

# *Water, Water, Everywhere ... But*

## *The Growing Thirst for Water Utility Investments*

California Water Association – Spring Meeting  
Sacramento, CA  
June 16-18, 2009

Kenneth L. Farer, Director

**CONFIDENTIAL AND PROPRIETARY.**

Permission to reprint or distribute any content from this presentation requires the written approval of Standard & Poor's.

Copyright (c) 2006 Standard & Poor's, a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved.

# U.S. Investor Owned Water Utility Ranking List

Company	Corporate credit rating*	Business risk profile	Financial risk profile
Baton Rouge Water Works Co.	AA/Stable/--	Excellent	Modest
Aqua Pennsylvania Inc	A+/Stable/--	Excellent	Intermediate
California Water Service Co.	A+/Stable/--	Excellent	Intermediate
American States Water Co.	A/Stable/--	Excellent	Intermediate
Golden State Water Co.	A/Stable/--	Excellent	Intermediate
Connecticut Water Service Inc.	A/Stable/--	Excellent	Intermediate
Connecticut Water Co.	A/Stable/--	Excellent	Intermediate
York Water Co.	A-/Stable/--	Excellent	Intermediate
Middlesex Water Co.	A-/Stable/--	Excellent	Intermediate
United Water New Jersey Inc.	A-/Stable/--	Excellent	Significant
United Waterworks Inc.	A-/Stable/--	Excellent	Significant
American Water Works Co. Inc.	BBB+/Stable/A-2	Excellent	Aggressive
American Water Capital Corp.	BBB+/Stable/A-2	Excellent	Aggressive
Pennsylvania-American Water Co.	BBB+/Stable/--	Excellent	Aggressive
New Jersey-American Water Co.	BBB+/Stable/--	Excellent	Aggressive

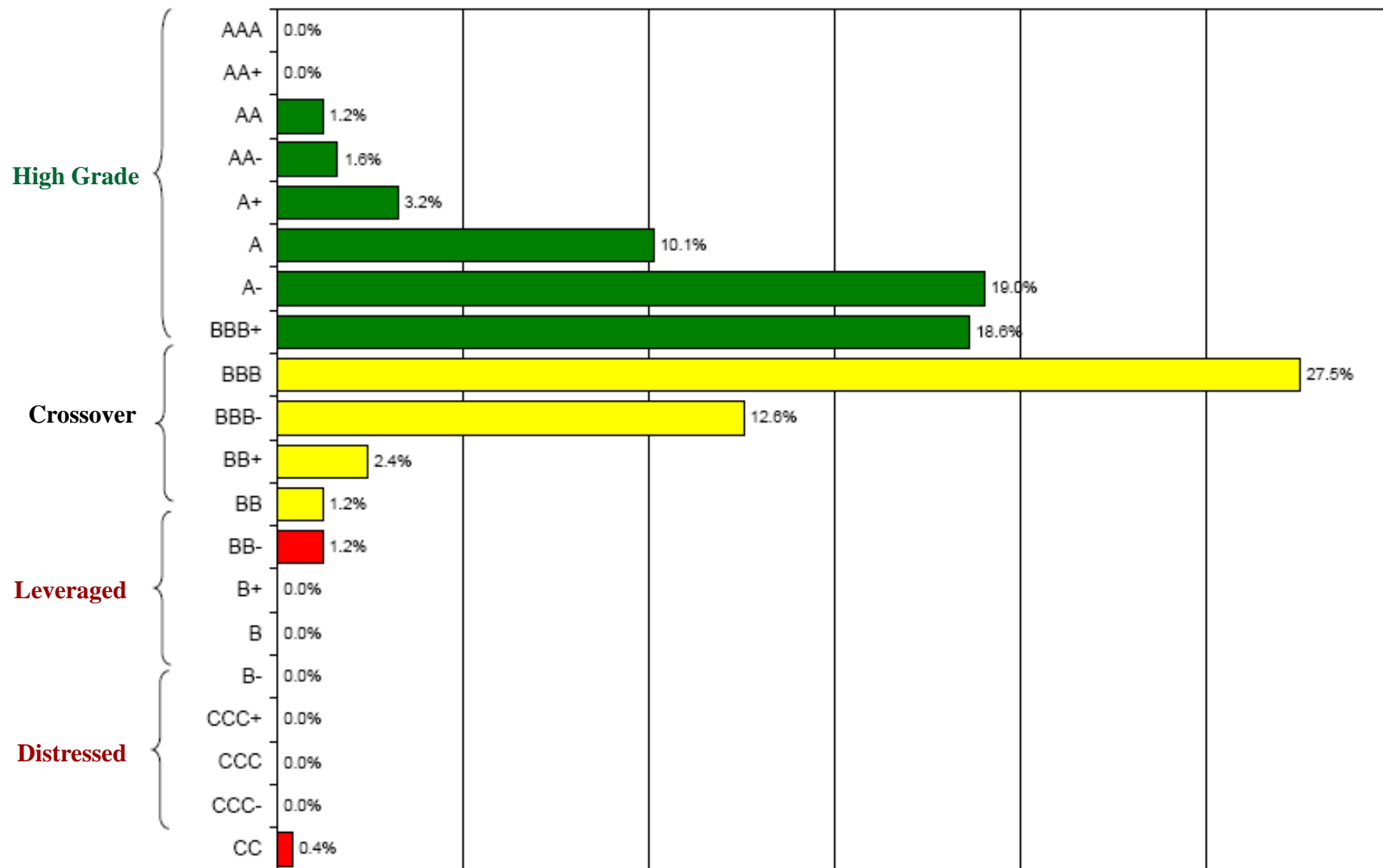
\*Ratings as Of June 15, 2009

CONFIDENTIAL AND PROPRIETARY.

2. Permission to reprint or distribute any content from this presentation requires the written approval of Standard & Poor's.

**STANDARD  
& POOR'S**

# U.S. Utility Sector Ratings Distribution



CONFIDENTIAL AND PROPRIETARY.

