RESEARCH

Return to Regular Format

Summary: RWE AG

Publication date: 04-Oct-2005
Primary Credit Analyst: Amrit Gescher, London (44) 20-7176-3733; mailto:amrit_gescher@standardandpoors.com
Secondary Credit Analysts: Ralf Etzelmueller, Frankfurt (49) 69-33-999-123; mailto:ralf_etzelmueller@standardandpoors.com
Peter Kernan, London (44) 20-7176-3618; mailto:peter_kernan@standardandpoors.com

Credit Rating: A+/Negative/A-1

Rationale

The ratings on Germany-based utility RWE AG reflect the group's strong and diversified business position as one of Europe's largest electricity suppliers and one of the world's largest water utilities. About one-half of RWE's operating earnings come from stable electricity distribution and supply activities in Continental Europe and low-risk regulated water markets in the U.K. and U.S. These credit strengths are offset by the company's moderate financial profile for the rating, and uncertainties about the impact of the planned German energy regulator.

RWE has benefited from its strong competitive position in the consolidating German electricity market, which provides most of the company's operating earnings. Performance at RWE Thames Water PLC (formerly Thames Water PLC; A+/Negative/A-1) and American Water Capital Corp. (A/Negative/--) has been marginally weaker than expected but still stable. RWE npower PLC (formerly Innogy PLC; A-/Negative/A-2) improved its underlying performance, although it has been negatively affected by generation plant revisions in 2004 and high carbon dioxide costs in the U.K. in 2005.

Although the recent introduction of a German network regulator and planned introduction of a new regulatory system from 2006 should not have an immediate negative impact on RWE, revenue pressures on German distribution and supply activities could increase.

RWE's performance improved significantly in 2004. Funds from operations (FFO) increased despite deconsolidation effects, owing to increasing prices and significant cost cutting. Together with disposals of noncore assets, this reduced net debt by 33% to about €12 billion ($15 billion), ahead of the company's net debt reduction target of €17 billion (before currency effects and disposals) by year-end 2005. Credit ratios improved, with net debt interest coverage of almost 6.0x and slightly more than 4.0x when adjusted for pensions, compared with about 5.0x and slightly less than 4.0x, respectively, in 2003. FFO to net pension-adjusted debt improved to 23% from 18% in 2003.

Additional debt reduction in 2005, and ongoing operating improvements moderated by high capital expenditure on water are expected to improve credit ratios further. The group's performance so far in 2005 has continued its favorable trend. Net financial debt (including long-term securities) stood at about €12 billion at the end of June 2005, which is about stable compared with year-end 2004 despite negative currency effects and payment of an increased dividend. Management does not, however, rule out moderate acquisitions in its existing markets, which could slow short-term improvements and slightly increase the company's exposure to high-growth but riskier activities.

Short-term credit factors

RWE's strong short-term credit quality is underpinned by large and predictable cash flows, a benign maturity profile, and material other sources of liquidity. These include its €13.6 billion cash and securities portfolio (notionally held to offset on-balance-sheet pension and nuclear liabilities) at year-end 2004; large credit facilities; and undrawn syndicated loan facility of €4 billion, of which €2 billion is for 364 days and €2 billion for five years. Cash flows before dividends and acquisitions are expected to remain robustly positive, despite considerable capital expenditure.

Outlook

The negative outlook reflects RWE's moderate financial headroom available at the existing rating level. Material credit-dilutive debt-funded acquisitions or a faster-than-expected competitive pace in the German electricity market could put pressure on the ratings.

Additional Contact: Infrastructure Finance Ratings Europe; mailto:InfrastructureEurope@standardandpoors.com

RESEARCH

Return to Regular Format

Summary: American Water Capital Corp.

Publication date: 22-Jun-2005
Primary Credit Analysts: Andrew Watt, CFA, New York (1) 212-438-7868; mailto:andrew_watt@standardandpoors.com
Kevin L Beicke, CFA, New York (1) 212-438-7847; mailto:kevin_beicke@standardandpoors.com

Credit Rating: A/Negative/NR

Rationale

The ratings on American Water Capital Corp. (AWCC) largely reflect the consolidated credit quality of its ultimate parent, German multiutility RWE AG. AWCC is a wholly owned subsidiary of American Water and serves as the funding vehicle for American Water's regulated water utility companies. RWE has a strong support arrangement with the company and has provided an equity infusion to American Water and substantially all the debt funding to AWCC.

American Water's stand-alone credit quality is supported by a strong business position, which is characterized by geographic and regulatory diversity, a large customer base that is mostly residential and commercial, and a generally supportive regulatory environment. These strengths are slightly offset by American Water's nonregulated water and wastewater operations, despite the fact that these operations are closely related to the company's core business and are mostly fee based and not capital intensive. American Water is also hampered by a weak, but improving, financial profile.

American Water is the largest U.S. water utility holding company, with regulated utility operations in 21 states. This geographic diversity mitigates adverse weather effects on the company's cash flows and cushions the company from unfavorable rate decisions in any particular regulatory jurisdiction. The majority of revenues come from residential and commercial customers, which provide a stable customer base with predictable water-usage patterns.

The overall regulatory environment is viewed as supportive, because the jurisdictions in which the regulated utility operations are located allow some combination of the following policies: use of a forward-looking test year, recovery of construction expenses in a relatively timely manner, regular rate increases, and single-tariff pricing. However, while being acquired by RWE, American Water postponed filing for rate increases to prevent what may have been perceived as a foreign parent trying to increase returns. These rate cases have since been filed and rate increases have been allowed in several jurisdictions.

These strengths are slightly offset by American Water's involvement in nonregulated water and wastewater operations. Although they are largely fee-based, contract management operations that are closely related to the company's core business and not capital intensive, some of these nonregulated operations may pose a somewhat greater business risk than the company's regulated utilities.

American Water's strong business profile is partly countered by the company's weak, but improving, stand-alone financial profile. Debt leverage has improved dramatically since the merger with RWE, dropping to

47.7% from 69.1% at year-end 2002. For the 12-months ended Oct. 1, 2004, adjusted funds from operations (FFO) to average total debt was just 11%, which is low, but an improvement from 8.2% in fiscal 2003. Adjusted FFO interest coverage and adjusted EBIT interest coverage have improved from previous years, to 3.4x and 2.2x, respectively. The company's ROE was a mere 1.3%, mainly due to RWE's $3 billion infusion of common equity and preferred stock in 2003 and American Water's postponement of filing for rate increases during a period of industrywide inflation.

RWE's performance improved significantly in 2004. FFO increased despite deconsolidation effects, due to increasing prices and cost cutting. Together with disposals of noncore assets, this reduced net debt by 33% to about €12 billion ($15 billion), ahead of the company's net debt-reduction target of €17 billion (before currency effects and disposals) by year-end 2005. Credit ratios improved, with net debt interest coverage of almost 6x and slightly above 4x when adjusted for pensions, compared with about 5x and slightly less than 4x, respectively, in 2003. FFO to net pension-adjusted debt improved to 23% from 18% in 2003. Additional debt reduction in 2005 and ongoing operating improvements, moderated by high capital expenditures on water, are expected to improve credit ratios further. However, management does not rule out moderated acquisitions in its existing markets, which could slow short-term improvements and slightly increase the company's exposure to high-growth, but riskier, activities.

Liquidity
AWCC's liquidity position largely reflects that of its ultimate parent. RWE's short-term credit quality is supported by large and predictable cash flows, a benign maturity profile, and other material sources of liquidity. These include its €13.6 billion cash and securities portfolio (notionally held to offset on-balance-sheet pension and nuclear liabilities) at year-end 2004, large credit facilities, and an undrawn syndicated loan facility of €4 billion, of which €2 billion is for 364 days and €2 billion for five years. Operating cash flows before dividends and acquisitions are expected to remain robustly positive, despite considerable capital expenditures.

Standard & Poor's expects RWE to continue to support AWCC in the form of intercompany loans, alleviating any liquidity constraints for American Water. Capital-spending needs for American Water will be partially funded internally, with the balance funded through tax-exempt debt issuances in the capital markets or through intercompany loans from RWE. American Water's long-term debt maturities are manageable in the near term, with $61.9 million maturing in 2005. In 2006, $1,219.8 million comes due, nearly all of which is in the form of RWE intercompany loans.

As of Oct. 1, 2004, American Water had $35.6 million in cash and cash equivalents. AWCC also has a $550 million, 364-day revolving credit agreement with RWE that will be up for renewal on Oct. 28, 2005. Borrowing under the credit agreement is based on LIBOR, and AWCC pays a commitment fee of 7.25 basis points on the entire amount. For 2003, the weighted-average interest rate on the outstanding lines was 1.16%.

Outlook

AWCC's negative outlook mirrors that of ultimate parent RWE. The negative outlook on RWE reflects the moderate financial headroom available to the company at the existing rating level. Credit-dilutive, debt-funded acquisitions or a faster-than-expected competitive pace in the German electricity market could pressure the ratings.

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RESEARCH

Return to Regular Format

Summary: American Water Capital Corp.

