level of KAWC's service or rates. Thus, conditions are neither necessary nor required by statute.

### **THE ATTORNEY GENERAL'S POSITION**

The AG does not recommend disapproval of the Proposed Transaction.<sup>90</sup> He alleges "problems" and proposes the imposition of conditions on the Commission's

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<sup>87</sup> TE at 36-37.

<sup>88</sup> KRS 278.040.

<sup>89</sup> Case No. 2002-00018, Order of May 30, 2002, at 7; Order of July 10, 2002, at 9.

<sup>90</sup> In fact, the AG's witness, Scott J. Rubin, "does not like the idea of keeping an owner in place that does not want to be there . . . ." Rubin Direct at 21.

approval of the Proposed Transaction allegedly to avoid the potentially adverse effects of the “problems.” But his alleged “problems” have nothing to do with the Proposed Transaction. Further, the alleged “problems” are unrelated to any RWE conduct. For these reasons and others set forth below, the AG’s proposed conditions should be rejected.

The AG’s witness, Scott J. Rubin, sets forth the alleged “problems” in his testimony. He begins his discussion by quoting from minutes of Supervisory Board meetings at RWE and attempting to divine from that limited information the reason for RWE’s decision to divest American Water. He lists American Water’s “lackluster” operating performance, American Water’s allegedly inefficient operations, including high levels of water loss, high capital requirements and allegedly ineffective management.<sup>91</sup>

Rather than attempt to divine the intent of RWE based on selected portions of meeting minutes from Germany, the Commission should turn to the Joint Petitioners’ filings in this proceeding, which make it clear that the decision to divest was the result of a need for RWE to focus on its core energy market.<sup>92</sup> Nothing in the board minutes contradicts this overriding reason for divestiture and any comments contained in the minutes should be viewed in that context.

The Commission has noted its implied power to impose conditions in this case. Further, the Commission has noted that such power exists to ensure that utility service will not be adversely affected. It is clear that conditions should not be used to remedy perceived “problems” with one of the parties to the transaction that have nothing to do with the transfer. The “problems” alleged by Mr. Rubin have nothing whatsoever to do

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<sup>91</sup> Rubin Direct at 8-12.

<sup>92</sup> Wolf Direct at 10.



with the Proposed Transaction and do not give rise to the need for any conditions to address the situation.

One of the “problems” alleged by Mr. Rubin is a need by American Water and KAWC for increased capital expenditures occasioned largely by aging infrastructure and abnormally high levels of water loss.<sup>93</sup> It is well known in the water industry that all systems in the United States face high levels of capital expenditure now and in the future to replace aging infrastructure. Many of the Joint Petitioners’ witnesses acknowledged the expected increased level of capital expenditures.<sup>94</sup> That is no reason to impose conditions on the approval of the Proposed Transaction. As to the alleged high level of water loss, Mr. Rubin acknowledged on cross-examination that KAWC’s level of unaccounted for water in 2005 was only 13.6%.<sup>95</sup> He also agreed that the American Water Works Association’s new M52 Manual states that it is not uncommon to find unbilled water to be over 20% in older systems, like KAWC’s.<sup>96</sup> Mr. Rubin’s conditions relating to water loss are “solutions” in search of a problem that does not exist.

Mr. Rubin claims that American Water’s pension plans and OPEB obligations are under funded and that this forms a basis for conditions to the approval of the Proposed Transaction.<sup>97</sup> When tested on this unsupported conclusion, Mr. Rubin acknowledged that he had no evidence that at any time American Water’s pension plan or its OPEB plan failed to meet all governmental requirements.<sup>98</sup>

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<sup>93</sup> Rubin Direct at 8-10.

<sup>94</sup> See, for example, Miller Direct at 6.

<sup>95</sup> TE at 109.

<sup>96</sup> TE at 110-111.

<sup>97</sup> Rubin Direct at 12-13.

<sup>98</sup> TE at 118.