Ratings as of June 8, 2009

**STANDARD  
& POOR'S**



# Standard & Poor's Role in the Capital Markets

---

**Investors And Issuers Use Credit Ratings Because They Provides Investors, Traders And Counterparties...**

- ***An Independent, Objective And Forward Looking Opinion Of Creditworthiness***
- ***A Global Benchmark For Investors To Evaluate Risk/Reward Metrics And Compare Credit Risk Among Peers***

# What Is A Credit Rating?

---

## A Credit Rating Represents An Opinion Regarding ...

- The Likelihood That An Issuer Will Default On Its Financial Obligations
- The Capacity And Willingness Of An Issuer Or Obligor To Make Timely Payments In Accordance With The Terms Of The Obligations
- **Credit Analysis Resulting In Assignment Of A Rating Opinion Is An Art, Not Science**
- **A Credit Rating Is The Result Of Qualitative And Quantitative Assessments, As Well As Historic And Prospective Data And Analysis**
- **It Is One Of Many Tools Used By Investors To Make Investment Decisions**



While A Rating Is The Result Of Independent, Objective Analysis ...

# What Is A Credit Rating *Not*?

---

- *It Is Not a Recommendation to Buy, Sell or Hold a Security*
- *It Is Not an Audit of Obligors' Financial Statements*
- *It Is Not An Indicator Of Investment Merit*
- *It Is Not A Guaranty Of Credit Quality*

# Standard & Poor's Rating Scale

General Summary Of The Opinions Reflected By Standard & Poor's Ratings		
Investment Grade 	'AAA'	Extremely strong capacity to meet financial commitments Highest rating
	'AA'	Very strong capacity to meet financial commitments
	'A'	Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances
	'BBB'	Adequate capacity to meet financial commitments, but more subject to adverse economic conditions
	'BBB-'	<i>Considered lowest investment grade by market participants</i>
Speculative Grade 	'BB+'	<i>Considered highest speculative grade by market participants</i>
	'BB'	Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions
	'B'	More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments
	'CCC'	Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments
	'CC'	Currently highly vulnerable
	'C'	A bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued
	'D'	Payment default on financial commitments

Ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

CONFIDENTIAL AND PROPRIETARY.

7. Permission to reprint or distribute any content from this presentation requires the written approval of Standard & Poor's.

**STANDARD  
& POOR'S**

# Rating Outlook

---

- **A Rating *Outlook* Of Stable, Positive, Negative Or Developing Is Assigned...**
  - **To All Issuer Ratings To Indicate Likely Credit Direction Over Next Three Years**
- **It Is Not Necessarily A Precursor To A Rating Change Or A “CreditWatch” Listing (Next Slide)**
- **Current Examples:**
  - California Water Service Co. (A+/Stable/--)
  - American States Water Co. (A/Stable/--)
  - Northwest Natural Gas Co. (AA-/Negative/A-1+)
  - Southern California Gas Co. (A/Negative/A-1)

# CreditWatch Listings

---

## ➤ **A *CreditWatch* Listing Of Positive, Negative Or Developing**

...

- **Is Assigned Selectively, With Anticipated Resolution Within 90 Days**

- **Focuses On Short-Term Direction And Is Event-Driven**

- **Requires Additional Information For Resolution**

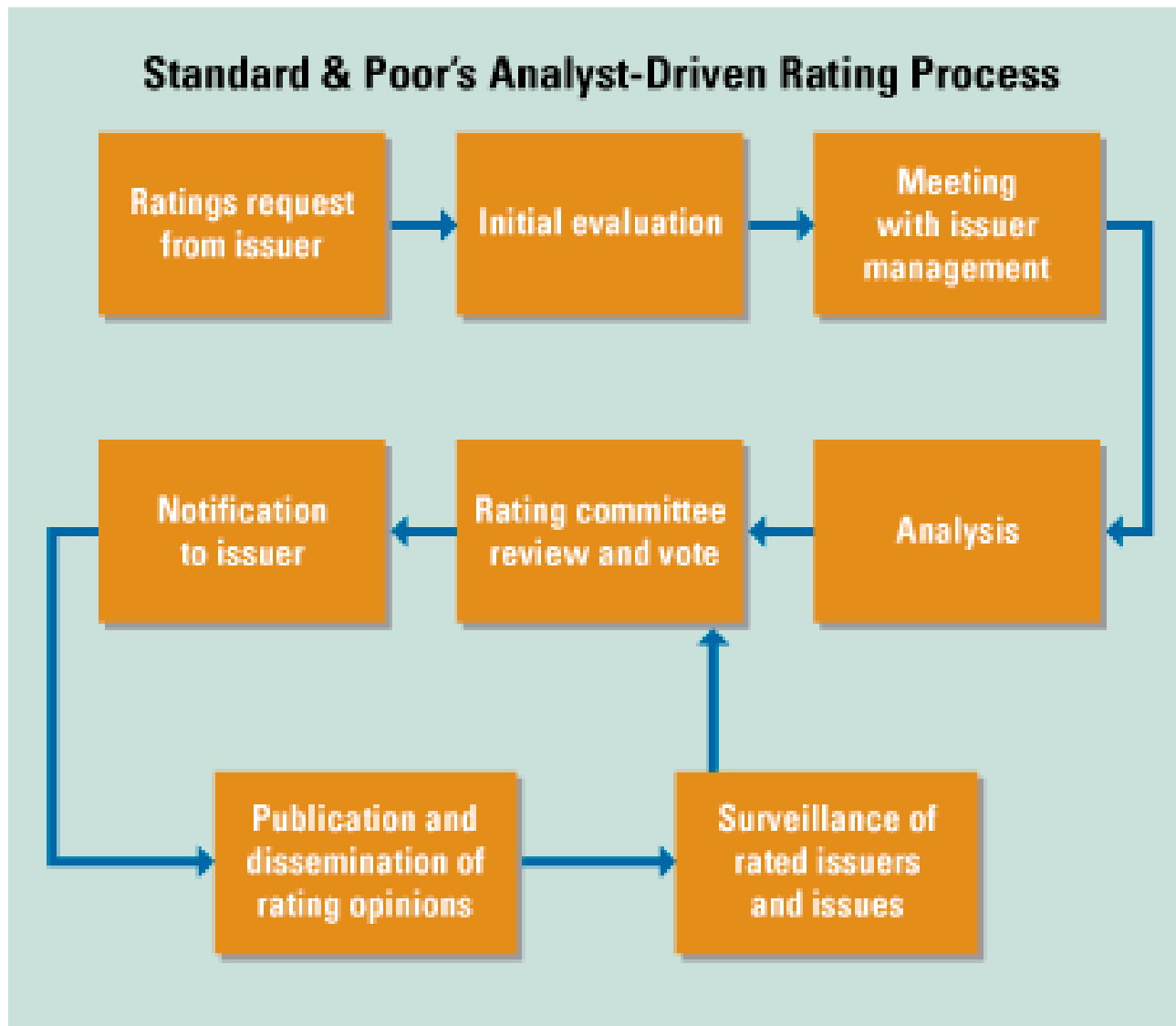
## ➤ **Current Examples**

- MXEnergy Holdings Inc. (CC/Watch Neg/--)