Publication date: 16-Sep-2005
Primary Credit Analysts: Andrew Watt, CFA, New York (1) 212-438-7868; mailto:andrew_watt@standardandpoors.com
Kevin L Beicke, CFA, New York (1) 212-438-7847; mailto:kevin_beicke@standardandpoors.com

Credit Rating: A/Negative/NR

Rationale

The ratings on American Water Capital Corp. (AWCC) largely reflect the consolidated credit quality of the company's ultimate parent, German multiutility RWE AG (A+/Negative/A-1). AWCC is a wholly owned subsidiary of American Water and serves as the funding vehicle for American Water's regulated water utility subsidiaries. RWE has a strong support arrangement with the company and has provided an equity infusion to American Water and substantially all the debt funding to AWCC.

American Water's stand-alone credit quality is supported by its '2' (excellent) business profile. (Utility business profiles are categorized from '1' (excellent) to '10' (vulnerable).) The company's business profile benefits from geographic and regulatory diversity, a large customer base that is mostly residential and commercial, and a generally supportive regulatory environment. These strengths are only slightly offset by American Water's nonregulated water and wastewater operations. American Water is also hampered by a weak, but improving, financial risk profile.

American Water is the largest U.S. water utility holding company, with regulated utility operations in 21 states. This geographic diversity mitigates adverse weather effects on the company's cash flows and cushions the company from unfavorable rate decisions in any particular regulatory jurisdiction. The majority of revenues come from residential and commercial customers, which provide a stable customer base with predictable water-usage patterns.

The overall regulatory environment is considered supportive, because the jurisdictions where the regulated utility operations are located allow some combination of the following policies: use of a forward-looking test year, recovery of construction expenses in a relatively timely manner, regular rate increases, and single-tariff pricing. However, while being acquired by RWE, American Water postponed filing for rate increases to prevent what may have been perceived as a foreign parent trying to increase returns. These rate cases were then filed within the last two years and the full effect of these rate case decisions will be realized this year.

These strengths are only slightly offset by American Water's involvement in nonregulated water and wastewater operations. Although they are largely fee-based, contract-management operations that are closely related to the company's core business and not capital intensive, some of these nonregulated operations may pose a greater business risk than the company's regulated utilities due to contract renewal risk and also depending on the structure of each contract.

American Water's excellent business risk profile is partly countered by the company's intermediate, stand-alone financial risk profile, which is weak for the rating. Debt leverage has improved dramatically since the merger with RWE, dropping to 48% from 69.1% at year-end 2002, due to RWE's $3 billion infusion of preferred stock and common equity in 2003. For year-ended Dec. 31, 2004, adjusted funds from operations (FFO) to average total debt was just 12.5%, which is low, but a significant improvement from 7.5% in fiscal 2003. Adjusted FFO interest coverage and adjusted EBIT interest coverage have also improved over the past year, to 3.7x and 2.2x, respectively. The company's ROE was a mere 1.2% in 2004, but it is expected to improve this year due to the full realization of rate increases in many of the company's service areas.

RWE's performance improved significantly in 2004. FFO increased despite deconsolidation effects, due to increasing prices and cost cutting. Together with disposals of noncore assets, this reduced net debt by 33% to about €12 billion ($15 billion), ahead of the company's net debt-reduction target of €17 billion (before currency effects and disposals) by year-end 2005. Credit ratios improved, with net debt interest coverage of almost 6x and slightly above 4x when adjusted for pensions, compared with about 5x and slightly less than 4x, respectively, in 2003. FFO to net pension-adjusted debt improved to 23% from 18% in 2003. Additional debt reduction in 2005 and ongoing operating improvements, moderated by high capital expenditures on water, are expected to improve credit ratios further. However, management does not rule out moderated acquisitions in its existing markets, which could slow short-term improvements and slightly increase the company's exposure to high-growth, but riskier, activities.

Liquidity

AWCC's liquidity position largely reflects that of its ultimate parent. RWE's short-term credit quality is supported by large and predictable cash flows, a benign maturity profile, and other material liquidity sources. These include its €13.6 billion cash and securities portfolio (notionally held to offset on-balance-sheet pension and nuclear liabilities) at year-end 2004, large credit facilities, and an undrawn syndicated loan facility of €4 billion, of which €2 billion is for 364 days and €2 billion for five years. Operating cash flows before dividends and acquisitions are expected to remain robustly positive, despite considerable capital expenditures.

Standard & Poor's expects RWE to continue to support AWCC via intercompany loans, alleviating any liquidity constraints for American Water. Capital-spending needs for American Water will be partially funded internally, with the balance funded through tax-exempt debt issuances in the capital markets or through intercompany loans from RWE. American Water's long-term debt maturities are manageable in the near term, with $45.7 million maturing in 2005. In 2006, $1,219.9 million comes due, nearly all of which is in the form of RWE intercompany loans.

As of Dec. 31, 2004, American Water had $52.8 million in cash and cash equivalents. AWCC also has a $550 million, 364-day revolving credit agreement with RWE that will be up for renewal on Oct. 28, 2005 and is expected to be renewed. AWCC had $239.9 million in availability from these credit lines as of Dec. 31, 2004. Borrowing under the credit agreement is based on LIBOR, and AWCC pays a commitment fee of 6.575 basis points on the entire amount. For 2004, the weighted-average interest rate on the outstanding lines was 1.43%.

Outlook

AWCC's negative outlook mirrors that of ultimate parent, RWE. The negative outlook on RWE reflects the moderate financial headroom available at the existing rating level. Credit-dilutive, debt-funded acquisitions or a faster-than-expected competitive pace in the German electricity market could pressure the ratings.

A ratings downgrade of one notch for RWE would result in a one-notch downgrade for AWCC. A downgrade of more than one notch for RWE would likely result in the equalization of the two ratings, reflecting the stand-alone credit profile of AWCC combined with the parent's rating as a ceiling.

RESEARCH

Return to Regular Format

American Water Capital Corp.

Publication date: 16-Sep-2005
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Corporate Credit Rating

A/Negative/NR

Business Profile

1 2 3 4 5 6 7 8 9 10

Financial risk profile:
Intermediate

Debt maturities:
As of Dec. 31, 2004:
2005: $45.7 million
2006: $1,219.9 million
2007: $244.2 million
2008: $23.4 million
2009: $116 million
Thereafter: $2,350.3 million

Total rated debt:
As of Dec. 31, 2004, American Water, the unrated parent, had $4,359.8 million of debt, $1,754.7 million of preferred stocks without mandatory redemption requirements, and $26.3 million of preferred stocks with mandatory redemption requirements.

Outstanding Rating(s)

American Water Capital Corp.

Sr unsecd debt	
Local currency	A-

Corporate Credit Rating History

Sept. 21, 2000	A/A-2
July 15, 2003	A/A-1
Dec. 30, 2003	NR

Major Rating Factors

Strengths:

- Strong support from ultimate parent, RWE AG;
- Geographic and regulatory diversity;
- Large customer base that is mostly residential and commercial; and
- Generally supportive regulatory environment.

Weaknesses:

- Nonregulated water and wastewater operations; and
- Intermediate financial risk profile, which is weak for the rating.

Rationale

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A ratings downgrade of one notch for RWE would result in a one-notch downgrade for AWCC. A downgrade of more than one notch for RWE would likely result in the equalization of the two ratings, reflecting the stand-alone credit profile of AWCC combined with the parent's rating as a ceiling.

Accounting

The financial statements for American Water are prepared according to U.S. GAAP. The company's independent auditor, PricewaterhouseCoopers LLP, expressed a nonqualified opinion for 2004.

In 2004, American Water discovered errors in its 2003 consolidated financial statements related to the inclusion of preferred dividends in comprehensive income and the computation of unrealized holding gains/ losses on marketable securities, including the related deferred taxes. Because of these errors, the company restated its consolidated financial statements for year-ended Dec. 31, 2003.

American Water's pension and other postretirement benefit plans are significantly underfunded, by $277.1 million and $177.3 million, respectively. The utility's total pension funding ratio, which Standard & Poor's defines as the fair value of the plan assets divided by the plan's projected benefit obligation, is low for the utility sector, at 60.7%. The average funding ratio for the industry is about 90%. The total additional minimum liability for American Water's pension plans increased to $222 million as of Dec. 31, 2004, from $44 million at Dec. 31, 2003. This increase is primarily attributable to a decrease in the discount rate to 6% from 6.25%. American Water plans to contribute amounts equal to the minimum required contributions in 2005 to the qualified pension plans and its 2005 other postretirement benefit cost to its Voluntary Employees' Beneficiary Association (VEBA) trusts. Pension expense in excess of the amount contributed to the pension plans is deferred by certain regulated subsidiaries pending future recovery in rates charged for utility services, as contributions are made to the plans.

Standard & Poor's also makes adjustments to account for the company's operating leases. We calculate an off-balance-sheet (OBS) amount for debt, interest expense, and depreciation, and include these amounts in the calculation of adjusted ratios. The amounts included in American Water's adjusted ratios for 2004 were $47.2 million for OBS debt, $4.9 million for OBS interest expense, and $11.1 million for OBS depreciation expense.

