STATE OF MISSOURI
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held at its office in Jefferson City on the 15th day of July, 2008.

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**

ORDER GRANTING MOTION TO REOPEN CASE AND SUPPLEMENTAL ORDER MODIFYING CONDITIONS OF ORDER GRANTING FINANCING APPLICATION

Issue Date: July 15, 2008 Effective Date: July 25, 2008

Background

On January 24, 2007, Missouri-American Water Company ("MAWC") filed an application seeking authority to issue notes in one or more series evidencing up to $200,000,000 of long-term indebtedness payable to American Water Capital Corporation ("AWCC").[1] MAWC also proposed to issue and sell, from time to time, shares of common stock, no par value, to American Water Works Company, Inc. ("AWW"), or receive additional paid-in-capital, in an aggregate amount not to exceed $105,000,000.[2]

On April 5, 2007, the Commission granted MAWC's application subject to certain

[1] MAWC is engaged in the business of furnishing water and wastewater services in over one hundred municipalities within twelve counties throughout Missouri. MAWC is a wholly-owned subsidiary of AWW, and AWCC is AWW's wholly-owned financing subsidiary.

[2] MAWC seeks this approval pursuant to Section 393.190 and 393.200, RSMo 2000, and 4 CSR 240-2.060, 2.080 and 3.615.

conditions.[3] One of those conditions was suggested by MAWC and was subsequently incorporated in the Order Granting Financing Application ("Order"). That condition was memorialized in ordered paragraph number 2 of the Order and it reads as follows:

> The new long-term debt issued, payable to American Water Capital Corporation, shall be made for maturities not to exceed thirty-five years at market interest rates. Specifically, the interest cost of the debt instruments, including any applicable discounts, shall not exceed 2.00 percentage points (200 basis points) above the yield on U.S. Government Treasury Bonds having similar terms of maturity as published in *The Wall Street Journal* on the date prior to the date or dates on which the terms and conditions of the indebtedness shall be determined.

The Commission takes official notice of its prior Order approving MAWC's financing application in this matter and incorporates all of its provisions by reference in this order.

MAWC's Motion to Reopen the Case for a Supplemental Order

On May 23, 2008, Missouri-American Water Company ("MAWC") filed a motion requesting the Commission to reopen this case for the purpose of issuing a supplemental order modifying its April 5, 2007 Order that would authorize MAWC to issue new long-term unsecured indebtedness payable to AWCC at an interest rate, including any applicable spreads/discounts, that shall not exceed 3.25 percentage points (325 basis points) above the yield on U.S. Government Treasury Bonds having similar terms to maturity as published in *The Wall Street Journal* on the date prior to the date on which the terms and conditions of the indebtedness shall be determined.

[3] See Order Granting Financing Application in this same case number, issued April 5, 2007, effective April 15, 2007. MAWC intended to use the net proceeds from the unsecured new long-term debt and equity (from either paid-in capital or the actual sale of new shares to AWW) for the acquisition of property, the construction, completion, extension or improvements or additions to facilities, or other capital investments, all of which MAWC maintained would be necessary and proper for the provision of public water supply and wastewater service and the improvement or maintenance of its service. MAWC will also planned to use the funds for the discharge or lawful refunding of outstanding indebtedness, and to reimburse its treasury for any costs incurred subsequent to five years prior to the date of filing of this Application. Some of the proceeds from the equity contribution and/or debt issuances were planned to be used to replace maturing long-term debt at market rates and replace outstanding short-term borrowings.

MAWC states that the interest rate cap imposed in the Commission's Order, i.e. 2.00 percentage points (200 basis points) above the yield on U.S. Government Treasury Bonds having similar terms of maturity, has become an obstacle to the issuance of new long-term unsecured debt because of current market conditions. AWCC's recent negotiations (April 2008) with banks interested in purchasing AWCC notes indicated interest rates on ten-year and fifteen-year notes are 2.80 percentage points (280 basis points) and 3.10 percentage points (310 basis points), respectively, above the current ten-year U.S. Treasury Note rate. Thus, the increase in the spread to AWCC for the 10-year note from March 2007 to April 2008 is 170 basis points. The increase in the spread to AWCC for the 15-year note over the same time period is 185 basis points.

MAWC asserts that rates quoted to AWCC in April 2008 are a function of changes that have occurred in the credit markets since March 2007. Consequently, MAWC is not currently able to issue new long-term unsecured debt at an interest rate that is at or below 2.00 percentage points (200 basis points) above the yield on a U.S. Treasury Bond possessing a similar term to maturity.

MAWC proposes to issue up to and including $97 million of additional long-term indebtedness payable to AWCC under the authority granted to it by virtue of the Commission's Order, and MAWC claims there is good cause for the Commission to grant it more flexibility by increasing the interest rate cap limitation from 2.00 percentage points (200 basis points) to 3.25 percentage points (325 basis points) above the yield on U.S. Government Treasury Bonds having similar terms to maturity.

