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September 27, 2013

HAND DELIVERED

Jeff Derouen
Executive Director
Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

Re: Audit Report of Financial Statements of Kentucky American Water

Dear Mr. Derouen:

In conformity with 807 KAR 5:006 Section 4(3), enclosed please find an original and ten copies of the audit report for Kentucky American Water's 2012 financial statements. Should you have any questions, please do not hesitate to contact me.

Very truly yours,

Stoll Keenon Ogden PLLC

Lindsey W. Ingram III

Lindsey W. Ingram III

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Kentucky-American Water Company, Inc.

(a wholly-owned subsidiary of American Water Works Company, Inc.)

Financial Statements

As of and for the years ended December 31, 2012 and 2011

pwc

Independent Auditor's Report

To the Board of Directors and Stockholder of
Kentucky-American Water Company

We have audited the accompanying financial statements of Kentucky-American Water Company, which comprise the balance sheets and statements of capitalization as of December 31, 2012 and 2011, and the related statements of operations, of changes in common stockholder's equity and of cash flows for the years then ended.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kentucky-American Water Company at December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

March 21, 2013

PricewaterhouseCoopers LLP, Two Commerce Square, Suite 1700, 2001 Market Street, Philadelphia, PA 19103-7042
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KENTUCKY-AMERICAN WATER COMPANY
Balance Sheets
December 31, 2012 and 2011
(Dollars in thousands)

Assets

	2012	2011
Property, plant and equipment		
Utility plant - at original cost, net of accumulated depreciation	$ 495,913	$ 485,717
Utility plant acquisition adjustments	243	251
Nonutility property	250	250
Total property, plant and equipment	496,406	486,218
Current assets		
Cash and cash equivalents	384	282
Accounts receivable	3,743	3,216
Allowance for uncollectible accounts	(715)	(602)
Unbilled revenues	3,705	3,893
State income tax receivable	394	1,567
Federal income tax refund due from affiliated company	-	6,369
Materials and supplies	855	691
Other	420	147
Total current assets	8,786	15,563
Regulatory and other long-term assets		
Regulatory assets	11,731	11,784
Prepaid pension expense	2,028	1,332
Other	136	52
Total regulatory and other long-term assets	13,895	13,168
Total assets	$ 519,087	$ 514,949

The accompanying notes are an integral part of these financial statements.

KENTUCKY-AMERICAN WATER COMPANY
Balance Sheets
December 31, 2012 and 2011
(Dollars in thousands)

Capitalization and Liabilities

	2012	2011
Capitalization		
Common stockholder's equity	$ 159,214	$ 155,274
Preferred stock without mandatory redemption requirements	-	1,446
Long-term debt, excluding current portion		
Preferred stock with mandatory redemption requirements	4,500	4,500
Long-term debt	187,890	187,890
Total capitalization	351,604	349,110
Current liabilities		
Notes payable - affiliated company	11,023	11,509
Accounts payable	7,184	6,453
Accrued interest	2,024	1,926
Accrued taxes, including federal income taxes of $2,741 in 2012 and $2,278 in 2011	4,596	3,992
Other	3,253	4,020
Total current liabilities	28,080	27,900
Regulatory and other long-term liabilities		
Deferred income taxes	56,454	57,597
Advances for construction	11,922	12,675
Deferred investment tax credits	794	879
Regulatory liability - cost of removal	14,034	13,476
Regulatory liability - debt extinguishment	152	283
Accrued postretirement benefit expense	604	552
Other tax liabilities	3,582	2,771
Other	71	68
Total regulatory and other long-term liabilities	87,613	88,301
Contributions in aid of construction	51,790	49,638
Commitments and contingencies (See Note 17)	-	-
Total capitalization and liabilities	$ 519,087	$ 514,949

The accompanying notes are an integral part of these financial statements.

KENTUCKY-AMERICAN WATER COMPANY
Statements of Income
For the Years Ended December 31, 2012 and 2011
(Dollars in thousands)

	2012	2011
Operating revenues	$ 85,960	$ 83,301
Operating expenses		
Operation and maintenance	34,055	33,024
Depreciation	10,043	8,915
Amortization	1,756	2,182
General taxes	4,914	5,102
Total operating expenses	50,768	49,223
Operating income	35,192	34,078
Other income (expenses)		
Interest on long-term debt	(11,709)	(10,864)
Interest on short-term debt to affiliated company	(57)	(73)
Allowance for other funds used during construction	675	281
Allowance for borrowed funds used during construction	317	132
Amortization of debt issuance costs	(74)	(86)
Other, net	(76)	(394)
Total other expenses	(10,924)	(11,004)
Income before income taxes	24,268	23,074
Provision for income taxes	9,664	4,944
Net income	14,604	18,130
Dividends on preferred stock	40	78
Net income available to common stockholder	$ 14,564	$ 18,052

The accompanying notes are an integral part of these financial statements.

