

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. WF-2011-0173, Missouri-American Water Company

FROM: Zephania Marevangeo, Financial Analysis Department

/s/ Zephania Marevangeo 08/27/2013

Financial Analysis Department / Date

/s/ Amy Moore 08/27/2013

Staff Counsel's Office / Date

SUBJECT: Staff Recommendation to approve the Application of Missouri-American Water Company (Missouri-American) for authority to increase its existing long-term unsecured debt financing capacity by \$2,095,000.

DATE: August 27, 2013

Missouri-American Water Company

1. (a) **Type of Issue:** Long-Term Unsecured Debt.
(b) **Amount:** Increase existing financing capacity by \$2,095,000 (\$212,500,000 up to \$214,595,000).
(c) **Rate:** The interest rate on the long-term unsecured debt will not exceed the rate (8.250 percent) on the debt (\$25,000,000) that Missouri-American proposes to refinance.
2. **Proposed Date of Transaction:** As soon as the Commission so authorizes.
3. (a) **Statement of purpose of the Transaction:** Approval of this application will provide Missouri-American with sufficient long-term unsecured debt capacity to refinance \$25,000,000 of existing long-term indebtedness proposed in its application.
(b) **From a financial perspective, does Staff deem this purpose reasonable?**
Yes X No
4. **Type of Transaction:** Missouri-American proposes to issue the long-term unsecured debt through its financing affiliate - American Water Capital Corporation (AWCC).
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 ☒ No
7. **Capital expenditure schedule reviewed:**
- Yes No ☒
8. **Recommendation of the Staff:**
- ☒ Grant by session order (see Comments)
- 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:

The Company:

Missouri-American Water Company (MAWC, 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. MAWC provides water service to approximately 454,000 customers in and around the cities of St. Joseph, Joplin, Brunswick, Mexico, Warrensburg, Mexico, Parkville, Riverside, Jefferson City; and parts of St. Charles, Warren, Jefferson, Morgan, Pettis, Benton, Barry, Stone, Green, Teen, Cole, Christian and Platte Counties, and most of all St. Louis County, Missouri. MAWC also provides sewer service to approximately 4,000 customers in Callaway, Jefferson, Pettis, Cole, Morgan, Platte, and Warren Counties, Missouri.

Missouri-American is not a publicly traded company and does not have a standalone credit rating. Missouri-American receives most of its debt proceeds through internal loan agreements with American Water Capital Corporation (AWCC).

AWCC is a wholly-owned financing subsidiary of AWW, and an affiliate of Missouri-American, vested with the sole responsibility of issuing third-party debt and lending the debt proceeds to AWCC's other operating subsidiaries through the loan agreements between AWCC and the operating subsidiaries. AWCC also provides short-term borrowing and cash management services – *see The Financial Services Agreement (Appendix 2), attached to Missouri-American's Application in Case No. WF-2002-1096.*

Case Background:

On December 17, 2010, Missouri-American filed an application (Case No. WF-2011-0173) requesting that the Commission authorize the Company to issue up to \$212,500,000 in aggregate principal amount of long-term unsecured debt through AWCC. The Commission issued an order granting the financing authorization on March 2, 2011.

The Current Request:

On July 25, 2013, Missouri-American filed a motion to reopen Case No. WF-2011-0173 and requested a supplemental order. In its motion, Missouri-American states that it plans to refinance an aggregate amount of \$25,000,000 existing long-term unsecured indebtedness at favorable rates by the end of 2013, but the existing financing authorization does not provide sufficient capacity to actuate the transaction.

Missouri-American had \$42,905,000 of Commission financing authority remaining, as of the day of filing. After Missouri-American's planned issuance of \$20,000,000 of long-term unsecured debt at 3.40 percent on July 31, 2013, MAWC's Commission financing authority was reduced to \$22,905,000. Consequently, Missouri-American proactively filed a MOTION TO REOPEN CASE AND FOR SUPPLEMENTAL ORDER to allow for a sufficient financing authority to issue \$25,000,000 long-term unsecured indebtedness to refinance existing long-term debt.

In its motion, MAWC requests the Commission reopen Case No. WF-2011-0173 and grant a supplemental order allowing the extension of MAWC's existing financing debt authorization by \$2,095,000. MAWC expressed in its request that the increase of the debt financing authority will create sufficient capacity (\$22,605,000 plus \$2,095,000) to facilitate the proposed refinancing of the \$25,000,000 of existing long-term unsecured indebtedness.

