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September 22, 2015

RECEIVED

SEP 22 2015

PUBLIC SERVICE COMMISSION

***HAND DELIVERED***

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

*Re: Audit Report of 2014 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 four copies of the audit report for Kentucky American Water's 2014 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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SEP 22 2015

PUBLIC SERVICE
COMMISSION

# 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, 2014 and 2013**

pwc

## Independent Auditor's Report

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

We have audited the accompanying financial statements of Kentucky-American Water Company, Inc., which comprise the balance sheets as of December 31, 2014 and 2013, and the related statements of income, of changes in shareholder'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, 2014 and 2013, 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 27, 2015

*PricewaterhouseCoopers LLP, Two Commerce Square, Suite 1700, 2001 Market Street, Philadelphia, PA 19103-7042*
*T: (267) 330 3000, F: (267) 330 3300, www.pwc.com/us*

**KENTUCKY-AMERICAN WATER COMPANY, INC.**
**Balance Sheets**
**December 31, 2014 and 2013**
(Dollars in thousands)

| Assets | | 2014 | | 2013 |
|---|---|---|---|---|
| **Property, plant and equipment** | | | | |
| Utility plant - at original cost, net of accumulated depreciation | $ | 530,011 | $ | 519,037 |
| Utility plant acquisition adjustments, net | | 226 | | 234 |
| Nonutility property | | 250 | | 250 |
| Total property, plant and equipment | | 530,487 | | 519,521 |
| **Current assets** | | | | |
| Cash | | 193 | | 209 |
| Accounts receivable | | 5,541 | | 5,249 |
| Allowance for uncollectible accounts | | (766) | | (1,052) |
| Unbilled revenues | | 4,229 | | 4,965 |
| State income tax receivable | | 814 | | 284 |
| Materials and supplies | | 950 | | 638 |
| Deferred income taxes | | 1,475 | | 382 |
| Accounts receivable – affiliated company | | 703 | | - |
| Other | | 272 | | 351 |
| Total current assets | | 13,411 | | 11,026 |
| **Regulatory and other long-term assets** | | | | |
| Regulatory assets | | 15,427 | | 13,812 |
| Prepaid pension expense | | 2,439 | | 2,134 |
| Other | | 130 | | 150 |
| Total regulatory and other long-term assets | | 17,996 | | 16,096 |
| **Total assets** | $ | 561,894 | $ | 546,643 |

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

**KENTUCKY-AMERICAN WATER COMPANY, INC.**
**Balance Sheets**
**December 31, 2014 and 2013**
(Dollars in thousands)

| Capitalization and Liabilities | 2014 | 2013 |
|---|---|---|
| **Capitalization** | | |
| Common stockholder's equity | $ 167,716 | $ 163,769 |
| Preferred stock with mandatory redemption requirements | 4,500 | 4,500 |
| Long-term debt | 195,749 | 195,749 |
| Total capitalization | 367,965 | 364,018 |
| **Current liabilities** | | |
| Notes payable - affiliated company | 22,489 | 20,174 |
| Accounts payable | 5,192 | 4,510 |
| Accrued interest | 2,090 | 2,090 |
| Accrued taxes, including federal income taxes of $10 in 2014 and $43 in 2013 | 136 | 106 |
| Refunds due to customers | 482 | 1,189 |
| Other | 3,731 | 3,374 |
| Total current liabilities | 34,120 | 31,443 |
| **Regulatory and other long-term liabilities** | | |
| Regulatory liabilities | 16,924 | 15,785 |
| Deferred income taxes | 71,509 | 65,290 |
| Deferred investment tax credits | 624 | 709 |
| Advances for construction | 12,202 | 12,192 |
| Accrued postretirement benefit expense | 712 | 656 |
| Other | 1,882 | 2,595 |
| Total regulatory and other long-term liabilities | 103,853 | 97,227 |
| **Contributions in aid of construction** | 55,956 | 53,955 |
| **Commitments and contingencies (see Note 16)** | - | - |
| **Total capitalization and liabilities** | $ 561,894 | $ 546,643 |