KENTUCKY-AMERICAN WATER COMPANY
Statements of Cash Flows
December 31, 2012 and 2011
(Dollars in thousands, except per share amounts)

	2012	2011
Cash flows from operating activities		
Net income	$ 14,604	$ 18,130
Adjustments		
Depreciation and amortization	11,799	11,097
Amortization of debt issuance costs	74	86
Deferred income tax benefit	(1,861)	(11,750)
Amortization of deferred investment tax credits	(85)	(84)
Provision for losses on accounts receivable	597	614
Allowance for other funds used during construction	(675)	(281)
Pension and non-pension post retirement benefits	2,002	1,849
Other, net	273	(425)
Changes in assets and liabilities		
Accounts receivable and unbilled revenues	(823)	624
Federal income tax-affiliated company	6,369	7,895
Other current assets	740	(1,157)
Pension and non-pension post retirement benefits contribution	(2,697)	(3,910)
Accounts payable	(128)	1,095
Accrued taxes	1,529	956
Other current liabilities	(669)	(1,178)
Net cash provided by operating activities	31,049	23,561
Cash flows from investing activities		
Capital expenditures	(19,906)	(24,252)
Removal costs from property, plant and equipment retirements, net of salvage	(1,238)	(845)
Net cash used in investing activities	(21,144)	(25,097)
Cash flows from financing activities		
Proceeds from issuance of long-term debt to affiliated company	-	20,000
Repayment of long-term debt to affiliate	-	(3,100)
Debt issuance costs	(87)	-
Net repayments of short-term borrowings-affiliated company	(486)	(4,008)
Advances and contributions for construction, net of refunds of $1,025 in 2012 and $716 in 2011	2,958	2,308
Capital contributions	4,000	-
Redemption of preferred stock	(1,446)	-
Dividends paid	(14,742)	(13,651)
Net cash (used in) provided by financing activities	(9,803)	1,549
Net increase in cash and cash equivalents	102	13
Cash and cash equivalents at beginning of year	282	269
Cash and cash equivalents at end of year	$ 384	$ 282
Cash paid (received) during the year for:		
Interest, net of capitalized amount	$ 11,857	$ 11,086
Income taxes, net of refunds of $504 in 2012 and $0 in 2011	$ (504)	$ 10,028
Non-cash investing activity		
Capital expenditures acquired on account but unpaid as of year end	$ 4,101	$ 3,220
Non-cash financing activity		
Capital contribution (See Note 13)	$ 78	$ 79

The accompanying notes are an integral part of these financial statements.

KENTUCKY-AMERICAN WATER COMPANY
Statements of Capitalization
December 31, 2012 and 2011
(Dollars in thousands, except per share amounts)

	Call Price Per Share	2012	2011
Stockholder's equity			
Common stock - no par value, authorized 2,000,000 shares 1,567,391 shares issued and outstanding in 2012 and 2011		$ 36,569	$ 36,569
Paid-in capital		78,846	74,768
Retained earnings		43,799	43,937
Total common stockholder's equity		159,214	155,274
Preferred stocks - $100 par value			
Cumulative preferred stocks without mandatory redemption requirements:			
5.75% series, 3,888 shares outstanding in 2011, Redeemed in 2012	$ 101.00	-	389
5.50% series, 4,860 shares outstanding in 2011, Redeemed in 2012	$ 100.50	-	486
5.00% series, 5,708 shares outstanding in 2011, Redeemed in 2012	$ 100.00	-	571
		-	1,446
Long-term debt			
Preferred stocks - $100 par value			
Cumulative preferred stocks with mandatory redemption requirements:			
8.47% series, 45,000 shares outstanding in 2012 and 2011 due for redemption 2036	$ 100.00	4,500	4,500
		4,500	4,500
General mortgage bonds:			
6.96% series due 2023		7,000	7,000
7.15% series due 2027		7,500	7,500
6.99% series due 2028		9,000	9,000
Notes payable to affiliate:			
6.593% series due 2037		47,000	47,000
6.25% series A due 2039		45,390	45,390
5.625% series B due 2039		26,000	26,000
5.375% series due 2040		26,000	26,000
5.05% series due 2037		20,000	20,000
Total long-term debt and mandatory redeemable preferred stock		192,390	192,390
Total capitalization		$ 351,604	$ 349,110

The accompanying notes are an integral part of these financial statements.

KENTUCKY-AMERICAN WATER COMPANY
Statements of Changes in Common Stockholder's Equity
December 31, 2012 and 2011
(Dollars in thousands, except per share amounts)

	Common Stock		Paid-in	Retained	
	Shares	Par Value	Capital	Earnings	Total
Balance at December 31, 2010	1,567,391	$ 36,569	$ 74,689	$ 39,458	$ 150,716
Net income	-	-	-	18,130	18,130
Capital contributions	-	-	79	-	79
Preferred stock dividends	-	-	-	(78)	(78)
Common stock dividends	-	-	-	(13,573)	(13,573)
Balance at December 31, 2011	1,567,391	$ 36,569	$ 74,768	$ 43,937	$ 155,274
Net income	-	-	-	14,604	14,604
Capital contributions	-	-	4,078	-	4,078
Preferred stock dividends	-	-	-	(40)	(40)
Common stock dividends	-	-	-	(14,702)	(14,702)
Balance at December 31, 2012	1,567,391	$ 36,569	$ 78,846	$ 43,799	$ 159,214

The accompanying notes are an integral part of these financial statements.