Table 1

American Water Capital Corp. -- Competitors

	--Average of past three fiscal years--			
	American Water Capital Corp.	Aqua America Inc.	California Water Service Group	Connecticut Water Service Inc.
Rating	A/Negative/--*	A+/Stable/--¶	A+/Stable/--§	A/Stable/--
(mil. $)				
Sales	1,770.1	377.1	285.3	47.1
Net income from cont. oper.	115.7	72.7	21.5	9.1

Funds from oper. (FFO)	395.5	142.2	49.3	15.5
Capital expenditures	491.1	165.1	76.8	13.0
Total debt	4,267.9	828.2	281.1	73.0
Preferred stock	1,181.4	0.1	3.5	0.8
Common equity	2,619.6	632.6	243.8	83.7
Total capital	8,068.9	1,461.8	528.4	157.6
Ratios				
Adj. EBIT interest coverage (x)	1.9	3.4	2.6	3.5
Adj. FFO interest coverage (x)	2.9	4.0	3.5	4.6
Adj. FFO/avg. total debt (%)	9.9	18.1	17.6	21.6
Net cash flow/capex (%)	63.3	61.9	40.6	68.1
Adj. total debt/capital (%)	53.2	57.0	54.1	46.6
Return on common equity (%)	2.2	12.1	8.7	10.7
Common dividend payout (%)	51.4	56.2	85.1	71.3

*Rating reflects that of American Water Capital Corp.; American Water is the unrated parent. ¶Rating reflects that of Aqua Pennsylvania Inc.; Aqua America Inc. is the unrated parent. §Rating reflects that of California Water Service Co.; California Water Service Group is the unrated parent.

Table 2

American Water Capital Corp. -- Financial Summary

	--Fiscal year ended Dec. 31--				
Rating history*	A/ Negative/--	A/ Negative/--	A-/Watch Pos/A-2	A-/Watch Pos/A-2	A-/Stable/A-2
	2004	**2003**	**2002**	**2001**	**2000**
(mil. $)					
Sales	1,839.0	1,756.1	1,715.2	1,438.9	1,350.6
Net inc. from cont. oper.	145.1	57.6	144.4	161.5	161.1
Funds from oper. (FFO)	542.2	307.4	337.0	342.7	345.5
Capital expenditures	525.0	506.0	442.2	371.7	363.5
Total debt	4,386.1	4,354.2	4,063.3	3,130.2	2,844.8
Preferred stock	1,754.7	1,755.7	33.9	49.4	52.7
Common equity	3,047.4	3,009.4	1,801.9	1,758.0	1,669.7
Total capital	9,188.2	9,119.3	5,899.1	4,937.6	4,567.2
Ratios					
Adj. EBIT interest coverage (x)	2.2	1.8	1.8	2.4	2.3

Adj. FFO interest coverage (x)	3.7	2.5	2.5	2.7	2.8
Adj. FFO/avg. total debt (%)	12.5	7.5	9.5	11.6	12.7
Net cash flow/capex (%)	83.6	50.2	54.0	66.9	69.8
Adj. total debt/capital (%)	48.0	48.0	69.1	63.6	62.5
Return on common equity (%)	1.2	(0.4)	7.3	8.9	8.7
Common dividend payout (%)	0.0	0.0	67.9	58.0	56.0

*Ratings reflect that of American Water Capital Corp.; American Water is the unrated parent.

RESEARCH

Return to Regular Format

Research Update: American Water Capital Ratings Are Lowered To 'A-', On Watch Neg Re: Sale By Parent

Publication date: 07-Nov-2005
Primary Credit Analyst: Kevin L Beicke, CFA, New York (1) 212-438-7847; kevin_beicke@standardandpoors.com

Credit Rating: A-/Watch Neg/NR

Rationale

On Nov. 7, 2005, Standard & Poor's Ratings Services lowered its corporate credit rating on American Water Capital Corp. (AWCC) to 'A-' from 'A' and placed the ratings on CreditWatch with negative implications. In addition, AWCC's senior unsecured ratings were lowered to 'BBB+' from 'A-'.

AWCC is a wholly owned subsidiary of American Water and serves as the funding vehicle for American Water's regulated water utility subsidiaries. American Water is a wholly owned subsidiary of parent RWE AG (A+/Negative/A-1).

The rating action follows the announcement made by RWE of its intention to sell its U.K. and U.S. water businesses and reflects the weaker, stand-alone credit quality of AWCC, absent RWE's support. Standard & Poor's will meet with American Water's management to discuss in detail the effect of this announcement, especially in relation to the future strategic direction, financial policy, capital structure, liquidity, and funding of the company. The CreditWatch listing on AWCC is not expected to be resolved until the completion of the sale, due to the greater amount of uncertainty regarding the future plans for the American Water operations versus those of the U.K. water business, RWE Thames Water PLC (A/Watch Neg/A-1).

RWE's decision is driven by its desire to focus on electricity and gas operations in Europe. The sale process will start with the U.S. water operations. Once this transaction is well underway, it will continue with RWE Thames Water. The process will be lengthy, as it requires the approval of RWE's supervisory board and regulatory approvals. The goal is to complete both transactions during 2007.

American Water's stand-alone credit quality is supported by its '2' (excellent) business profile. (Utility business profiles are categorized from '1' (excellent) to '10' (vulnerable).) The company's business profile benefits from geographic and regulatory diversity, a large customer base that is mostly residential and commercial, and a generally supportive regulatory environment. These strengths are only slightly offset by

American Water's nonregulated water and wastewater operations. American Water is also hampered by a weak, but improving, financial risk profile.

American Water's excellent business risk profile is partly countered by the company's intermediate, stand-alone financial risk profile, which is weak for the rating. Debt leverage has improved dramatically since the merger with RWE, dropping to 48% from 69.1% at year-end 2002, due to RWE's $3 billion infusion of preferred stock and common equity in 2003. For year-ended Dec. 31, 2004, adjusted funds from operations (FFO) to average total debt was just 12.5%, which is low, but a significant improvement from 7.5% in fiscal 2003. Adjusted FFO interest coverage and adjusted EBIT interest coverage have also improved over the past year, to 3.7x and 2.2x, respectively. The company's ROE was a mere 1.2% in 2004, but is expected to improve this year due to the full realization of rate increases in many of the company's service areas.

Liquidity

AWCC's liquidity position is adequate. American Water has received previous support from RWE in the form of intercompany loans, but this support will lessen going forward. Leading up to the completion of the sale of RWE's U.S. water operations, it is expected that American Water will gradually need to start sourcing its own funding. However, Standard & Poor's expects RWE's continued, although diminished, support to American Water before the completion of the sale to alleviate any near-term liquidity constraints.

Capital-spending needs for American Water will be partially funded internally, with the balance funded through tax-exempt debt issuances in the capital markets or through intercompany loans from RWE. American Water has $1,219.9 million of long-term debt maturing in 2006, nearly all of which is in the form of RWE intercompany loans.

As of March 31, 2005, American Water had $41.7 million in cash and cash equivalents. AWCC also has a $550 million, 364-day revolving credit agreement with RWE. AWCC had $239.9 million in availability from these credit lines as of Dec. 31, 2004. Borrowing under the credit agreement is based on LIBOR, and AWCC pays a commitment fee of 6.575 basis points on the entire amount. For 2004, the weighted-average interest rate on the outstanding lines was 1.43%.

Ratings List

Ratings Lowered, Placed On Watch Neg

American Water Capital Corp.

	To	From
Corp. credit rating	A-/Watch Neg/--	A/Negative/--
Senior unsecured rating	BBB+/Watch Neg	A-

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search.

RESEARCH

Return to Regular Format

Summary: American Water Capital Corp.

Publication date: 16-Dec-2005
Primary Credit Analyst: Kevin L Beicke, CFA, New York (1) 212-438-7847; mailto:kevin_beicke@standardandpoors.com

Credit Rating: A-/Watch Neg/NR

Rationale

American Water Capital Corp. (AWCC) is a wholly owned subsidiary of American Water and serves as the funding vehicle for American Water's regulated water utility subsidiaries. American Water is a wholly owned subsidiary of parent RWE AG (A+/Negative/A-1).

The ratings on AWCC reflect the stand-alone credit quality of American Water. RWE recently announced its intention to sell its U.K. and U.S. water businesses and focus on its electricity and gas operations in Europe. The intercompany funding support RWE has given AWCC is expected to remain until all the intercompany debt has been refinanced, which should occur sometime before the sale has been completed. The sale process will start with RWE's U.S. water operations and then will continue with its U.K. water business, RWE Thames Water PLC (A/Watch Neg/A-1). The process will be lengthy, because it requires the approval of RWE's supervisory board as well as several regulatory jurisdictions. The goal is to complete both transactions during 2007.

The CreditWatch listing on AWCC is not expected to be resolved until the completion of the sale, because of the greater amount of uncertainty regarding the future plans for the American Water operations versus those of RWE Thames Water. This uncertainty is the result of the extensive regulatory approval process that will be required, due to American Water's large and geographically diverse operations.

American Water's stand-alone credit quality is supported by its '2' (excellent) business profile. (Utility business profiles are categorized from '1' (excellent) to '10' (vulnerable)). The company's business profile benefits from geographic and regulatory diversity, a large customer base that is mostly residential and commercial, and a generally supportive regulatory environment. These strengths are slightly offset by American Water's nonregulated water and wastewater operations.

American Water's excellent business risk profile is partly countered by the company's intermediate, stand-alone financial risk profile, which is weak for the rating. Debt leverage has improved dramatically since the merger with RWE, dropping to 48% from 69.1% at year-end 2002, due to RWE's $3 billion infusion of preferred stock and common equity in 2003. However, for year-ended Dec. 31, 2004, adjusted funds from operations (FFO) to average total debt was just 12.5%, which is low, but a significant improvement from 7.5% in fiscal 2003. Adjusted FFO interest coverage and adjusted EBIT interest coverage have also improved over the past year, to 3.7x and 2.2x, respectively. The company's ROE was a mere 1.2% in 2004, but is expected to improve this year due to the full realization of rate increases in many of the company's service areas.

