

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of Missouri-American Water)
Company for Authority (1) to Issue up to)
\$200,000,000 of Unsecured Long-Term)
Debt and (2) to Issue and Sell Additional)
Common Stock to, or Receive Additional)
Paid-in Capital from Its Parent Company)
in an Aggregate Amount up to)
\$105,000,000.)

Case No. WF-2007-0279

STAFF RECOMMENDATION

COMES NOW the Staff of the Missouri Public Service Commission and, for its Staff Recommendation, states to the Missouri Public Service Commission as follows:

On February 20, 2007, the Commission ordered the Staff to file a recommendation regarding Missouri-American Water Company's Application in this case by no later than March 26, 2007.

Attached hereto as Appendix A and incorporated herein by reference is the Staff Memorandum, which sets forth in detail the Staff's recommendation regarding Missouri-American's Application herein. The Staff recommends that the Company's Application be approved, subject to the following conditions:

- That nothing in the Commission's order shall be considered a finding by the Commission of the value of this transaction for rate making purposes, which includes, but is not limited to the capital structure, and that the Commission reserves the right to consider the rate making treatment to be afforded these financing transactions and their effect on cost of capital, in any later proceeding.

- That the Company file with the Commission any information concerning communication with credit rating agencies concerning the proposed financing.
- That the Company file with the Commission all final terms and conditions of the proposed financing, including, but not limited to, the aggregate proceeds received, price information, and estimated expenses.
- That the Company file with the Commission, upon refunding of any outstanding debt, the net present value calculations indicating the amount of interest cost savings.

WHEREFORE, the Staff submits its Recommendation for the Commission's consideration.

Respectfully submitted,

/s/ Keith R. Krueger

Keith R. Krueger
Deputy General Counsel
Missouri Bar No. 23857

Attorney for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-4140 (Phone)
(573) 751-9285 (Fax)
keith.krueger@psc.mo.gov

Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or emailed to all counsel of record this 26th day of March, 2007.

/s/ Keith R. Krueger

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water)
Company for Authority (1) Issue up to)
\$200,000,000 of Unsecured Long-Term Debt and)
(2) to Issue and Sell Additional Common Stock to,) Case No. WF-2007-0279
or Receive Additional Paid-in Capital from Its)
Parent Company in an Aggregate Amount up to)
\$105,000,000)

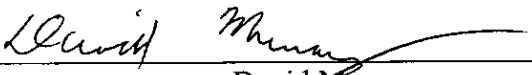
AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David Murray, being of lawful age, on his oath states: that as a Financial Analyst in the Financial Analysis Department, of the Utility Services Division, he has participated in the preparation of the foregoing report, consisting of 6 pages to be presented in the above case, that he has verified that the following Staff Memorandum was prepared by himself and Staff of the Commission that have knowledge of the matters set forth as described below; that he has verified with each of the Staff members listed below that the matters set forth in the Staff Memorandum are true and correct to the best of his knowledge and belief,

Dan Redel: Fee Schedule, Budget and Fiscal Services, Public Service Commission

that he has knowledge of the matters set forth in such report and that such matters are true to the best of his knowledge and belief.

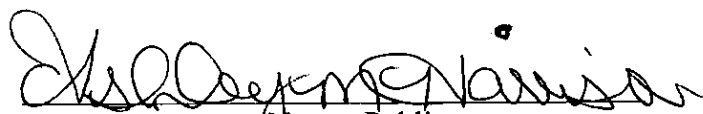


David Murray

Subscribed and sworn to before me this 20th day of March, 20 07



ASHLEY M. HARRISON
My Commission Expires
August 31, 2010
Cole County
Commission #06899978



Notary Public

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. WF-2007-0279, Missouri-American Water Company

FROM: David Murray, Financial Analysis Department

/s/ David Murray 03/22/07 /s/ Keith Krueger 03/22/07
Financial Analysis Department General Counsel's Office

SUBJECT: Staff Recommendation to approve the Application of Missouri-American Water Company for authority to (1) receive up to \$200,000,000 in aggregate principal amount of unsecured long-term debt from American Water Capital Corporation and (2) to issue and sell additional common stock to, or receive additional paid-in-capital from its parent company, American Water Works Company, Inc. in an aggregate amount of \$105,000,000.

