BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Mater 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 May 23, 2008, Missouri-American Water Company filed a motion requesting that the Commission reopen this case for the purpose of issuing a Supplemental Order modifying the Order that the Commission previously entered in this case on April 5, 2007. Missouri-American requested authority to issue unsecured debt, payable to American Water Capital Corporation, at an interest rate that shall not exceed 3.25 percentage points above the yield on U.S. Government Treasury Bonds having similar terms to maturity. On June 10, 2008, the Commission ordered the Staff to file a recommendation regarding Missouri-American's motion by no later than July 11, 2008.

Attached hereto as Attachment A and incorporated herein by reference is the Staff Memorandum.

In the Commission's April 5, 2007 Order, the Commission authorized Missouri-American to issue debt at a yield that would "not exceed 2.00 percentage points (200 basis points) above the yield on U.S. Government Treasury Bonds." The Staff finds that, due to changes in the financial and credit markets, there has been a general increase in the required spreads between the yield on corporate bonds and the yield on similar maturity U.S. Treasury Bonds, and Missouri-American can no longer issue debt under its volunteered and imposed 200-basis-point restriction.

Furthermore, the Staff further believes that, because the credit markets are dynamic, it is appropriate for the Commission to go one step beyond Missouri-American's request, and to authorize Missouri-American to issue the remaining authorized debt, so long as the yield on this debt are consistent with the rates for similar securities of comparable credit quality and maturities issued by other issuers.

WHEREFORE, the Staff submits its Recommendation for the Commission's consideration, and requests that the Commission authorize Missouri-American to issue debt at a rate that is consistent with the rates on similar securities of comparable credit quality and maturities issued by other issuers.

Respectfully submitted,

/s/ Keith R. Krueger________________
Keith R. Krueger
Deputy General Counsel
Missouri Bar No. 23857

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronic mail to all counsel of record on this 9th day of July, 2008.

/s/ Keith R. Krueger________________

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 07/09/2008 Project Coordinator / Date

/s/ Keith R. Krueger 07/09/2008 General Counsel's Office / Date

SUBJECT: Staff Recommendation to the Commission to issue a supplemental order concerning 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: July 9, 2008

COMMENTS:

Missouri-American Water Company (MAWC, 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.

MAWC filed an Application on January 24, 2007, 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. MAWC also requested 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.

Paragraph 14 of the Company's Application represented that any debt issued under the requested authority would "…not exceed 2.00 percentage points (200 basis points) above the yield on U.S. Government Treasury Bonds…" The Commission's April 5, 2007 *Order Granting Financing Application* (*"Order"*) relied on this representation and specifically incorporated this limitation under Ordered Paragraph 2.

In the Applicant's May 23, 2008, *Motion to Reopen Case and for Supplemental Order* (*"Motion")*, MAWC claims it can no longer issue debt under this volunteered and imposed restriction. According to MAWC, this is not possible due to current market conditions, which has experienced a general increase in required spreads for corporate bonds over that of similar maturity U.S. Treasury bonds. This is supported by the information provided in the table on page 3 of the

Applicant's *Motion*. This is also consistent with Staff's general knowledge of recent trends in the credit markets and its own research that shows an increase in the spread of utility bond yields over U.S. Treasury bond yields. 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.

MAWC's *Motion* requests that the Commission issue a supplemental order modifying its April 5, 2007, *Order* to allow a maximum spread of 3.25 percentage points (325 basis points) above the yield on U.S. Government Treasury bonds having similar terms to maturity. Staff believes it is appropriate to go one step further to allow for flexibility and to be consistent with other recommendations it has made in other finance cases. 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.

RECOMMENDED 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 should be substituted with the following condition:

2. That the rate be consistent with similar securities of comparable credit quality and maturities issued by other issuers.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water	)	
Company for Authority (1) Issue up to	)	Case No. WF-2007-0279
$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		

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

David Murray, 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.

David Murray

David Murray

Subscribed and sworn to before me this 9th day of July, 2008.

NIKKI SENN
Notary Public - Notary Seal
State of Missouri
Commissioned for Osage County
My Commission Expires: October 01, 2011
Commission Number: 07287016

Nikki Senn

Notary Public