

**EVIDENCE**

**06-0336**

IAWC Exhibit 2.4R

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**Research Update:**

**American Water Works Assigned 'A-' Corporate Credit Rating, On Watch Neg**

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**Rationale**

On Oct. 13, 2006, Standard & Poor's Ratings Services assigned its 'A-/A-2' corporate credit rating to American Water Works Co. Inc. At the same time, Standard & Poor's affirmed its 'A-' rating on American Water Capital Corp., a wholly owned subsidiary of American Water Works, that serves as the funding vehicle for American Water Works' regulated water utility subsidiaries. Standard & Poor's also assigned its 'A-2' rating to American Water Capital's \$700 million commercial paper program.

The ratings on American Water Works were placed on CreditWatch with negative implications. The ratings on American Water Capital are also on CreditWatch with negative implications, where they were placed on Nov. 7, 2005.

The ratings on the companies will remain on CreditWatch until the completion of the sale of American Water Works by parent RWE AG (A+/Negative/A-1), which is expected in 2007. The CreditWatch listing reflects continued uncertainty surrounding the extensive regulatory process associated with approving the sale, the need for an updated business plan, and completion of significant debt and equity offerings.

The ratings on American Water Works and American Water Capital reflect the stand-alone credit quality of American Water Works. American Water Works' stand-alone business risk profile is '2' (excellent). (Utility business profiles are categorized from '1' (excellent) to '10' (vulnerable)). The strength of the business profile stems from insulation from competition, geographically diverse and largely residential markets, supportive regulatory environment, and the relatively low operating risk of managing groundwater and water treatment facilities. Uncertainty associated with American Water Works' IPO in 2007, increasingly stringent water quality standards, and the company's reliance on acquisitions to provide growth partly offset its strengths.

American Water Works' stand-alone financial risk profile is intermediate and includes management's projected post-IPO debt-to-capital ratio of 45% to 55%. We will reassess the financial risk profile when additional information is available concerning the company's post-IPO business plan and capital structure.

Historical earnings and margins are stable, supported by healthy markets and regulatory recovery of operating and capital costs, although increased operating and capital expenses can lag regulatory recovery. For the past five years, funds from operations (FFO) to debt has been about 10% and FFO interest coverage was in the 1.5x to 2.5x area. Given the business risk profile of '2', American Water Works' cash flow metrics are somewhat weak for the 'A-' rating.

In RWE's investor presentation related to the sale of its water businesses, the company stated that its North American Water segment, which includes some operations outside of American Water Works, plans to spend \$3.6 billion on capital expenditures from 2005 to 2009, compared with about \$500 million per year recently. American Water Works' increased capital spending is needed to upgrade aging water systems, accommodate population and economic growth, and comply with environmental regulations. RWE projects negative free cash flow and external financing to fund the higher capital spending. Over the intermediate term, continued customer growth and regulatory rate increases

could improve credit measures. However, improvements could be hindered if future regulatory rate increases do not keep pace with the company's increased capital spending.

#### Short-term credit factors

The 'A-2' short-term rating on American Water Works and American Water Capital reflects:

- Adequate consolidated liquidity,
- Stable cash flows from regulated subsidiaries,
- American Water Capital's \$800 million revolving credit facility, which matures on Sept. 15, 2011 (excluding extensions), and
- Manageable debt maturities over the next few years.

American Water Works has maintained adequate cash balances, typically exceeding \$50 million, although future levels could differ after the sale by RWE. Uses of American Water Capital's \$800 million revolving credit facility, which matures on Sept. 15, 2011, are targeted for backup to the company's \$700 million commercial paper program and LOCs, as needed. Financial covenants in the revolving credit facility include a maximum debt to capital (with adjustments) of 70% and restrictions on liens, distributions, debt incurred at American Water Works, and asset sales. The change of control provision is more restrictive than most revolving credit agreements as a change of control is defined as one entity owning 25% or more of the post-IPO outstanding common stock or certain majority changes to the membership of the board of directors.

## Ratings List

### Ratings Assigned

American Water Works Co. Inc.  
Corporate credit rating                      A-/Watch Neg/A-2

American Water Capital Corp.  
Commercial paper rating                      A-2

### Ratings Affirmed

American Water Capital Corp.  
Corporate credit rating                      A-/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); under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search.

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