Using accounting standard FAS 87, Mr. Rubin defines the pension “funding ratio” as the ratio of plan assets to the projected benefit obligation.<sup>99</sup> However, this definition is inconsistent with Mr. Rubin’s statements regarding the long-term funding of the plans. Mr. Rubin’s measure of funding ratio is a snapshot measure of plan assets and obligations under FAS 87. The appropriate measure of funding as required by law (for purposes of determining the appropriate level of cash contributions to the pension plan) is based on a long-term measure of assets and obligations. That long-term measure is derived from the minimum funding rules set forth in the Employee Retirement Income Security Act of 1974 (“ERISA”). Mr. Rubin confuses the rules for determining the accounting cost of the pension plan under FAS 87 and the rules for determining the minimum required contribution under ERISA, the federal statute. The undisputed fact is that at no time (either before or after the RWE acquisition) were the plans out of compliance with all governmental requirements. Regardless of the measure used to determine funding status, the funding of the plans is completely unrelated to the Proposed Transaction, and, thus, is not a basis for the imposition of conditions.

Mr. Rubin complains that the IPO will not raise any capital for American Water.<sup>100</sup> It is true that the IPO is not being made for the purpose of raising capital for American Water. It is being made for the purposes of allowing a controlling shareholder to divest its holding in American Water and of allowing American Water to again be a publicly traded company. This issue is a red herring.

Mr. Rubin argues that American Water might be harmed by the redemption by RWE of its preferred stock in American Water. He also asserts, incorrectly, that the

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<sup>99</sup> Rubin Direct at 12.

<sup>100</sup> Rubin Direct at 14.

preferred stock was issued illegally because he believes that it is guaranteed by American Water's operating subsidiaries, including KAWC.<sup>101</sup> Mr. Rowe and Ms. Wolf testified unequivocally that Mr. Rubin is incorrect in his belief that the preferred stock was guaranteed by KAWC or any other American Water operating subsidiary.<sup>102</sup> Mr. Rubin cannot change the fact that RWE has a legal and contractual right to redeem the preferred stock in the manner contemplated by the Joint Petitioners.

The AG's other witness, J. Randall Woolridge, devotes most of his testimony to a rehash of the "problems" identified by Mr. Rubin. Many of Dr. Woolridge's conclusions about the performance of American Water since its acquisition by RWE are based on a flawed comparison of American Water with Aqua America.<sup>103</sup> A comparison of American Water with Aqua America is a true "apples and oranges" comparison. Dr. Woolridge acknowledged numerous differences between the companies during cross-examination at the public hearing.<sup>104</sup> For example, he acknowledged that Aqua America added at least three large utilities to its system since RWE acquired American Water, yet he failed to examine the impact of those acquisitions on the growth of Aqua America's revenues, net income, rate base or number of customers.<sup>105</sup>

Dr. Woolridge focuses his entire criticism of past activities on American Water and RWE. He never mentions KAWC or whether these "problems" (which do not have any connection with the Proposed Transaction) will have any impact on KAWC or its customers. They do not. He also performs a "rough estimate of the impact of the

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<sup>101</sup> Rubin Direct at 18-21.

<sup>102</sup> TE at 37, 62. See also, Joint Petitioners' Response to Hearing Data Request No. 3.

<sup>103</sup> Woolridge Direct at 9-11.

<sup>104</sup> TE at 141-142.

<sup>105</sup> TE at 141.

divestiture on American Water's cost of capital."<sup>106</sup> This "rough estimate" inappropriately becomes the basis for a proposed condition discussed below.

Mr. Rubin proposes to address his alleged "problems" by having the Commission force RWE to pay 20% of the proceeds it receives in the IPO to American Water as a condition to the Commission's approval of the Proposed Transaction.<sup>107</sup> Mr. Rubin supports his unjustified and inappropriate taking of a shareholder's proceeds of the sale of its stock by asserting that the 20% exit fee is "a way for RWE to make good on some of the commitments it made when it acquired AWW – commitments that have not been met, such as improving the safety, reliability and efficiency of service."<sup>108</sup>

Even if Mr. Rubin could factually support such claims regarding RWE's alleged failure to meet its "commitments," which he cannot, conditions are only to be used to mitigate any adverse effect of the proposed transfer of control, not as a means to assess punitive damages for alleged past actions by a shareholder.

