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RESEARCH

Summary:

Union Electric Co. d/b/a AmerenUE

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Credit Rating: BBB/Watch Neg/A-3

Rationale

The ratings on electric and gas utility Union Electric Co. (UE), its St. Louis, Mo.-based parent Ameren Corp. and its subsidiaries are on CreditWatch with negative implications. The ratings on UE are based on the consolidated credit profile of the Ameren family of companies. Ameren's units include its utilities UE, Central Illinois Public Service Co. (CIPS), Central Illinois Light Co. (CILCO), and Illinois Power Co., and its unregulated generation units, Ameren Energy Generating Co. (AEGC) and AmerenEnergy Resources Generating Co. (AERG), CILCO's unregulated generation subsidiary. ✓

The CreditWatch listing reflects Standard & Poor's concern over the financial health of Ameren and its units raised by possible legislation mandating an electric rate-freeze extension or an unfavorable mandatory rate-deferral plan. These proposals follow the Illinois Commerce Commission's (ICC) authorized reverse auction process held in September 2006 that resulted in significantly higher power supply prices. The inability to adjust rates to reflect full and timely recovery could, in the extreme, lead to its Illinois utilities filing for bankruptcy. In this regard, Ameren has taken steps to structurally separate the Illinois companies from the rest of the Ameren family. These measures include removing CIPS, CILCO, and Illinois Power as borrowers under Ameren's $1.15 billion credit facility and removing provisions that would treat the Illinois units as subsidiaries for purposes of cross default provisions. Moreover, beginning in 2007, Ameren's unregulated generating units will supply by law no more than 35% of Ameren's Illinois transmission and distribution utilities power needs. Illinois Power's power supply needs are currently supplied under separate non-affiliated contracts.

Less clear is how the utilities would procure power in the event that suppliers refuse to sell to them once credit quality deteriorates, they become insolvent, or they declare bankruptcy. In California, when Pacific Gas and Electric and Southern California Edison defaulted, the state had to step in to act as an intermediary through its Department of Water Resources (DWR), procuring power on behalf of the insolvent utilities. The DWR continues today, five years after the defaults, to procure a significant portion of the utilities' power. Standard & Poor's knows of no similar plan in Illinois.

Meanwhile, the Illinois House narrowly failed to achieve the 71 super-majority needed to pass legislation to extend the rate freeze for all customers in the state for an additional three years during the two November veto sessions. However, rate-freeze legislation could resurface when the 94th Illinois General Assembly reconvenes for three days in its final session on Jan. 7, 2007, when only a simple majority would be required to pass legislation. Standard & Poor's would immediately lower the credit ratings on the Illinois utilities to the 'B' category in the event the rate freeze is signed into law. Ameren estimates that its Illinois units would incur costs of about $1 billion annually, or $2.5 million per day, more than they could pass on to customers. Insolvency would be unavoidable.

On Nov. 30, 2006, the Illinois Senate passed (House Bill 2197) calling for a mandatory phase-in of residential rates. For Ameren utilities, rate increases would be capped at 14% in each of 2007, 2008, and 2009. Deferrals would be recorded as a regulatory asset and recovered over the 2010-2012 period, with no recovery of carrying costs. Utilities would be allowed to issue securitization debt to recover deferred amounts. Standard & Poor's views the ability to issue rate-securitization bonds under a mandatory phase-in as critical to sustaining current bondholder protection measures.

In the interim, the September 2006 supply auction rates go into effect Jan. 2, 2007, unless the ICC issues an order before then approving some form of rate phase-in proposed by Ameren. Under Ameren's pending rate-mitigation plan, filed with the ICC, residential, eligible schools, local governments and small commercial customers would have the choice to pay full market costs in 2007 or phase in the increases over a period of years. Ameren has proposed rates be phased in at an annual maximum increase of 14% over three years or until the full amount of the rate increase is reached, whichever is earlier. At the end of 2009, customers would have three years to repay the deferred costs. Under this opt-in proposal, deferred balances should be manageable. Therefore, the issuance of securitization debt is not included.

It remains unclear whether any compromise bill will be passed in January. However, until the rate-freeze extension measure is truly dead and a credit-supportive rate-mitigation plan enacted, the ratings will remain under significant negative pressure.