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

**KENTUCKY-AMERICAN WATER COMPANY, INC.**
**Statements of Income**
**For the Years Ended December 31, 2014 and 2013**
(Dollars in thousands)

| | 2014 | 2013 |
|---|---|---|
| **Operating revenues** | $ 88,746 | $ 83,618 |
| **Operating expenses** | | |
| Operation and maintenance | 32,160 | 33,028 |
| Depreciation | 11,917 | 11,566 |
| Amortization | 2,014 | 1,822 |
| General taxes | 5,762 | 5,058 |
| | 51,853 | 51,474 |
| **Operating income** | 36,893 | 32,144 |
| **Other income (expenses)** | | |
| Interest on long-term debt | (12,132) | (11,905) |
| Interest on short-term debt to affiliated company | (51) | (46) |
| Allowance for other funds used during construction | 317 | 778 |
| Allowance for borrowed funds used during construction | 145 | 363 |
| Amortization of debt issuance costs | (91) | (89) |
| Other, net | (72) | (81) |
| Total other expenses | (11,884) | (10,980) |
| **Income before income taxes** | 25,009 | 21,164 |
| **Provision for income taxes** | 9,296 | 8,398 |
| **Net income available to common stockholder** | $ 15,713 | $ 12,766 |

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

**KENTUCKY-AMERICAN WATER COMPANY, INC.**
**Statements of Cash Flows**
December 31, 2014 and 2013
(Dollars in thousands)

| | 2014 | 2013 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | $ 15,713 | $ 12,766 |
| Adjustments | | |
| Depreciation and amortization | 13,931 | 13,388 |
| Amortization of debt issuance costs | 91 | 89 |
| Deferred income tax benefit | 5,548 | 7,734 |
| Amortization of deferred investment tax credits | (85) | (85) |
| Provision for losses on accounts receivable | 1,042 | 1,092 |
| Allowance for other funds used during construction | (317) | (778) |
| Pension and non-pension postretirement benefits | 626 | 1,766 |
| Deferred programmed maintenance expense | (2,873) | (2,131) |
| Other, net | (817) | (605) |
| Changes in assets and liabilities | | |
| Accounts receivable and unbilled revenues | (884) | (2,859) |
| Federal income tax payable - affiliated company | (33) | (2,698) |
| Other current assets | (754) | 400 |
| Pension and non-pension postretirement benefits contribution | (931) | (1,871) |
| Accounts payable | 584 | (1,051) |
| Accrued taxes | 63 | (1,792) |
| Other current liabilities | (242) | 875 |
| Net cash provided by operating activities | 30,662 | 24,240 |
| **Cash flows from investing activities** | | |
| Capital expenditures | (23,116) | (36,900) |
| Acquisition | (520) | - |
| Removal costs from property, plant and equipment retirements, net of salvage of $226 in 2014 and $ 303 in 2013 | (762) | (86) |
| Net cash used in investing activities | (24,398) | (36,986) |
| **Cash flows from financing activities** | | |
| Proceeds from issuance of long-term debt to affiliated company | - | 7,859 |
| Debt issuance costs | - | (32) |
| Net borrowings of short-term borrowings-affiliated company | 2,315 | 9,151 |
| Advances and contributions for construction, net of refunds of $1,154 in 2014 and $1,187 in 2013 | 3,254 | 3,884 |
| Dividends paid | (11,849) | (8,291) |
| Net cash provided by (used in) financing activities | (6,280) | 12,571 |
| **Net decrease in cash and cash equivalents** | (16) | (175) |
| **Cash at beginning of year** | 209 | 384 |
| **Cash at end of year** | $ 193 | $ 209 |
| **Cash paid during the year for:** | | |
| Interest, net of capitalized amount | $ 10,120 | $ 11,970 |
| Income taxes | $ 1,395 | $ 3,710 |
| **Non-cash investing activity** | | |
| Capital expenditures acquired on account but unpaid as of year end | $ 2,115 | $ 2,512 |
| **Non-cash financing activity** | | |
| Capital contribution (See Note 12) | $ 83 | $ 80 |

