

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE JOINT PETITION OF KENTUCKY-AMERICAN)
WATER COMPANY, THAMES WATER AQUA) Case No. 2006-00197
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)

OFFICE OF THE ATTORNEY GENERAL
POST-HEARING BRIEF
- Redacted -

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OVERVIEW OF APPLICATION FOR DIVESTMENT

The Joint Petitioners (Kentucky American Water Company, American Water Works Company, Thames Water Aqua US Holdings, Inc., Thames Water Aqua Holdings GmbH, and RWE Aktiengesellschaft) apply for Commission approval for RWE's divestment plan. The plan has three components. Thames Water Aqua US Holdings, Inc. (TWUS) will merge with and into American Water Works Company. Thames Water Aqua Holdings GmbH (Thames GmbH), which is a wholly-owned subsidiary of RWE, will sell up to 100% of the share of common stock of AWW in one or more public offerings. The plan will result in the transfer of control of KAW from RWE to unidentified persons who are not parties to this proceeding. The Joint Petitioners also request the removal of all conditions they accepted as part of RWE's acquisition of Kentucky American.

The Attorney General of the Commonwealth of Kentucky, through his Office of Rate Intervention, and the Lexington-Fayette Urban County Government have been granted leave to intervene in this proceeding. Following discovery and a hearing held on 16 August 2006, the Attorney General submits this post-hearing brief.

The Commission should deny the application for an unconditional divestment. Accordingly, any Commission grant of approval for the transactions should expressly condition approval upon the acceptance by each Joint Petitioner of conditions that are necessary for the assurance of reasonable rates, adequate service, and the protection of the public interest.

STANDARD OF REVIEW

The subject-matter jurisdiction of the Commission to review proposals for the transfer of control of a jurisdictional utility is clear. The corresponding standard of review for this application is addressed by the Commission's 14 August 2006 Order in this proceeding. Specifically, KRS 278.020 (5) is applicable to this plan,¹ and it provides the following:

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.

The Commission's duty to protect the public interest is ever present. Thus, the August 14th Order expressly rejects any notion that the Commission lacks the power to fully protect the public interest.²

¹ Order, 14 August 2006, page 11.

² Order, 14 August 2006, page 9.

ARGUMENT

1. The Commission should deny RWE's application for approval of its application for an unconditional divestment.

RWE no longer wants American Water Works. Notwithstanding any window-dressing for the transaction that may be urged by the Joint Petitioners, RWE, acting to further its own interests, wants to sell its investment in American Water Works and put the proceeds from the sale of AWW to use elsewhere.

RWE does not have an unconditional right to divest itself of American Water Works. The plan of divestment requires approval by this Commission. In sum, the plan that the Joint Petitioners submit is a request for approval in order that RWE can sell American Water Works to anyone who is willing to buy it.

One remarkable feature of the plan is that RWE has no vested interest in the success or failure of American Water Works following the divestment. RWE is "cashing out" in the true sense of the phrase. Fortunately, there is a regulatory process in place to review this plan.

Just a few months ago, RWE spent great resource to purchase American Water Works. RWE, through its voluntary act, took on a responsibility in becoming the owner of AWW and Kentucky American Water. If RWE now wants to walk away, it must demonstrate that American Water Works will succeed post-divestment. The pending application for divestment does not meet that test (which is a summary of the applicable legal standard), and the application should, therefore, be denied.

2. Commission authorization of the divestment should be conditioned upon the Joint Petitioners accepting certain conditions.

If RWE seeks to divest itself of American Water Works, then the plan must be consistent with the requirements of Kentucky law. First, there must be a demonstration that the owners of the utility following the transfer will have the financial, technical, and managerial ability to operate the utility.³ Given the absence of 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.

Under the plan, there will be numerous owners with no one person or group in control. Therefore, RWE, which following the divestiture will have no vested interest in the success or failure of AWW, points to American Water Works as the entity that satisfies this requirement. It is interesting to consider RWE's assessment of American Water Works on this issue. Excerpts from the minutes of RWE's Supervisory Board include the following:

If a decision were taken in favor of [RWE] retaining the holding in American Water, it would be essential to install a new management in the US. The restructuring of the American Water group would then have to be pursued with special urgency.⁴

In connection with the discussions about the most recent planning by American Water's management, it had become clear to him that leakage problems in the US would tend to

³ KRS 278.020(5)

⁴ Supervisory Board minutes dated September 16, 2005, page 6.