Liquidity

AWCC's liquidity position is adequate. American Water has received previous support from RWE in the form of intercompany loans, but this support will lessen going forward. Leading up to the completion of the sale of RWE's U.S. water operations, American Water will most likely need to start sourcing its own funding. However, Standard & Poor's expects RWE's continued, although diminished, support to American Water until the sale has been completed to alleviate any near-term liquidity constraints.

Capital-spending needs for American Water will be partially funded internally, with the balance funded through tax-exempt debt issuances in the capital markets or through intercompany loans from RWE. American Water has $1,219.9 million of long-term debt maturing in 2006, nearly all of which is in the form of RWE intercompany loans.

As of March 31, 2005, American Water had $41.7 million in cash and cash equivalents. AWCC also has a $550 million, 364-day revolving credit agreement with RWE. AWCC had $239.9 million in availability from these credit lines as of Dec. 31, 2004. Borrowing under the credit agreement is based on LIBOR, and AWCC pays a commitment fee of 6.575 basis points on the entire amount. For 2004, the weighted-average interest rate on the outstanding lines was 1.43%.

RESEARCH

Return to Regular Format

Summary: American Water Capital Corp.

Publication date: 14-Feb-2006
Primary Credit Analyst: Kevin L Beicke, CFA, New York (1) 212-438-7847; mailto:kevin_beicke@standardandpoors.com

Credit Rating: A-/Watch Neg/NR

Rationale

American Water Capital Corp. (AWCC) is a wholly owned subsidiary of American Water (unrated) and serves as the funding vehicle for American Water's regulated water utility subsidiaries. The ratings on AWCC remain on CreditWatch with negative implications. American Water is a wholly owned subsidiary of parent RWE AG (A+/Negative/A-1).

The ratings on AWCC reflect the stand-alone credit quality of American Water. In November 2005, RWE announced its intention to sell its U.K. and U.S. water businesses and focus on its electricity and gas operations in Europe. The intercompany funding support RWE has given AWCC is expected to remain until all the intercompany debt has been refinanced, which should occur sometime before the sale has been completed. The sale process will start with RWE's U.S. water operations, and then will continue with its U.K. water business, RWE Thames Water PLC (A/Watch Neg/A-1). The process will be lengthy, because it requires the approval of RWE's supervisory board, as well as several regulatory jurisdictions. The goal is to complete both transactions during 2007.

The CreditWatch listing on AWCC is not expected to be resolved until the completion of the sale, because of the greater amount of uncertainty regarding the future plans for the American Water operations versus those of RWE Thames Water. This uncertainty is the result of the extensive regulatory approval process that will be required, due to American Water's large and geographically diverse operations.

American Water's stand-alone credit quality is supported by its '2' (excellent) business risk profile. (Utility business risk profiles are categorized from '1' (excellent) to '10' (vulnerable)). The company's business risk profile benefits from geographic and regulatory diversity, a large customer base that is mostly residential and commercial, and a generally supportive regulatory environment. These strengths are slightly offset by the somewhat increased risk from American Water's nonregulated water and wastewater operations.

American Water's excellent business risk profile is partly countered by the company's intermediate, stand-alone financial risk profile, which is weak for the rating. Debt leverage has improved dramatically since the merger with RWE, dropping to 47.5% from 69.1% at year-end 2002, due to RWE's $3 billion infusion of preferred stock and common equity in 2003. However, for the 12-months ended Sept. 30, 2005, adjusted funds from operations (FFO) to average total debt was just 13%, which is low, but a significant improvement from 7.5% in fiscal 2003. Adjusted FFO interest coverage and adjusted EBIT interest coverage have also improved since 2003, to 3.6x and 2.2x, respectively. The company's ROE was a mere 1.4%, but is expected to improve due to the continued filing of rate cases.

Liquidity

AWCC's liquidity position is adequate. American Water has received previous support from RWE in the form of intercompany loans, but this support will lessen going forward. Leading up to the completion of the sale of RWE's U.S. water operations, American Water will most likely need to start sourcing its own funding. However, Standard & Poor's expects RWE's continued, although diminished, support to American Water until the sale has been completed to alleviate any near-term liquidity constraints.

Capital-spending needs for American Water will be partially funded internally, with the balance funded through tax-exempt debt issuances in the capital markets or through intercompany loans from RWE. American Water has $1,219.9 million of long-term debt maturing in 2006, nearly all of which is in the form of RWE intercompany loans.

As of Sept. 30, 2005, American Water had $51.6 million in cash and cash equivalents. AWCC also has a $550 million, 364-day revolving credit agreement with RWE. AWCC had $239.9 million in availability from these credit lines as of Dec. 31, 2004. Borrowing under the credit agreement is based on LIBOR, and AWCC pays a commitment fee of 6.575 basis points on the entire amount. For 2004, the weighted-average interest rate on the outstanding lines was 1.43%.

RESEARCH

Return to Regular Format

Summary: American Water Capital Corp.

Publication date: 31-May-2006
Primary Credit Analyst: Kevin L Beicke, CFA, New York (1) 212-438-7847; mailto:kevin_beicke@standardandpoors.com

Credit Rating: A-/Watch Neg/NR

Rationale

American Water Capital Corp. (AWCC) is a wholly owned subsidiary of American Water (unrated) and serves as the funding vehicle for American Water's regulated water utility subsidiaries. The ratings on AWCC remain on CreditWatch with negative implications. American Water is a wholly owned subsidiary of parent RWE AG (RWE; A+/Negative/A-1).

The ratings on AWCC reflect the stand-alone credit quality of American Water. In November 2005, RWE announced its intention to sell its U.K. and U.S. water businesses and focus on its electricity and gas operations in Europe. The intercompany funding support RWE has given AWCC is expected to remain until all the intercompany debt has been refinanced, which should occur sometime before the sale has been completed. The sale process will start with RWE's U.S. water operations, and then will continue with its U.K. water business, RWE Thames Water PLC (A/Watch Neg/A-1). The sale of American Water will be a lengthy process, because it requires the approval of RWE's supervisory board, as well as each of the U.S. regulatory jurisdictions in which American Water's regulated operations are located. The goal is to complete both transactions during 2007.

The CreditWatch listing on AWCC is not expected to be resolved until the completion of the sale, due to the greater amount of uncertainty regarding the sale of American Water versus that of RWE Thames Water. This uncertainty results from the extensive U.S. regulatory approval process that will be required, due to American Water's multijurisdictional regulated operations, and also the need for an updated business plan and stand-alone capital structure.

American Water's stand-alone credit quality is supported by its '2' (excellent) business risk profile. (Utility business risk profiles are categorized from '1' (excellent) to '10' (vulnerable)). The company's business risk profile benefits from geographic and regulatory diversity, a large customer base that is mostly residential and commercial, and a generally supportive regulatory environment. These strengths are slightly offset by the somewhat increased risk from American Water's nonregulated water and wastewater operations.

American Water's excellent business risk profile is partly countered by the company's intermediate, stand-alone financial risk profile. Debt leverage improved since the merger with RWE, due to the parent's $3 billion infusion of preferred stock and common equity in 2003. However, American Water's large amount of RWE-funded preferred stock on its balance sheet ($1.75 billion, or almost 20% of total capital) would not receive as much equity credit if it were refinanced as is following RWE's planned sale of American Water. The following financial metrics have not been adjusted for pensions and other postretirement obligations, and remain weak for the rating. For the 12-months ended Sept. 30, 2005, adjusted funds from operations (FFO) to average total debt was just 13%, which is low, but an improvement from 7.5% in fiscal 2003. Adjusted FFO interest coverage and adjusted EBIT interest coverage have also improved since 2003, to 3.6x and 2.2x, respectively. The company's ROE was a mere 1.4%, but is expected to improve this year due to the continued filing of rate cases.

Liquidity

AWCC's liquidity position is adequate. American Water has received previous support from RWE in the form of intercompany loans, but this support will lessen going forward. Leading up to the completion of the sale of RWE's U.S. water operations, American Water will most likely need to start sourcing its own funding. However, Standard & Poor's expects RWE's continued, although diminished, support to American Water until the sale has been completed to alleviate any near-term liquidity constraints.

Capital-spending needs for American Water will be partially funded internally, with the balance funded through tax-exempt debt issuances in the capital markets or through the existing revolving credit agreement with RWE. American Water has $1,455.8 million of long-term debt maturing in November 2006, all of which is in the form of RWE intercompany loans. These loans are likely to be refinanced externally without the support of RWE.

As of Dec. 31, 2005, American Water had $66.6 million in cash and cash equivalents. AWCC also has a $550 million, 364-day revolving credit agreement with RWE that has sufficient availability. Borrowing under the credit agreement is based on LIBOR, and AWCC pays a commitment fee of 6.575 basis points on the entire amount. For 2005, the weighted-average interest rate on the outstanding lines was 3.3%.

Rating Action: American Water Capital Corporation

MOODY'S AFFIRMS RWE'S A1 RATINGS, DOWNGRADES THAMES WATER UTILITIES FINANCE PLC TO A2 AND RWE THAMES WATER PLC TO A3 BOTH WITH NEGATIVE OUTLOOK FOLLOWING RWE'S STRATEGIC REASSESSMENT

London, 04 November 2005 -- Moody's Investors Service has today affirmed the A1 senior unsecured ratings of RWE AG with a stable outlook following the announcement that RWE intends to divest its water activities in North America and the UK to focus on core European electricity and gas businesses.