Staff's Recommendation

On July 9, 2008, pursuant to the Commission's direction, the Commission's Staff filed its recommendation regarding MAWC's motion and request for modification of its prior Order. Staff asserts that MAWC is correct in its analysis of the current trends in the credit markets, and that under the present Order it is not possible for MAWC to issue debt under the restriction imposed by the Commission. Staff's research demonstrates that there has been an increase in required spreads of utility bond yields over U.S. Treasury Bond yields, and Staff explains its analysis as follows:

> In the context of utility rate cases, Staff analyzes the differences between the yields on thirty-year U.S. Treasury Bonds and the average yields on long-term public utility bonds. Although the spread as recently as April 2008 was less than 200 basis points (193 basis points), this spread is based on the average public utility bond yields' for companies' with Moody's credit ratings from Baa to Aa (equivalent to BBB to AA based on S&P's categorization system) and is based on a simple average of each category average. The April 2008 average public utility bond yield for Baa-rated public utility bond yields published in the May 2008 Mergent Bond Record was 6.82 percent. This represents a spread of 238 basis points over the yield on thirty-year U.S. Treasury Bonds. These increased spreads can be attributed to both a decrease in the required yields for U.S. Treasury Bonds and an increase in the required yields for U.S. corporate bonds and utility bonds.
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> As a cross-check, Staff also determined the spread over U.S. Treasury Bonds for debt issued by another Missouri utility, The Empire District Electric Company ("Empire"). Empire issued ten-year First Mortgage Bonds on May 16, 2008. These bonds were priced to yield at 6.375 percent. On May 16, 2008, ten-year U.S. Treasury Bonds yielded 3.850 percent, which represents a spread of 2.525 percent. If Empire's debt had been unsecured (which is the case with AWCC debt), then the spread would have been even wider. This confirms that debt issued by other Missouri utilities with a similar credit rating have been above the 200 basis point spread imposed on MAWC.
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> It is important to understand that the cost of debt MAWC carries on its books for debt proceeds it receives from AWCC is driven by the overall creditworthiness of AWW, and not the stand-alone creditworthiness of MAWC. On June 19, 2008, S&P downgraded AWW to BBB+ from A- and placed it on a Stable Outlook. S&P cited concerns that "the pace and extent of cash flow improvement will be considerably slower than we previously

> expected." S&P also cited concerns that "Funding from the secondary equity market could be more challenging as RWE AG's attempts to divest its holdings will compete with offerings from AWW, which may slow improvements in leverage."
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> Although S&P's downgrade of American Water's credit rating may have some impact on the cost of debt issued by AWCC, based on MAWC's response to Staff Data Request No. 8, $70 million of the remaining $97 million of authority will be allocated from the 6.55 percent bond identified on page 2 of MAWC's *Motion*, which was issued on May 15, 2008. Consequently, it is certain that the debt that will be provided to MAWC was issued prior to the downgrade and the cost is certain.[4]

Consequently, Staff believes it is appropriate to go a step beyond MAWC's request to allow for flexibility and to be consistent with other recommendations it has made in other finance cases.

Staff believes that because the capital markets are dynamic, the cost of funds proposed in a financing case will almost always be at least slightly different from the assumptions provided in a finance case. Staff believes that as long as the financing is consistent with a rate for similar securities of comparable credit quality and maturities issued by other issuers, the issuance of the financing would be acceptable. This allows the Company the flexibility to issue debt as long as the cost of the debt is consistent with current market conditions. Staff recommends that the Commission issue a supplemental order maintaining all previous conditions outlined in the Commission's April 5, 2007, *Order*, with the exception of ordered paragraph 2, which Staff believes should be substituted with the condition that the rate be consistent with similar securities of comparable credit quality and maturities issued by other issuers.

[4] Staff Recommendation and Memorandum, filed July 9, 2008.

Decision

The Commission has reviewed and considered MAWC's verified application and the Staff's verified memorandum and recommendation. The Commission concludes it is not detrimental to the public interest to issue a supplemental order modifying the condition for MAWC to issue notes of long-term indebtedness payable to AWCC. Consequently, the Commission shall grant MAWC's motion to reopen this matter and grant its request to modify the restrictive condition on it issuing long-term indebtedness. MAWC shall be allowed to issue new long-term unsecured indebtedness at an interest rate that is consistent with similar securities of comparable credit quality and maturities issued by other issuers.

IT IS ORDERED THAT:

1. Missouri-American Water Company's motion to reopen this matter is granted.

2. The Commission's Order Granting Financing Application, issued on April 5, 2007 is modified as follows:

a. Ordered Paragraph Number 2 that reads: "The new long-term debt issued, payable to American Water Capital Corporation, shall be made for maturities not to exceed thirty-five years at market interest rates. Specifically, the interest cost of the debt instruments, including any applicable discounts, shall not exceed 2.00 percentage points (200 basis points) above the yield on U.S. Government Treasury Bonds having similar terms of maturity as published in *The Wall Street Journal* on the date prior to the date or dates on which the terms and conditions of the indebtedness shall be determined" is hereby modified and replaced with the language in subpart b of this ordered paragraph.

b. Ordered Paragraph Number 2, as delineated above, is replaced with the following language: "The new long-term debt issued, payable to American Water Capital Corporation, shall be made for maturities not to exceed thirty-five years at market interest rates. Specifically, the interest cost of the debt instruments, including any applicable discounts, shall be consistent with similar securities of comparable credit quality and maturities issued by other issuers."

3. The remainder of the Commission's Order Granting Financing Application, issued on April 5, 2007, remains in full force and effect in all other respects with the exception of the singular change delineated in Ordered Paragraph Number 2 of this order.

4. This order shall become effective on July 25, 2008.

5. This case shall be closed on July 26, 2008.

BY THE COMMISSION

Colleen M. Dale
Secretary

(S E A L)

Davis, Chm., Murray, Clayton, Jarrett,
and Gunn, CC., concur

Stearley, Regulatory Law Judge