

**STATE OF MISSOURI
PUBLIC SERVICE COMMISSION**

At a session of the Public Service
Commission held at its office in
Jefferson City on the 27th day of
January, 2009.

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

**ORDER EXTENDING DURATION OF THE GRANT OF FINANCING
AUTHORITY**

Issue Date: January 27, 2009

Effective Date: February 6, 2009

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 sought this approval pursuant to Sections 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 (“Original 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 Original Order approving MAWC’s financing application.

MAWC’s First Motion to Reopen the Case for a Supplemental Order

On May 23, 2008, 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.

MAWC stated that the interest rate cap imposed in the Commission’s Order, i.e. 2.00

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 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.

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 negotiations (April 2008) with banks interested in purchasing AWCC notes indicated interest rates on ten-year and fifteen-year notes were 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 was 170 basis points. The increase in the spread to AWCC for the 15-year note over the same time period was 185 basis points.

MAWC asserted that rates quoted to AWCC in April 2008 were a function of changes that occurred in the credit markets since March 2007. Consequently, MAWC was not currently able to issue new long-term unsecured debt at an interest rate that was 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 at the time of its request to modify the Original Order.

MAWC proposed 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 claimed there was 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 MAWC's First Motion to Reopen the Case

On July 9, 2008, the Commission's Staff filed a recommendation regarding MAWC's motion and request for modification of the Commission's Original Order. Staff asserted that

MAWC was correct in its analysis of the current trends in the credit markets, and that under the Original Order it was impossible for MAWC to issue debt under the restriction imposed by the Commission. Staff's research demonstrated that there was 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.

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.

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."

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 believed it was appropriate to go a step beyond MAWC's request to allow for flexibility and to be consistent with other recommendations it made in other finance cases.

Staff believed that because the capital markets are dynamic, the cost of funds proposed in a financing case would almost always be at least slightly different from the assumptions provided in a finance case. Staff believed that as long as the financing was 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 recommended that the Commission issue a supplemental order maintaining all previous conditions outlined in the Commission's April 5, 2007, Original Order, with the exception of ordered paragraph 2, which Staff believed should be substituted with the condition that the rate be consistent with similar securities of comparable credit quality and maturities issued by other issuers.

The Commission's Decision on MAWC's First Motion to Reopen the Case

On July 15, 2008, based upon its review of MAWC's verified application and the Staff's verified memorandum and recommendation, the Commission concluded it was 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

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

Commission granted MAWC's motion to reopen this matter and granted its request to modify the restrictive condition on it issuing long-term indebtedness ("Modification Order"). MAWC was allowed to issue new long-term unsecured indebtedness at an interest rate consistent with similar securities of comparable credit quality and maturities issued by other issuers. The Commission takes official notice of its Modification Order.⁵

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

On January 21, 2009, MAWC filed its second motion to reopen this matter. In its second motion MAWC avers that:

- a. From the time of the first order of modification until the present, Applicant has issued \$173 million dollars of unsecured, long-term debt. Applicant has remaining under the authority granted pursuant to the Order and the Supplemental Order, the ability to issue \$27 million dollars of additional long-term, unsecured indebtedness.
- b. MAWC anticipates that it will issue an additional \$25 million dollars of unsecured long-term indebtedness, in one or more transactions, under the authority granted pursuant to the Order and the Supplemental Order during calendar year 2009. The proceeds from any such issuance will be used for the same purposes as set forth in ¶ 17 of the Application.
- c. In its January 24, 2007 Application, the company stated that it anticipated that debt and equity transactions totaling up to \$130 million dollars would occur prior to June 30, 2007, and that any remaining balances of the proposed long-term debt and common equity or additional paid in capital would occur prior to **December 31, 2008**. (Emphasis added)

The Commission's July 15, 2008 Modification Order did not expressly state that the authority granted by the Commission would expire as of December 31, 2008, and MAWC has been operating under the assumption that the Modification Order is not time limited.

MAWC currently plans to issue \$20 million dollars of long-term unsecured indebtedness under the authority granted by the Commission during the first quarter of

⁵ Order Granting Motion to Reopen Case and Supplemental Order Modifying Conditions of Order Granting Financing Application, issued July 15, 2008.

2009, the purpose of which is to refund outstanding short-term indebtedness incurred by MAWC in connection with its ongoing operations. Consequently, to address any ambiguity as to any temporal limits associated with the Commission's Modification Order, MAWC is requesting the Commission to either issue an order extending the time period of its financing authority until December 31, 2009 or, alternatively, issue an order stating that no such modification is required. MAWC requested the Commission to consider its request on an expedited basis and issue its decision no later than February 4, 2009.

Staff's Response to MAWC's Second Motion to Reopen the Case

On January 23, 2009, Staff responded to MAWC's requests. Staff notes that the July 15, 2008 grant of financing authority was subject to the conditions Staff had recommended at that time, and that the financing authority granted was granted on the premise that the total amount was restricted and that the authority would be exercised prior to December 31, 2008. Nevertheless, Staff believes that a three month extension of the financing authority to cover the first quarter of 2009 is reasonable. Beyond this extension any further grant of authority should be addressed in a new application from MAWC.

Decision

After reviewing the Commission's prior orders, MAWC's requests and Staff's recommendations, the Commission concludes that the Commission's prior grant of financing authority was limited to the specific request outlined by MAWC and to the conditions suggested by the Commission's Staff. The authority granted to MAWC extended only through December 31, 2008. However, because the Commission's Staff has stated that it is not opposed to an extension of that grant until March 31, 2009, the Commission finds it is reasonable to allow that extension. Should MAWC desire financing authority to

extend beyond that date, regardless if it issues the total remaining debt under the current grant of authority, it shall be required to revisit the Commission with a new application.

IT IS ORDERED THAT:

1. Missouri American Water Company's motion to re-open this docket is granted.
2. The Commission extends the grant of financing authority, embodied in its prior orders in this matter, through March 31, 2009.
3. The Commission's July 15, 2008 Order Granting Motion to Reopen Case and Supplemental Order Modifying Conditions of Order Granting Financing Application remains in full force and effect in all other respects.
4. This order shall become effective on February 6, 2009.
5. This case shall be closed on February 7, 2009.

BY THE COMMISSION

A handwritten signature in black ink, appearing to read 'Colleen M. Dale', written in a cursive style.

Colleen M. Dale
Secretary

(S E A L)

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

Stearley, Senior Regulatory Law Judge