At the same time, Moody's has downgraded to A2 from A1 the long-term ratings of all debt issued by Thames Water Utilities Finance Plc ("TWUF") and guaranteed by Thames Water Utilities Limited (Thames Water), the UK regulated water and wastewater utility. Moody's has also downgraded to A3 from A2 the issuer rating of RWE Thames Water Plc ("RWETW"). All ratings for TWUF and RWETW have a negative outlook.

Whilst timing and proceeds are as yet unclear, the proposed divestments could improve RWE's financial profile, although Moody's believes that RWE will consider (a) returning cash to shareholders and (b) seeking out appropriate reinvestment opportunities in power and energy markets in Europe over time. Such a strategy may result in a shift to a less stable business profile as the low risk cash flow streams from its water businesses are reduced and potentially replaced with those from higher-risk power and energy investments. Nonetheless, the rating agency would also expect the company, which continues to target a high single-A rating, to maintain a disciplined approach to any such new investments and to target an appropriate financial structure for its changing business risk mix. Moody's will continue to monitor developments for rating implications as further clarity emerges as regards the impact of this shift in strategic direction.

As regards Thames Water, the rating downgrades reflect (a) the fact that Thames Water will no longer be core to RWE's business and (b) the uncertainty concerning the UK utility's future capital structure, which cannot be predicted whilst RWE explores potential exit routes. The downgrade is also based on Moody's view that, ultimately, Thames Water's leverage is likely to be at a level inconsistent with its current ratings. This view is based on the regulatory assumptions for an efficient capital structure -- industry regulator Ofwat has assumed leverage of around 55% of regulated asset value for the 2004 price review -- and the level of gearing observed across the UK water sector. Taking into account the high debt component of transactions involving a change of ownership of water companies in recent years (although none of them have been of Thames Water's size), Moody's has assigned a negative outlook to Thames Water's ratings to reflect the possibility that the utility's cash flows may have to support a substantial debt burden. The rating agency cautions that leverage materially in excess of the regulatory assumptions would be likely to result in lower ratings.

The following ratings are affirmed as a result of this announcement:

RWE AG

- Senior Unsecured: unchanged at A1, stable outlook.

- Senior Unsecured MTN: unchanged at A1, stable outlook.

- Commercial Paper and other Short-Term Debt: unchanged at Prime-1.

RWE Finance BV

- Guaranteed Senior Unsecured: unchanged at A1, stable outlook.

- Guaranteed Senior Unsecured MTN: unchanged at A1, stable outlook.

- Guaranteed Other Short-Term Debt: unchanged at Prime-1.

RWE npower plc

- Long-Term Issuer Rating: unchanged at Baa1, stable outlook.

- Senior Unsecured: unchanged at Baa1, stable outlook.

The following ratings were downgraded:

- All issuance under Thames Water Utilities Finance Plc's US$4.0 billion EMTN Programme guaranteed by Thames Water Utilities Limited, downgraded to A2 from A1, negative outlook.

- RWE Thames Water Plc's issuer rating to A3 from A2, negative outlook.

Headquartered in Essen, Germany, RWE AG is a large international utility with core activities in electricity, gas, water and wastewater. For the year ending 31 December 2004, it reported group turnover of EUR42,137 million.

Headquartered in London, England, RWE Thames Water Plc is the holding company of a group of companies whose main operating subsidiary is Thames Water Utilities Limited, the largest of the ten water and wastewater utilities in England and Wales.

London
Stuart Lawton
Managing Director
European Corporates
Moody's Investors Service Ltd.
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

London
Helen Francis
Vice President - Senior Analyst
European Corporates
Moody's Investors Service Ltd.
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

April 2006

Contact	Phone
London	
Nick Curtis Helen Francis Stuart Lawton	44.20.7772.5454

RWE AG

Corporate Profile

A LEADING EUROPEAN UTILITY WITH STRONG POSITIONS IN ITS CORE ELECTRICITY AND GAS MARKETS

Headquartered in Essen, Germany, RWE AG ("RWE", rated A1/Prime-1, stable outlook) is one of the largest listed European utilities with leading market positions in its core electricity and gas activities. RWE is also the world's third-largest water and waste water operator, but in November 2005 the company announced its intention to exit from its water activities in North America and the UK to focus on its core electricity and gas businesses.

Figure 1: Operational Highlights

€ million	Revenue			EBITDA				EBITDA Margin	
	2004	2005	Var %	2004	% Tot	2005	% Tot	2004	2005
RWE Power *	6,741	6,832	1.3%	2,571	30.6%	2,800	33.6%	38.1%	41.0%
RWE Energy	22,450	24,318	8.3%	2,927	34.8%	3,142	37.7%	13.0%	12.9%
RWE npower	5,605	6,382	13.9%	698	8.3%	561	6.7%	12.5%	8.8%
RWE Thames Water	4,065	4,210	3.6%	1,979	23.6%	2,045	24.6%	48.7%	48.6%
Other **	3,276	77	-97.6%	225	2.7%	-224	-2.7%	6.9%	-290.9%
Total	**42,137**	**41,819**	**-0.8%**	**8,400**	**100.0%**	**8,324**	**100.0%**	**19.9%**	**19.9%**

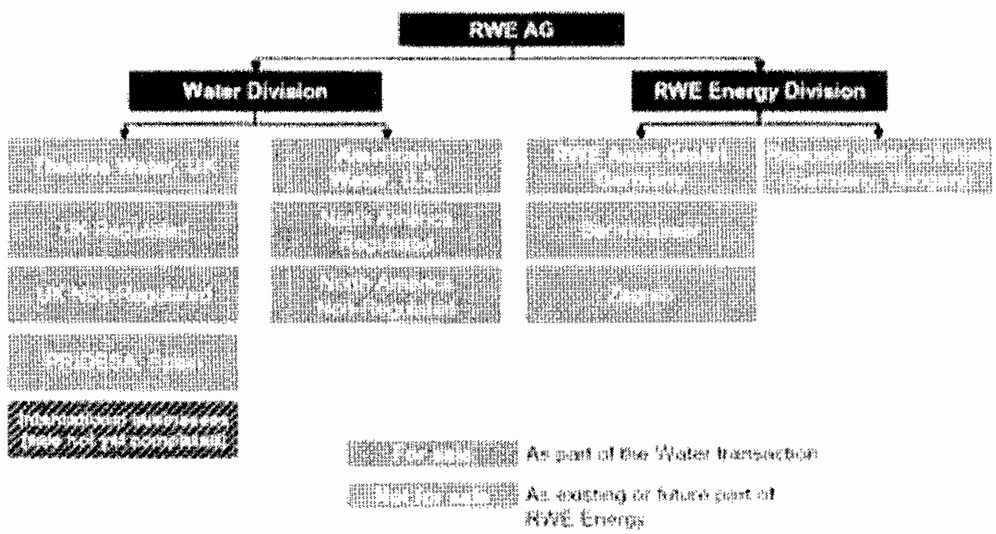
** RWE Trading activities are included in the RWE Power business unit*
*** Includes RWE Umwelt and Heidelberger Druckmaschinen (discontinued activities)*

RWE Power (representing 16% of 2005 Group revenues) is the largest electricity generator in Germany accounting for approximately one-third of German electricity production. In 2005, RWE's German plants produced approximately 183 TWh of electricity, of which lignite accounted for 41%, hard coal 25%, nuclear 25%, gas 6% and hydro 3%. RWE is also a significant generator in the UK through RWE npower (representing 15% of 2005 Group revenues) which generated 33 TWh in 2005, of which 53% was coal and 44% gas. Vertical integration and the ownership of RWE Dea (the oil & gas producer) and lignite mines mitigate RWE's commodity risk exposure, which is managed by RWE Trading. RWE's approach is to hedge its commodity risk on a forward basis when it becomes liquid in terms of volume and tenor, i.e. tradeable on the wholesale market; or via retail on a wholesale based pricing strategy. This provides good earnings and cashflow visibility. Currently when the year of delivery starts RWE hedges its commodity risk on a rolling 36-month basis, with 90% plus locked in 12 months in advance. The result however, is that rising commodity prices will benefit RWE's P&L only after a certain delay.

RWE Energy (representing 58% of 2005 Group revenues) comprises RWE's regulated transmission and distribution assets and energy supply activities. The electricity distribution business comprises some 350,000 km of high, medium and low-voltage grid, serving nearly 16 million customers in Germany and Eastern Europe, and more than 4 million in the UK. In gas, RWE owns approximately 117,000 km of pipelines supplying more than 8 million customers through a number of companies in Germany and elsewhere, including the 100% owned Czech monopoly transmission and storage company, Transgas, and holdings in various gas distributors in the Czech Republic, Hungary and Slovakia.

RWE Thames Water (representing 10% of 2005 Group revenues) has grown by acquisition, purchasing Thames Water in 2000 and American Water in 2003 and is now the number three water and wastewater company worldwide. The division serves approximately 15 million customers in London and the Thames Valley area in the UK, and 20 million customers in the Americas where it supplies 27 states in the US, principally in the North-East and South-West, as well as Canada and Chile. On 4 November 2005, RWE announced its intention to sell Thames Water in the UK and American Water in the US, in order to focus on its European gas and electricity activities. The remaining RWE water activities in Continental Europe (except the recently sold Spanish Pridesa) will be retained and integrated into RWE Energy, owing to the synergies they have with the regional energy operations. RWE has decided to IPO the American business first, and subsequently to start the process of selling the UK activities, likely to be either through a sale to a financial investor with a long-term view or via a listing on the stock market. The disposals are both subject to approval from national regulators in US and the UK. RWE's objective is to complete both divestments by the end of 2007.