Note 1: Organization and Operation

Kentucky-American Water Company (the "Company") provides water service to approximately 124,400 (unaudited) customers and wastewater service to approximately 700 (unaudited) customers. These services are provided in 12 (unaudited) communities located in 10 (unaudited) counties in the state of Kentucky. As a public utility operating in Kentucky, the Company functions under rules and regulations prescribed by the Kentucky Public Service Commission (the "Commission"). The Company is a wholly-owned subsidiary of American Water Works Company, Inc. ("AWW").

Note 2: Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("U.S. GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The Company considers benefit plans assumptions, the carrying value of long-lived assets, including regulatory assets and liabilities, revenue recognition and accounting for income taxes to be its critical accounting estimates. The Company's significant estimates that are particularly sensitive to change in the near term are amounts reported for pension and other postemployment benefits and contingency-related obligations.

Regulation

The Company is subject to regulation by the Commission and the local governments of the State of Kentucky (collectively the "Regulators"). These Regulators have allowed recovery of costs and credits which the Company has recorded as regulatory assets and liabilities. Accounting for future recovery of costs and credits as regulatory assets and liabilities is in accordance with authoritative guidance provided by U.S. GAAP. Regulated utilities defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that those costs and credits will be recognized in the rate making process in a period different from the period in which they would have been reflected in operations by a market based company. These deferred regulatory assets and liabilities are then reflected in the statement of income in the period in which the costs and credits are reflected in the rates charged for service.

Property, Plant and Equipment

Property, plant and equipment consist primarily of utility plant. Additions to utility plant and replacements of retirement units of property are capitalized. Costs include material, direct labor and such indirect items as engineering and supervision, payroll taxes and benefits, transportation and an allowance for funds used during construction. Repairs and maintenance are charged to current operations.

Note 2 (continued):

When units of property are replaced, retired or abandoned, the recorded value thereof is credited to the asset account and charged to accumulated depreciation. To the extent the Company recovers cost of removal or other retirement costs through rates, a regulatory asset or liability may occur where timing differences exist between when the Company incurs costs of removal and when the Company recovers such costs in rates. Removal costs, net of salvage, are recorded as reductions to the regulatory liability or an increase to the regulatory asset, as applicable.

The cost of utility property, plant and equipment is depreciated using the straight-line average remaining life using the composite method.

Computer software is either purchased or internally developed and their costs are capitalized as a unit of property. The carrying value of these assets amounts to $2,884 at December 31, 2012. There was no capitalized computer software costs at December 31, 2011. The 2012 increase was primarily due to the implementation of a new ERP system.

Utility plant acquisition adjustments represent the difference between the fair value of plant at the date of purchase and its original cost when first devoted to public service (less accumulated depreciation) and are amortized to expense over the remaining useful lives of the corresponding purchased plant assets. Amortization of utility plant acquisition adjustments was $8 and $12 for 2012 and 2011, respectively. The remaining lives range from 28 to 33 years.

Cash and Cash Equivalents

Substantially all of the Company's cash is invested in interest-bearing accounts. The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents. There were no cash equivalents held at December 31, 2012 or 2011.

Accounts Receivable

The majority of the Company's accounts receivable is due from utility customers and represents amounts billed to the Company's water and wastewater customers on a cycle basis. Credit is extended based on the guidelines of the applicable Regulators and generally, collateral is not required.

Allowance for Uncollectible Accounts

Allowance for uncollectible accounts are maintained for estimated probable losses resulting from the Company's inability to collect receivables. Accounts that are outstanding longer than the payment terms are considered past due. A number of factors are considered in determining the allowance for uncollectible accounts, including the length of time receivables are past due and previous loss history. The Company writes-off accounts when they become uncollectible.

Note 2 (continued):

Materials and Supplies

Materials and supplies are stated at the lower of cost or net realizable value. Cost is determined using the average cost method.

Advances and Contributions in Aid of Construction

The Company may receive advances and contributions from customers, home builders, real estate developers, and others to fund construction necessary to extend service to new areas. Advances for construction are refundable for limited periods of time as new customers begin to receive service or other contractual obligations are fulfilled. Advances which are no longer refundable are reclassified to contributions in aid of construction. Contributions in aid of construction are permanent collections of plant assets or cash for a particular construction project. For ratemaking purposes, the amount of such advances and contributions generally serves as a rate base reduction, since they represent non-investor supplied funds.

The Company depreciates utility plant funded by contributions. The Company amortizes these amounts as a reduction to depreciation expense, producing a result which is functionally equivalent to reducing the original cost of the utility plant for the contributions. Amortization of contributions in aid of construction was $1,465 and $1,390 for the years ended December 31, 2012 and 2011, respectively. For the years ended December 31, 2012 and 2011, non-cash advances and contributions received were $7 and $95, respectively.