worsen in the future. For instance, the share of water production in New Jersey that is lost by leakage had risen from 15% to currently 18%. The comparable value for Pennsylvania stood at 30%. While replacing Thames Water's entire pipe system would take 125 years at the current renewal rate, the corresponding figure for American Water was over 200 years. The reason for this extraordinarily high value was that American Water, across a period of several years, had not met regulatory stipulations in various US states. In part, this was due to insufficient investment by American Water in the previous 10 years prior to RWE acquiring its holdings.⁵

Thus, it appears to be RWE's position that American Water Works financial, managerial, and technical ability is not good enough for RWE, but it is good enough for Kentucky. It is also the case that RWE's plan contains no elements or features to address these challenges. Consequently, conditions are necessary in order to satisfy this requirement.

The starting point for conditions is management. American Water Works' regulated operations are profitable.⁶ "Growth in regulated basic business was largely on track (growth from investment)."⁷ Thus, the backbone (and reason for being) of AWW, its provision of regulated water service, is relatively stable and a sustainable business unit.

American Water Works' frolic into non-regulated ventures warrants the descriptive term "disaster." "Growth in non-regulated business was well below expectations due to the weak distribution team."⁸ RWE's description of the

⁵ Supervisory Board Minutes dated November 4, 2005, page 8.

⁶ Transcript of Evidence (TE) for 16 August 2006 hearing, page 42.

⁷ Supervisory Board Minutes dated September 16, 2005, page 3.

⁸ Supervisory Board Minutes dated September 16, 2005, page 3.

managerial resource for the non-regulated business as "weak" appears to be quite charitable given its conclusion that "a new management" would be "essential" if RWE were to continue to hold AWW.⁹

If American Water Works' non-regulated operations were robust and RWE's exit was for reasons other than extreme disappointment in its water investment, then, perhaps, this would not be as big an issue. AWW's non-regulated operations, however, are not robust. Close to home, for example, Kentucky-American Water Company has yet to demonstrate that its non-regulated operations are profitable.¹⁰ American Water Works has been focusing tremendous resource (in terms of talent and money) on its non-regulated business¹¹ at the expense of its regulated business. If American Water Works is to be a viable and sustainable business entity post-divestment, the non-regulated operations' hemorrhaging of resource and wasteful attributes must be stopped.

It is clear that while generally stable relative to the non-regulated activities, American Water Works' basic regulated water service operations face a major challenge concerning AWW's distribution systems.¹² It is essential for American Water Works to focus resource on addressing infrastructure issues. It is time for AWW to abandon its passion for non-regulated follies and concentrate on meeting the challenges of its basic business, regulated water.

⁹ Supervisory Board Minutes dated September 16, 2005, page 6.

¹⁰ See, for example, *In the Matter of: Adjustment of the Rates of Kentucky-American Water Company*, Case No. 2004-00103, TE Vol. 1 (8 November 2004), page 119.

¹¹ See, for example, Case No. 2004-00103, KAWC response to OAG 1 - 176 (KAWC desire to "leverage" its regulated water service for the development of its non-regulated business).

¹² Supervisory Board Minutes dated November 4, 2005, page 8.

Once American Water Works gets its regulated water business in order, it may want to pursue non-regulated opportunities. If its shareholders want to lose money on such fancies, that is their choice. Admittedly, (and unfortunately) this Commission cannot order American Water Works to refrain from continuing down an ill-chosen path. Nonetheless, while this Commission does not "regulate" American Water Works *per se*, it does regulate Kentucky American Water Company. The Commission can protect Kentucky American Water's regulated operations with the following conditions.

All AWW or KAWC unregulated activities in Kentucky should be conducted through a separate corporate entity. Any services provided to that entity by KAWC should be charged at no less than KAWC's fully allocated embedded cost.

There is a need, identified by RWE, to focus on the distribution system and non-revenue water. The Commission may also protect Kentucky American Water regulated operations and help ensure their sustainability on this point as well through the following conditions.

KAWC should adopt new procedures to closely monitor lost water.

KAWC should be required to file quarterly water loss reports with the Commission.

It is abundantly clear that this transaction will have a negative impact on American Water Works and Kentucky American Water's cost of capital. In buying AWW and KAWC, no one touted the advantages of RWE's access to capital with more passion than RWE's representative who exclaimed that

American Water Works "can never borrow money as cheaply as RWE."¹³

Further, as noted in the initial Order authorizing RWE's purchase of AWW.