- Exelon Corp. (BBB/Watch Neg/A-2)

- NRG Energy Inc. (B+/Watch Pos/B-2)

# Standard & Poor's Ratings Process

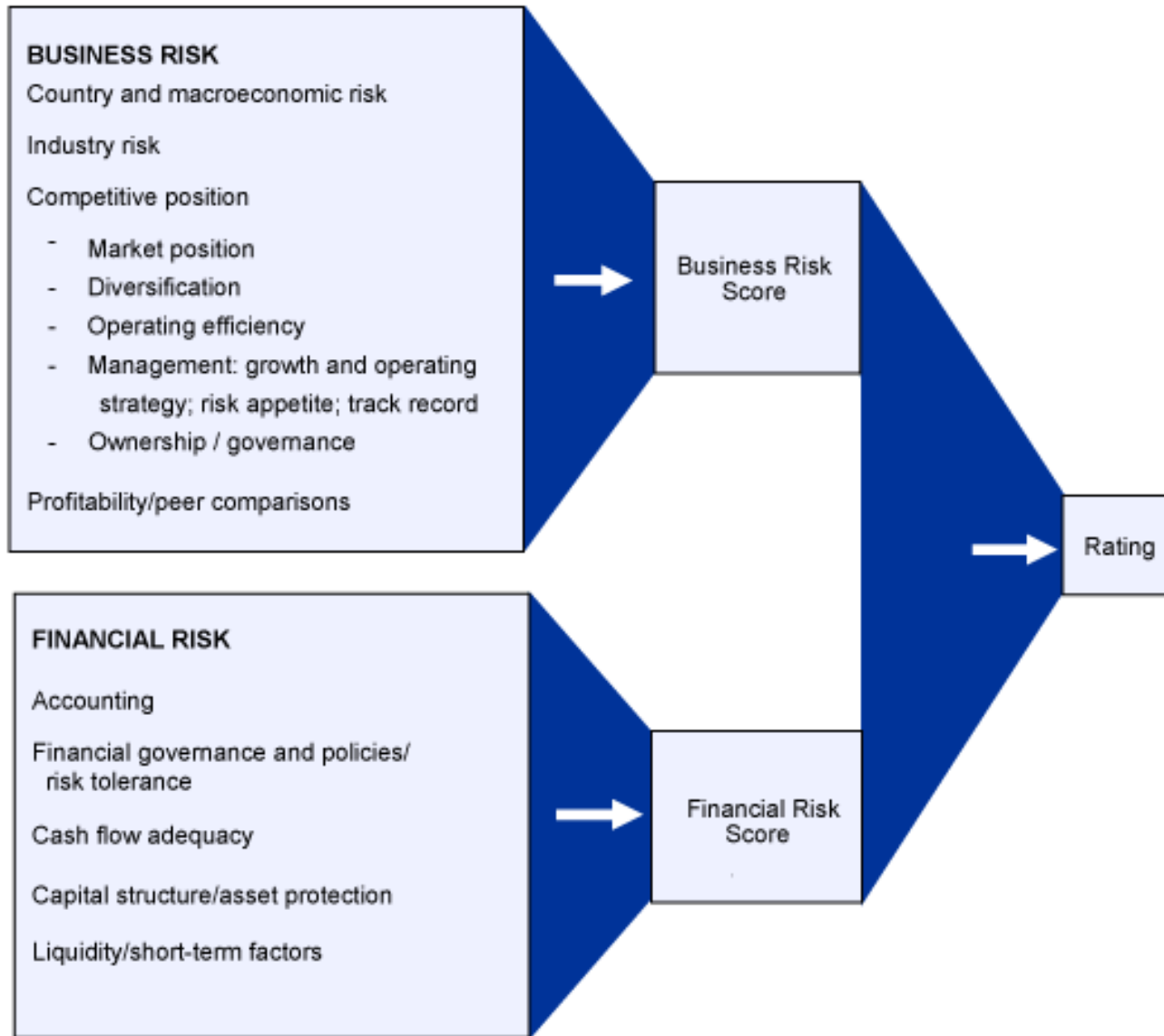


CONFIDENTIAL AND PROPRIETARY.

10. Permission to reprint or distribute any content from this presentation requires the written approval of Standard & Poor's.

**STANDARD  
& POOR'S**

# The Analytical Process: Deriving The Corporate Credit Rating



CONFIDENTIAL AND PROPRIETARY.

---

# Business Profile

---

CONFIDENTIAL AND PROPRIETARY.

12. Permission to reprint or distribute any content from this presentation requires the written approval of Standard & Poor's.

**STANDARD**  
**& POOR'S**

# Business Profile - Regulation

---

- **Without The Regulatory Safety Net (And Franchised Service Territory) the Financial Performance of Utilities Would Generally Represent Speculative Grade Quality**
- **Regulation...**
  - Provides A Level Of Support During Periods Of Stress
  - Allows Deferral Of Costs For Later Recovery
  - Provides The Opportunity To Earn A Set Return On Assets And To Maintain Financial Strength Regardless Of Economic Or Financial Environment

# Business Profile – Regulation (Cont'd)

## Characteristics Of Credit-Supportive Regulation

- **Consistency And Predictability Of Decisions**
- **Timeliness Of Rate Orders**
- **Use Of Forward-Looking Measures**
- **Use Of Adjustment Clauses/Trackers**
  - *Pass-through of Purchased Water, Power, Etc.*
  - *Construction Work In Progress (CWIP)/Infrastructure Surcharges*
  - *Pre-Approval Of Significant Capital Outlays*
  - *Environmental*
  - *Conservation*
  - *Demand Side Management*
  - *Bad Debt*
  - *Pensions and other post-retirement obligations*
  - *Etc.*