A responsive rate order from the Missouri Public Service Commission (MPSC) with regard to UE's pending electric rate case is also crucial to help sustain current credit quality. In July 2006, UE filed for a $360.7 million (17.7%) rate increase. At the same time, UE asked MPSC to adopt a fuel adjustment mechanism that would allow the company to recoup fuel and purchased-power costs in a timely manner. A final commission decision is expected by June 2007.

Ameren's weak business profile of '7' (business profiles are categorized from '1' (excellent) to '10' (vulnerable)) results from increasingly hostile political environment in Illinois, the challenges of owning and operating a nuclear facility, and the riskier, unregulated generating fleet, offset somewhat by its position as one of the lowest-cost producers in the Midwest, strong transmission ties, and limited industrial exposure. The Illinois utilities business risk profiles are also regarded as weak, at '8' and AEGC's business profile is considered a vulnerable '9'. On a stand-alone basis, UE's business profile is stronger than that of Ameren at a satisfactory '5' reflecting the absence of the unregulated generation businesses but encompassing many of the aforementioned attributes and weaknesses. Union Electric also has a healthier financial condition due to a lower debt burden.

Due to decreased plant availability, higher-cost sources of power, reduced interchange sales, increased expenses resulting from the breach of the Taum Sauk plant upper reservoir and storm damage, the long-term absence of electric rate relief, and accelerating environmental expenditures, Ameren's key financial metrics are expected to continue to slip in 2006. In this regard, Standard & Poor's expects funds from operations (FFO) to total debt (adjusted for operating leases) to fall below the current 19%, which is weak for the current rating. Although adjusted FFO interest coverage and adjusted total debt to capital are expected to decline from relatively healthy levels of about 4.4x and 49%, respectively, they should remain suitable for the rating category.

Short-term credit factors

The short-term rating on Ameren and Union Electric is 'A-3'. Standard & Poor's expects Ameren's four relatively low-risk regulated utility subsidiaries to continue to generate reasonably stable cash flows throughout 2006. Standard & Poor's expects that consolidated cash flow from operations will hover around $1.3 billion in 2006. This level of cash will fall somewhat short of projected capital expenditures of about $1.2 billion and dividends of roughly $520 million. The increase in construction spending is attributable to $290 million for the acquisition of peaking generation facilities.

Ameren faces a manageable maturity schedule with $100 million and $250 million of debt coming due in February and May 2007, respectively. CILCO has $50 million of debt maturing in January 2007. The company currently has sufficient liquidity with $1.65 billion of committed credit facilities, $34 million of cash and cash equivalents (at Sept. 30 2006), and $2.3 billion of securities remaining under various shelf registrations. The subsidiaries have adequate liquidity, given their access to certain credit facilities and money pool arrangements. Ameren's liquidity position in 2007 and beyond will depend upon on the ultimate recovery of increased power procurement costs.

An amended $1.15 billion agreement will terminate on July 14, 2010 with respect to Ameren. UE and AEGC will have the option to seek an annual renewal on a 364-day basis after their current termination dates. The termination date for UE and AEGC was extended to July 12, 2007. CIPS, CILCO, and Illinois Power no longer have borrowing authority under this facility. Ameren will continue to have $1.15 of borrowing availability, while UE and AEGC will have $500 million and $150 million, respectively. Ameren, UE, and AEGC are required to maintain a debt to capital ratio of 65% or less, with which they comfortably comply. This facility is used to support commercial paper programs. As of Sept. 30, 2006, the company had $309 million commercial paper outstanding.

CIPS, CILCORP, CILCO, Illinois Power, and AERG have entered into a new $500 million multiyear credit facility that terminates on Jan. 14, 2010. The obligations of each borrower are several and not joint, and are not guaranteed by Ameren. As of the end of October, $285 million had been borrowed under this facility.

The facilities require Ameren and each subsidiary to maintain a debt to capital ratio of 65% or less, with which they comfortably comply. None of Ameren's credit facilities or financing arrangements contains credit rating triggers. The $1.15 billion credit agreement does not require a no material adverse change representation in order to borrow; however, the $500 million facility does include such requirement subject to certain exceptions.

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