The proposed merger will allow KAWC to draw upon RWE's extensive borrowing power. It will permit KAWC to access world capital markets. As RWE has high bond ratings than AWWC, capital will likely be available to KAWC at a cost lower than AWWC's. Given the increasing capital expenditures needed to replace aging water infrastructure, access to capital at the lowest possible cost will be critical to KAWC maintaining its present system at the lowest possible rates.¹⁴

RWE, seeking to cut loose American Water Works, actually objected to a request to gain information regarding the impact of this transaction on the financial structure and/or debt cost rates of AWW.¹⁵ For RWE, it is too much trouble (or perhaps simply too painful) to supply information on a central element to this proceeding, namely, AWW's post-divestment financial ability.

American Water Works' capital costs will increase following the divestment.¹⁶ Specifically, American Water Works cost of capital stands to increase by {Begin Confidential [REDACTED] End Confidential}. Joint Petitioners', who have the burden of proof, offer nothing to protect KAW and its ratepayers. The Commission should require the following condition.

For the next five years, in any KAWC rate case the cost of capital should be adjusted in order to insulate KAWC's ratepayers and hold them harmless for the adverse effect of AWW's cost of capital consequent to the divestiture.

¹³ Case No. 2002-00018, TE Vol. I (1 May 2002), page 180.

¹⁴ Case No. 2002-00018, Order, 30 May 2002, page 13 (footnote in original omitted); also see page 29 (merger in public interest due, in part, to increase in KAWC's access to capital).

¹⁵ Joint Petitioners' Response to OAG 1 - 53.

¹⁶ OAG pre-filed testimony, J. Randall Woolridge, pages 11 to 13.

Oddly enough, while the Joint Petitioners object to a request to examine evidence relating to cost of capital, they assert "transparency" as a key benefit for this application. The bedrock of this assertion is the post-divestment necessity of compliance with Sarbanes-Oxley requirements for publicly-traded companies.

The Sarbanes-Oxley requirements are not requirements of this Commission; instead, they are Securities and Exchange Commission requirements for protecting investors.¹⁷ Admittedly, Sarbanes-Oxley could provide some incidental benefits to Kentucky American Water Company; however, such benefits are questionable, at best. In approving RWE's purchase of AWW, the following was noted regarding the LFUCG's request for surrogate SEC reports as a condition for approval.

LFUCG proposes that additional reporting requirements be placed upon the Joint Applicants. We find that these additional reporting requirements are unnecessary. By our Orders of May 30, 2002 and July 10, 2002, we imposed extensive reporting requirements as a condition to our approval of the proposed transaction. We have incorporated these requirements into this Order.¹⁸

There is no suggestion that Sarbanes-Oxley requirements are bad. In terms of necessity for regulation of KAWC, Sarbanes-Oxley is unnecessary (and would remain inapplicable if RWE were to continue with its ownership). In terms of value, while there may be some value to ratepayers, there is also a very

¹⁷ TE (16 August 2006), page 137 to 139.

¹⁸ Case No. 2002-00317, Order, 20 December 2002, page 22 (footnotes omitted); see LFUCG Brief for Case No. 2002-00317, page 13, condition "11" for request; also see Case No. 2002-00018, TE Vol. I (1 May 2002), page 70 (RWE witness assessment that SEC filing information not significant from the perspective of a utility business).

significant cost for those benefits. These cost include the dedication of resource to Sarbanes-Oxley work that has delayed work on the implantation of operation efficiencies.¹⁹ Bluntly enough, RWE wants its regulated ratepayers to pay for the shareholders' meal in return for the "privilege" of picking up whatever leftovers are available.

If the post-divestiture American Water Works is to look to its regulated companies for paying the Sarbanes-Oxley tab, then there should be a protection built in to limit exposure to these costs. Importantly, Joint Petitioners' estimate of American Water Works increased annual audit costs for Sarbanes-Oxley compliance, \$1.0 million per year,²⁰ is unrealistically low. Joint Petitioners make this representation in furtherance of their efforts to obtain this Commission's approval. As a consequence, they should be held to this representation through the following condition.

AWW should be held to its representations concerning the Sarbanes-Oxley compliance costs, and AWW will not be permitted to charge Kentucky American Water Company an amount that would represent more than KAWC's pro rata share of \$1.0 million per year (adjusted for inflation) for AWW's Sarbanes-Oxley compliance costs. Kentucky American Water Company will not seek to recover through rates an amount in excess of its pro rata share of an allocation of this estimate (adjusted for inflation) of Sarbanes-Oxley compliance costs.