Mr. Rubin devotes three pages of his direct testimony to a currency hedge that was utilized by RWE to its advantage.<sup>109</sup> Like its investment in American Water, RWE took the entire risk of loss on the currency hedge and it should be allowed to retain the benefits of that strategy. Indeed, Mr. Rubin acknowledged on cross-examination that he did not expect the ratepayers of American Water to make good on any loss that RWE may have experienced on the hedging transaction.<sup>110</sup> Mr. Rubin somehow inexplicably morphs into the argument that an exit fee should be required because RWE will receive funds from four different sources as a result of the Proposed Transaction.

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<sup>106</sup> Direct Testimony of J. Randall Woolridge ("Woolridge Direct") at 12-13.

<sup>107</sup> Rubin Direct at 22.

<sup>108</sup> Id.

<sup>109</sup> Rubin Direct at 23-25.

<sup>110</sup> TE at 126.

Mr. Rubin says that RWE will receive funds when its debt instruments are paid, when its preferred stock is redeemed, when it sells American Water's common stock in the IPO and when it cashes out the hedging transaction.<sup>111</sup> Even Mr. Rubin cannot deny that RWE has a right to be paid monies it has loaned to American Water, or anyone else for that matter. It has a right to redeem its preferred stock in accordance with its terms, which is the case here. It has a right to receive the proceeds of the sale of common stock that it owns. It has a right to benefit from a prudent hedging transaction for which it bore all the risk. Mr. Rubin does not suggest that RWE's receipt of monies from these transactions is improper or unfair; only that it is a lot of money<sup>112</sup> and that RWE should be forced to share it.

Furthermore, the concept of an exit fee assessed against selling shareholders was proposed by LFUCG in Case No. 2002-00018 and specifically rejected by the Commission. The Commission set forth LFUCG's suggestion as follows: "It further suggests that the public interest requires American Water's shareholders to share 'the enormous cash benefits' created by the Proposed Transaction with KAWC shareholders."<sup>113</sup> The Commission responded:

We find no legal support for this proposition. Courts have long recognized that ratepayers are not entitled to a share of a portion of the proceeds of the sale of capital stock 'simply because they are the users of the service furnished by the utility.' (citing Democratic Central Committee of D.C. v. Washington Metropolitan Area Transit Comm'n, 485 F.2d 786, 805 (D.C. Cir. 1973)).<sup>114</sup>

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<sup>111</sup> Rubin Direct at 25.

<sup>112</sup> Interestingly, the calculation of the total "proceeds" by Dr. Woolridge was incorrect as he double counted the proceeds from the redemption of the preferred stock. Confidential Transcript of Evidence of Hearing dated August 16, 2006, at 9.

<sup>113</sup> Case No. 2002-00018, Order of May 30, 2002, at 9.

<sup>114</sup> Id. The Commission also referenced Board of Public Utility Commissioners v. New York Telephone Co., 271 U.S. 23, 32 (1926).

The Commission based its conclusion on the concept that only the utility's shareholders bore the risk of the investment and they should not be required to share a portion of the proceeds of the sale of the stock with others. Here, American Water did not bear any risk with respect to the value of its stock that was held by RWE. That risk was borne solely by RWE. It is inappropriate, therefore, to require RWE to pay an exit fee of any amount for the right to sell its stock in American Water.

Presumably, Mr. Rubin's recommendation of an exit fee seeks to protect the interests of the ratepayers, as the AG is the statutory representative of the ratepayers.<sup>115</sup> In support of this recommended condition, the AG must demonstrate by clear and satisfactory<sup>116</sup> evidence that the ratepayers' interests will be negatively affected by the Proposed Transaction. As set forth herein, exactly the opposite is true.