# Business Profile - Markets

---

## ➤ Diversity

- Geography
- Regulatory Jurisdictions
- Climate
- Economic conditions

## ➤ Absolute Size of Customer Base

## ➤ Customer Mix - Residential, Commercial, Industrial, Other

## ➤ Other Demographic Factors

- Population Growth
- Income Statistics
- Unemployment

# Business Profile - Operations

---

## ➤ **Stability Of Operations**

- Cost
- Reliability
- Safety

## ➤ **Key Credit Considerations**

- Supply position
  - Treatment capacity vs. Peak demand
  - Ground/Surface/Purchased Water
  - Contracts for Purchased Water
- Infrastructure
  - Age of existing pipes
  - Replacement practices
- Capital Needs
  - Maintenance
  - Growth

# **Business Profile – Competitiveness**

---

- **Absence of Competition in Regulated Service Territory**
- **Rating Factors Related to Growth**
  - Cost Structure
  - Industrial Profile
- **Attractiveness When Pursuing Acquisitions of Private or Municipal Water Systems**

# Business Profile - Management

---

- **Ownership Structure**
- **Commitment To Credit Quality**
- **Credibility/Track Record**
- **Strategic Focus**
  - Regulated Activities (lower risk)
  - Unregulated Activities (higher risk)
- **Relationship With Regulators**
- **Enterprise Risk Management**
  - Understanding of Risk/Reward and Cost/Benefit
  - Financial/Accounting Practices
  - Staffing to Address Top Risks/Strategic Decisions

# Business Profile – Nonregulated Activities

---

## ➤ Rationale

- Generate Higher Returns Than Those Provided By Regulated Operations

## ➤ Examples

- Public-Private Partnerships for Operations and Maintenance Services
  - Private and Municipal Water Companies
  - Military Bases, Universities, and Other Large Institutions
- Additional Services for Other Utilities
  - Back Office Support
  - Engineering and Construction Services
- Service Line Protection Plans

---

# Financial Profile

---

CONFIDENTIAL AND PROPRIETARY.

20. Permission to reprint or distribute any content from this presentation requires the written approval of Standard & Poor's.

**STANDARD**  
**& POOR'S**

# Rationale for Adjusting Financial Statements

---

- **In Our View, Adjustments Create A More Accurate Depiction Of The Economic Reality Of An Issuer's Risks, Rights And Benefits**
- **Adjustments Enable More Meaningful Peer And Period-over-period Comparisons**
- **Common Adjustments for Water Utilities**
  - Pensions and Post-retirement Benefit Obligations
  - Operating Leases
  - Hybrid Instruments (Preferred Stock)

# Financial Profile - Cash Flow Protection

---

## ➤ Considerations

- Stability Of Cash Flows
- Ability To Service Financial Obligations
- Capital Expenditure Schedule

## ➤ Key Credit Protection Measures

- FFO Interest Coverage
- FFO/Average Total Debt
- Discretionary Cash Flows

# Financial Profile: Capital Structure

---

## ➤ **Considerations:**

- Size and Timing of Upcoming Debt Maturities
- Form of Equity (common/preferred) and Debt (fixed/floating, convertible, triggers)
- Interest Rate Environment
- Short-Term vs. Long-term Debt
- Off-Balance Sheet Obligations

## ➤ **Key Credit Protection Measures**

- Total Debt To Total Capital
- Level Of Equity
- Headroom Under Covenants

# Financial Profile: Flexibility

---

## ➤ Internal Sources

- Cash Balances
- Ability to Defer Capital Expenditures
- Measurement: Net Cash Flow Coverage Of Capex

## ➤ External Sources

- Commercial Paper or Credit Facilities
- Ability To Access Capital Markets (Equity, Debt, Other)
- Access to State Economic Development Authority/State Revolving Funds
- Headroom Under Covenants

# Standard & Poor's Ratings Matrix

<i>Financial</i> > <i>vBusiness</i>	Minimal	Modest	Intermediate	Significant	Aggressive	Highly Leveraged
Excellent	AAA	AA	A	<b>A- *</b>	<b>BBB *</b>	--
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	<b>BB- *</b>	B+
Fair	--	BBB-	BB+	BB	<b>BB- *</b>	B
Weak	--	--	BB	BB-	B+	B-
Vulnerable	--	--	--	B+	B	CCC+

\*Median Utility/Corporate Rating

CONFIDENTIAL AND PROPRIETARY.

**STANDARD  
& POOR'S**

# Private Ownership and Ratings

---

## ➤ Why Private Companies Seek Ratings

- Access public debt markets
- Benchmark performance against publicly rated peers
- Attract additional private investors
- Transparency in negotiating with counterparties

## ➤ Characteristics of Private Companies That May Affect Ratings

- May have less public information available
- May have a significantly higher equity component
- May have financially healthy owners

---

# Current Credit Pressures

---

CONFIDENTIAL AND PROPRIETARY.

27. Permission to reprint or distribute any content from this presentation requires the written approval of Standard & Poor's.