Recognition of Revenues

Revenues are recognized as water and wastewater services are provided and include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the date of the latest meter reading to the end of the accounting period. Other operating revenues are recognized when services are performed.

The Company accounts for sales tax collected from customers and remitted to taxing authorities on a net basis.

Income Taxes

AWW and its subsidiaries participate in a consolidated federal income tax return for U.S. tax purposes. Members of the consolidated group are charged with the amount of federal income tax expense determined as if they filed separate returns. Federal income tax expense for financial reporting purposes is provided on a separate return basis.

Certain income and expense items are accounted for in different time periods for financial reporting than for income tax reporting purposes. Deferred income taxes have been provided on the difference between the tax basis of assets and liabilities and the amounts at which they are carried in the financial statements. These deferred income taxes are based on the enacted tax rates anticipated to be in effect when such temporary differences are projected to reverse. Anticipated tax rates are the currently enacted tax rates, as the Company is not aware of

Note 2 (continued):

any tax rate changes. In addition, regulatory assets and liabilities are recognized for the effect on revenues expected to be realized as the tax effects of temporary differences previously flowed through to customers reverse.

Investment tax credits have been deferred and are being amortized to income over the average estimated service lives of the related assets.

Allowance for Funds Used During Construction ("AFUDC")

AFUDC is a non-cash credit to income with a corresponding charge to utility plant, which represents the cost of borrowed funds and a return on equity funds devoted to plant under construction. AFUDC is recorded to the extent permitted by the Regulators.

Environmental Costs

The Company's water and wastewater operations are subject to federal, state, and local requirements relating to environmental protection, and as such the Company periodically becomes subject to environmental claims in the normal course of business. Environmental expenditures that relate to current operations or provide a future benefit are expensed or capitalized as appropriate. Remediation costs that relate to an existing condition caused by past operations are accrued when it is probable that these costs will be incurred and can be reasonably estimated. There were no remediation costs accrued at December 31, 2012 and 2011.

Long-Lived Assets

Long-lived assets and certain identifiable intangible assets held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. If the sum of the future cash flows expected to result from the use of the assets and their eventual disposition is less than the carrying amount of the assets, an impairment loss is recognized. Measurement of an impairment

loss would be based on the fair value of the assets. A regulatory asset is charged to earnings if and when future recovery in rates of that asset is no longer probable. New Accounting Standards

The following recently announced accounting standards have been adopted by the Company and have been included in the results of operations, financial position or footnotes of the accompanying Financial Statements:

Fair Value Measurements

In May 2011, the Financial Accounting Standards Board ("FASB") issued updated accounting guidance related to fair value measurements and disclosures that result in common fair value measurements and disclosures between U.S. Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards. This new guidance

Note 2 (continued):

amends current fair value measurement and disclosure guidance to increase transparency around valuation inputs and investment categorization. This guidance is effective for interim and annual periods beginning on January 1, 2012 and is required to be applied prospectively. The adoption of this guidance did not have a significant impact on the Company's results of operations, financial position or cash flows.

Testing Goodwill for Impairment

In September 2011, the FASB updated the accounting guidance related to testing goodwill for impairment. This update permits an entity to assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test that is currently in place. Under the new guidance, an entity will not be required to calculate the fair value of a reporting unit unless the entity determines, based on the qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. This update is effective for annual and interim goodwill impairment tests performed by the Company beginning on January 1, 2012. The adoption of this update is not expected to have a significant impact on its results of operations, financial position or cash flows.

The following recently issued accounting standards are not yet required to be adopted by the Company or included in the results of operations or financial position of the Company:

Balance Sheet Offsetting

In December 2011, the FASB issued accounting guidance to amend the existing disclosure requirements for offsetting financial assets and liabilities to enhance current disclosures, as well as to improve comparability of balance sheets prepared under GAAP and IFRS. In January 2013, the FASB issued additional guidance on the scope of these disclosures. The revised disclosure guidance applies to derivative instruments and securities borrowing and lending transactions that are subject to an enforceable master netting arrangement or similar agreement. The revised disclosure guidance is effective on a retrospective basis for interim and annual periods beginning January 1, 2013. As this guidance provides for additional disclosure requirements only, the adoption of this guidance is not expected to have an impact on the Company's results of operations, financial position or cash flows.

Testing Indefinite-Lived Intangible Assets for Impairment

In July 2012, the FASB updated the accounting guidance related to testing indefinite-lived intangible assets for impairment. This update permits an entity to perform a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test under current guidance. This update is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The Company is evaluating the specific provisions of the updated guidance, but does not expect the adoption of this guidance to have a significant impact on the Company's results of operations, financial position or cash flows.

(Dollars in thousands, except per share amounts)

Note 2 (continued):

Reclassifications

Certain reclassifications have been made to conform previously reported data to the current presentation.

