

**Ingram III, Lindsey**

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COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

COMPLIANCE OF KENTUCKY-AMERICAN )  
WATER COMPANY, AMERICAN WATER WORKS )  
COMPANY, RWE AKTIENGESELLSCHAFT AND )  
THAMES WATER AQUA HOLDINGS GMBH )  
WITH THE PROVISIONS OF THE ORDERS )  
APPROVING THE TRANSFER OF CONTROL )  
OF KENTUCKY-AMERICAN WATER COMPANY )  
TO RWE AKTIENGESELLSCHAFT AND )  
THAMES WATER AQUA HOLDINGS GMBH )

CASE NO.  
2002-00277

CONDITION 23 NOTICE

Come Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, American Water Works Company, Inc., Thames Water Aqua U.S. Holdings, Inc. and Kentucky-American Water Company, and pursuant to Condition 23 of the Commission's Order dated December 20, 2002, in Case No. 2002-00317, give notice of the attached Standard & Poor's ratings report.

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By *Lindsey W. Ingram III*

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Thames Water Aqua U.S. Holdings, Inc. and  
Kentucky-American Water Company

**CERTIFICATION**

In conformity with paragraph 7 of the Commission's Order dated January 30, 2002, in **Case No. 2002-00018**, this is to certify that the electronic version of this pleading is a true and accurate copy of the pleading that will be filed in paper medium with the Public Service Commission on July 18, 2008, the Petitioners have (1) notified the Commission, the Attorney General, the Lexington-Fayette Urban County Government, and Bluegrass FLOW, Inc. by electronic mail; (2) the electronic version of this pleading has been transmitted to the Commission; and (3) a copy has been served by mail, postage prepaid, on July 18, 2008, upon:

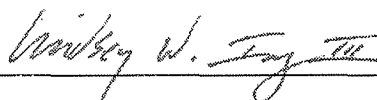
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Thames Water Aqua U.S. Holdings, Inc. and  
Kentucky-American Water Company

June 19, 2008

**Research Update:**

**American Water Works, Capital  
Corp Downgraded To 'BBB+', Off  
Credit Watch; Outlook Stable**

**Primary Credit Analyst:**

Kenneth L. Farer, New York (1) 212-438-1679, kenneth\_farer@standardandpoors.com

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## Research Update:

# American Water Works, Capital Corp Downgraded To 'BBB+', Off CreditWatch; Outlook Stable

## Rationale

On June 19, 2008, Standard & Poor's Ratings Services lowered its corporate credit ratings on American Water Works Co. Inc. (AWW) and its funding subsidiary American Water Capital Corp. (AWCC) to 'BBB+' from 'A-'. At the same time, we removed the ratings from CreditWatch with negative implications. The outlook is stable.

The downgrade primarily reflects our concern that the pace and extent of cash flow improvement will be considerably slower than we previously expected. Despite an 8% increase in revenues in the first quarter of 2008, key credit metrics, including adjusted funds from operations (FFO) to total debt of around 9%, FFO interest coverage under 3x, and adjusted debt to total capital of 60%, were unchanged from the prior quarter and are weak for the 'A-' rating. Over the intermediate term, the company will be engaged in a greater number of rate proceedings than we expected, as AWW seeks to phase in rate increases incrementally to avoid rate shock while prudently financing capital spending of up to \$1 billion per year over the next several years. This is likely to result in sizable back-to-back rate filings in a number of states and make achieving financial metrics appropriate for the 'A' category a longer term proposition. Funding from the secondary equity market could be more challenging as RWE AG's attempts to divest its holdings will compete with offerings by AWW, which may slow improvements in leverage.

Notwithstanding the medium-term weakness in AWW's financial profile, these risks are partially offset against AWW's excellent business risk profile. A favorable competitive position, diverse and supportive regulatory environment, and stable, above-average service territory characterize AWW's business risk profile. AWW's regulatory framework includes reasonably allowed ROEs and various cost-recovery mechanisms, including incentives for infrastructure improvements. The company's geographic diversity provides it with some market, cash flow, and regulatory diversification. In addition, we view AWW's operating risks associated with its regulated and nonregulated operations as fairly low. AWW's aggressive financial profile, uncertainties associated with planned equity offerings, elevated capital-spending requirements for infrastructure replacement, increased compliance costs with water-quality standards, and the company's reliance on acquisitions to provide growth partly offset these strengths.