**STANDARD**  
**& POOR'S**

# **Corporate Credit Quality 2009 – The Worst May Be Yet to Come**

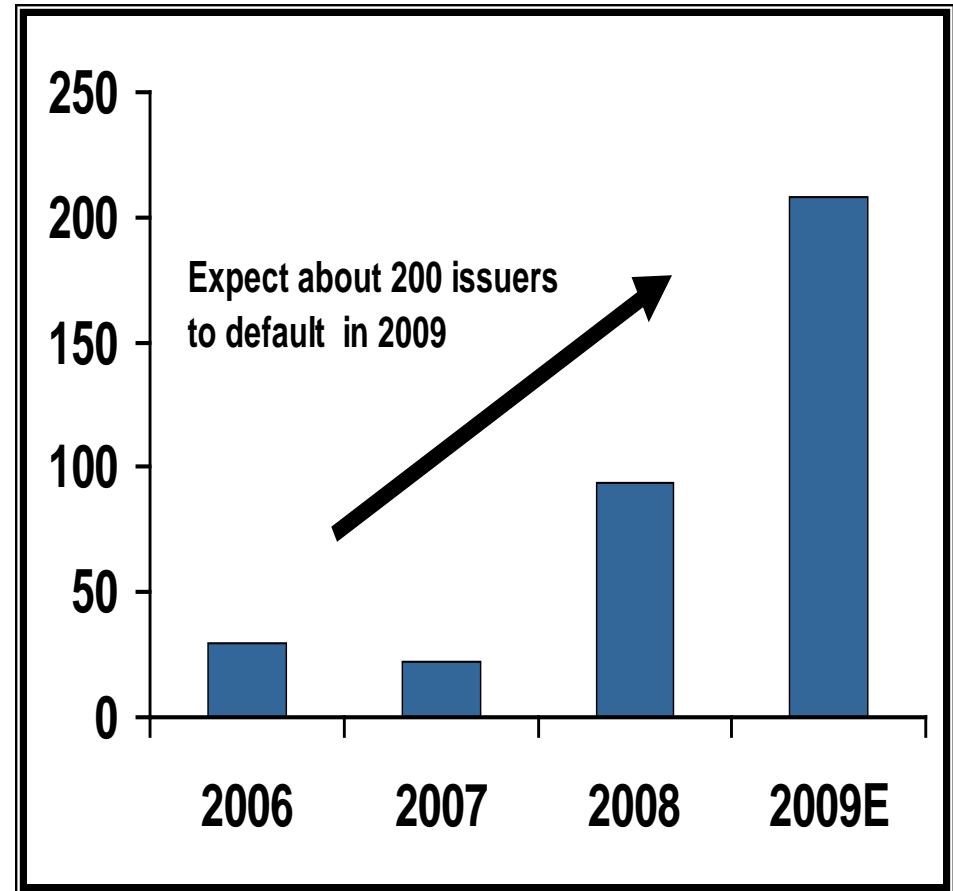
---

- **Difficult Market Conditions For Speculative Grade Issuers**
- **More Speculative-Grade Issuers Than At Any Point in History**
  - 49% of Corporate Ratings are 'B' category or lower
- **Improved Conditions For Investment Grade Issuers**
- **Most Of The Global Economy Remains In A Recession**
- **Post-Default Recovery Ratings – Will It Be Different This Time?**

# Corporate Credit Quality 2009 – The Worst May Be Yet to Come

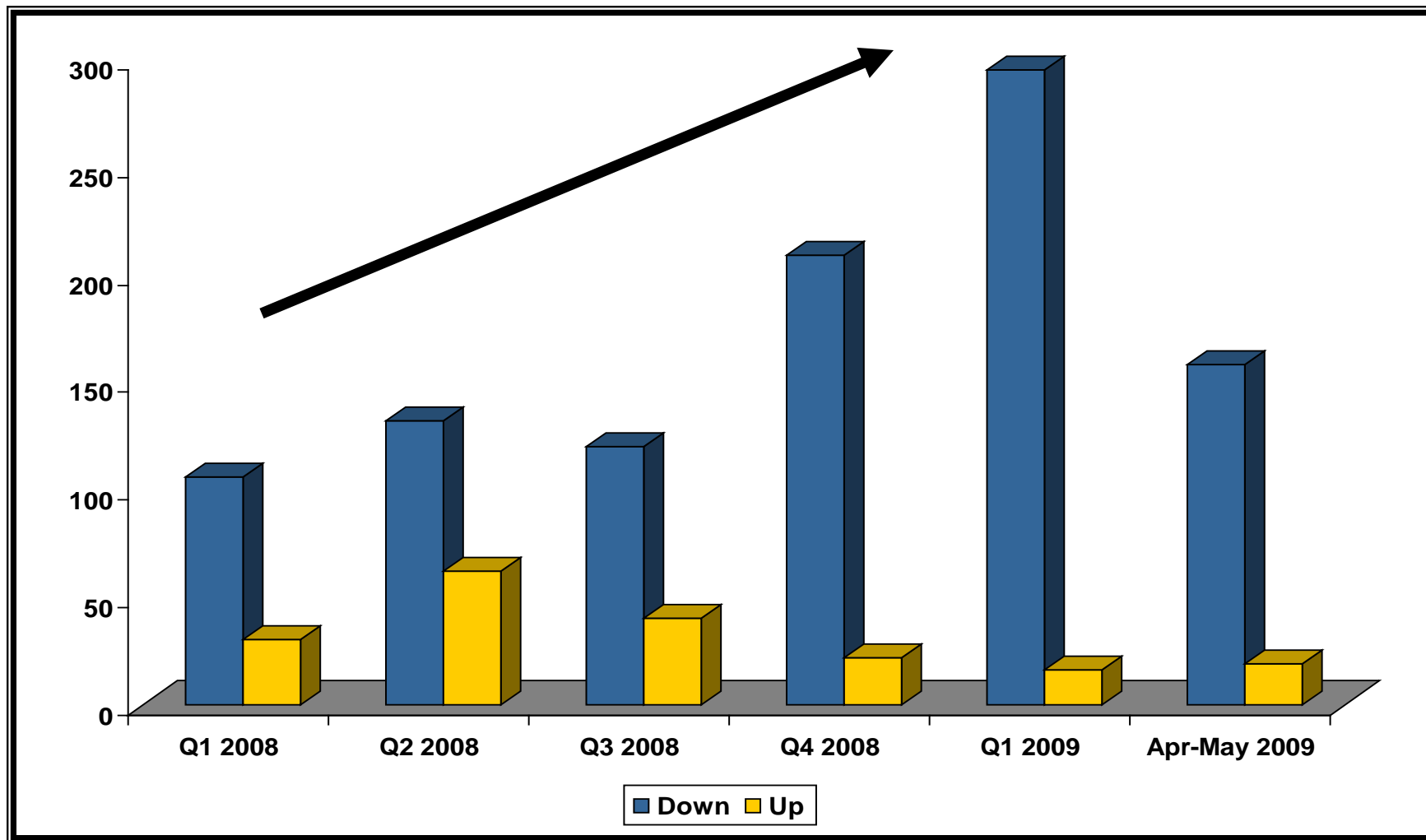
## *Credit Quality Continues to Deteriorate*