Figure 2: Overview of Planned Divestments and Continued Water Activities



Management Strategy

THE ANNOUNCEMENT OF THE SALE OF THE WATER ACTIVITIES REPRESENTS A PIVOTAL CHANGE IN RWE'S STRATEGY ...

Over the past few years, management has been pursuing a strategy to be a leading international multi-utility delivering steady financial growth. When this strategy was launched it involved a reshuffle of RWE's business portfolio with a series of acquisitions and divestments of non-core activities to create a broadly based international energy and water utility. In November 2005, however, RWE announced a change in its strategic direction, involving the sale of most of RWE's water division. The regulated water businesses, acquired in 2000 (Thames Water) and 2003 (American Water), contributed to the Group's performance as a stabilising factor in the portfolio during the downturn in the German energy market, but it became apparent that there were few synergies between RWE's energy and UK/US water businesses. In addition, these businesses had high and continuing capital requirements and, relative to energy, lower returns on invested capital. Against this background, and with the view that the full value of the water activities were not being recognised within the RWE Group, management decided to dispose of the regulated water activities and focus on energy.

... WITH PROCEEDS UTILISED TO REDUCE DEBT, PAID OUT IN HIGHER DIVIDENDS AND TO BE REINVESTED ...

RWE's management has announced that it intends, subject to the completion of the disposal processes for the RWE Thames and American Water and the availability of funds, to utilise the proceeds from the divestments by:

- Increasing the dividend payout ratio for the fiscal years 2006 and 2007 to between 70% and 80% of the recurrent net income in order to return funds to shareholders. Following these two exceptional increases, the payout ratio will be reviewed from 2008 onward, with a 50% payout ratio as the lower limit;
- Not refinancing the financial liabilities maturing during 2006 and 2007 (approximately €5 billion of bonds and bank debt);
- Examining potential acquisition and investment opportunities to develop its core electricity and gas interests in the European region, whilst ensuring that RWE's strict investment criteria are met.

... IN ITS CORE POWER GENERATION AND GAS ACTIVITIES

Following the sale of the UK and American water business, RWE's activities will be focused on its core electricity and gas competencies in the European region. As noted above, the divestment will also create additional financial flexibility which is likely to be utilised by investing in new assets, upgrading existing assets and acquisitions in RWE's core Europe's energy market.

Strengthening RWE's position in power generation and grid networks will be a top priority over the next five years, and RWE Power has announced an annual €1.8 billion capital expenditure plan for the period 2006-2010. This expenditure will be directed primarily towards the construction of new power plants in Germany and increasing RWE Dea's oil and gas production. This latter objective links into RWE's plan to expand its European gas and liquid natural gas ("LNG") activities, where the Group aims to connect its existing gas production areas in North Africa with its core gas demand in the European region. In the UK, RWE npower will invest €600 million per year from 2006 to 2010 to modernise its power plant portfolio and reduce its emissions. On the grid side, RWE Energy has planned €1.1 billion capital expenditure per year in order to modernise and expand the electricity and gas grids. Overall, RWE is planning to invest around €3.5 billion per year in capital expenditure over the next five years, of which 25% relates to growth projects.

Key Rating Considerations

RWE's financial profile is underpinned by an improving trend, and a business risk profile that combines RWE's strong and vertically integrated electricity and gas supply business in Germany as well as a substantial regulated asset base that generates predictable and strong cash flows. Whilst the disposal of the water activities will result in the loss of the regulated cash flow from the water activities, Moody's recognises that, even after the sale, approximately one-third of the Group's operating cashflow will still be generated from RWE's regulated activities.

RATINGS ARE SUPPORTED BY STABLE CASHFLOWS GENERATED FROM LEADING MARKET POSITIONS

RWE's ratings are supported by the cashflows generated by its leading positions in the German energy market, where it is the largest generator and the second-largest electricity and gas supplier, and in the UK energy market where it is third-largest electricity and gas supplier. The company's ratings are also supported by its monopoly in Czech gas transmission as well strong positions elsewhere in Eastern Europe. These leading positions generate stable cashflows not only through the nature of the utility cashflows but also through their scale and market influence. Overall, in 2005 approximately 50% of RWE's EBITDA was derived from credit supportive regulated activities; although after the disposal of RWE's main water activities, the proportion of regulated EBITDA is expected to fall to approximately one-third.

VERTICAL INTEGRATION UNDERPINS RWE'S POSITION IN VOLATILE PRICING ENVIRONMENTS

RWE is one of the most vertically integrated of Europe's energy utilities in terms of both the supply of underlying commodity fuels and supply-demand balance. This integration mitigates RWE's exposures from the significant commodity price movements that have occurred over the past few years, thereby increasing the stability of its long-term cashflows. Approximately 25% of RWE's generation capacity is underpinned by its lignite operations, and the production of RWE Dea represents around 15% of RWE's gas supply requirements. In electricity supply, RWE itself generated nearly 220 TWh and sold, excluding electricity trading, approximately the same volume.

Business Risk Factors

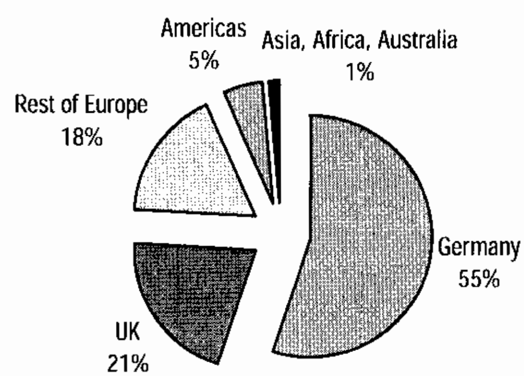
THE DIVESTMENT OF WATER ACTIVITIES IS EXPECTED TO RESULT IN AN INCREASE IN BUSINESS RISK

The divestment of the UK and American regulated water companies will remove a business that Moody's generally considers to be one of the lowest business risk activities and which has, in the past, supported RWE's low business risk assessment. As a result, Moody's expects that RWE's overall business risk will rise. This reflects our expectation that RWE's share of cashflow from regulated activities will fall, although we note that RWE's generation-to-supply balance and vertical integration are credit supportive. The inflow of funds from the disposals is expected to compensate for part of this increase in business risk, although Moody's is waiting to see how these funds will be utilised, and assumes that RWE will seek to maintain a prudent risk profile in its planned expansion of European electricity and gas activities.

GEOGRAPHIC DIVERSIFICATION INTO SELECTED EUROPEAN MARKETS SUPPORTS RWE'S CREDIT RATING

As at December 2005, 45% of RWE's revenues are outside Germany, principally the UK and rest of Europe. Following the planned exit from UK and North American water activities, RWE's utility interests will be limited to gas and electricity operations in its domestic German market, the UK and four Central Eastern European countries (Poland, Czech Republic, Hungary and Slovakia). This will serve to reduce RWE's geographic diversity, although Moody's expects this to be only temporary as reinvestment is likely to be outside Germany. Regions of potential future interest are likely to be clustered around its existing core and could include the Netherlands and the current and future EU member states in Central and Eastern Europe. In Moody's opinion, diversification from a single geographical market and business activity and the well-balanced presence in selected and stable European markets supports RWE's credit.

Figure 3: Revenue by Region 2005



RWE'S DIVERSIFIED GENERATION MIX PROVIDES A VALUABLE HEDGE FROM VOLATILE MARKETS

The European wholesale market for electricity and gas has seen a significant recovery in prices over the past three years. German baseload electricity prices have risen from the low €20/MWh in early 2003 to an average of €46/MWh in 2005, whilst UK baseload prices have risen from below GBP20/MWh to above GBP50/MWh in Q2 2006. At the same time oil, gas, coal and carbon prices have seen substantial increases and significantly movements relative to each other, thereby changing the relative economics of generation. RWE - with approximately one-third of the German generation market and a diversified generation portfolio including principally coal, gas, lignite and nuclear (as shown in figure 4 below) - has benefited, both from the price increases and the volatility. Moody's notes, however, that due to RWE's conservative hedging strategy of locking in 90% of prices 12 months in advance and around 50% 24 months in advance, will result in a gradual unwinding of this benefit. Moody's will continue to monitor the direction of the wholesale market and its impact on RWE's credit profile.

Figure 4: RWE Installed Generation Capacity as at 31 December 2005

Installed Capacity	Germany MW	International MW	UK MW	Total MW	Total %
Coal	9,580	0	4,415	13,995	32%
Lignite	10,135	714	0	10,849	25%
Nuclear	6,308	0	0	6,308	15%
Gas	4,133	1	2,962	7,096	16%
Oil, Hydro & Other	3,262	222	1,537	5,021	12%
Total	**33,418**	**937**	**8,914**	**43,269**	**100%**

Moody's also notes that RWE has a number of long-term power procurement arrangements, accounting for approximately 10% of its generation capacity, which are not reflected on RWE's balance sheet. A proportion of these contracts are with Steag, a subsidiary of RAG, from whom RWE purchases approximately 85% of Steag's output of around 22 TWh. The Steag contracts are structured on a costs plus rate of return basis, and whilst RWE does not necessarily take all the risks of ownership, it does take the reward from an increasing wholesale price.