Note 3: Utility Plant

The components of utility plant by category at December 31 are as follows:

	Range of Remaining Useful Lives	2012	2011
Land and other non-depreciable assets	-	9,664	9,718
Sources of supply	34 to 75 Years	50,494	57,757
Treatment and pumping	4 to 53 Years	113,015	104,191
Transmission and distribution	40 to 72 Years	274,109	271,438
Services, meters and fire hydrants	34 to 84 Years	104,054	96,944
General structures and equipment	5 to 52 Years	43,689	36,830
Wastewater assets	5 to 50 Years	3,837	3,766
Construction work in progress	-	9,560	10,177
		608,422	590,821
Less: Accumulated depreciation		(112,509)	(105,104)
		$ 495,913	$ 485,717

The provision for depreciation expressed as a percentage of the aggregate average depreciable asset balances was 2.13% in 2012 and 1.94% in 2011. The Company records depreciation in conformity with amounts approved by state regulators after regulatory review of information the Company submits to support its estimates of the assets remaining lives.

Note 4: Regulatory Assets and Liabilities

Regulatory Assets

Regulatory assets represent costs that are expected to be fully recovered from customers in future rates. Certain assets are included in the Company's rate base and others are recovered based on specific Commission approval.

(Dollars in thousands, except per share amounts)

Note 4 (continued):

The components of regulatory assets are as follows:

	2012	2011
Income taxes recoverable through rates	$ 4,273	$ 4,445
Programmed maintenance expense	3,628	3,209
Debt and preferred stock expense	1,733	1,804
Bluegrass water project	1,598	1,655
Other	499	671
	$ 11,731	$ 11,784

The Company has recorded a regulatory asset for the additional revenues expected to be realized as the tax effects of temporary differences reverse. These temporary differences are primarily related to the difference between book and tax depreciation on property placed in service before the adoption by the Commission of full normalization for rate making purposes.

The regulatory asset for income taxes recoverable through rates is net of the reduction expected in future revenues as deferred taxes previously provided, attributable to the difference between the state and federal income tax rates under prior law and the current statutory rates, reverse over the average remaining service lives of the related assets.

Programmed maintenance costs are deferred and amortized to current operations on a straight-line basis over a period ranging between five and fifteen years, as authorized by the Commission in their determination of rates charged for service.

Debt expense is amortized over the lives of the respective issues. Unamortized debt expense is deferred and amortized to the extent it will be recovered through future service rates. Expenses of preferred stock issues without sinking fund provisions are amortized over the life of the issuance, whereas expenses of issues with sinking fund provisions are charged to operations as shares are retired.

The Company has recorded a regulatory asset for the Bluegrass water project source of supply costs in the amount of $2,283 to be amortized over a forty year period. Approval was granted per the Commission order dated May 9, 2001.

Regulatory Liabilities

Regulatory liabilities represent amounts that are expected to be refunded to customers in future rates or amounts recovered from customers in advance of incurring the costs.

Cost of removal represents amounts where the Company recovers retirement costs through rates during the life of the associated assets and before the costs are incurred. These amounts result in a regulatory liability being reported based on the amounts previously recovered through customer rates, until the costs to retire those assets are incurred.

Note 4 (continued):

Debt extinguishment relates to the 4.75% note payable due 2014 issued to AWCC, which was redeemed in October, 2007 by the Company. As agreed with the Regulators, the difference between the book value of the note and the cash consideration required to extinguish it was deferred as a regulatory liability. The regulatory liability of $827 is amortized as a component of net interest expense through 2014.

Note 5: Preferred Stock Without Mandatory Redemption

In the event of voluntary liquidation, the 5.75% series, the 5.50% series, and the 5.00% series are redeemable at $101 per share, $100.50 per share, $100 per share respectively. In the event of involuntary liquidation or governmental acquisition, the 5.75% series, the 5.50% series, and the 5.00% series are all paid at $100 per share, together with accrued dividends. All call prices are on 30 days' notice plus accrued dividends. The Company voluntarily called all of the preferred stock without mandatory redemptions on July 2, 2012 and paid a $6 early call premium which is presented in Other Income-Other, net in the accompanying Statement of Income.

Note 6: Long-Term Debt

The general mortgage bonds are issuable in series. No bonds senior to the general mortgage bonds may be issued so long as the general mortgage bonds are outstanding. Based on the calculation methodology specified by debt agreements, the amount of bonds authorized is limited only to the extent that long-term debt cannot exceed 65% of total capitalization and adjusted net income of the Company must be equal to or greater than 1.5 times the aggregate annual interest charges on all long-term debt of the Company. At December 31, 2012, long-term debt was 56% of total capitalization and net income excluding gains or losses on property sales, amortization of debt issuance costs, interest on long-term debt, and provision for income taxes was 3.1 times the aggregate annual interest charges on all long-term debt. General mortgage bonds are collateralized by utility plant.

The senior notes payable to affiliate are unsecured and were issued to American Water Capital Corporation ("AWCC"), a subsidiary of AWW, for the principal amount. AWCC provided the funding for these notes by issuing senior notes to institutional investors at a price equal to the principal amount.

