

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

ORDER

Kentucky-American Water Company ("KAWC") has acknowledged violating the provisions of a Commission Order by making, without prior Commission approval, dividend payments in 2009 that exceeded five percent of its retained earnings as of December 31, 2008 and has made an offer of settlement to resolve all issues arising from its violation. Having reviewed the circumstances surrounding the acknowledged violation, we find that the proposed offer is not reasonable and decline to accept it.

In our approval of the transfer of control of KAWC,¹ we placed numerous conditions upon the Joint Applicants – KAWC, Thames Water Aqua Holdings GmbH ("Thames"), RWE Aktiengesellschaft ("RWE"), Thames Water Aqua US Holdings, Inc. ("TWUS"), and American Water Works Company, Inc. ("AWWC"). Condition 32 required that "RWE, Thames, TWUS, AWWC, and KAWC . . . obtain Commission approval prior to KAWC's payments of any dividend or transfers of any funds within a calendar year that collectively represent more than 5 percent of KAWC's retained

¹ Case No. 2002-00317, *The Joint Petition of Kentucky-American Water Company, Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, Thames Water Aqua US Holdings, Inc., Apollo Acquisition Company and American Water Works Company, Inc. for Approval of a Change of Control of Kentucky-American Water Company* (Ky. PSC Dec. 20, 2002) App. A at 4.

earnings as of December 31 of the prior calendar year to RWE, Thames, TWUS or any other entity related to RWE.”² Its purpose was to guard against any drain on KAWC’s financial resources through excessive dividend payments.

Prior to RWE’s acquisition of AWWC, KAWC maintained a policy of paying 75 percent of earnings available for common stock dividends. The Appendix reports, *inter alia*, KAWC’s earning and dividend history since December 2002. It shows that, since December 31, 2002, KAWC has declared and paid dividends that have been roughly 75 percent of its available earnings.

On September 4, 2009, KAWC applied to the Commission for approval of its 2009 third quarter stock dividend of \$2,006,260. In its application, KAWC indicated that it had made quarterly dividend payments of \$1,983,480 and \$2,691,086 for the first and second quarters of 2009, respectively. Each of these payments was in excess of five percent of KAWC’s retained earnings as of December 31, 2008. In the case of both of these payments, KAWC had failed to obtain Commission approval prior to the dividend payment. Both payments were in violation of the Commission’s Order of December 20, 2002 in Case No. 2002-00317.

² *Id.*, App. A at 6. Condition 32 ceased to be effective as of November 30, 2009 when RWE and Thames GmbH sold their remaining interest in AWWC and ceased to have any beneficial interest in any class of securities of AWWC. As of that date, the conditions imposed by our Orders in Cases No. 2002-00018 and No. 2002-00317 terminated. See Case No. 2006-00197, *The Joint Petition of Kentucky-American Water Company, Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, Thames Water Aqua US Holdings, Inc., and American Water Works Company, Inc. for Approval of a Change in Control of Kentucky-American Water Company* (Ky. PSC Apr. 16, 2007) at 36. With the completion of RWE’s divestiture, the Joint Applicants’ application for Commission approval of KAWC’s 2009 third quarter dividend payment was rendered moot. The Commission allowed the case to remain on its docket for the sole purpose of addressing KAWC’s offer of settlement.

At an informal conference conducted on October 13, 2009, KAWC representatives acknowledged that KAWC had violated Condition 32 in making the two dividend payments. They stated that the matter “had fallen through the cracks” and KAWC had not willfully or knowingly violated Condition 32.³ They further explained that, while KAWC had established mechanisms to ensure that all requirements established by the Order of December 20, 2002 that had a specific time deadline were met, Condition 32 had no such deadline. Usually, the dividend payments in the first and second quarters were not of sufficient size to meet the threshold level of Condition 32. Generally, such approval was required only in the last two quarters of a calendar year. It was in preparing the request for approval for KAWC’s third quarter dividend payment that KAWC officials recognized that the earlier two payments met the threshold level of Condition 32.⁴

On October 27, 2009, KAWC submitted an Offer of Settlement to the Commission. Under the terms of its offer, KAWC agrees to pay a penalty of between \$25 and \$2,500 for its failure to comply with Condition 32. While making this offer, KAWC contends that it did not willfully violate Condition 32. It notes that its action was an innocent mistake and that the goal of Condition 32 was met in all respects. KAWC notes that all dividend payments made in 2009 were consistent with KAWC’s long-standing dividend policy of paying, on a quarterly basis, 75 percent of its available earnings as dividends. It further contends that it took no action to conceal its conduct.

