DIRECT TESTIMONY

OF

ROCHELLE PHIPPS

FINANCIAL ANALYSIS DIVISION

FINANCE DEPARTMENT

ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY

PETITION FOR AUTHORITY TO INCUR $28,500,000 OF INDEBTEDNESS AND

APPROVAL OF AFFILIATED INTEREST TRANSACTION

DOCKET NO. 07-0371

NOVEMBER 8, 2007

1. Q. Please state your name and business address.

A. My name is Rochelle Phipps. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

2. Q. By whom are you employed and in what capacity?

A. I am employed by the Illinois Commerce Commission ("Commission") as a Senior Financial Analyst with the Finance Department of the Financial Analysis Division.

3. Q. Please describe your qualifications and background.

A. I received a Bachelor of Arts degree in Finance from Illinois College, Jacksonville, Illinois. I received a Master of Business Administration degree from the University of Illinois at Springfield. I have been employed by the Commission since June 2000.

4. Q. What is the purpose of your testimony in this proceeding?

A. I will present my evaluation of Illinois-American Water Company's ("IAWC" or the "Company") proposal to issue up to $28,500,000 of new indebtedness and request for approval of affiliated interest transactions with American Water Capital Corporation ("AWCC") pursuant to Sections

6-102(b), 7-101, 7-102 and 6-108 of the Illinois Public Utilities Act (the "Act").

5. Q. Please summarize your conclusions and recommendations.

A. I do not object to IAWC's proposal to incur up to $28,500,000, of new indebtedness, provided IAWC will issue new indebtedness only to the extent such indebtedness does not reduce IAWC's equity ratio to less than 40% of its total capitalization. Furthermore, I do not object to IAWC's proposal to issue long-term indebtedness through its affiliate AWCC, provided such issuance will result in a lower overall cost to IAWC than would an independent debt issuance by IAWC for securities of comparable type, maturity and terms.

Should the Commission authorize the proposed new indebtedness, I agree with the Company that (1) it will owe a financing fee to the Commission equal to $68,400, pursuant to Section 6-108 of the Act; and (2) it should be required to file with the Commission's Chief Clerk quarterly reports in accordance with 83 Illinois Administrative Code Part 240 ("Part 240"). Finally, I recommend the Commission limit IAWC's authority to incur new indebtedness authorized in the instant docket to a date two

years from the date of the Commission Order authorizing the proposed new indebtedness.

6. Q. Please describe the Company's financing program.

A. IAWC requests authority to issue up to a maximum of $28,500,000 of indebtedness as part of a $51 million financing program that will fund a new surface water treatment facility for the Champaign District (the "Champaign Facility"). Under the Company's proposed financing program, IAWC's parent company, American Water Works Company ("AWW"), will provide IAWC equity infusions totaling $22,500,000. IAWC will not issue any new shares of IAWC common stock in connection with its proposed financing program.[1]

7. Q. Please describe the terms of the proposed indebtedness.

A. IAWC requests authority to issue new indebtedness in one or more transactions, in one or more of the following forms: (1) promissory notes issued pursuant to the Financial Services Agreement between IAWC and its affiliate, AWCC ("Notes"); (2) General Mortgage Bonds ("Taxable Bonds"); (3) loan obligations to a governmental issuer (*i.e.* governmental

[1] IAWC Exhibit No. MJH-1.0 (CORRECTED), lines 65-70 and 136-137.

bodies or political subdivisions of the State of Illinois) in connection with the issuance by the governmental issuer of one or more series of tax-exempt bonds ("Tax-Exempt Bonds); and (4) borrowings from the State of Illinois Public Water Supply Loan Program created under the Illinois Environmental Protection Act ("Revolving Fund Loans"). According to IAWC, the aggregate amount of new indebtedness issued under authority granted in the instant docket will not exceed $28,500,000 outstanding at any time and the Company's common equity to capitalization ratio will not fall below 40%.[2]

8. Q. Do you object to AWCC loaning funds to IAWC in the form of Notes pursuant to the Financial Services Agreement ("FSA")?

A. No. The Commission's Order in Docket No. 04-0582 authorized AWCC to provide to IAWC certain cash management services pursuant to the FSA; prohibited IAWC from engaging in long-term borrowing from AWCC without obtaining further approval to do so pursuant to Sections 6-102 and 7-101 of the Act; and confirmed that approval of the FSA does not restrict IAWC's ability to acquire long-term or short-term capital from sources other than AWCC.[3] In the instant case, IAWC requests authority for

[2] IAWC Exhibit No. MJH-1.0 (CORRECTED), lines 74-92.
[3] Order, Docket No. 04-0582, June 29, 2005, pp. 3-4.