In 2011, the Company issued a $20,000 long-term note payable to AWCC, at a rate of 5.05% due in 2037. The proceeds were used to pay down outstanding short-term debt.

Maturities of long-term debt, including sinking funds, will amount to $0 in 2013 through 2017, and $192,390 thereafter.

(Dollars in thousands, except per share amounts)

Note 6 (continued):

Preferred stock agreements contain provisions for redemption at various prices on thirty days notice at the Company's discretion. In the event of voluntary liquidation, the 8.47% series is redeemable at $100 per share plus the make-whole premium, together with accrued dividends.

Note 7: Short-Term Borrowings

The Company maintained a line of credit through AWCC of $25,000 at December 31, 2012 and 2011, respectively. The Company may borrow from, or invest in, the line of credit. No compensating balances are required under the agreements. Funds were primarily used for short-term operating needs. Short-term borrowings are presented as notes payable-affiliated company in the accompanying balance sheets

At December 31, 2012 and 2011, there was $11,023 and $11,509 of short-term borrowings outstanding, respectively. The weighted average annual interest rates on the borrowings at December 31, 2012 and 2011 were 0.50% and 0.40%, respectively.

The Company received cash capital contributions of $4,000 in 2012 from AWW. The proceeds were primarily used to pay down short-term debt.

AWW, through AWCC, has committed to make additional financing available to the Company, as needed, to pay its obligations as they come due.

Note 8: General Taxes

Components of general tax expense for the years presented in the statements of income are as follows:

	2012	2011
Property	$ 4,257	$ 4,417
Payroll	539	568
Gross receipts and franchise	-	11
Other	118	106
	$ 4,914	$ 5,102

(Dollars in thousands, except per share amounts)

Note 9: Income Taxes

Components of income tax expense for the years presented in the statements of income are as follows:

	2012	2011
State income taxes:		
Current	$ 1,823	$ (313)
Deferred		
Current	(7)	(9)
Non-current	(416)	1,059
	1,400	737
Federal income taxes:		
Current	9,787	17,091
Deferred		
Current	(38)	(49)
Non-current	(1,400)	(12,751)
Amortization of deferred investment tax credits	(85)	(84)
	8,264	4,207
Total income taxes	$ 9,664	$ 4,944

The 2011 total income tax expense includes a tax benefit of $4,472 related to the contribution of non-utility property to a county authority.

The primary components of the net deferred tax liability of $56,454 at December 31, 2012 include basis differences in utility plant, partially offset by advances and contributions.

No valuation allowances were required on deferred tax assets at December 31, 2012 and 2011, as management believes it is more likely than not that deferred tax assets will be realized.

At December 31, 2012 and 2011, the Company had state net operating loss carryforwards ("NOLs") of $0 and $2,515, respectively.

As of December 31, 2012 and 2011, the reserve for uncertain tax position is $3,841 and $3,130, respectively, excluding accrued interest and penalties. The Company does not expect a material change in this estimate in the next twelve months. The reserve for uncertain tax positions could increase or decrease for things such as the expiration of statutes of limitations, audit settlements, or tax examination activities.

The Company recognizes interest and penalties related to income tax matters in income tax expense. The Company recognized net interest expense (income) and penalties of $9 and $7 for 2012 and 2011, respectively.

Note 9 (continued):

The federal tax years that remain open are 2009 to 2011, with the earliest year's statute expiring in 2013. The Company is subject to state taxes. The state tax returns from 2008 to 2011 are currently open and will not close until the respective statutes of limitations expire. The statute of limitations will begin to expire in 2013.

Note 10: Rate Matters

As necessary, the Company applies to the Commission for changes in the rates charged for service. The revenues requested are based on forecasted sales, operating expenses, and investments for the first full year after the effective dates of the new rates. The Company can provide no assurances that any rate increase request will be granted by the Commission.

The Company filed a petition with the Commission seeking authority to increase its rates and charges for water service on December 28, 2012. The Company requested a $12,318 authorized increase in annualized revenues or 14.64%.

Note 11: Employee Benefit Plans

Savings Plan for Employees

The Company maintains a 401(k) savings plan, sponsored by AWW that allows employees to save for retirement on a tax-deferred basis. Employees can make contributions that are invested at their direction in one or more funds. The Company makes matching contributions based on a percentage of an employee's contribution, subject to certain limitations. Due to the Company's discontinuing new entrants into the defined benefit pension plan, on January 1, 2006 the Company began providing an additional 5.25% of base pay defined contribution benefit for union employees hired on or after January 1, 2001 and non-union employees hired on or after January 1, 2006. The Company expensed contributions to the plans totaling $315 and $278 for 2012 and 2011, respectively. All of the Company's contributions are invested in one or more funds at the direction of the employee.

