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RECEIVED
SEP 28 2017
PUBLIC SERVICE
COMMISSION

September 28, 2017

HAND DELIVERED

Mr. John S. Lyons
Acting Executive Director
Kentucky Public Service Commission
211 Sower Blvd
Frankfort, KY 40601

Re: Kentucky American Water Audited Financial Statements

Dear Mr. Lyons:

In conformity with 807 KAR 5:006 Section 4(3), enclosed please find the audit report for Kentucky American Water's 2016 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

Enclosure
010311.003026/4706214.1

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, 2016 and 2015

pwc

Report of Independent Auditors

To the Board of Directors 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, 2016 and 2015, and the related statements of income, 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, Inc. as of December 31, 2016 and 2015, 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 24, 2017

PricewaterhouseCoopers LLP, Two Commerce Square, Suite 1800, 2001 Market Street, Philadelphia, PA 19103
T: (267) 330 3000, F: (267) 330 3300, www.pwc.com/us

KENTUCKY-AMERICAN WATER COMPANY, INC.
Balance Sheets
December 31, 2016 and 2015
(Dollars in thousands)

Assets

Property, plant and equipment	**2016**	**2015**
Utility plant - at original cost, net of accumulated depreciation of $135,238 and $124,096 at December 31, 2016 and 2015, respectively	$ 571,635	$ 553,472
Utility plant acquisition adjustments, net	210	218
Non-utility property	250	250
Total property, plant and equipment	572,095	553,940
Current assets		
Cash and cash equivalents	439	200
Utility customer accounts receivable	7,380	6,500
Allowance for uncollectible accounts	(876)	(807)
Unbilled utility revenues	4,405	4,232
Federal income tax receivable - affiliated company	761	-
State income tax receivable	213	199
Materials and supplies	758	914
Other current assets	341	296
Total current assets	13,421	11,534
Regulatory and other long-term assets		
Regulatory assets	17,061	15,288
Goodwill	21	-
Prepaid pension expense	1,921	2,171
Other long-term assets	101	167
Total regulatory and other long-term assets	19,104	17,626
Total assets	$ 604,620	$ 583,100

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

KENTUCKY-AMERICAN WATER COMPANY, INC.
Balance Sheets
December 31, 2016 and 2015
(Dollars in thousands)

Capitalization and Liabilities

	2016	2015
Capitalization		
Common stockholder's equity	$ 186,819	$ 171,249
Long-term debt	200,708	195,749
Preferred stock with mandatory redemption requirements	2,250	2,250
Total capitalization	389,777	369,248
Current liabilities		
Notes payable - affiliated company	21,137	26,112
Accounts payable	3,733	6,636
Accrued interest	2,098	2,066
Accounts payable affiliated company	6	4,656
Federal income tax payable - affiliated company	-	1,308
Accrued taxes	4,620	1,120
Refunds due to customers	591	648
Other current liabilities	4,696	4,265
Total current liabilities	36,881	46,811
Regulatory and other long-term liabilities		
Advances for construction	12,196	12,467
Deferred income taxes	82,728	75,130
Deferred investment tax credits	455	539
Regulatory liabilities	17,849	18,269
Accrued postretirement benefit expense	701	753
Other long-term liabilities	219	1,694
	114,148	108,852
Contributions in aid of construction	63,814	58,189
Commitments and contingencies (see note 15)	-	-
Total capitalization and liabilities	$ 604,620	$ 583,100

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

KENTUCKY-AMERICAN WATER COMPANY, INC.
Statements of Income
December 31, 2016 and 2015
(Dollars in thousands)

	2016	2015
Operating revenues	$ 95,348	$ 91,239
Operating expenses		
Operation and maintenance	34,480	34,118
Depreciation	12,816	11,670
Amortization	2,177	2,093
General taxes	6,334	6,574
Total operating expenses, net	55,807	54,455
Operating income	39,541	36,784
Other income (expenses)		
Interest, net	(12,092)	(12,237)
Allowance for other funds used during construction	1,093	770
Allowance for borrowed funds used during construction	492	351
Amortization of debt issuance costs	(108)	(105)
Other, net	(153)	(101)
Total other expenses	(10,768)	(11,322)
Income before income taxes	28,773	25,462
Provision for income taxes	11,003	10,710
Net income	$ 17,770	$ 14,752