Missouri-American also stated in its request that the \$25,000,000 of existing indebtedness will be refinanced at more favorable rates, which would result in net benefits to Missouri-American customers in the form of lower interest expenses. The contemplated \$25,000,000 long-term unsecured indebtedness on MAWC's books currently carries an interest of 8.25 percent. To date, MAWC has issued approximately \$189,595,000 of long-term unsecured indebtedness, under its existing \$212,500,000 authorization, at an average rate of 3.93 percent.

Issuance of Debt:

AWCC will issue long-term unsecured debt to a third-party and distribute a portion or all proceeds to Missouri-American. The distributed proceeds will be evidenced by a Promissory Note, payable to AWCC, attached as Appendix 1 to the Company's Application in case WF-2011-0173. The cost of proceeds or the debt financing provided to Missouri-American is based on the creditworthiness of AWCC, whose credit rating is also based on AWW's corporate credit rating. This is the case because AWCC is AWW's financing subsidiary responsible for issuing publicly-traded debt securities on behalf of AWW's other operating subsidiaries and all the debt issued is supported by AWW's credit.

Consequently, the proceeds distributed by AWCC to other operating subsidiaries of AWW will always carry the same interest rate that is charged to AWCC on debt issued to raise those specific proceeds.

Existing Authorization and Credit Quality Analysis:

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 MAWC does not have a credit rating and the cost of the debt it receives from AWCC is based on the corporate credit quality of AWW, Staff does not believe this analysis is warranted.

However, Staff notes that as of December 31, 2012, the time when MAWC had used \$169,595,000 of its \$212,500,000 debt authorization capacity for new financing and refinancing, AWW's reported credit metrics (1. Funds From Operations to Debt, 2. Debt to Earnings Before Interest, Tax and Depreciation; and 3. Debt to Capital) reflected signs of improvement in relation to the metrics reported as of December 31, 2011. The metrics improved respectively from 13.75 percent to 16.44 percent, 5.44 percent to 4.56 percent and 60.46 percent to 58.26 percent.

A few months later, Standards & Poor's Rating Services (S&P) and Moody's Investors Service (Moody's) increased the credit rating of AWW and other rated subsidiaries by one notch. On May 24, 2013, S&P increased the credit rating from 'BBB+' to 'A-'. On May 29, 2013, Moody's increased the credit rating from 'Baa1' to 'A3'.¹

Effect of requested authorization on credit metrics:

Staff believes that if MAWC uses the incremental authorization (\$2,095,000) requested in this case to effectuate its planned \$25,000,000 refinancing, both the authorization and the subsequent refinancing transaction would have a positive cash flow effect as a result of lower rates and interest expenses. Consequently, Staff believes the contemplated transaction will have a positive impact on AWW's credit metrics and credit quality which drives the cost of the debt proceeds that Missouri-American receives from AWCC.

¹ Moody's 'Baa1' and 'A3' credit ratings are respectively an equivalent of S&P's 'BBB+' and 'A-' ratings.

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 (WF-2011-0173), 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. This Indenture 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:

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.

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.

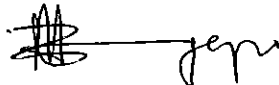
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of)
Missouri-American Water Company for) File No. WF-2011-0173
Authority to Issue up to \$212,500,000 of)
Long-Term Unsecured Debt)

AFFIDAVIT OF ZEPHANIA MAREVANGEPO

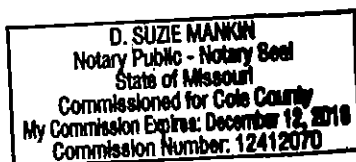
STATE OF MISSOURI)
)
COUNTY OF COLE) ss.

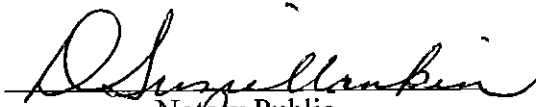
Zephania Marevangepo, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by him; that he has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of his knowledge and belief.



Zephania Marevangepo

Subscribed and sworn to before me this 26th day of August, 2013.





Notary Public