NUCLEAR GENERATION COULD ENHANCE RWE'S CREDIT

Over the last decade or so nuclear generation has been out of favour in Germany. However, with the increasing price of fossil fuels, increasing wholesale electricity prices and the introduction of carbon taxes, nuclear generation has become increasing attractive. National governments are also beginning to recognise these benefits and an extension of the German nuclear plants' operating lives has been mooted. Moody's regards such a possibility positively, but we recogise that it would not result in an immediate improvement of RWE's cash flows.

With 6,300MW of nuclear generation in Germany, life extensions would generate additional cash beyond the currently expected life of the nuclear plants with limited additional operating costs on "sunk cost" investments. Whilst the impact would be longer term, as cash would not be generated for a number of years, there would be an improvement in RWE's credit metrics because of a reduction in the net present value of nuclear decommissioning provisions. Overall, Moody's expects that a nuclear life extension would improve the quality of RWE's credit, but that with the current German political situation any consensus may take some time to emerge. Moody's will monitor these areas for developments that could affect RWE's financial profile in the medium term.

CARBON TAXES ARE A REALITY, BUT THEIR LONG-TERM IMPACT IS NOT YET CLEAR

The European Union Emission Trading Scheme commenced operation on 1 January 2005. EU-member countries have allocated carbon credits to their industrial carbon dioxide emitters who must balance their carbon output with their allocated carbon credits. Emissions in excess of allocation will result in the emitter having to buy credits in the market. Carbon prices, which were around €7-8/tonne carbon on 1 January 2005, posted record highs of nearly €30/tonne carbon in early July, and then stabilised around mid to high €20/tonne carbon. Recent falls in carbon prices back into the mid-teens raises questions about the long term signals given to the market given the uncertainties and volatility.

RWE was allocated certificates for about 130 million tonnes of $CO2$ in Germany and the UK in 2005, whilst its power plants emitted about 142 million tonnes of $CO2$, with a consequent purchase requirement of 12 million tonnes of carbon certificates in the wholesale market.

Overall, Moody's does not expect RWE to be materially effected by carbon prices despite its significant coal generation component (55% of generation is coal and lignite - see Figure 4 below) due to its allocation of carbon credits and the current gas/coal fuel price differentials. Moody's believes that the new regime will in time impact behaviours and, potentially, capital expenditure choices and we will continue to monitor how the market evolves.

THE DEVELOPMENT OF EUROPEAN ENERGY REGULATION, PARTICULARLY IN GERMANY, CREATES SOME UNCERTAINTY

The new German Energy Act (EnGW) entered into force in July 2005. The regulatory approval of grid fees is expected in April 2006 for electricity and July 2006 for gas, whilst the detailed rules for access to the gas grid are still under discussion and are likely to be introduced in October 2006. In Moody's view, the regulatory intervention will increase transparency in the market over the medium term and will cause a fall of the transmission grid fees, particularly in gas. This is unlikely to be good news for the grid owners and incumbent suppliers of electricity who may witness increased competition as third parties gain grid access and lower revenues on their existing assets. However, Moody's expects that any erosion of RWE's revenue base may be offset to a large extent by cost reduction and efficiency enhancement.

Moody's will carefully monitor the development of the regulatory process and be alert for changes that could affect the financial profile of RWE in the medium term.

RWE NPOWER REMAINS A RELATIVELY WEAK LINK IN THE GROUP

RWE npower, RWE's UK business is the number three player in the unregulated electricity generation, and electricity and gas supply business. RWE npower remains short generation in a market where wholesale prices are rising and is not currently, by RWE's own estimates, covering its cost of capital. Moody's expects that growth from RWE npower will likely be hard to achieve in the short term although RWE appears to have recognised RWE npower's position and higher business risk profile, and is planning to invest in additional generation assets in the UK.

MANAGEMENT'S CHALLENGE IS TO ACHIEVE GROWTH WITHIN ITS STRICT INVESTMENT CRITERIA

The availability of additional resources and the increased financial flexibility following the sale of the water activities will create room for acquisition opportunities in order to achieve RWE's objectives of value creation. The challenge for management is meeting its strict investment criteria to ensure that the return on capital employed (ROCE) of acquired activities meets RWE's cost of capital no later than in the third year of ownership (including goodwill).

RWE has announced that potential growth through acquisitions will be matched by the continued focus on the delivery of cost reduction measures, with the stated objective of achieving €680 million of cost efficiencies by 2006 (€450 million of cost savings and synergies secured in the period 2003-2005). The objectives of 5% growth in organic operating results per annum and ROCE of 14% are also confirmed.

Financial Risk Factors

RWE HAS IMPROVED ITS FINANCIAL PROFILE OVER THE PAST FEW YEARS

RWE's management has delivered on its policy outlined in 2003 to integrate its acquisitions and concentrate on disposing of non-core assets, reducing RWE's balance sheet reported unadjusted net debt from around €23 billion to below €12 billion by the end of 2005. This has improved RWE's cash generation and has created a profile that is moving sustainably towards ratios in the A1 rating category for a low business risk company. Moody's notes that, whilst the disposal of the water businesses is expected to generate additional financial flexibility in the future, it is likely to result in an increase of RWE's business risk towards the medium category, and consequently will require relatively stronger credit metrics for RWE to maintain its A1 rating.

Figure 5: RWE Financial Ratio Analysis

Eur Million	2004	2005
Gross Cash Flow before WC changes as reported	5,551	5,232
Gross Cash Flow related to discontinued operations	0	341
Interest related to put options & commitments	-36	-42
Two-Thirds of operating lease expenses	54	51
Cash Flow from Operations (FFO) as adjusted by Moody's	**5,569**	**5,581**
Dividends	-939	-1,070
Retained Cash Flow (RCF)	**4,630**	**4,511**
Eur Million	**2004**	**2005**
Interest expense as reported	2,247	2,193
Pensions and nuclear waste management	701	625
Operating Leases	27	25
Purchase Commitments	60	70
Interest expense as adjusted*	**3,035**	**2,913**
Adj. FFO Interest Coverage	**2.8x**	**2.9x**

* *Moody's attributes an interest expense, using a borrowing rate of 3.49% in 2005 and 3.78% in 2004, to the adjustments made to debt.*

Figure 5: RWE Financial Ratio Analysis (continued)

Eur Million	2004	2005
Gross Financial Debt	27,383	27,452
Cash & Marketable Securities	-13,575	-12,787
Net Financial Debt	**13,808**	**14,665**
Operating Leases	533	469
Pensions & Nuclear Liabilities (net of equity credit)	18,541	17,903
Swaps treated as synthetic debt (hedge for investments)	-2,024	-1,267
Guarantees, etc	743	186
Irrevocable purchase commitments	1,580	2,376
Net Adjusted Financial Debt incl. Nuclear Liabilities	**33,181**	**34,332**
Net Adjusted Financial Debt excl. Nuclear Liabilities	**25,201**	**27,204**
Adj. FFO/Net Adj Debt (incl. nuclear liabilities)	**16.8%**	**16.3%**
Adj. FFO/Net Adj Debt (excl. nuclear liabilities)	**22.1%**	**20.5%**
Adj. RCF/Net Adj Debt (incl. nuclear liabilities)	**14.0%**	**13.1%**
Adj. RCF/Net Adj Debt (excl. nuclear liabilities)	**18.4%**	**16.6%**

RISING SHAREHOLDER DISTRIBUTIONS

For the year ended 31 December 2005, RWE increased its dividend by 17% after a 20% increase in 2004 (with a pay-out ratio increasing to 44% of recurrent net income) and, following the sale of the water activities, it plans to increase the dividend payout ratio for 2006 and 2007 years to between 70% and 80% of the recurrent net income. The payout ratio will again be reviewed from 2008 onward, with a 50% lower limit. Whilst more shareholder-friendly policies will not necessarily alter the balance between debt- and equity-holders, Moody's notes that it is generally easier to raise dividends than to cut them. Moody's currently assumes that, following the sale of the water activities, share buybacks will not occur.

THE TRADING DIVISION IS CONSERVATIVELY MANAGED

RWE undertakes large quantity of trading and hedging, both to mitigate its exchange- and interest-rate risks and to mitigate its commodity risk exposures. Whilst Moody's recognises that trading is a tool that can enhance operating efficiency, if not properly controlled it has the potential to cause material financial loss. Moody's recognises RWE's culture of strong financial discipline and clear guidelines for risk and control as well as its integrated generation to supply model, which mitigate the trading risk and the exposure to commodity risk.

RWE'S BALANCE SHEET HAS SIGNIFICANT LIABILITIES

RWE has substantial nuclear decommissioning and pension liabilities. On the year-end balance sheet at 31 December 2005 these amounted to €8.7 billion of nuclear provisions and €12 billion of pension liabilities, together totalling €20.7 billion. Whilst Moody's makes an adjustment net of an equity credit of €17.9 billion for these liabilities in its calculation of net adjusted debt, it is recognised that much of these liabilities are very long term. For example, the nuclear provisions are expected to be utilised over a period of 80 years. Moody's also notes, however, that there is considerable uncertainty over the size of these provisions (due to technical uncertainty and a lack of knowledge of future costs), as regards when they may fall due and the returns on the assets to pay for them. Nonetheless, they will require funding in the future and are treated by Moody's as debt-like. The rating agency notes that RWE's provisions are among the highest in the industry at nearly €1.4 million per MW.