AWCC to fund any Notes to IAWC through long-term senior unsecured debt instruments. According to the Company, AWCC has more ready access to the capital markets than IAWC, which should result in a lower interest rate and financing costs than would an independent debt issuance by IAWC. IAWC also states it will not issue Notes to AWCC unless it can determine that such issuance will result in the lowest overall cost available to IAWC for the securities of comparable type, maturity and terms.[4] That is, the FSA could provide IAWC long-term, unsecured financing at a lower cost than would be available to IAWC as a standalone borrower. Thus, I do not object to IAWC's proposal to issue long-term Notes to its affiliate AWCC pursuant to the FSA approved by the Commission in Docket No. 04-0582.

9. Q. Please describe the interest rate estimates for the new indebtedness.

A. According to IAWC, the interest rates for Notes and Taxable Bonds will not exceed a rate equal to the current yield on U.S. Treasury bonds, plus 200 basis points; the interest rates for Tax-Exempt Bonds will not exceed a rate equal to the most currently available Municipal Market Data Index, plus 100 basis points; and the Revolving Fund Loans will have an interest

[4] IAWC Exhibit No. MJH-1.0 (CORRECTED), lines 183-197; Company response to ICC Staff data request RP 1.06.

rate below the market rates for securities of similar risk. Furthermore, IAWC will insure any Taxable and Tax Exempt Bonds if such insurance reduces the overall cost of new indebtedness vis-à-vis uninsured bonds.[5] I recommend that IAWC should be required to report the actual interest rates for any new indebtedness authorized in the instant docket. Further, in the event that IAWC elects to issue indebtedness through AWCC, the Company should provide a comparison of the costs to issue indebtedness through AWCC (including interest) and the costs the Company estimated it would incur to issue indebtedness directly to investors. The interest rate on the new indebtedness , and if applicable, the cost comparison for the new indebtedness could be either included in the reports filed pursuant to Part 240 or provided in a separate filing. Staff does not have a preference.

10. Q. Please describe how the proceeds from the $28,500,000 issuance of indebtedness will be applied.

A. IAWC indicates the proceeds from the new indebtedness will be used for (1) reimbursing IAWC for expenditures relating to construction or improvements of or additions to its Champaign district facilities; (2)

[5] IAWC Exhibit No. MJH-1.0 (CORRECTED), lines 154-157, 201-203, 213-218, 227-231, 257-261 and 281-282.

refinancing short-term debt incurred to temporarily fund expenditures relating to construction or improvements of additions to its facilities needed to provide adequate and reliable water service, including the new Champaign Facility; and (3) other corporate purposes, including the temporary investment of borrowed funds pending use for purposes stated previously; repayment of principal, interest and debt expense on indebtedness; and costs and expenses related to the design, study, planning, engineering, architect, legal, insurance and surety, materials and supplies, permit and other fees in connection with the Champaign Facility.[6]

11. Q. Does IAWC currently have access to the capital markets on reasonable terms?

A. Yes. Standard & Poor's ("S&P") categorizes debt securities according to the risk that a company will default on its interest or principal payment obligations. The resulting credit rating reflects both the operating and financial risk of a utility.[7] S&P rates both IAWC's parent company, AWW, and its affiliate, AWCC, A-, which reflects AWW's standalone credit quality. According to S&P, an A-rated utility has a strong capacity to meet

[6] IAWC Exhibit No. MJH-1.0 (CORRECTED), lines 95-103; Company response to ICC Staff data request FD 1.04.
[7] Standard & Poor's, "Research: Standard & Poor's Ratings Definitions," December 10, 2002, p. 5.

its financial obligations. S&P notes AWW's financial metrics are weak for the current rating and states the following regarding potential downgrades:

> 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.[8]

Similarly, Moody's Investors Service rates AWCC Baa1 (which is equivalent to a BBB+ rating from S&P, or one notch lower than the A-rating S& P currently assigns AWW and AWCC). Moody's also recognizes AWW's financial metrics are weak for its current rating, but notes that potential downgrades would be limited to two notches, or Baa3, which remains investment grade.[9]

12. Q. Would IAWC's proposed financing program limit its ability to access the capital markets on reasonable terms?

[8] Standard & Poor's, "Research Update: American Water Works 'A-' Corp Rating Is Affirmed, Off Watch, Outlook Neg; Debt Issues Rated," September 19, 2007.
[9] Moody's Investors Service, "Rating Action: American Water Capital Corp.; Moody's Places American Water on Review for Possible Downgrade," August 28, 2007, provided in response to ICC Staff data request RP 2.01.