- Expect The U.S. Speculative Grade Corporate Default Rate To Increase To 14% In 2009
- Defaults Are Rising, With 25 In May; over 100 YTD
  - *No utility company has defaulted*
- Corporate Downgrades Outpaced Upgrades By More than 10 to 1 (YTD May 2009)



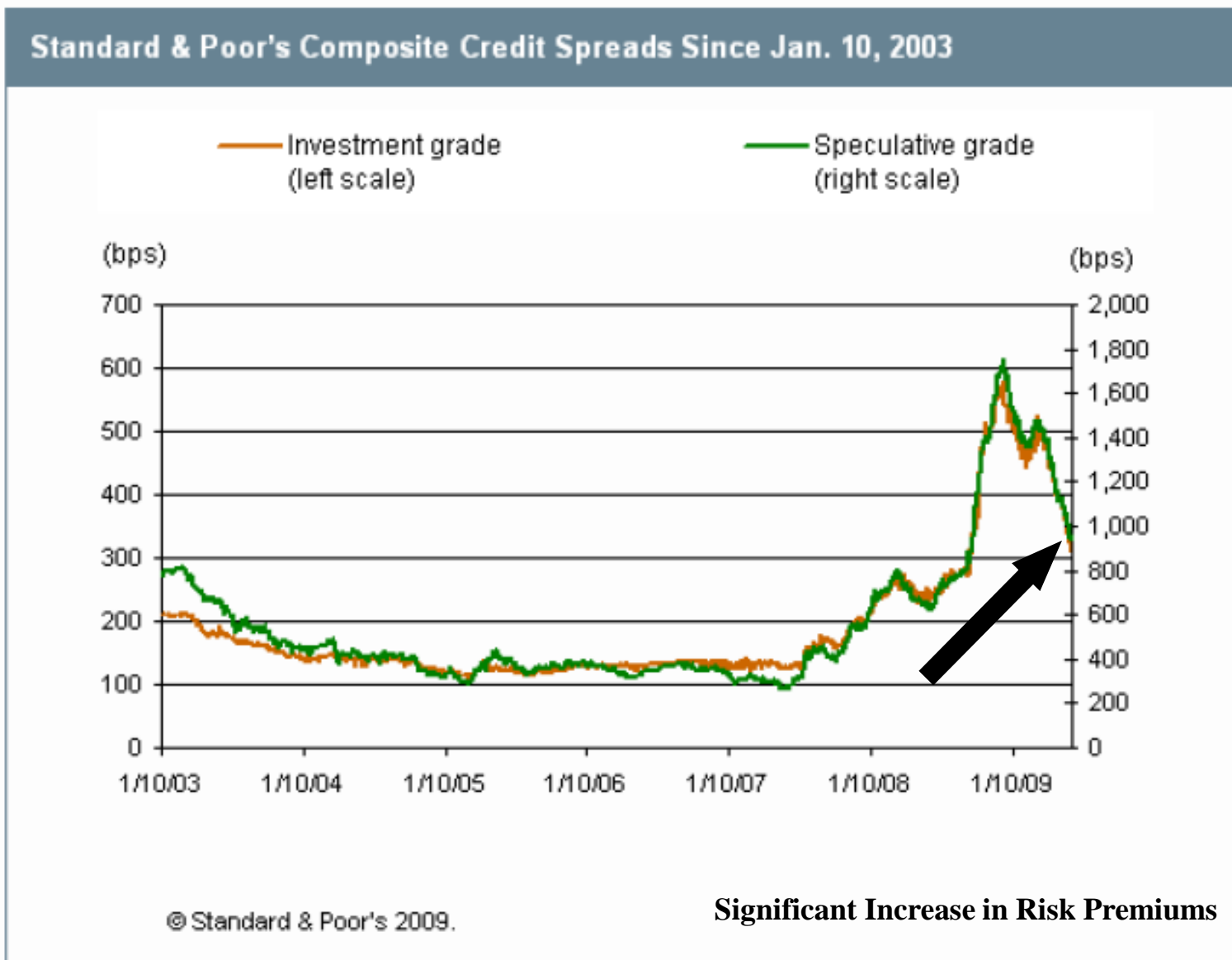
# Corporate Credit Quality 2009 – The Worst May Be Yet to Come

*Over 550 Downgrades in 2008; Over 450 YTD 2009*



CONFIDENTIAL AND PROPRIETARY.