DATE: March 26, 2007

Missouri-American Water Company

1. (a) **Type of Issue:** Unsecured Long-Term Debt and Common Stock or Additional Paid-in Capital.
- (b) **Amount:** Up to \$200,000,000 of debt proceeds and up to \$105,000,000 of equity proceeds.
- (c) **Rate:** The interest rate on the unsecured long-term debt will not exceed 200 basis points above the yield on U.S. Government Treasury Bonds having similar terms of maturity.
2. **Proposed Date of Transaction:** As soon as the Commission so authorizes.
3. (a) **Statement of Purpose of the Transaction:** The Applicant proposes to apply the net proceeds from the unsecured long-term debt and equity for the acquisition of property, the construction, completion, extension or improvements or additions to facilities, or other capital investments, all of which shall be necessary and proper for the rendition of public water supply and wastewater service, the improvement or maintenance of its service, the discharge or lawful refunding of indebtedness outstanding, and to reimburse its treasury for any costs heretofore incurred subsequent to five (5) years prior to the date of filing of this Application. Without limiting the scope of the foregoing, some of the proceeds from the equity contribution and/or debt issuances will be used to replace maturing long-term debt at market rates and replace outstanding short-term borrowings.
- (b) **From a financial perspective, does Staff deem this purpose reasonable?**

Yes X No

4. **Type of Transaction:** The Applicant proposes to receive unsecured debt proceeds from American Water Capital Corporation and equity proceeds from American Water Works Company, Inc.

5. **Copies of executed instruments defining terms of the proposed transaction:**

 X (a) If such instruments have been previously filed with the Commission, a reference to the Case Number in which the instruments were furnished.

 (b) If such instruments have not been executed at the time of filing, a commitment to provide the terms and conditions of the instruments when they are available has been made.

 (c) If no such instruments are either executed or to be executed, a statement of how the securities are to be sold.

6. **Certified copy of resolution of the directors of applicant, or other legal documents authorizing the proposed transaction reviewed:**

Yes X No

7. **Capital expenditure schedule reviewed:**

Yes X No

8. **Journal entries are required to be filed by the Company to allow for the Fee Schedule to be applied:**

Yes X No

9. **Recommendation of the Staff:**

 Grant by session order (see Comments)

 X Conditional Approval granted pending receipt of definite terms of transaction (see Comments)

 Require additional and/or revised data before approval can be granted (see Comments)

 Formal hearing required (see Comments)

_____ Recommend dismissal (see Comments)

COMMENTS:

Missouri-American Water Company (Missouri-American, Applicant, or Company) is a Missouri corporation with its principal office and place of business at 727 Craig Road, St. Louis, Missouri 63141. Missouri-American is a wholly-owned subsidiary of American Water Works Company, Inc. (AWW). Applicant is qualified to conduct business as a public utility in the State of Missouri subject to the jurisdiction of the Commission as provided by law. Applicant is engaged, generally, in the business of furnishing water and wastewater service to the public in over one hundred (100) municipalities within twelve (12) counties throughout the State of Missouri.

Missouri-American has filed an Application requesting that the Commission authorize the Company to issue up to \$200,000,000 in aggregate principal amount of unsecured long-term debt to American Water Capital Corporation (AWCC), AWW's wholly-owned financing subsidiary. Missouri-American is also requesting Commission authority to receive up to \$105,000,000 of equity from AWW, whether this is through additional paid-in capital or the actual sale of new shares to AWW.

Issuance of Stock. It is not clear that Missouri-American needs to request Commission authority to receive equity from its parent company. Section 393.200, RSMo requires that any "gas corporation, water corporation or sewer corporation organized or existing or hereafter incorporated under or by virtue of the laws of this state may issue stocks, bonds, notes or other evidences of indebtedness..." after receiving authority from the Commission.

Missouri-American does not need to issue stock to its parent company in order to receive equity funds. In fact, it is not clear to Staff why AWW would use such a process to infuse equity into its subsidiary, Missouri-American, when it can simply contribute capital to its subsidiary by providing additional paid-in capital. Staff submitted Staff Data Request No. 0003 to request an explanation as to why Missouri-American would desire to issue common stock to AWW rather than AWW simply making an equity capital infusion. Missouri-American responded as follows: "Missouri American's preference is to receive a capital infusion from American Water to support its equity needs. However, Missouri American wanted to have the flexibility to do either or both as circumstances may dictate."

Even if Missouri-American desires to have the flexibility to issue additional common equity shares to its parent company, it is not clear to Staff what purpose issuing new shares to AWW would serve because AWW already owns 100 percent of Missouri-American. Therefore, it would not matter if AWW owned one share or a million shares of Missouri-American, because it still maintains control of the subsidiary.

Issuance of Debt. The debt proceeds proposed in the Application would come from an inter-company loan from AWW's financing subsidiary, AWCC. This loan will be evidenced by a Promissory Note that Missouri-American filed in Case No. WF-2002-1096. Although not a part

of this Application, AWCC also manages Missouri-American's cash through a Financial Services Agreement (see Appendix 2, attached to Missouri-American's Application in Case No. WF-2002-1096).