A. No. In my judgment, IAWC's proposed financing program will not limit its ability to access the capital markets on reasonable terms because under the Company's proposed financing program, AWW will provide IAWC equity infusions as the Company's debt balance increases, which will result in negligible changes to IAWC's capital structure and allow IAWC to maintain an equity-to-capital ratio of between 40% and 50%, as required by the Commission's Order in Docket No. 06-0336.[10]

Moreover, using the Company's June 30, 2007, financial statements,[11] I calculated IAWC's current financial metrics and compared those to pro forma metrics that assume IAWC issues debt and equity totaling $51 million and utilizes the remaining $94 million of refinancing authority granted by a prior Commission Order.[12] To assess the impact the proposed financing program would have on IAWC, I compared the Company's current and pro forma financial metrics to target ranges that S&P uses in its analysis of investor-owned utilities. The target ratios measure financial risk and vary according to business profile score.[13]

[10] Order, Docket No. 06-0336, June 27, 2007, p. 25. Specifically, Condition 9 of the Commission's Docket No. 06-0336 Order states, "For three years following the date of this Order, IAWC will maintain its equity-to-capital ratio between 40% and 50%. If the equity-to-capital ratio falls outside this range, IAWC will notify the Commission in writing within 30 days.
[11] Company response to ICC Staff data request RP 2.03.
[12] Order, Docket Nos. 06-0650/0651 Consolidated, May 16, 2007, granting approval of IAWC's proposed issuance and sale of $198 million of indebtedness pursuant to Section 6-102(d) of the Act.
[13] Standard & Poor's, "Research: New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised," June 2, 2004.

From this comparison, I conclude that the proposed financing program would not materially weaken IAWC's financial metrics. Thus, I do not object to IAWC's proposal to incur up to $28,500,000, of new indebtedness, provided that immediately following each debt issuance, equity infusions from IAWC's parent company will be sufficient to maintain an equity ratio of at least 40%.

13. Q. Why do you recommend the Commission require IAWC to issue any indebtedness authorized in the instant docket within two years of the date of the Commission's Order granting the requested financing authority?

A. IAWC requests authority to issue debt until December 31, 2009, which would allow IAWC to respond to favorable capital market conditions when they arise and to finance the Champaign Facility capital expenditures in an efficient and cost-effective manner.[14] I recommend the Commission limit IAWC's authority to issue new indebtedness to a date two years from the date the Commission issues its Order in the instant proceeding. In my judgment, a two year window in which to issue new indebtedness is appropriate because it mirrors the United States Securities and Exchange

[14] IAWC Exhibit No. MJH-1.0 (CORRECTED), lines 129-131.

Commission requirements that certain registered securities must be issued no later than two years from the registration date. Moreover, in my judgment, two years would still provide IAWC sufficient flexibility to respond to favorable capital market conditions when they arise and to finance the Champaign Facility capital expenditures in an efficient and cost-effective manner.

14. Q. Do you agree with IAWC's calculation of the financing fee due pursuant to Section 6-108 of the Act in connection with the proposed indebtedness?

A. Yes. Provided the Commission grants IAWC's request for authority to incur up to $28,500,000, in new indebtedness, IAWC will owe the Commission a financing fee totaling $68,400, which shall be paid to the Commission within 30 days after service of the Commission Order authorizing the new indebtedness, pursuant to Section 6-108 of the Act.[15]

15. Q. If the Commission grants IAWC authority to issue the proposed indebtedness, should IAWC be required to file financing reports in accordance with 83 Illinois Administrative Code Part 240?

[15] 220 ILCS 5/6-108. $68,400 = $0.24/$100 * $28,500,000.

A. Yes. Furthermore, any reports that IAWC files with the Commission's Chief Clerk in accordance with Part 240 for debt authority granted in the instant docket should specify that they are filed in connection with Docket No. 07-0371.

16. Q. Has IAWC specified how many identification numbers it would need for the proposed indebtedness pursuant to Section 6-101 of the Act?

A. Yes. IAWC requests four identification numbers for the proposed indebtedness.[16]

17. Q. Does this conclude your direct testimony?

A. Yes, it does.

[16] Company response to ICC Staff data request RP 1.09.