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

**KENTUCKY-AMERICAN WATER COMPANY, INC.**
**Statements of Changes in Shareholder's Equity**
December 31, 2014 and 2013
(Dollars in thousands)

| | Common Stock Shares | Par Value | Paid-in Capital | Retained Earnings | Total |
|---|---|---|---|---|---|
| **Balance at December 31, 2012** | 1,567,391 | $ 36,569 | $ 78,846 | $ 43,799 | $ 159,214 |
| Net income | - | - | - | 12,766 | 12,766 |
| Capital contributions | - | - | 80 | - | 80 |
| Common stock dividends | - | - | - | (8,291) | (8,291) |
| **Balance at December 31, 2013** | 1,567,391 | 36,569 | 78,926 | 48,274 | 163,769 |
| Net income | - | - | - | 15,713 | 15,713 |
| Capital contributions | - | - | 83 | - | 83 |
| Common stock dividends | - | - | - | (11,849) | (11,849) |
| **Balance at December 31, 2014** | 1,567,391 | $ 36,569 | $ 79,009 | $ 52,138 | $ 167,716 |

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

## Note 1: Organization and Operation

Kentucky-American Water Company, Inc. (the "Company") provides water and wastewater service to customers 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 estimates used in impairment testing of other 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"). The Commission has 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 non-regulated company. These deferred regulatory assets and liabilities are then reflected in the statements 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, supervision, payroll taxes, benefits, transportation and an allowance for funds used during construction. Repairs and maintenance are charged to operation and maintenance expense as incurred.

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 costs of removal or other retirement costs through rates, a regulatory asset or liability is recorded when 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.

The costs incurred to acquire and internally develop computer software for internal use are capitalized as a unit of property. The carrying value of these assets amounts to $9,063 at December 31, 2014 and $8,892 at December 31, 2013.

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 $9 for 2014 and 2013, respectively. The remaining lives range from 26 to 31 years.

*Cash*

Substantially all of the Company's cash is invested in interest-bearing accounts.

*Accounts Receivable*

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

*Allowance for Uncollectible Accounts*

Allowance for uncollectible accounts is 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.

*Unbilled Revenues*

Unbilled revenues are accrued when service has been provided but has not been billed to customers.

*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.

*Long-Lived Assets*

Long-lived 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.

*Advances for Construction and Contributions in Aid of Construction*

The Company may receive advances for construction ("advances") and contributions in aid of construction ("contributions") from customers, home builders, real estate developers, and others to fund construction necessary to extend service to new areas. Advances are refundable for limited periods of time as new customers begin to receive service or other contractual obligations are fulfilled.

Advances that are no longer refundable are reclassified to contributions. Contributions are permanent collections of plant assets or cash for a particular construction project. For rate-making purposes, the amount of such contributions generally serves as a rate base reduction, since it represents non-investor supplied funds.

The Company depreciates utility plant funded by contributions and amortizes its contribution balance 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 was $1,573 and $1,548 for the years ended December 31, 2014 and 2013, respectively. For the years ended December 31, 2014 and 2013, no non-cash advances or contributions were received.

*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 meter reading associated with the latest customer invoice 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 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.

**New Accounting Standards**

The following recently issued 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:

*Obligations Resulting from Joint and Several Liability Arrangements*

In February 2013, the Financial Accounting Standards Board ("FASB") issued guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. Examples of obligations within the scope of the updated guidance include debt arrangements, other contractual obligations and settled litigation and judicial rulings. The update requires an entity to measure obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date as the sum of the following: (a) the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and (b) any additional amount the reporting entity expects to pay on behalf of its co-obligors. The updated guidance also includes additional disclosures regarding the nature and amount of the obligation, as well as other information about those obligations. The update was effective on a retrospective basis for interim and annual periods beginning after December 15, 2013, which for the Company was January 1, 2014. The adoption of this updated guidance did not have an impact on the Company's results of operations, financial position or cash flows.