As the Commission and courts have recognized, ratepayers are not entitled to a share of the proceeds of the sale of capital stock "simply because they are the users of the service furnished by the utility." Recognizing this limitation, the AG does not recommend that the ratepayers directly receive a portion of the proceeds. Instead, the AG recommends limiting the amount of IPO proceeds that can be retained by RWE. The stock sale from RWE to third-party purchasers will be at arms-length with the price being set by the market. RWE, alone, bore all of the risks of stock ownership and, therefore, it is entitled to retain all of the proceeds from the sale of stock under the Commission's precedent and the authorities cited herein.

The proposed exit fee (as well as the AG's proposals of a rate case adjustment relating to cost of capital and a cap on the ability to recover Sarbanes-Oxley costs) invite

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<sup>115</sup> KRS 367.150(8)

<sup>116</sup> KRS 278.340

the Commission to step outside the bounds of its statutorily given authority. The Commission has stated in this case that it may impose conditions to ensure that the Proposed Transaction will not adversely affect utility service. But the AG's proposed conditions are unrelated to the provision of service or the public interest. Rather, they are penal in nature and would require the Commission to exceed its authority as proscribed in South Central Bell Tel. Co. v. Utility Regulatory Comm'n, 637 S.W.2d 649, 654 (Ky. 1982).

The AG's recommendation would amount to an "exaction" (in the form of an exit fee) from RWE. An exaction is a concession made in order to receive a governmental permit or approval. To benefit the Kentucky ratepayers, the Commission would require RWE to give up its right to a portion of the IPO proceeds in exchange for the right to sell its stock.

The conditioning of the grant of a permit (or other approval) on an exaction may result in a regulatory taking claim.<sup>117</sup> The doctrine was further explained by the United States Supreme Court in Dolan:<sup>118</sup>

Under the well-settled doctrine of 'unconstitutional conditions,' the government may not require a person to give up a constitutional right -- here the right to receive just compensation when the property is taken for public use -- in exchange for a discretionary benefit conferred by the

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<sup>117</sup> See Nollan v California Coastal Commission, 483 U.S. 825 (1987). In Nollan, the Nollans applied for a coastal development permit to demolish their existing beachfront bungalow and to replace it with a three-bedroom house. 483 U.S. at 828. Finding that the construction of the new house would obstruct the public's view of the seashore, the California Coastal Commission conditioned approval of the building permit on the Nollans granting a lateral public easement over the beach portion of their property. Id. The Supreme Court held that even though the Commission could have denied the building permit altogether, it could not condition the grant of the permit on a concession by the property owners that lacked an "essential nexus" to the justification for the prohibition. 483 U.S. at 837. Because allowing members of the public already on the beach to walk along the Nollans' land would in no way address the barrier to visual access created by the new house, the Commission's attempted exaction was a taking without just compensation.

<sup>118</sup> Dolan v. City of Tigard, 512 U.S. 374 (1994).

government where the property sought has little or no relationship to the benefit.

In other words, under the Fifth and Fourteenth Amendments to the United States Constitution,<sup>119</sup> a business must be allowed to obtain a fair return on its property given the risks. American Water, KAWC and the ratepayers of KAWC bear no risk in the fluctuation or sale of shares in the IPO. The right to capital gains or losses from the sale of the stock belongs to RWE. Furthermore, the exit fee sought against RWE bears no “essential nexus” to the justification for it. The Proposed Transaction is not the cause of the alleged “problems” Mr. Rubin identifies. Finally, the imposition of an exit fee would establish bad precedent that could adversely impact other utilities by chilling any desire to invest in those utilities for fear of an arbitrary and unjustified penalty upon a sale of that investment.

