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ILLINOIS COMMERCE COMMISSION

ORIGINAL

American Water

Mary G. Sullivan
Corporate Counsel
Central Region

October 8, 2007

Ms. Elizabeth A. Rolando
Chief Clerk
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701

Report

RE: Docket No. 06-0336

Dear Ms. Rolando:

We are providing a September 19, 2007 credit report from Standard and Poor's.

If I can be of further assistance, please let me know.

Very truly yours,

Mary G. Sullivan

Mary G. Sullivan
Corporate Counsel

cc: Mary Selvaggio

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RWE Group

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September 19, 2007

Research Update:

American Water Works 'A-' Corp Rating Is Affirmed, Off Watch, Outlook Neg; Debt Issues Rated

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Research Update:

American Water Works 'A-' Corp Rating Is Affirmed, Off Watch, Outlook Neg; Debt Issues Rated

Rationale

On Sept. 19, 2007, Standard & Poor's Ratings Services affirmed its 'A-' corporate credit rating on American Water Works Co. Inc. (AWW) and its funding subsidiary, American Water Capital Corp. (AWCC). The ratings were removed from CreditWatch with negative implications. The outlook is negative.

The rating action reflects the stand-alone credit quality of AWW, which has received all regulatory approvals necessary for its parent RWE AG (A+/Negative/A-1) to sell the company via an IPO in late 2007. The rating action also reflects our reassessment of AWW's financial risk profile, based on the company's post-IPO business plan and proposed capital structure.

At the same time, Standard & Poor's assigned its 'A-' senior unsecured debt rating to AWCC's proposed $1.5 billion debt and 'BBB' preferred stock rating to AWCC's $500 million proposed equity unit offering. The specific amount of five-year, 10-year, and 30-year notes has not yet been determined.

AWW's subsidiary debt of $2.1 billion is less than 20% of the company's assets, after adjusting for goodwill. Therefore, the senior unsecured debt issued by the holding company does not merit a lower rating due to structural subordination. However, there is little cushion for additional subsidiary obligations before the 20% threshold would be breached.

The equity unit consists of a debtlike component, the payment of quarterly interest, and a forward common stock purchase contract with the number of shares dependent on AWW's stock price at maturity. We treat the equity units as two financings rather than a single "net" equity financing. Although the transaction incorporating the equity issuance could theoretically be applied to repaying the debt, there is no legal or in-substance defeasance, or any other basis to expect that this will be the case, as there are also remarketing provisions available for the debt portion of the security.

AWW's excellent business risk profile of '2' (Utility business profiles are categorized from '1' (excellent) to '10' (vulnerable)) is characterized by:

- An excellent competitive position with high barriers to entry;
- A supportive regulatory environment;
- An above-average service territory in terms of size and interconnections;
- A stable customer base that is predominantly residential and commercial; and
- The relatively low operating risk of regulated and nonregulated operations.

These strengths are partly offset by uncertainties associated with AWW's weak financial profile, planned IPO and debt offerings, elevated capital-spending requirements for infrastructure replacement, increased

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compliance costs with water quality standards, and the company's reliance on acquisitions to provide growth partly offset its strengths.

AWW is currently indirectly owned by RWE, and through its regulated subsidiaries, provides water and wastewater services to more than 3.3 million customers in 20 states. The company's regulated utility subsidiaries represent almost 90% of total revenues and have provided almost 100% of adjusted EBIT for the past three years. The company's nonregulated subsidiaries include the management and maintenance of water and wastewater facilities, and the 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 limited revenue and cash flow contribution, modest expected capital requirements, and contractual terms, which are largely with a municipal or governmental entity.

AWW's financial metrics are weak for the current rating. The weak financial measures are partly attributed to agreements not to file rate cases with some state regulators for up to three years as a condition of RWE's acquisition of the company. Another reason for the weak performance is AWW's goodwill impairments of more than $700 million recorded over the past three years. The impairments were based on downward adjustments to the growth expectations in RWE's North America water segment, slower-than-expected privatization of water utilities in North America, and valuation of its nonregulated businesses. All of the stay-out provisions expired on June 30, 2007, and AWW is expected to actively pursue rate cases in all jurisdictions as determined by its rising operating costs, capital-spending plans, and pension and other postretirement obligations. As of June 30, 2007, AWW's pro forma total debt, including capitalized operating leases and tax-effected pension and postretirement obligations, was about $5.3 billion, with adjusted debt to capital of 53%. For the 12 months ended Dec. 31, 2006, adjusted funds from operations (FFO) was $460 million and FFO interest coverage was 2.6x, which are appropriate figures for the current rating. However, adjusted FFO to total debt of 9% is well below the minimum expectation of 12% for the 'A' category. In addition, significant rate relief is necessary for the company to earn its authorized rate of return, which is about 10%.

Although AWW's subsidiaries recover underfunded pension and postretirement benefit obligations through regulatory deferrals, AWW's consolidated pension and other postretirement obligations were underfunded by $459 million as of Dec. 31, 2006, the last reported date.

Short-term credit factors

The 'A-2' short-term rating on AWW and AWCC reflects:

- Adequate liquidity sources;
- Stable cash flows from regulated subsidiaries;
- The expectation of regulatory support to fund the company's sizable capital-spending requirements through rate cases or supportive policies such as infrastructure surcharges, forward-looking test years, and single tariff pricing; and
- Meaningful debt maturities over the next few years.

As of June 30, 2007, AWW had $51 million in cash, about $740 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, which matures on Dec. 31, 2007, unless extended. 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 AWW, 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.

Over the past three years, cash flow has steadily declined due to the regulatory stay-out provisions implemented after the company's acquisition by RWE. We expect adjusted FFO, which was subpar at $460 million in 2006, to benefit from continued customer growth and rate increases in several key states. AWW's uses of cash include high levels of capital spending, substantial upcoming debt maturities, and expectations that the company will institute a common stock dividend on completion of its proposed IPO. Capital expenditures are projected at $4 billion to $4.5 billion for the next five years for infrastructure replacements, construction of new facilities, maintenance of water quality and environmental standards, and system reliability. For 2007, the company has forecast capital spending of between $740 million and $780 million. Despite the current debt and equity issuances, 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. Before the IPO and refinancing of its debt obligations, AWW's scheduled debt maturities of $287 million and $196 million in 2007 and 2008, respectively, are fairly sizable. We expect AWW's dividend policy to roughly match the average dividend yield of other companies in its peer group, which is about 2%, and, therefore, annual dividend payments could exceed $100 million.

Outlook

The outlook on AWW is negative. The negative outlook reflects the company's current weak financial profile. A downgrade could occur if the pending rate cases, particularly in New Jersey and Pennsylvania, do not allow for adequate rate relief to improve the company's financial profile, the company is unable to complete its planned debt and equity offerings and achieve its stated leverage target in the near term, or if debt leverage steadily increases over the intermediate term. Conversely, we could revise the outlook to stable if AWW's financial profile improves through favorable regulatory rate increases at current ROEs, with limited additional debt leverage.

Ratings List

Ratings Affirmed, Off Watch, Outlook Negative

	To	From

American Water Works Co. Inc.		
Corp. credit rating	A-/Negative/A-2	A-/Watch Neg/A-2
American Water Capital Corp.		
Corp. credit rating	A-/Negative/A-2	A-/Watch Neg/A-2
Senior unsecured debt	A-	BBB+/Watch Neg

Ratings Assigned

Preferred Stock	
$500 million equity units	BBB
Senior unsecured debt	
$1.5 billion senior unsecured debt	A-

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