The following recently issued accounting standards are not yet required to be adopted by the Company:

*Service Concession Arrangements*

In January 2014, the FASB issued guidance for an operating entity that enters into a service concession arrangement with a public sector grantor who controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide the services and at what price. The grantor also controls, through ownership or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement. The guidance specifies that an operating entity should not account for the service concession arrangement as a lease. The operating entity should refer instead to other accounting guidance to account for the various aspects of the arrangement. The guidance also specifies that the infrastructure used in the arrangement should not be recognized as property, plant and equipment of the operating entity. This update should be applied on a modified retrospective basis to service concession arrangements that exist at the beginning of an entity's fiscal year of adoption. This requires the cumulative effect of applying the update to be recognized as an adjustment to the opening retained earnings balance for the annual period of adoption. The update is effective for interim and annual periods beginning after December 15, 2014, which for the Company is January 1, 2015. The adoption of this updated guidance will not have an impact on the Company's results of operations, financial position or cash flows.

*Reporting Discontinued Operations*

In April 2014, the FASB issued guidance that changes the criteria for determining which disposals can be presented as discontinued operations and modifies related disclosure requirements. Under the updated guidance, a discontinued operation is defined as a component or group of components that is disposed of or is classified as held for sale and represents a strategic shift that has or will have a major effect on an entity's operations and financial results. A strategic shift could include a disposal of a major geographical area of operations, a major line of business, a major equity method investment or other major part of the entity. A component comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity including a reportable segment, an operating segment, a reporting unit, a subsidiary or an asset group. The update no longer precludes presentation as a discontinued operation if there are operations and cash flows of the component that have not been eliminated from the reporting entity's ongoing operations or if there is significant continuing involvement with a component after its disposal. The updated guidance is effective on a prospective basis for interim and annual periods on or after December 15, 2014, which for the Company is January 1, 2015. In general, this guidance is likely to result in fewer disposals of assets qualifying as discontinued operations, but will ultimately be based on the Company's future disposal activity.

*Revenue from Contracts with Customers*

In May 2014, the FASB issued a comprehensive new revenue recognition standard that supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the new guidance is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The guidance is effective for annual and interim periods beginning December 15, 2016, which for the Company is January 1, 2017. Early adoption is not permitted. The new guidance allows for either full retrospective adoption, meaning the guidance is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements. The Company is evaluating the new guidance, the best transition method and the impact the new standard will have on its results of operations, financial position or cash flows.

*Accounting for Stock-based Compensation with Performance Targets*

In June 2014, the FASB issued guidance for the accounting for stock-based compensation tied to performance targets. The amendments clarify that a performance target that affects vesting of a share-based payment and that could be achieved after the requisite service period is a performance condition. As a result, the target is not reflected in the estimation of the award's grant date fair value and compensation cost would be recognized over the required service period, if it is probable that the performance condition will be achieved. The updated guidance may be applied either: (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. The updated guidance is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015, which for the Company is January 1, 2016. Early adoption is permitted. The Company is evaluating the impact the updated guidance will have on its results of operations, financial position or cash flows.

*Disclosures of Uncertainties about an Entity's Ability to Continue as a Going Concern*

In August 2014, the FASB issued guidance that explicitly requires an entity's management to assess the entity's ability to continue as a going concern. The new guidance requires an entity to evaluate, at each interim and annual period, whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued (or are available to be issued) and to provide related disclosures, if applicable. The new guidance is effective for annual periods ending after December 15, 2016 and for interim and annual periods thereafter, which for the Company is January 1, 2017. Early adoption is permitted. The adoption of this updated guidance is not expected to have a material impact on results of operations, financial position or cash flows.

*Hybrid Financial Instruments Issued in the Form of a Share*

In November 2014, the FASB updated the derivatives and hedging guidance requiring issuers of, or investors in, hybrid financial instruments to determine whether the nature of the host contract is more akin to a debt instrument or an equity instrument by considering the economic characteristics and risks of the entire hybrid financial instrument, including the embedded derivative feature that is being evaluated for separate accounting from the host contract. This update should be applied on a modified retrospective basis to hybrid financial instruments issued in the form of a share that exist at the beginning of an entity's fiscal year of adoption. The updated guidance is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015, which for the Company is January 1, 2016. Early adoption is permitted. The adoption of this updated guidance is not expected to have a material impact on results of operations, financial position or cash flows.

