COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

KENTUCKY-AMERICAN WATER COMPANY'S REQUEST FOR APPROVAL OF PAYMENT OF DIVIDEND	)))	**CASE NO. 2009-00359**

<u>KENTUCKY-AMERICAN WATER COMPANY'S PROPOSED SETTLEMENT</u>

Kentucky-American Water Company ("KAW") proposes the following settlement to the Commission to fully and finally resolve its omission in failing to seek Public Service Commission approval prior to paying dividends on common stock on March 31, 2009 and June 30, 2009.

Condition No. 32 of the Commission's Order of December 20, 2002 in Case No. 2002-00317 requires KAW to obtain Commission approval prior to paying dividends in any calendar year that collectively exceed five percent of KAW's retained earnings as of December 31 of the preceding year. On March 31, 2009, KAW inadvertently paid dividends that exceeded the five percent threshold without seeking prior approval from the Commission. The same inadvertent omission occurred when KAW paid a dividend on June 30, 2009. KAW realized its omission when it declared a dividend to be paid on September 29, 2009. On September 4, 2009, KAW requested Commission approval in this case for the dividend that was to be paid on September 29, 2009. That request is pending and the dividend has not been paid. The request also reported the inadvertent error related to the March 31, 2009 and June 30, 2009 dividend payments.

KAW regrets its omission. KAW's failure to seek Commission approval was not willful or purposeful. It was an innocent omission. However, KAW recognizes the importance of its omission and the failure to abide by the terms of Condition No. 32. KAW notes that it self-reported its omission and that the dividend payments in question were paid in exact accordance with KAW's long-standing dividend policy of paying, on a quarterly basis, 75% of its available earnings as dividends. Thus, although the spirit of Condition No. 32 – to guard against excessive dividend payments – was met, KAW recognizes and regrets its failure to seek prior approval of the payments in question.

KAW has implemented a process that will prevent this omission from occurring again. First, the question of whether Condition No. 32 has been triggered will be an agenda item on every KAW Board of Directors meeting agenda for as long as Condition No. 32 is in effect. Second, KAW's Secretary and Treasurer will both be responsible for raising the issue of whether Condition No. 32 has been triggered at every board meeting. Third, the KAW Treasurer or an individual working under the direct supervision of the Treasurer will be responsible for performing all calculations necessary to ascertain whether a declared dividend has triggered Condition No. 32 prior to or at the time a dividend is declared. Fourth, all declared dividends will be reported to KAW's outside legal counsel, who will then perform independent calculations to determine whether Condition No. 32 has been triggered. The result of those calculations will be communicated to KAW. Finally, KAW's common stockholder, American Water Works Company, Inc. ("AWW") will also determine whether Condition No. 32 has been triggered as a prerequisite for the payment of dividends.

Although the omission was an innocent mistake and the goal of Condition No. 32 was met in all respects, KAW recognizes its failure to adhere to the Condition, and, therefore, proposes a resolution of this matter by which it: (1) recognizes and takes responsibility for its error as set forth above; (2) ensures that its error will not occur again by its implementation of the preventive measures described above; (3) makes a penalty payment as determined by the Commission within the statutory range of $25.00 to $2,500.00 per KRS 278.990(1); and (4) commits that it will not seek rate recovery for the costs, fees and penalty payment related to the error.

As to the amount of the penalty payment, the applicable portion of KRS 278.990(1) sets the monetary range from $25.00 to $2,500.00 and KAW agrees to pay a penalty within that range at an amount set by the Commission. The facts and circumstances surrounding the error weigh in favor of setting the penalty at the lower end of the range. As mentioned above, the intent of Condition No. 32 – to prevent KAW from making inappropriate dividend payments – was achieved at all times. In fact, the Commission has recognized that the need for Condition No. 32 will be eliminated when RWE AG ("RWE") has completely divested itself of AWW. To explain, Condition No. 32 was imposed in 2002 in connection with the RWE's acquisition of AWW. When the Commission subsequently approved RWE's divestiture of AWW in Case No. 2006-00197, a new set of conditions was imposed. The new set of conditions does not include a "prior approval requirement" for the payment of dividends as Condition No. 32 from Case No. 2002-00317 does. Instead, the new set of conditions only requires KAW to include dividend payment information in the annual reports it files with the Commission.[1] Certainly, KAW recognizes that Condition No. 32 from Case No. 2002-00317 applied at the time of KAW's error and will continue to be effective until RWE divestiture is complete (RWE's ownership of AWW continues to steadily decline and is now at approximately 24%). However, in terms of setting a penalty, the fact of diminishing need for Condition No. 32 should have some relevance.

[1] See Condition No. 21 of the Commission's April 16, 2007 Order in Case No. 2006-00197.

As KRS 278.990(1) sets the minimum penalty at $25.00 and the maximum penalty at $2,500.00, it is instructive to compare KAW's error and related conduct to a more egregious hypothetical set of circumstances. The maximum amount of penalty -- $2,500.00 – should be reserved for willful disobedience of Commission orders that defy the very authority of the Commission itself. For example, if KAW had willfully: (1) departed from its long-standing dividend policy of paying 75% of retained earnings by paying higher amounts; (2) decided not to inform the Commission of that departure; (3) decided not to seek approval for doing so by intentionally ignoring Condition No. 32; and (4) sought to conceal its conduct from the Commission, then the maximum amount of penalty would be appropriate.

None of that unacceptable type of conduct occurred here. Instead, KAW was always in strict adherence with its 75% dividend policy, innocently failed to recognize that Condition No. 32 had been triggered, immediately self-reported its error, takes full responsibility for its error, and has implemented safeguards that will prevent another occurrence. The higher end of the penalty range should be reserved and used for utilities that act in willful bad faith. KAW suggests that the lower end of the range should be reserved and used for instances like the one at hand where regretful and innocent errors have no detrimental effect on customers. KAW respectfully requests the Commission consider a penalty at the lower end of the spectrum in the interest of fairness and to send a message to all utilities that mistaken but good faith conduct will not be penalized as severely as bad faith conduct.

Respectfully submitted,

A.W. Turner, Jr., General Counsel
KENTUCKY-AMERICAN WATER COMPANY
2300 Richmond Road
Lexington, Kentucky 40502
Telephone: (859) 268-6339
A.Turner@amwater.com

and

STOLL KEENON OGDEN PLLC
300 West Vine Street, Suite 2100
Lexington, Kentucky 40507-1801
Telephone: (859) 231-3982
L.Ingram@skofirm.com

BY: Lindsey W. Ingram III
Lindsey W. Ingram III
Attorneys for Kentucky-American Water Company

CERTIFICATION

This is to certify that an original and one copy of the foregoing will be filed at the Public Service Commission on October 27th, 2009 in paper medium, that the electronic version of this document is a true and accurate copy of the document that will be filed in paper medium, that that the electronic version of this document has been electronically transmitted to the Commission, and that notification of that transmission has been made to the following on this 27th day of October, 2009:

David Edward Spenard
Assistant Attorney General
1024 Capital Center Drive, Suite 200
Frankfort, Kentucky 40601-8204

BY: Lindsey W. Ingram III
Stoll Keenon Ogden PLLC