AWW provides regulated water and wastewater services to more than 3.3 million customers in 20 states. AWW's regulated utility subsidiaries represent almost 90% of total revenues, but have provided almost 100% of adjusted EBIT for the past three years. The company's nonregulated subsidiaries consist of water and wastewater facility management and maintenance, as well as design

and construction consulting services related to water and wastewater plants. We view these nonregulated segments as having modest incremental risk to AWW due to their lack of cash flow contribution and modest expected capital requirements.

AWW's financial metrics are acceptable for the 'BBB+' rating. RWE's agreements to not file rate cases for up to three years following its AWW acquisition in 2003, as well as significant goodwill impairments, resulted in a deterioration of the financial profile. AWW has since filed a number of rate cases, which total about \$300 million to cover rising operating costs, capital expenditures, and pension and other postretirement obligations.

Adjusted FFO was \$514 million for the 12 months ended March 31, 2008. FFO to total debt was 9%, which are somewhat weak, but acceptable, for the rating. The uncertainties associated with the timing of the company's rate cases and the substantially higher capital plans are significant risks that may prevent adequate improvements to the company's financial profile. Adjusted debt to capital was 60% at March 31, 2008, from 49% as of the previous year. A portion of the increased leverage metric is attributed to the \$750 million goodwill impairment related to a post-IPO valuation test and the issuance of unsecured notes to redeem the company's outstanding preferred stock, which we consider to have intermediate equity characteristics.

#### **Short-term credit factors**

The 'A-2' short-term ratings on AWW and AWCC reflect sizable borrowing capacity under the company's revolving credit facility and stable cash flows from regulated subsidiaries. However, AWW's cash uses include high levels of capital spending, substantial upcoming debt maturities, and expectations that the company will institute a common stock dividend. Capital expenditures are projected at \$4 billion to \$4.5 billion during the next five years for infrastructure replacements, new facility construction, maintenance of water-quality and environmental standards, and system reliability.

With cash from operations for the past 12 months of only \$550 million, AWW's cash flow generation is insufficient to meet its ongoing operating and capital needs, and will require additional access to the capital markets over the intermediate term. Scheduled debt maturities of \$196 million in 2008, \$55 million in 2009, and \$54 million in 2010 are also fairly sizable. Contingent on board approval, AWW is expected to declare dividends equal to about \$128 million per year, starting in the third quarter. This equals a 3.8% dividend yield at recent market prices, which is materially higher than the average dividend yield of other companies in its peer group of about 2%.

As of March 31, 2008, AWW had \$9 million in unrestricted cash, about \$420 million available under its \$800 million revolving credit facility, which matures on Sept. 15, 2011, and a \$10 million short-term working-capital line of credit. Financial covenants include a maximum debt to capital (with adjustments) of 70% and restrictions on liens, distributions, debt incurred at AWW, and asset sales.

## Outlook

The stable outlook reflects our expectation that AWW will be granted supportive rate increases over the intermediate term to address rising costs and increased capital spending plans. The current rating can accommodate some acquisitions, assuming management funds the acquisitions in a balanced manner. The outlook could be revised to negative if financial performance stalls or deteriorates, which could result from substantial debt-financing of capital expenditures or acquisitions or if rate increases or allowed returns are set at levels substantially below the requested figures and significantly slower to be resolved than currently expected. Although less likely in the near term, the outlook could be revised to positive if higher-than-expected rate increases or favorable cost recovery mechanisms allow for adjusted FFO to total debt of closer to 12% and adjusted leverage between 50% to 55%.

## Ratings List

Ratings Lowered, Off CreditWatch

American Water Works Co. Inc.

	To	From
Corp. credit rating	BBB+/Stable/A-2	A-/Watch Neg/A-2

American Water Capital Corp.

Corp. credit rating	BBB+/Stable/A-2	A-/Watch Neg/A-2
Senior unsecured debt	BBB+/Stable/A-2	A-/Watch Neg/A-2
Preferred stock	BBB-	BBB/Watch Neg

Complete ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at [www.ratingsdirect.com](http://www.ratingsdirect.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com); select your preferred country or region, then Ratings in the left navigation bar, followed by Credit Ratings Search.

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