Next, Mr. Rubin proposes some additional conditions to address the concerns he and Dr. Woolridge allege in their direct testimony. First, he proposes a rate case adjustment for the next five years to the cost of capital to insulate KAWC’s customers from the “adverse effect” on American Water’s bond ratings from its divestiture from RWE.<sup>120</sup> Such a condition is inappropriate for at least three reasons: (i) it is single issue rate making in its most basic form; (ii) cost of capital must be examined in the context of a rate case as of the time the rates will be in effect, not as of the time of a change of control case; and (iii) it would be an unconstitutional confiscation to artificially restrict KAWC’s ability to recover a market based cost of capital, particularly when a market

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<sup>119</sup> The takings clause of the Fifth Amendment to the United States Constitution provides that private property shall not “be taken for public use, without just compensation.” U.S. Const. Amend. V. The takings clause is made applicable to the states through the Fourteenth Amendment. U.S. Const. Amend. XIV.

<sup>120</sup> Rubin Direct at 26.



based cost of capital has nothing to do with the Proposed Transaction. Finally, as discussed above, the proposed adjustment is inappropriately based on Dr. Woolridge’s “rough estimate.”<sup>121</sup> Utilities are not permitted to make rate case adjustments based on “rough estimates” and the AG should not be permitted to do so, especially in the unorthodox context of a change of control case.

Mr. Rubin also proposes two conditions relating to the reporting of information about unaccounted for water.<sup>122</sup> KAWC currently provides the Commission information on unaccounted for water and there is no need for additional reporting requirements given KAWC’s performance set forth above.

Mr. Rubin proposes that all American Water or KAWC unregulated activities be conducted through separate entities and specific methods for allocating the cost of services provided by KAWC.<sup>123</sup> There is a thorough and sophisticated affiliate transaction and cost allocation methodology set forth in Kentucky’s statutes<sup>124</sup> that deal fully with both issues. Thus, there is no need for the condition proposed by Mr. Rubin.

Finally, Mr. Rubin proposes a cap of \$1 million per year on Sarbanes-Oxley compliance costs allocated to all of American Water’s regulated subsidiaries.<sup>125</sup> Like the cost of capital adjustment above, this condition amounts to single issue ratemaking and is an unconstitutional confiscation. Also, the rate making process entails a determination of the reasonableness of proposed expenses; it is not appropriately made in a change of control case. It need not be made in a vacuum; it should be made during a rate case taking all elements of a utility’s cost of service into account.

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<sup>121</sup> Woolridge Direct at 12.

<sup>122</sup> Id.

<sup>123</sup> Id.

<sup>124</sup> KRS 278.2201, et seq.

<sup>125</sup> Id.

Mr. Rubin concludes his testimony with a list of the conditions imposed in Case No. 2002-00317 that he believes should be imposed here.<sup>126</sup> For the reasons set forth herein, the conditions imposed in Case No. 2002-00317 are inapplicable as they were designed for a different purpose and reflect facts that will no longer apply (such as foreign ownership) after the Proposed Transaction.

### **CONCLUSION**

The Joint Petitioners have demonstrated that American Water has the financial, technical and managerial abilities to provide reasonable service to the customers of KAWC. They have demonstrated that the Proposed Transaction will not adversely affect the existing level of KAWC's service or rates. They have demonstrated that the Proposed Transaction is in the public interest and that conditions to the approval of the Proposed Transaction are not necessary. Therefore, the Proposed Transaction should be approved without conditions.

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<sup>126</sup> Rubin Direct at 26-30.

**CERTIFICATION**

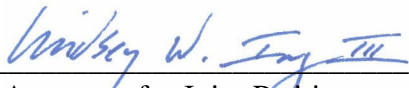
This is to certify that a true and accurate copy of the foregoing has been electronically transmitted to the Public Service Commission on September 22, 2006; that the Public Service Commission and other parties participating by electronic means have been notified of such electronic transmission; that, on September 25, 2006, the original and one (1) copy in paper medium will be hand-delivered to the Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601; and that on September 25, 2006, one (1) copy in paper medium will be served upon the following via U.S. mail:

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