Note 12: Postretirement Benefits

Pension Benefits

The Company participates in a Company funded defined benefit pension plan sponsored by AWW covering eligible employees hired before January 1, 2006. Benefits under the plan are based on the employees' years of service and average annual compensation for those 60 consecutive months of employment that yield the highest average. The pension plan has been closed for most employees hired on or after January 1, 2006. Union employees hired on or after January 1, 2001 had their accrued benefit frozen and will be able to receive this benefit as a lump sum upon termination or retirement. Union employees hired on or after January 1, 2001 and non-union employees hired on or after January 1, 2006

Note 12 (continued):

are provided with a 5.25% of base pay defined contribution plan. Pension cost of the Company is based on an allocation from AWW of the total cost related to the plan. Information regarding accumulated and

projected benefit obligations is not prepared at the subsidiary level. The Company was allocated costs of $1,219 and $1,106 for 2012 and 2011, respectively.

AWW's funding policy is to contribute at least the greater of the minimum amount required by the Employee Retirement Income Security Act of 1974 or the normal cost, and an additional contribution if needed to avoid "at risk" status and benefit restrictions under the Pension Protection Act of 2006. AWW may also increase its contributions, if appropriate, to its tax and cash position and the plan's funded position. The Company made contributions to the AWW plan of $1,914 in 2012 and $3,167 in 2011. The Company expects to contribute $1,149 to the AWW plan in 2013.

Postretirement Benefits Other Than Pensions

The Company participates in a Company-funded plan, sponsored by AWW, that provides varying levels of medical and life insurance to eligible retirees. and certain health care benefits for retired employees and their dependents. The retiree welfare plans are closed for union employees hired on or after January 1, 2006, and non-union employees hired on or after January 1, 2002.

Costs of the Company are based on an allocation from AWW of the total cost related to the plan. Information regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company was allocated costs of $783 and $743 for 2012 and 2011, respectively.

The Company made contributions to trust funds established for these postretirement benefits of $783 in 2012 and $743 in 2011. The Company's policy is to fund postretirement benefits costs accrued. The Company expects to contribute $722 to the AWW plan in 2013.

Note 13: Stock Based Compensation

Stock Options and Restricted Stock Units

In 2012 and 2011, AWW granted restricted stock units and stock options to certain employees of the Company under the AWW 2007 Omnibus Equity Compensation Plan ("Omnibus Plan"). The restricted stock units vest ratably over the three year performance period beginning January 1 of each year (the "Performance Period"); however, distribution of the shares is contingent upon the achievement of certain thresholds over the Performance Period. The thresholds are based on achievement of internal performance measures and separately certain market factors over the Performance Periods. The stock options vest ratably over a three year service period beginning January 1, 2013, 2012 and 2011, respectively.

(Dollars in thousands, except per share amounts)

Note 13 (continued):

The grant date fair value of restricted stock awards is amortized through expense over the requisite service period using the graded-vesting method. The value of stock options at the date of the grant is amortized through expense over the requisite service period using the straight-line method.

Costs of the Company are based on an allocation from AWW of the total cost for the Company's employees in the plan. The Company recorded compensation expense of $68 and $70, included in operation and maintenance expense, during the years ended December 31, 2012 and 2011, respectively. As the Company does not reimburse the cost of the awards to AWW, the offsetting entry to paid-in-capital is a capital contribution from AWW.

Employee Stock Purchase Plan

AWW's Nonqualified Employee Stock Purchase Plan ("ESPP") was effective as of July 1, 2008. Under the ESPP, the Company's employees can use payroll deductions to acquire AWW common stock at the lesser of 90% of the fair market value of a) the beginning or b) the end of each three-month purchase period. AWW's ESPP is considered compensatory. The Company's costs are based on an allocation from AWW of the total cost for the Company's employees in the plan. Compensation costs of $10 and $9 were included in operation and maintenance expense for the years ended December 31, 2012 and 2011, respectively. As the Company does not reimburse the cost of the awards to AWW, the offsetting entry to paid-in capital is a capital contribution from AWW.

Note 14: Related Party Transactions

American Water Works Service Company, Inc. ("AWWS"), a subsidiary of AWW, provides certain management services to the Company (administration, accounting, data processing, engineering, etc.) and other operating water companies in the AWW system on an at-cost, not-for-profit basis in accordance with a management and service agreement.

Purchases of such services by the Company were accounted for as follows:

	2012	2011
Included in operation and maintenance expense as a charge against income	$ 9,114	$ 7,751
Capitalized primarily in utility plant	4,582	4,024
	$ 13,696	$ 11,775

Note 14 (continued):

The Company provided workspace for certain associates of AWWS. Charges for direct costs and indirect overhead costs associated with these associates are billed to AWWS on an at-cost, not for profit basis, which amounted to $323 in 2012 and $268 in 2011.

The Company had operating arrangements with American Anglian Environmental Technologies, L.P. ("AAET"), a subsidiary of AWW, through March 31, 2011, for the lease of granular activated carbon at one of the Company's water treatment plants. The Company paid

$12 in 2011 to AAET under these arrangements. There were no payments made during 2012 under this arrangement.