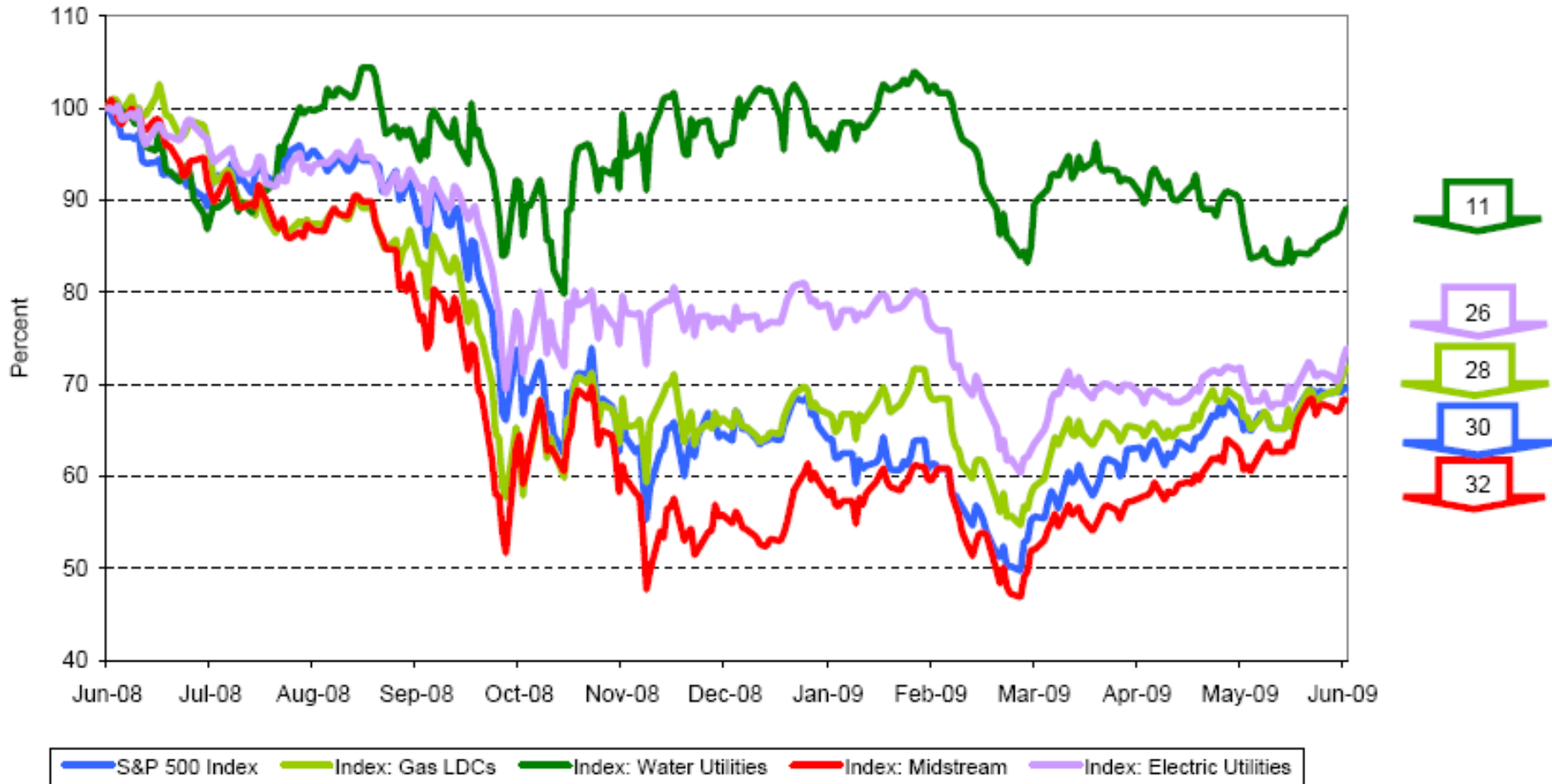
# Historical Composite Credit Spreads



CONFIDENTIAL AND PROPRIETARY.

# Utility Shareholder Value Is Not Immune To Market Conditions

## 12-month Performance of Standard & Poor's Utility & Infrastructure Practice



Source: Capital IQ, Standard & Poor's Ratings Services.

CONFIDENTIAL AND PROPRIETARY.

32. Permission to reprint or distribute any content from this presentation requires the written approval of Standard & Poor's.

**STANDARD  
& POOR'S**

# Principal Credit Themes We See Affecting Regulated Utilities

---

## **Significant Challenges Were Already Threatening Commissions' Ability To Achieve Reasonably Balanced Rate Decisions In "Normal" Times:**

- **Need for Substantial Infrastructure Spending**
  - Aging Infrastructure, Treatment Facilities, Environmental Mandates
- **Increasing Labor/Benefits And Volatile Material Costs**

## **... Then The Capital Markets And The Global Economy Seized Up:**

- **Stagnation And Even Decline In Customer Growth, At Least In Near Term**
- **Shrinking Capital Availability**
  - Uncertainty Of Liquidity/Borrowing Availability
  - Spiking Risk Premiums
- **Rising Bad Debt Expense**
- **Increasingly Underfunded Pension Plans**

## **Backlash To Rate Hikes Is Virtually A Certainty, Increasing Pressure On Regulators To Lower ROEs, And Perhaps Encourage Deferral of Capex And Costs**

- Infrastructure recovery mechanisms reduce or even eliminated the incentive to defer Capex

# U.S. Utilities – 2009 Ratings Trends

---

## Stable Ratings Trend For 2009 Are Supported By Expectations Of:

- Supportive And Responsive Regulatory Environment
- Continued Access To Debt And Equity Markets

## Higher Credit Ratings Longer Term May Be Limited By:

- Substantial And Often Growing Capital Expenditure Programs
  - Regulatory Lag
- Recessionary Pressure on Cash Flow and Debt Balances
- Carbon Debate (Federal and State)
- Political Interference