¹⁹ TE (16 August 2006), pages 51 through 53; also see for comparison, Supervisory Board Minutes for November 4, 2005, page 4 ("rises in efficiency were not implemented as planned.")

²⁰ Joint Petitioners' Response to OAG 1 - 19.

The situation with American Water Works' pension plan and its change in condition during RWE's ownership is alarming. The difference between American Water Works' benefit obligation and the fair value of plan assets continues to grow and the under-funding, as of 31 December 2005, stands at \$344 million.²¹ There has been a serious deterioration of the funding ratio during RWE's ownership of AWW.

The day of reckoning for this short-fall will come, and it will occur sooner rather than later. The post-divestiture American Water Works will not raise the money to bridge this gap or even make any meaningful contribution through its non-regulated operations. Therefore, post-divestiture, AWW will have to seek its remedy through increased rates, a reduction in benefits, or, perhaps, by taking both actions. Each course of action will have a negative impact.

The situation with American Water Works' capital spending needs is also alarming. RWE itself identifies a problem with American Water Works' investment in its system. RWE does not indicate any action it has taken during its ownership to improve American Water Works on this point. In fact, there has been an underinvestment.²² RWE does not offer any remedy through this transaction. Despite all of its promises, RWE wants to walk away. There is no demonstration that the post-divestment American Water Works will be better off as a consequence of this plan.

²¹ Joint Petitioners' supplemental response to Item No. 4 of the Hearing Data Requests, 2005 annual report of AWWC, page 26.

²² AG pre-filed testimony, J. Randall Woolridge, pages 10 and 11.

The proposed Initial Public Offering does not raise any capital for American Water Works. In fact, American Water Works has to spend money in order to complete this transaction. The purpose of the IPO is for RWE to achieve as much money as possible.²³ Once the IPO is complete, RWE will have no vested interest in the success or failure of American Water Works.

In order to assure that American Water Works has the ability to succeed post-divestment, RWE should be required to pay 20% of the proceeds from the IPO to AWW. In light of the pension fund deterioration as well as the capital investment requirements, this is an amount that is necessary to safeguard AWW.

There has been a claim that this request is similar to an LFUCG request from Case No. 2002-00018.²⁴ The comparison of this request and the LFUCG request is in error. LFUCG wanted a comparison of benefits between AWW shareholders with KAWC ratepayers.²⁵ The Attorney General does not suggest that American Water Works' ratepayers get a portion of the proceeds from the IPO. Instead, the Attorney General urges a result under which AWW will be properly capitalized, which is something that will help ensure that, on a going-forward basis, Kentucky American Water is properly capitalized.

Because there are other regulatory proceedings and approvals that will conclude and occur prior to the IPO, it is appropriate for this Commission to condition approval on the acceptance of a "Most Favored Nations" clause. The

²³ TE 16 August 2006, page 41.

²⁴ TE 16 August 2006, pages 122 through 124.

²⁵ Case No. 2002-00018, Order, 30 May 2002, pages 8 and 9.

Attorney General recommends the following condition (that differs from the condition in Case Numbers 2002-00018 and 22002-00317).

If any state regulatory commission approves or imposes conditions on RWE, Thames, TWUS, or AWWC as a condition for its approval of the proposed divestiture and those conditions would benefit ratepayers in that or any other jurisdiction, proportionate net benefits and conditions will be extended to KAWC ratepayers.

The Attorney General incorporates by reference his remaining requests for conditions as set forth in his pre-filed direct testimony. He also notes that the continuation of relevant conditions from Case Numbers 2002-00018 and 2002-00317 remain important and indispensable safeguards.

There is one remaining point from the public hearing that warrants clarification. With regard to the preferred stock that AWW issued to TWUS (now held by TWIL), the costs of paying off this stock will not be paid by the proceeds of the Initial Public Offering.

Q. The costs of paying off that stock, will those be passed down to the regulated entities?

A. It will, depending upon the method. It's not really the cost of – it's the cost to obtain either new debt or new equity. To the extent any of that debt is loaned down to the regulated entities, the answer would be yes. If it is not used to finance anything of the entity, the answer is no.²⁶

In terms of the public interest, the fundamental question is whether American Water Works will be better off post-divestiture under RWE's plan to cast off AWW. The answer: no. Many of the points that demonstrate how

²⁶ TE 16 August 2006, page 96.