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

KENTUCKY-AMERICAN WATER COMPANY, INC.
Statements of Cash Flows
December 31, 2016 and 2015
(Dollars in thousands)

	2016	2015
Cash flows from operating activities		
Net income	$ 17,770	$ 14,752
Adjustments to reconcile net cash flows provided by operating activities		
Depreciation and amortization	14,993	13,763
Amortization of debt issuance costs	108	105
Provision for deferred income taxes	7,140	5,267
Amortization of deferred investment tax credits	(85)	(85)
Provision for losses on accounts receivable	921	906
Allowance for other funds used during construction	(1,093)	(770)
Pension and non-pension postretirement benefits	1,216	1,424
Deferred programmed maintenance expense	(1,536)	(448)
Other, net	(156)	481
Changes in assets and liabilities		
Accounts receivable and unbilled revenues	(1,966)	(1,827)
Accounts receivable and payables - affiliate company	(622)	629
Federal income tax - affiliated company	(3,293)	942
State income tax	(37)	615
Other current assets	108	720
Pension and non-pension postretirement benefit contributions	(1,050)	(1,157)
Accounts payable	476	(713)
Accrued taxes	3,500	994
Other current liabilities	269	568
Net cash provided by operating activities	36,663	36,166
Cash flows from investing activities		
Capital expenditures	(34,741)	(33,553)
Acquisitions	(15)	-
Removal costs from property, plant and equipment retirements, net of salvage of $193 in 2016 and $56 in 2015	(2,639)	(923)
Net cash used in investing activities	(37,395)	(34,476)
Cash flows from financing activities		
Proceeds from issuance of long-term debt - affiliated company	5,000	-
Debt issuance costs	(53)	(64)
Net (repayments) borrowings of notes payables - affiliated company	(4,975)	3,623
Advances and contributions for construction, net of refunds of $851 and $1,235 in 2016 and 2015, respectively	7,269	4,265
Capital contributions	10,000	-
Redemption of preferred stock	-	(2,250)
Dividends paid	(16,270)	(7,257)
Net cash provided by (used in) financing activities	971	(1,683)
Net increase in cash and cash equivalents	239	7
Cash and cash equivalents at beginning of year	200	193
Cash and cash equivalents at end of year	$ 439	$ 200
Cash paid (received) during the year for:		
Interest, net of capitalized amount	$ 11,956	$ 12,161
Income taxes	$ 6,634	$ 4,422
Non-cash investing activity		
Capital expenditures acquired on account but unpaid as of year end	$ 1,475	$ 3,736
Non-cash financing activity		
Dividends accrued	$ -	$ 4,028
Capital contribution (see Note 11)	$ 42	$ 66

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

KENTUCKY-AMERICAN WATER COMPANY, INC.
Statement of Changes in Shareholder's Equity
December 31, 2016 and 2015
(Dollars in thousands)

	Common Stock		Paid-in	Retained	
	Shares	**Par Value**	**Capital**	**Earnings**	**Total**
Balance at December 31, 2014	1,567,391	$ 36,569	$ 79,009	$ 52,138	$ 167,716
Net income	-	-	-	14,752	14,752
Capital contributions	-	-	66	-	66
Common stock dividends	-	-	-	(11,285)	(11,285)
Balance at December 31, 2015	1,567,391	$ 36,569	$ 79,075	$ 55,605	$ 171,249
Net income	-	-	-	17,770	17,770
Capital contributions	-	-	10,042	-	10,042
Common stock dividends	-	-	-	(12,242)	(12,242)
Balance at December 31, 2016	1,567,391	$ 36,569	$ 89,117	$ 61,133	$ 186,819

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 services 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 Board of Public Utilities (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 ("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 its critical accounting estimates to include: the application of regulatory accounting principles and the related determination and estimates of regulatory assets; estimates used in impairment testing of goodwill and other long-lived assets, including regulatory assets and liabilities; revenue recognition; accounting for income taxes; benefit plan assumptions; and contingent liabilities. The Company's critical accounting estimates that are particularly sensitive to change in the near term are amounts reported for regulatory assets and liabilities, benefit plan assumptions and contingency-related obligations.