The cost of the debt financing provided to Missouri-American under the proposed Promissory Note would not be based on Missouri-American's stand-alone creditworthiness; rather, it would be based on the creditworthiness of AWW. This is the case because AWW pools the financing requirements of its water and wastewater utility subsidiaries and then issues an aggregate amount of debt to an investor(s). This results in AWW's subsidiaries being assigned the same debt costs if the debt proceeds they receive come from the same aggregate pool of funds.

If AWW's subsidiaries were being viewed as stand-alone subsidiaries for purposes of the cost of this debt, one would believe that differences in credit quality among the subsidiaries would result in cost differences, but because it is the parent company, AWW, that is providing the backing, *i.e.* a support agreement, for the ultimate payment of the aggregate debt issuance to the investor, the cost is based on the aggregate creditworthiness of AWW rather than that of the individual subsidiaries.

Effect on Credit Quality. Normally, Staff would perform a detailed analysis of the Company's credit quality by analyzing the major financial ratios evaluated by credit rating agencies, but because Missouri-American does not have a credit rating and the cost of the debt it receives from AWCC is based on the credit quality of AWW, Staff does not believe this analysis is warranted. However, Staff did review the Company's outstanding indentures to ensure that the Company can still avail itself of possible EIERA financing. Because the proposed debt proceeds in this Application amount to less than 5 percent of American Water's total outstanding debt as of December 31, 2005, Staff believes that this transaction will have minimal to no impact on AWW's credit quality, which drives the cost of the debt funds that Missouri-American receives from AWCC.

Financial Loan Covenants. To Staff's knowledge, Missouri-American must comply with three primary financial loan covenants. The first two are contained in either the original Indenture of Mortgage dated May 1, 1968, (1968 Indenture) or one of its supplements. The first financial covenant in the 1968 Indenture requires Missouri-American's "long-term debt" to not exceed 65 percent of the Applicant's "total capitalization" before Missouri-American can issue any additional General Mortgage Bonds. According to page 6, of Appendix 4, attached to Missouri-American's Application, Missouri-American will be able to remain in compliance with this financial loan covenant.

The second financial covenant, in the Eighteenth Supplemental Indenture attached to the 1968 Indenture, requires net income to "equal at least one and one-half times the aggregate annual interest charges on all Long-Term Debt outstanding immediately after such bonds are issued." According to the pro forma financial statements, the Company will also be in compliance with this financial covenant.

Staff emphasizes that both of these covenants only restrict Missouri-American from issuing additional debt under the General Mortgage Bonds. They do not restrict Missouri-American from receiving debt from AWCC, which Missouri-American has stated in the past would be its primary source of long-term debt and short-term debt.

The other primary financial loan covenant is contained in an Indenture originally dated December 1, 1942, which was originally issued by St. Louis County Water Company, which merged into Missouri-American with Missouri-American surviving. This loan covenant only applies to the issuance of additional bonds under the 1942 Indenture. Because the issuance of additional First Mortgage Bonds under the St. Louis County Water Company Indenture is prohibited by the Applicant's Indenture of Mortgage dated May 1, 1968, except for transfers, exchanges or substitutions, Staff did not give this loan covenant any weight in its analysis.

Other Analyses. Other than reviewing the above issues, Staff has not performed any quantitative analysis of the proposed transaction on Missouri-American's financial statements, because it is the impact that the proposed financing would have on AWW's consolidated operations that is most relevant to the cost of debt available to Missouri-American from AWCC.

Staff also emphasizes that although it is recommending approval of this financing transaction, it is in no way approving Missouri-American's capital structure as the appropriate capital structure for ratemaking purposes. Although this qualification is covered generally in Condition 1 below, Staff believes it is important to emphasize this specific point.

OTHER ISSUES:

The Staff has verified that the Company has filed its annual report and is not delinquent on any assessment. The Staff's Budget and Fiscal Services Department has reviewed the circumstances in this finance case and believes that the Company's proposal under Paragraph 24, of the Application, will suffice for determining if the fee schedule should apply, as set forth in Section 386.300 RSMo, 2000, in accordance with 4 CSR 240-3.615(1)(F).

RECOMMENDED CONDITIONS:

Staff recommends that this Application be approved with the following conditions:

1. That nothing in the Commission's order shall be considered a finding by the Commission of the value of this transaction for rate making purposes, which includes, but is not limited to the capital structure, and that the Commission reserves the right to consider the rate making treatment to be afforded these financing transactions and their effect on cost of capital, in any later proceeding.
2. That the Company files with the Commission any information concerning communication with credit rating agencies concerning the proposed financing.

3. That the Company files with the Commission all final terms and conditions of the proposed financing, including, but not limited to, the aggregate proceeds received, price information, and estimated expenses.
4. That the Company file with the Commission, upon refunding of any outstanding debt, the net present value calculations indicating the amount of interest cost savings.