*Extraordinary and Unusual Items*

In January 2015, the FASB issued guidance that eliminates the concept of an extraordinary item. As a result, an entity will no longer segregate an extraordinary item and present it separately from the results of ordinary operations or separately disclose income taxes or earnings per share information applicable to an extraordinary item. The presentation and disclosure guidance for items that are unusual in nature or occur infrequently has been retained and expanded to include items that are both unusual in nature and infrequently occurring. The updated guidance is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015, which for the Company is January 1, 2016. Early adoption is permitted. The updated guidance may be applied prospectively or retrospectively to all periods presented in the financial statements. The adoption of this updated guidance is not expected to have a material impact on results of operations, financial position or cash flows.

## Note 3: Acquisitions

During 2014, the Company acquired one regulated water and wastewater system for a total aggregate purchase price of $520. Assets acquired, principally plant, totaled $742 and liabilities assumed totaled $222.

(Dollars in thousands)

## Note 4: Utility Plant

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

| | Range of Remaining Useful Lives | 2014 | 2013 |
|---|---|---|---|
| Land and other non-depreciable assets | - | $ 9,686 | $ 9,664 |
| Sources of supply | 34 to 75 Years | 52,639 | 51,061 |
| Treatment and pumping | 4 to 53 Years | 104,442 | 117,433 |
| Transmission and distribution | 40 to 72 Years | 301,212 | 278,368 |
| Services, meters and fire hydrants | 34 to 84 Years | 114,101 | 109,542 |
| General structures and equipment | 5 to 52 Years | 46,031 | 48,600 |
| Wastewater assets | 5 to 50 Years | 6,646 | 4,043 |
| Construction work in progress | - | 9,513 | 20,596 |
| | | 644,270 | 639,307 |
| Less: Accumulated depreciation | | (114,259) | (120,270) |
| | | $ 530,011 | $ 519,037 |

The provision for depreciation expressed as a percentage of the aggregate average depreciable asset balances was 2.38% and 2.40% in 2014 and 2013, respectively. 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 5: Regulatory Assets and Liabilities

*Regulatory Assets*

Regulatory assets represent costs that are expected to be fully recovered from customers in future rates. Except for income taxes, regulatory assets are excluded from the Company's rate base and generally do not earn a return.

The components of regulatory assets are as follows:

| | 2014 | 2013 |
|---|---|---|
| Income taxes recoverable through rates | $ 3,721 | $ 4,104 |
| Programmed maintenance expense | 7,755 | 5,325 |
| Debt and preferred stock expense | 1,592 | 1,663 |
| Bluegrass water project | 1,484 | 1,541 |
| Other | 875 | 1,179 |
| | $ 15,427 | $ 13,812 |

The Company has recorded a regulatory asset for 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.

(Dollars in thousands)

Programmed maintenance costs are deferred and amortized to current operations on a straight-line basis over a fifteen year period, 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.

Other regulatory assets are mostly comprised of deferred rate case expense, certain employee related benefits and deferred waste disposal costs.

*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.

The components of regulatory liabilities are as follows:

| | 2014 | 2013 |
|---|---|---|
| Cost of removal | $ 16,924 | $ 15,764 |
| Debt extinguishment | - | 21 |
| | $ 16,924 | $ 15,785 |

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.

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.

(Dollars in thousands)

## Note 6: Long-Term Debt

The components of long-term debt at December 31 are as follows:

| | Rate | Weighted Average Rate | Maturity Date | 2014 | 2013 |
|---|---|---|---|---|---|
| General mortgage bonds | 6.96%-7.15% | 7.03% | 2023-2028 | $ 23,500 | $ 23,500 |
| Notes payable to affiliated company | 4.00%-6.59% | 5.88% | 2037-2040 | 172,249 | 172,249 |
| Preferred stock with mandatory redemption requirements | 8.47% | 8.47% | 2036 | 4,500 | 4,500 |
| Total long-term debt | | | | $ 200,249 | $ 200,249 |

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, 2014, long-term debt was 57% 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 2013, the Company issued a $7,859 long-term note payable to AWCC, at a rate of 4.00% 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 2015 through 2019, and $200,249 thereafter. Preferred stock agreements contain provisions for redemption at various prices on thirty day 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.