Regulation

The Company is subject to regulation by the Commission, the Kentucky Department of Environmental Protection and the U.S. Environmental Protection Agency. The Commission generally authorizes revenue at levels intended to recover the estimated costs of providing service, plus a return on net investments, or rate base. The Commission may also impose certain penalties or grant certain incentives. Due to timing and other differences in the collection of utility revenue, an incurred cost that would otherwise be charged to expense is deferred as a regulatory asset if it is probable that the cost is recoverable in future rates. Conversely, GAAP requires recording of a regulatory liability for amounts collected in rates to recover costs expected to be incurred in the future or amounts collected in excess of costs incurred and refundable to customers.

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 cost of removal or other retirement costs through rates after the retirement costs are incurred, a regulatory asset is recorded. In some cases, the Company recovers retirement costs through rates during the life of the associated asset 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.

The Company records depreciation in conformity with amounts approved by the Commission after regulatory review of information the Company submits to support its estimates of the assets' remaining useful lives. The cost of property, plant and equipment is generally 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 amounted to $8,528 at December 31, 2016 and $8,537 at December 31, 2015. Computer software is included in the general structures and equipment category in Note 4.

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 amortization periods authorized by the Commission. Amortization of utility plant acquisition adjustments was $8 for the years ended December 31, 2016 and 2015. The remaining useful lives range from 24 to 29 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 Commission 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.

Goodwill

The Company has $21 and $0 of goodwill at December 31, 2016 and 2015, respectively. The Company's annual impairment test is performed as of November 30 of each year, in conjunction with the completion of its annual strategic business plan. The Company also undertakes interim reviews when it determines that a triggering event that would more likely than not reduce the fair value of the Company below its carrying value has occurred.

The Company performs a two-step impairment test to evaluate the carrying value of goodwill for the Company if qualitative factors indicate that it is more likely than not that the Company's fair value is less than its carrying value. The step one calculation used to identify potential impairment compares the estimated fair value for the Company to its net carrying value, including goodwill, on the measurement date. If the estimated fair value of the Company is less than its carrying value, then step two is performed to measure the amount of the impairment loss (if any.)

The step two calculation of the impairment test compares the implied fair value of the goodwill to the carrying value of goodwill. The implied fair value of goodwill is equal to the excess of the fair value of the Company above the fair value of identified assets and liabilities. If the carrying value of goodwill exceeds the implied fair value of goodwill, an impairment loss is recognized in an amount equal to the excess (not to exceed the carrying value of goodwill.)

The determination of the fair value of the Company and the fair value of the Company's assets and liabilities is performed as of the measurement date using observable market data before and after the measurement date (if that subsequent information is relevant to the fair value on the measurement date.)

After assessing various events and circumstances in 2016, the Company determined that no qualitative factors were present that would indicate the estimated fair value was less than the carrying value. As such, the Company determined that the two-step goodwill impairment test was not necessary at November 30, 2016.

Advances for Construction and Contributions in Aid of Construction

The Company may receive advances for construction and contributions in aid of construction 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 contributions 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 $1,817 and $1,659 for the years ended December 31, 2016 and 2015, respectively. For the years ended December 31, 2016 and 2015, 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 that represents the cost of borrowed funds or a return on equity funds devoted to plant under construction. AFUDC is recorded to the extent permitted by the Commission.

New Accounting Standards

The following recently issued accounting standards have been adopted by the Company at December 31, 2016.

Accounting for Fees Paid in a Cloud Computing Arrangement

In April 2015, the FASB issued guidance clarifying how customers should account for fees paid in a cloud computing arrangement. Under the new guidance, if a cloud computing arrangement contains a software license, the customer would account for the software license element of the arrangement consistent with the acquisition of other software licenses. If the cloud computing arrangement does not include a software license, the customer would account for the arrangement as a service contract. The guidance is effective January 1, 2016 for the Company and has been adopted on a prospective basis. The adoption of this standard did not impact the Company's results of operations, financial position or cash flows.

The following recently issued accounting standards have not been adopted by the Company at December 31, 2016.