³ Memorandum from Gerald Wuetcher to Case File (Oct. 14, 2009) at 1.

⁴ *Id.*

To the extent that a penalty is assessed, KAWC argues, it should be towards the lower end of the spectrum.

In his response to KAWC's Offer, the Attorney General concedes that no evidence exists that KAWC acted in bad faith and offers to stipulate that the violation of the Commission Order was not willful. He argues that a penalty should be assessed but provides no specific amount. He states that the penalty assessed should be a meaningful amount and not merely constitute a perfunctory gesture. The Attorney General further states that KAWC self-reported its violation and, as such, the penalty should not be so excessive as to discourage self-reporting in the future. He also urges the Commission to consider the remedial actions that KAWC put into place following the violation to avoid future violations.⁵

In considering KAWC's offer, we must place KAWC's conduct in perspective. The current case is not the first instance in which KAWC has failed to obtain required Commission approvals before making dividend payments. In December 2005, KAWC paid dividends that exceeded 5 percent of the previous year's retained earnings. On that occasion, we refused to retroactively approve or affirm KAWC's action. We stated:

⁵ KAWC took the following actions to prevent future unauthorized dividend payments: first, the question of whether the Condition 32 threshold will now be placed on the agenda of each KAWC Board of Directors meeting. Board Members will therefore be required to address the issue at any meeting in which the payment of dividends is also an agenda item. Second, KAWC's Secretary and Treasurer will also raise the issue at any board meeting in which the issue of dividend payments appears. Third, a KAWC employee within KAWC's Finance Department has been assigned responsibility to review all dividend payments and perform the required test to determine whether the threshold level has been met. Fourth, whenever KAWC's Board of Directors approves a dividend payment, outside counsel will be informed and will separately perform the required test to determine if the threshold level has been met. Fifth, AWWC has amended its processes for cash transfers with KAWC and will also perform the threshold test to ensure compliance with Condition 32 as a prerequisite for any transfer from KAWC to AWWC. See KAWC's Proposed Settlement at 2 (filed Oct. 27, 2009); Memorandum from Gerald Wuetcher to Case File (Oct. 14, 2009) at 2.

Retroactive approval of Kentucky-American's Third Quarter Dividend would only encourage utilities to enter into unauthorized transactions without obtaining the necessary regulatory approval and then present the transaction to the Commission as a fait accompli. Utilities that have failed to observe the law should not be excused from its requirements. **We place Joint Applicants on notice that in the future their failure to fully comply with all Merger Commitments will subject each Joint Applicant to administrative sanctions. See KRS 278.990(1).** We choose not to employ administrative sanctions here because of Kentucky American's assurance that appropriate mechanisms are indeed now in place to prevent a recurrence.⁶

KAWC's Offer of Settlement, if accepted, would significantly limit the amount of any penalty that could be assessed for the violations of the Commission Order. Assuming a penalty is assessed only against KAWC, the maximum penalty that the Commission may assess for the conduct at issue is \$5,000.⁷ The total potential liability of all applicants is \$25,000.⁸ KAWC proposes to resolve the matter with the payment of a penalty not to exceed \$2,500.

We are concerned about the appearance that the acceptance of the Offer of Settlement would have on the regulated community and the public. KAWC's actions

⁶ Case No. 2002-00277, *Compliance of Kentucky-American Water Company, American Water Works Company, RWE Aktiengesellschaft and Thames Water Aqua Holdings GmbH With the Provisions of the Orders Approving the Transfer of Control of Kentucky-American Water Company To RWE Aktiengesellschaft and Thames Water Aqua Holdings GmbH* (Ky. PSC May 19, 2006) (emphasis added).