(Dollars in thousands)

## Note 7: Short-Term Debt

The Company maintained a line of credit through AWCC of $40,000 and $30,000 at December 31, 2014 and 2013, 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, 2014 and 2013, there was $22,489 and $20,174 of short-term borrowings outstanding, respectively. The weighted average annual interest rates on the borrowings at December 31, 2014 and 2013 were 0.32% and 0.40%, respectively.

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:

| | 2014 | 2013 |
|---|---|---|
| Property | $ 5,116 | $ 4,419 |
| Payroll | 489 | 483 |
| Other | 157 | 156 |
| | $ 5,762 | $ 5,058 |

(Dollars in thousands)

## Note 9: Income Taxes

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

| | 2014 | 2013 |
|---|---|---|
| **State income taxes:** | | |
| Current | $ 743 | $ 578 |
| Deferred | | |
| Current | (17) | (18) |
| Non-current | 662 | 512 |
| | 1,388 | 1,072 |
| **Federal income taxes:** | | |
| Current | 3,090 | 171 |
| Deferred | | |
| Current | (91) | (91) |
| Non-current | 4,994 | 7,331 |
| Amortization of deferred investment tax credits | (85) | (85) |
| | 7,908 | 7,326 |
| **Total income taxes** | $ 9,296 | $ 8,398 |

The primary components of the net deferred tax liability of $70,033 and $64,908 at December 31, 2014 and December 31, 2013, respectively, include basis differences in utility plant, partially offset by advances and contributions.

No valuation allowances were required on deferred tax assets at December 31, 2014 and 2013, as management believes it is more likely than not that deferred tax assets will be realized.

As of December 31, 2014 and 2013, the reserve for uncertain tax position is $2,635 and $3,359, 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 a net benefit of $1 and $20 for 2014 and 2013, respectively, related to interest and penalties on income tax matters in income tax expense.

The federal tax years that remain open are 2012 to 2013, with the earliest year's statute expiring in 2015. The Company is subject to state taxes. The state tax returns from 2010 to 2013 are currently open and will not close until the respective statutes of limitations expire. The statute of limitations will begin to expire in 2015.

## Note 10: 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 that are 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 $261 and $338 for 2014 and 2013, respectively. All of the Company's contributions are invested in one or more funds at the direction of the employee.

## Note 11: 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 compensation. The pension plan was 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. Pension cost of the Company is based on an allocation from AWW of the total cost related to the plan. The allocation is based upon the Company's participants' pensionable earnings as a percentage of AWW's total plan pensionable earnings. Information regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company was allocated costs of $314 and $1,044 for 2014 and 2013, respectively.

AWW's funding practice 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. Further, AWW will consider additional contributions if needed to avoid "at risk" status and benefit restrictions under the Pension Protection Act of 2006. AWW may also consider increased contributions based on other financial requirements and the plan's funded position. Pension contributions of the Company are based on an allocation from AWW of the total contributions related to the plan. Contributions are allocated to the Company from AWW based upon the Company's participants' pensionable earnings as a percentage of AWW's total plan pensionable earnings. The Company made contributions to the AWW plan of $619 in 2014 and $1,149 in 2013. The Company expects to contribute $496 to the AWW plan in 2015.

*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. The allocation is based upon the Company's covered participants as a percentage of AWW's total plan covered participants. Information regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company was allocated costs and made contributions of $312 and $722 for 2014 and 2013, respectively.

The Company's policy is to fund postretirement benefits costs accrued. The Company expects to contribute $661 to the AWW plan in 2015.