The Company also purchased granular activated carbon from AAET under these arrangements. The Company paid $154 in 2011 under these agreements. There were no payments made during 2012 under this arrangement.

The Company maintains a line of credit through AWCC. The Company also participates in AWCC's centralized treasury function whereby the Company transfers its cash to AWCC and the Company's checks are issued out of AWCC. Under this arrangement, available cash is used to pay-down the line of credit and issued checks increase the Company's line of credit balance. The Company paid AWCC fees, including debt issuance cost, of $124 in 2012 and $42 in 2011 and interest expense on borrowings of $57 in 2012 and $73 in 2011. Interest expense on long-term debt due to AWCC, net of capitalized amount, was $9,806 in 2012 and $8,960 in 2011.

Accrued interest on the accompanying Balance Sheet included interest due to AWCC of $1,681 and $1,582 as of December 31, 2012 and 2011, respectively.

The Company pays dividends to AWW on a periodic basis. The amount of the dividend is based on a percentage of net income adjusted for certain items.

Note 15: Fair Values of Financial Instruments

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Current assets and current liabilities: The carrying amounts reported in the Balance Sheets for current assets and current liabilities approximate their fair values.

Preferred stock with mandatory redemption requirements and long-term debt: The fair values of preferred stock with mandatory redemption requirements and long-term debt are determined by a valuation model which is based on a conventional discounted cash flow

(Dollars in thousands, except per share amounts)

Note 15 (continued):

methodology and utilizes assumptions of current market rates. As a majority of the Company's debts do not trade in active markets, the Company calculated a base yield curve using a risk-free rate (a U.S. Treasury securities yield curve) plus a credit spread that is based on the following two factors: an average of AWW's own publicly-traded debt securities and the current market

rates for U.S. Utility BBB+ debt securities. The Company used these yield curve assumptions to derive a base yield and then adjusted the base yield for specific features of the debt securities of call features, coupon tax treatment and collateral.

The carrying amounts and fair values of the financial instruments are as follows:

	Carrying Amount	At Fair Value as of December 31, 2012			
		Level 1	Level 2	Level 3	Total
Preferred stock with mandatory redemption requirements	$ 4,500			$ 6,065	$ 6,065
Long-term debt (excluding capital lease obligations)	$ 187,890	$ 82,209		$ 142,251	$ 224,460

As of December 31, 2011	Carrying Amount	Fair Value
Preferred stock with mandatory redemption requirements	$ 4,500	$ 5,656
Long-term debt (excluding capital lease obligations)	$ 187,890	$ 225,043

Fair Value Measurements

To increase consistency and comparability in fair value measurements, FASB guidance establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels as follows:

- Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access as of the reporting date.

  Financial assets and liabilities utilizing Level 1 inputs include active exchange-trade equity securities, exchange-based derivatives, mutual funds, and money market funds.

- Level 2 – inputs other than quoted prices included within Level 1 that are directly observable for the asset or liability or indirectly observable through corroboration

Note 15 (continued):

with observable market data. Financial assets and liabilities utilizing Level 2 inputs include fixed income securities, non-exchanged-based derivatives, commingled investment funds not subject to purchase, and sale restrictions and fair-value hedges.

- Level 3 –unobservable inputs, such as internally-developed pricing models for the asset or liability due to little or no market activity for the asset or liability. Financial assets and liabilities utilizing Level 3 inputs include infrequently-traded non-exchange-based derivatives and commingled investment funds subject to purchase and sale restrictions.

Recurring Fair Value Measurements

As of December 31, 2012 and 2011, the Company had no assets or liabilities measured and recorded at fair value on a recurring basis.

Note 16: Operating Lease

The Company has entered into operating leases involving certain facilities and equipment. Rental expenses under operating leases were $69 in 2012 and $34 in 2011. The operating leases for equipment expire in 2013 through 2015.

At December 31, 2012, the minimum annual future rental commitments under operating leases that have initial or remaining non-cancelable lease terms in excess of one year are $18 in 2013, $12 in 2014, $3 in 2015, $1 in 2016 and 2017 and $26 thereafter.

Note 17: Commitments and Contingencies

Commitments have been made in connection with certain construction programs. The estimated capital expenditures required under legally binding contractual obligations amounted to $2,557 at December 31, 2012.

The Company has entered into certain service agreements in excess of one year duration. As of December 31, 2012 the future annual commitments under these agreements are estimated to be $91 in 2013 through 2016, $30 in 2017 with none thereafter.

The Company is also routinely involved in legal actions incident to the normal conduct of its business. For certain matters, the Company is unable to estimate possible losses. The Company believes that damages or settlements, if any, recovered by plaintiffs in such claims or actions will not have a material adverse effect on the Company's results of operations, financial position or cash flows.

Note 18: Subsequent Events

The Company performed an evaluation of subsequent events for the accompanying financial statements through March 21, 2013, the date this report was issued, to determine whether the circumstances warranted recognition and disclosure of those events or transactions in the financial statements as of December 31, 2012.