RWE's plan is contrary to the public interest (for example, the increase in American Water Works' cost of capital) have already been discussed. Nevertheless, at this point, reference to the 30 May 2002 Order of approval for Case No. 2002-00018, is appropriate and quite telling.

Our review of the record leads us to conclude that, if the Joint Applicants, AWWC and RWE accept these conditions and commitments set for in Appendix A, the proposed merger is in the public interest. It will not result in any increase in utility rates or reduction in the quality of water service. By placing KAWC into a larger company system, the proposed merger will increase KAWC's access to capital, cutting edge technologies, and enhanced R&D. It will allow KAWC to draw upon Thames' experience in the area of security practices and to better protect its facilities at lower cost. It will permit greater employee training opportunities and should result in a better-trained work force.²⁷

Under the RWE divestment plan, it is likely to result in an increase in utility rates, and all of the benefits of placing KAWC into a larger company will be lost. The only conclusion that will remain, arguably, applicable for this transaction is that there will be no reduction in the quality of water service. There certainly is no demonstration by RWE of any enhancement on this point.

The RWE proposal does not advance the public interest. The IPO does not solve the problems of American Water Works or Kentucky American Water. In fact, it stands to create more problems. The only problem solving through the IPO is in favor of RWE which will solve the problem of being an uninterested, disenchanted, and unwilling owner. The imposition by the Commission and the

²⁷ Case No. 2002-00018, Order, 30 May 2002, page 29.

acceptance by the Joint Petitioners of the Attorney General conditions are necessary in order for this transaction to be in the public interest.

3. The Commission, which at all times has jurisdiction over the rates and service of Kentucky American Water Company, should continue to actively monitor the Joint Petitioners through the execution of the transaction for which approval is sought. The monitoring should include a "final check" as a means to ensure that Kentucky 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.

There is a lot of activity that will take place after any approval by this Commission through the consummation of the transaction. The Commission should continue to actively monitor this transaction. It may either keep this docket open or establish a new docket.

It is important for the parties and this Commission to have an opportunity to review new information as it becomes available. It is equally important for this Commission to have notice of any material changes in the transaction and have the ability to address any issues that may arise prior to consummation of the Initial Public Offering.

Therefore, the Attorney General recommends that the Commission continue to actively monitor the Joint Petitioners (and afford the parties the same opportunity) after any approval under this proceeding up to the actual implementation of the plan. The monitoring should include a reporting process to act as a "final check" that the transaction that takes place is consistent with any approval by this Commission.

WHEREFORE, the Attorney General submits his post-hearing Brief and asks that the Joint Petitioners' application be denied. He further asks that any approval of this transaction be conditioned upon acceptance by the Joint Petitioners of the Attorney General's recommendations. He also asks for the continuation of this docket or a new docket for the continual monitoring of the Joint Petitioners' further activities in this transaction.

Respectfully submitted,

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Notice of Filing

Counsel gives notice of the filing (pursuant to Instruction 1 of the Commission's 5 June 2006, Order of procedure) of the original (redacted Brief), one photocopy in paper medium, and a photocopy of the non-redacted Brief filed under seal by hand delivery to Beth O'Donnell, Executive Director, Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601 on 25 September 2006. Further, one copy of the redacted Brief in electronic medium has been filed by uploading the filing to the file transfer protocol site designated by the Executive Director on this 22nd day of September 2006.

David E. Egan
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Instruction 6 Certification

Per Instructions 6 of the 5 June 2006, Order of procedure, counsel certifies that the electronic version is a true and accurate copy of the redacted document filed in paper medium, a copy in paper medium of the redacted document has been served on all the parties of record, the electronic version of this document been transmitted to the Commission, and the Commission and other parties have been notified by electronic mail (on 22 September 2006) that the electronic version has been transmitted to the Commission.

David E. Egan
Assistant Attorney General

Certificate of Service

Counsel certifies that this response has been served by mailing a true and correct photocopy of the redacted Brief and the non-redacted Brief, first class postage prepaid, to Lindsey W. Ingram, Jr., Lindsey W. Ingram III, Stoll Keenon Ogden, 300 West Vine Street, Suite 2100, Lexington, Kentucky 40507-1801. Counsel also certifies sending a true and correct photocopy of the redacted Brief to Anthony G. Martin, P. O. Box 1812, Lexington, Kentucky 40588 and David Barberie, Lexington-Fayette Urban County Government, Department of Law, 200 East Main Street, Lexington, Kentucky 40507. Service took place on this 22nd day of September 2006.

David E. Ingram