## Note 12: Stock Based Compensation

*Stock Options and Restricted Stock Units*
In 2014 and 2013, AWW granted restricted stock units, both with and without performance conditions, and stock options to certain employees of the Company under the AWW 2007 Omnibus Equity Compensation Plan ("Omnibus Plan"). The restricted stock units without performance conditions vest ratably over the three-year service period beginning January 1 of the year of the grant. The restricted stock units with performance conditions vest ratably over the three year performance period beginning January 1 of each year (the "Performance Period"). Distribution of the performance 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, 2014 and 2013, respectively.

The grant date fair value of restricted stock unit awards with performance conditions is amortized through expense over the requisite service period using the graded-vesting method. The value of stock options and the restricted stock unit awards without performance conditions 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 the cost of the Company's employees participating in the AWW Omnibus Plan. The Company recorded compensation expense of $73 and $71, included in operation and maintenance expense, during the years ended December 31, 2014 and 2013, 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*
Under AWW's Nonqualified Employee Stock Purchase Plan ("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

(Dollars in thousands)

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, 2014 and 2013, 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 13: 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:

| | 2014 | 2013 |
|---|---|---|
| Included in operation and maintenance expense as a charge against income | $ 8,776 | $ 9,164 |
| Capitalized primarily in utility plant | 2,217 | 2,947 |
| | $ 10,993 | $ 12,111 |

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 $120 in 2014 and 2013.

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 of $72 in 2014 and $67 in 2013 and interest expense on borrowings of $51 in 2014 and $46 in 2013. Interest expense on long-term debt due to AWCC, net of capitalized amount, was $10,120 in 2014 and $10,002 in 2013. Accrued interest on the accompanying balance sheets included interest due to AWCC of $1,746 as of December 31, 2014 and 2013.

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 14: Fair Values of Financial Instruments

*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 input 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 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.

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

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

*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 categorized within the fair value hierarchy based on the inputs that are used to value each instrument. The fair value of long-term debt classified as Level 1 is calculated using quoted prices in active markets. Level 2 instruments are valued using observable inputs and Level 3 instruments are valued using observable and unobservable inputs. The fair values of instruments classified as Level 2 and 3 are determined by a valuation model that is based on a conventional discounted cash flow 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 the Company'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 for the Level 2 and Level 3 securities. Additionally, the Company adjusted the base yield for specific features of the debt securities including call features, coupon tax treatment and collateral for the Level 3 instruments.

(Dollars in thousands)

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

| | | At Fair Value as of December 31, 2014 | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Level 1 | Level 2 | Level 3 | Total |
| Preferred stock with mandatory redemption requirements | $ 4,500 | $ - | $ - | $ 6,207 | $ 6,207 |
| Long-term debt (excluding capital lease obligations) | 195,749 | - | 92,808 | 141,023 | 233,831 |

| | | At Fair Value as of December 31, 2013 | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Level 1 | Level 2 | Level 3 | Total |
| Preferred stock with mandatory redemption requirements | $ 4,500 | $ - | $ - | $ 5,397 | $ 5,397 |
| Long-term debt (excluding capital lease obligations) | 195,749 | - | 82,554 | 137,235 | 219,789 |

## Note 15: Leases

The Company has entered into operating leases involving certain facilities and equipment. Rental expenses under operating leases were $33 in 2014 and $126 in 2013.

At December 31, 2014, the minimum annual future rental commitments under operating leases that have initial or remaining non-cancelable lease terms in excess of one year are $4 in 2015, $1 per year in 2016 through 2019 and $21 thereafter.

## Note 16: 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 $4,174 at December 31, 2014.

The Company has entered into certain service agreements in excess of one year duration. As of December 31, 2014 the future annual commitments under these agreements are estimated to be $65 in 2015 through 2017, with none thereafter.

The Company is also routinely involved in legal actions incident to the normal conduct of its business. At December 31, 2014, the Company has not identified any loss contingencies that are either probable or reasonably possible.

## Note 17: Subsequent Events

The Company performed an evaluation of subsequent events for the accompanying financial statements through March 27, 2015, 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, 2014.