# General Conclusions On The Utility Industry

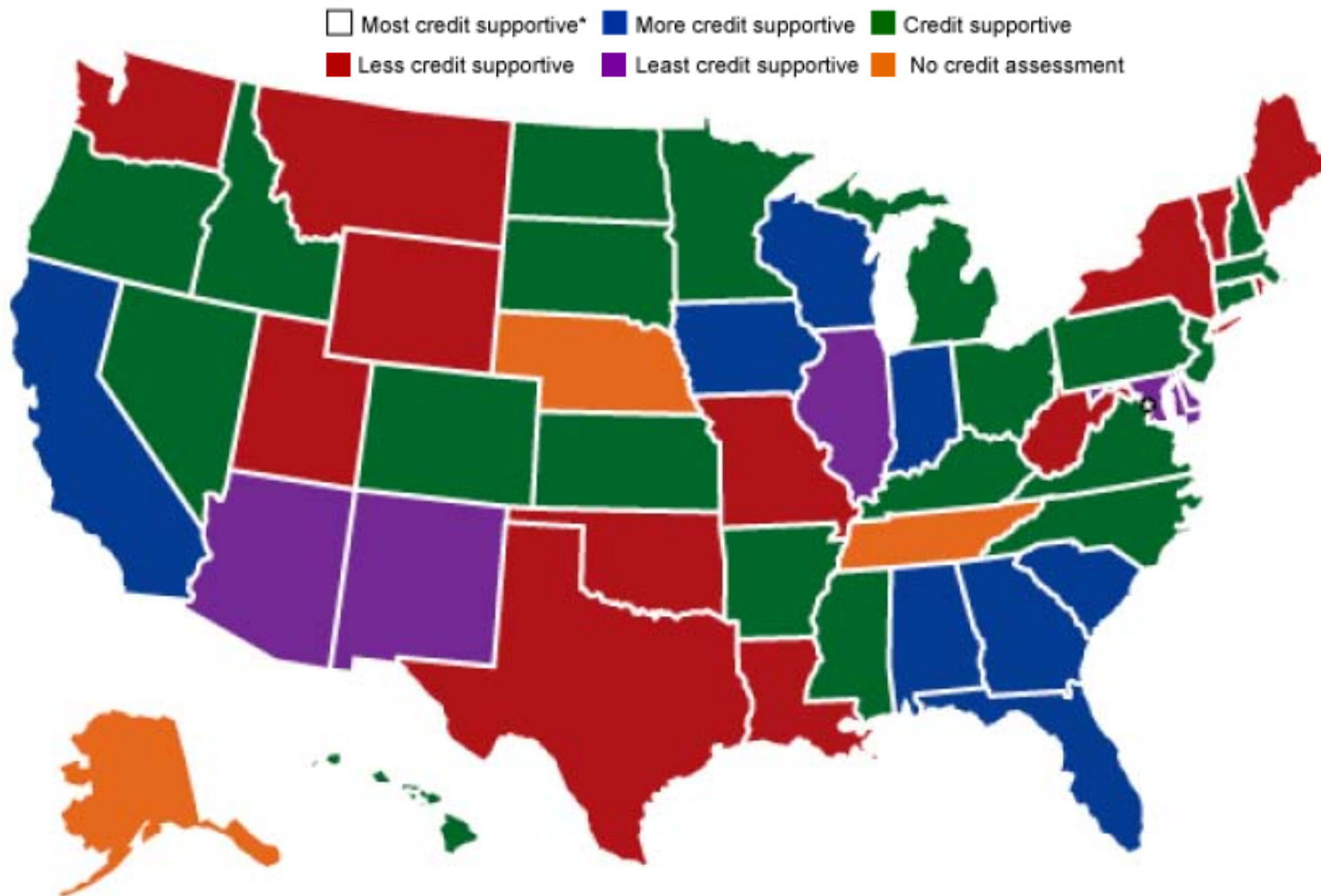
---

- **Regulated Utilities Appear As Well Positioned Or Better Than Other Sectors To Contend With The Current Credit Markets**
- **Liquidity Secured During The Years Of Credit Amnesia Should Serve Them Well**
  - But Credit Has Become More Costly
  - Refinancing Terms Will Be Dictated By The Banks (Credit Obsession)
- **Some Projects May Be Delayed**
  - Will Reliability Suffer?
- **Investors (Fixed Income and Equity)**
  - Increased Focus On The Relationship Between Utilities And Regulatory Commissions

# Regulation Will Continue To Be A Significant Credit Driver

- **Rate Cases Will Likely Be A Sustained Characteristic Of Utility Activity For Several Years**
- **Regulators Will Be Challenged To Achieve The “Right” Balance Among Various Conflicting Goals:**
  - Customer Protection/Rate Constraint
  - Upward Cost Pressures
  - Depressed Economic Conditions
  - Reliability of Service
  - *Financially Healthy And Solvent Utilities*

# Standard & Poor's Assessment of State Regulatory Climates



**Standard & Poor's views the regulatory climate in California as "more supportive"**

CONFIDENTIAL AND PROPRIETARY.



---

# Appendix

---

# Key Utility Industry Credit Risk Drivers vs. Other Industries

	Utilities regulated	Competitive power	Oil & gas downstream	Autos	Airlines
<b>Industry dynamics and competitive environment</b>					
Industry cyclicality	M	H	H	H	H
Ease of entry	L	M/H	H	M/H	M/H
Product cycle/obsolescence	L	L	L	H	L
Level of product quality	L	L	M	H	M
Disintermediation/substitution	L	L	L	L/M	L
Competition/commoditization	L/M	H	M	H	H
Pricing inflexibility	M	H	M	H	H
Business model stability	M	M/H	L	L/M	M
Demographic trends	L	L	M	H	L
<b>Growth and profitability</b>					
Growth outlook	L	M	L	M/H	L/M
Profit margin pressure/outlook	M	M/H	M	M/H	H
Earnings volatility	M	M/H	H	H	H

# Credit Risk Drivers (continued)

	Utilities regulated	Competitive power	Oil & gas downstream	Autos	Airlines
<b>Operating considerations and costs</b>					
Technological risk/change	L	L	L/M	L/M	L/M
Cost efficiency/pressures	M	H	M	H	H
Operating leverage	M/H	H	H	H	H
R&D costs	L	L	L	H	L
Energy cost sensitivity	H	H	H	H	H
Raw material cost sensitivity	H	H	H	H	L
Labor costs	M	M	M	H	H
Labor inflexibility/unrest	L	L	M	H	H
Pension costs/contingents	M	L	L/M	H	M/H
Environmental impact/costs	H	L	H	H	M/H
Marketing costs	L	L	M	H	L/M
Customer concentration	L	M	L	L	L
Supplier concentration	H	H	H	M	M
Risk management	M	H	M	M	M
Asset/plant quality and age/upkeep	M	H	H	M	M/H
Event risk sensitivity	M/H	H	H	M/H	H
Financial market volatility/sensitivity	M	M/H	L	M	M
Fashion/fad/design sensitivity	L	L	L	H	L/M
<b>Capital and financing characteristics</b>					
Capital intensity	H	H	H	H	H
Borrowing requirement	H	H	L/M	H	H
Interest rate sensitivity	L/M	L/M	L/M	H	L/M
<b>Government, regulatory, and legal environments</b>					
Regulation/deregulation	H	H	M	M/H	H
Government microeconomic and social policies	H	H	H	H	M/H
Litigiousness/legal risk	L	H	M	M	M

CONFIDENTIAL AND PROPRIETARY.

Ratings as of April 15, 2009.

**STANDARD  
& POOR'S**

# Factors Reviewed for the Regulatory Climate Assessments

## ➤ **Ratemaking factors**

- Cost recovery and earned returns,
- Ratemaking timeliness,
- Resource procurement process,
- Oversight of large capital commitments, and
- Nontraditional ratemaking practices.

## ➤ **Political factors**

- Method of commissioner selection,
- Record of political influence, and
- Behavior of influential intervenors.

## ➤ **Financial stability factors**

- Rate treatment of large capital expenditures,
- Rate treatment of large expenses,
- Cash flow metrics of regulated utilities, and
- Rate design.

The assessments are of the whole jurisdiction, not just the regulatory body.

The assessments are done on an absolute basis, not on a relative scale.

The assessments are made from a credit perspective.

# STANDARD & POOR'S

---

Analytic services and products provided by Standard & Poor's are the result of separate activities designed to preserve the independence and objectivity of each analytic process. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during each analytic process.