LIQUIDITY REMAINS STRONG

With nearly €12.8 billion in cash, cash equivalents and marketable securities as at December 2005, and additional proceeds to be received following the planned divestment of the water division, RWE has the financial flexibility to fund its long-term pension and nuclear liabilities as well as its shorter term liquidity requirements and debt repayments. Figure 6 below shows RWE's debt structure and maturities as at December 2005. The Company plans to use the proceeds from the divestment of its water activities with the objective of not refinancing most of its financial liabilities maturing prior to 2008 (approximately €5 billion of bonds and bank debt).

Figure 6: RWE's Debt Structure as at 31 December 2005

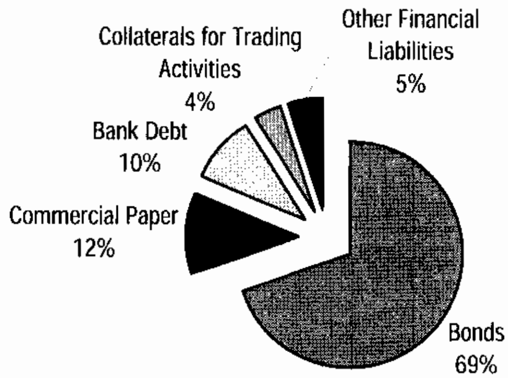
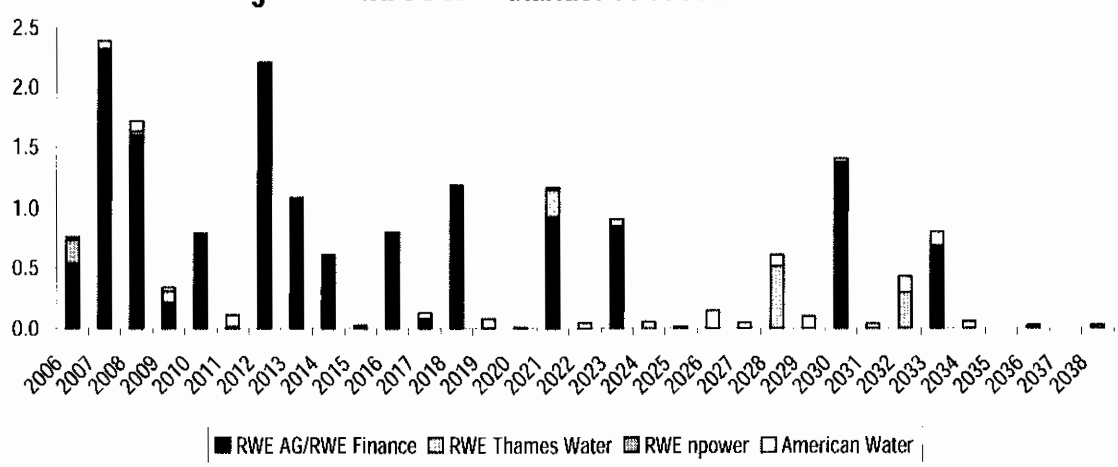


Figure 7: RWE's Debt Maturities as at 31 December 2005



RWE's liquidity is further supported by a €4 billion facility with no financial covenants which is available to fund its future financial needs. In addition, at 31 December 2005, RWE had a commercial paper programme (US$5 billion, with currently US$3.8 billion outstanding) and a medium-term note programme (€20 billion, of which €15.2 billion outstanding). RWE's weighted average maturity profile is 11 years.

RATING POSITIONING & PEER COMPARISONS

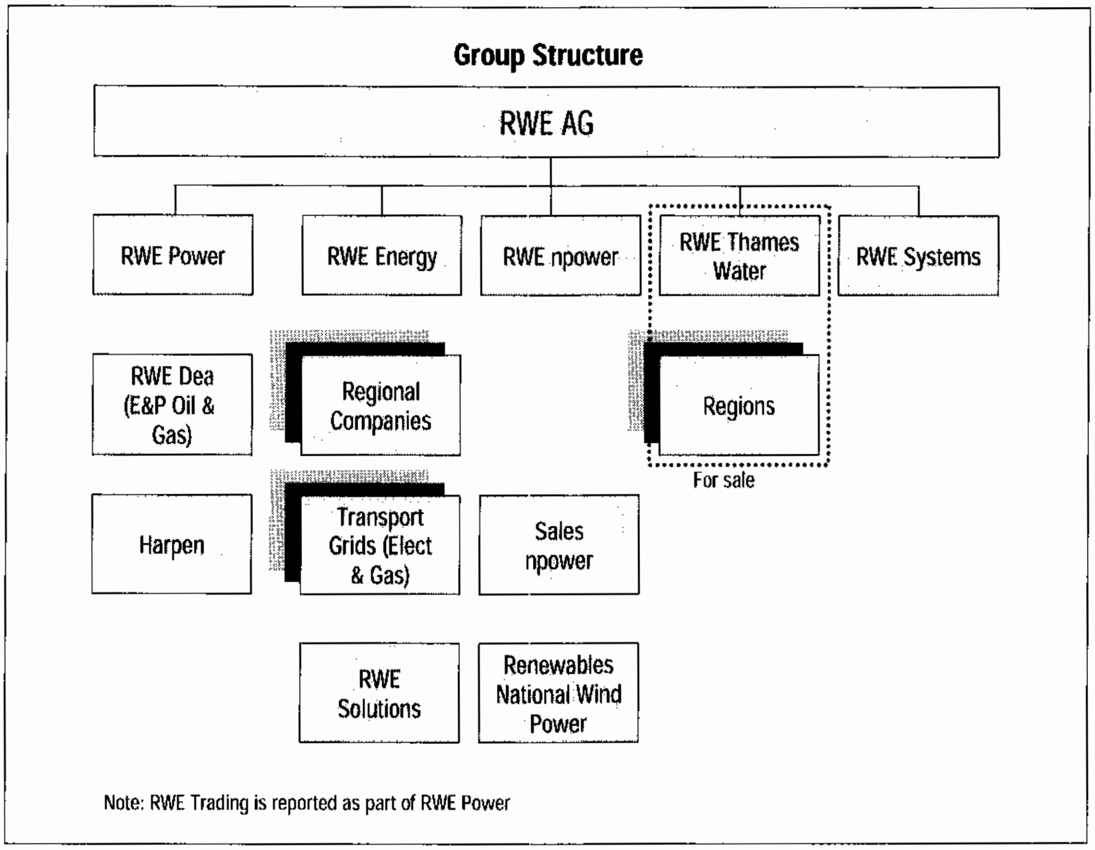
Based on the peer analysis shown below which utilised historic numbers, RWE appears to be weakly positioned in its rating category compared to its peers. However, this analysis neither reflects the forward-looking nature of ratings nor the expectation - resulting from RWE's announced disposal of water businesses and improving operating performance - that debt protection measures are anticipated to show a marked improvement over the next few years. Furthermore, RWE is underpinned by its conservative business approach and its scale, all of which indicate that RWE can exhibit debt protection measures that may be somewhat lower than some of its peers.

Figure 8: Peer Comparisons - 2004 Financial Indicators

Company	Ratings	Adj. FFO/Net Adj. Debt	Adj. RCF/Net Adj. Debt	FFO Interest Coverage
RWE*	A1/P-1/Stable	16.8%	14.0%	2.8x
EDF	Aa1/P-1/Stable	21.4%	20.5%	7.6x
E.ON	Aa3/P-1/Urd	28.8%	21.2%	5.5x
Enel	Aa3/Stable	16.5%	2.4%	4.9x
Verbund	A1/Stable	20.8%	17.9%	3.0x
EWE	A2/Stable	19.6%	15.6%	7.5x
Iberdrola	A2/P-1/Urd	20.0%	14.0%	5.1x

** Please note that RWE FFO and RCF are calculated before WC changes and net adjusted debt calculation is consistent with Moody's new methodology on pensions and nuclear liabilities*

Appendix


Group Structure
RWE AG
RWE Power
RWE Energy
RWE npower
RWE Thames Water
RWE Systems
RWE Dea (E&P Oil & Gas)
Regional Companies
Regions
For sale
Harpen
Transport Grids (Elect & Gas)
Sales npower
RWE Solutions
Renewables National Wind Power
Note: RWE Trading is reported as part of RWE Power

Related Research

Rating Methodologies:

Global Regulated Electric Utilities, March 2005 (91730)

The Analysis of Off-Balance Sheet Exposures - A Global Perspective, July 2004 (87408)

Industry Outlooks:

European Gas, February 2006 (96548)

European Electricity, October 2005 (94486)

Special Comments:

The Ratings Implications of the IRS's Changes of the Simplified Service Cost Method Rules for Electric Utilities, March 2006 (96897)

Corporate Europe: 2004 Review & 2005 Outlook, December 2004 (90074)

Financial Reporting Assessments:

Moody's Adjustment to RWE's Accounts, September 2004 (88944)

Moody's Adjustment to RWE's Accounts, November 2005 (95455)

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Author	Editor	Associate Analyst	Production Associate
Nick Curtis	*Wendy Arthur*	*Raffaella Altamura*	*Yelena Ponirovskaya*