⁷ KRS 278.990(1) provides for the assessment of a penalty not to exceed \$2,500 for any person "who fails to obey any order of the commission from which all rights of appeal have been exhausted." In the current instance, two violations of the Commission's Order have occurred.

⁸ In our Order of December 20, 2002, the Commission imposed Condition 32 on each of the Joint Applicants and each Joint Applicant accepted that condition. While KAWC and AWWC are the primary actors in any issuance of KAWC dividends, each of the Joint Applicants had a duty to ensure compliance with Condition 32. A failure to comply with Condition 32, therefore, can conceivably be imputed to each Joint Applicant.

represent repeat violations of the Commission's Order of December 20, 2002. At a minimum, KAWC has been extremely lax and negligent in exercising proper management responsibility, especially after its first violation three years earlier. The assessment of a small penalty in the current proceeding, after we had warned of but not imposed administrative sanctions after the last violation, may adversely affect public confidence in the Commission's commitment to enforcement of our Orders and create the wrong impression among regulated utilities as to the need to comply with Commission Orders.

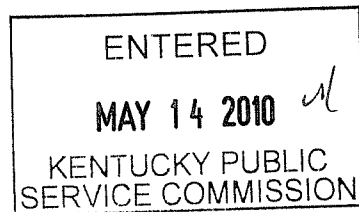
Finally, we find little evidence in the record to support the contention that the violations were self-reported. KAWC did not acknowledge any violation in its application nor can the existence of a violation be readily discerned from the information provided in its application. The record strongly suggests that KAWC acknowledged a violation only after Commission Staff inquiries.

Based upon the above, the Commission finds that the penalty amount set forth in KAWC's Offer of Settlement is inadequate to address the nature of the violations and that the Offer of Settlement should not be accepted. We further find that this proceeding should be kept open for an additional 20 days to permit KAWC to make any additional filings. Absent any new filings at the end of that period, this case will be closed and a new proceeding specifically initiated to address the Joint Applicants' failures to comply with the Commission's Order of December 20, 2002.

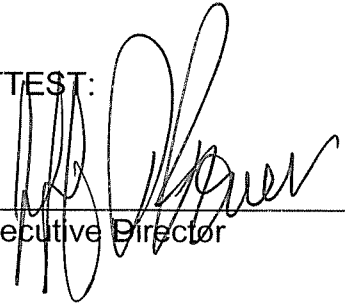
IT IS THEREFORE ORDERED that:

1. KAWC's Offer of Settlement is not accepted.
2. This case shall remain open for 20 days from the date of this Order to accept any additional filings. Absent any new filings at the end of that period, this case shall be closed and removed from the Commission's docket.

By the Commission



ATTEST:



Executive Director

**APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2009-00359 DATED MAY 14 2010**

Quarter	Quarter Ending	Payable Date	Earnings Available	Quarterly Dividend	Dividends as % of Earnings	Per Share Rate	Accumulated Yrly Dividend	Retained Earnings Prior Yr	Accumulated Dividends As % of Ret. Earnings	PSC Approval Required
4-2002	12/31/02	03/28/03	\$1,281,941	\$ 956,108	74.583%	\$ 0.47	\$ 956,108	\$25,177,597	3.80%	N
1-2003	03/28/03	06/23/03	\$ 607,466	\$ 454,543	74.826%	\$ 0.29	\$ 1,410,651	\$25,177,597	5.60%	Y
2-2003	06/27/03	09/22/03	\$ 990,033	\$ 752,347	75.992%	\$ 0.48	\$ 2,821,302	\$25,177,597	11.21%	Y
3-2003	09/26/03	12/15/03	\$1,656,661	\$ 1,238,239	74.743%	\$ 0.79	\$ 5,642,604	\$25,177,597	22.41%	Y
4-2003	12/12/03	03/29/04	\$1,059,560	\$ 799,369	75.443%	\$ 0.51	\$ 799,369	\$26,304,492	3.04%	N
1-2004	04/02/04	06/28/04	\$ 160,286	\$ 109,717	68.451%	\$ 0.07	\$ 909,086	\$26,304,492	3.46%	N
2-2004	06/25/04	09/20/04	\$ 806,206	\$ 611,282	75.822%	\$ 0.39	\$ 1,520,368	\$26,304,492	5.78%	Y
3-2004	09/24/04	12/06/04	\$ 515,915	\$ 391,848	75.952%	\$ 0.25	\$ 1,912,216	\$26,304,492	7.27%	Y
4-2004	12/10/04	03/21/05	\$ 49,559	\$ 31,348	63.254%	\$ 0.02	\$ 31,348	\$25,924,242	0.12%	N
1-2005	03/25/05	06/20/05	\$ 124,982	\$ 862,065	689.751%	\$ 0.55	\$ 893,413	\$25,924,242	3.45%	N
2-2005	06/24/05	09/19/05	\$ (632,171)	\$ -	0.000%	\$ -	\$ 893,413	\$25,924,242		N/A
3-2005	09/23/05	12/05/05	\$2,761,477	\$ 830,717	30.082%	\$ 0.53	\$ 1,724,130	\$25,924,242	6.65%	Y
4-2005	12/09/05	03/20/06	\$ (556,372)	\$ -	0.000%	\$ -	\$ 0	\$25,898,028	0	N/A
1-2006	03/24/06	06/19/06	\$ 635,759	\$ 62,652	9.855%	\$ 0.04	\$ 62,652	\$25,898,028	0.24%	N
2-2006	06/30/06	09/18/06	\$ 918,150	\$ 689,652	75.113%	\$ 0.44	\$ 752,304	\$25,898,028	2.90%	N
3-2006	09/30/06	12/04/06	\$1,683,018	\$ 1,253,913	74.504%	\$ 0.80	\$ 2,006,217	\$25,898,028	7.75%	Y
4-2006	12/31/06	03/29/07	\$1,305,189	\$ 971,782	74.455%	\$ 0.62	\$ 971,782	\$28,434,769	3.42%	N
1-2007	03/31/07	06/28/07	\$ 295,479	\$ 235,109	79.569%	\$ 0.15	\$ 1,206,891	\$28,434,769	4.24%	N
2-2007	06/30/07	09/27/07	\$1,428,149	\$ 1,050,152	73.532%	\$ 0.67	\$ 2,257,043	\$28,434,769	7.94%	Y
3-2007	09/30/07	12/31/07	\$2,533,648	\$ 956,109	75.473%	\$ 1.22	\$ 3,213,152	\$28,434,769	11.30%	Y
4-2007	12/31/07	03/28/08	\$1,467,968	\$ 1,097,174	74.741%	\$ 0.70	\$ 1,097,174	\$30,159,867	3.64%	N
1-2008	03/31/08	06/27/08	\$1,286,411	\$ 956,109	74.324%	\$ 0.61	\$ 2,053,283	\$30,159,867	6.81%	Y
2-2008	06/30/08	09/26/08	\$1,846,501	\$ 1,394,978	75.547%	\$ 0.89	\$ 3,448,261	\$30,159,867	11.43%	Y
3-2008	09/30/08	12/29/08	\$3,410,309	\$ 2,554,847	74.915%	\$ 1.28	\$ 6,003,108	\$30,159,867	19.90%	Y
4-2008	12/31/08	03/31/09	\$2,282,205	\$ 1,708,456	74.860%	\$ 1.09	\$ 1,708,456	\$32,786,720	5.21%	Y
1-2009	03/31/09	06/29/09	\$1,983,480	\$ 1,489,021	75.071%	\$ 0.95	\$ 3,197,477	\$32,786,720	9.75%	Y
2-2009	06/30/09	09/29/09	\$2,691,086	\$ 2,006,260	74.552%	\$ 1.28	\$ 5,203,737	\$32,786,720	15.87%	Y

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