Revenue from Contracts with Customers

In May 2014, the FASB issued a new revenue recognition standard that will replace most existing revenue recognition guidance in GAAP, including industry-specific guidance. The core principle of the new guidance is that an entity will recognize revenue for the transfer of goods or services to customers equal to the amount that it expects to be entitled to receive for those goods or services. The guidance also requires additional disclosures about the nature, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments. The new standard is effective January 1, 2019 for the Company. Early adoption is permitted, but not before January 1, 2018 for the Company. The Company is evaluating the impact on the consolidated financial statements and related disclosures, as well as the transition method to be used to adopt the guidance. The Company is also considering the impacts of the new standard on its accounting for contributions in aid of construction. The Company does not expect to early adopt.

Accounting for Leases

In February 2016, the FASB issued guidance that changed the accounting and reporting guidelines for leasing arrangements. Under the new guidance, lessees will be required to recognize the following for all leases, excluding short-term leases, at the commencement date: (i) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (ii) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. This guidance is effective January 1, 2020 for the Company and will be adopted on a modified retrospective basis. Early adoption is permitted. The Company is currently evaluating the effect on the financial statements and related disclosures, as well as the timing of adoption.

Classification of Certain Cash Receipts and Cash Payments on the Statement of Cash Flows

In August 2016, the FASB issued guidance that clarifies the presentation and classification in the statement of cash flows for certain cash receipts and payments. These cash receipts and payments include: (i) debt prepayment or debt extinguishment costs; (ii) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of borrowing; (iii) contingent consideration payments made after a business combination; (iv) proceeds from the settlement of insurance claims; (v) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (vi) distributions received from equity method investees; (vii) beneficial interest in securitization transactions; (viii) and separately identifiable cash flows and application of the predominance principle. The new standard is effective January 1, 2019 for the Company. Early adoption is permitted, but not before January 1, 2018 for the Company. This guidance is to be applied on a retrospective basis. The adoption of this updated guidance is not expected to have a material impact on the Company's statement of cash flows.

Presentation of Changes in Restricted Cash on the Statement of Cash Flows

In November 2016, the FASB issued guidance that updates the accounting and disclosure guidance for the classification of presentation of changes in restricted cash on the statement of cash flows. The amended guidance requires that a statement of cash flows explain the change during the period in total cash, cash equivalents and amounts described as restricted cash or restricted cash equivalents. Restricted cash and restricted cash equivalents will now be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The new standard is effective January 1, 2019 for the Company. Early adoption is permitted, but not before January 1, 2018 for the Company. This guidance is to be applied on a retrospective basis. The adoption of this updated guidance is not expected to have a material impact on the Company's statement of cash flows.

Clarifying the Definition of a Business

In January 2017, the FASB issued guidance that clarifies the definition of a business with the objective of assisting entities with evaluating whether transactions should be accounted for as acquisitions, or disposals, of assets or businesses. The new standard is effective January 1, 2019 for the Company. Early adoption is permitted, but not before January 1, 2018 for the Company.

This guidance is to be applied on a prospective basis. The Company is currently evaluating the effect on the financial statements and related disclosures.

Simplification of Goodwill Testing Impairment

In January 2017, the FASB issued guidance that updates the authoritative guidance which simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under the amendments in the update, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying value exceeds the reporting unit's fair value, however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The new standard is effective January 1, 2020 for the Company. Early adoption is permitted but not before January 1, 2017. The Company is currently evaluating the effect on the financial statements and related disclosures, as well as the timing of the adoption.

Measurement of Credit Losses

In June 2016, the FASB issued guidance that updates the accounting guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities. Under this guidance, expected credit losses are required to be measured based on historical experience, current conditions and reasonable and supportable forecasts that affect the collectability of the reported amount of financial assets. Also, this guidance requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a direct write-down. The new standard is effective January 1, 2021 for the Company. Early adoption is permitted, but not before January 1, 2019 for the Company. This guidance is to be applied on a modified retrospective basis. The Company is currently evaluating the effect on the financial statements and related disclosures, as well as the timing of the adoption.

Note 3: Acquisitions

During 2016, the Company acquired one regulated wastewater system for a total aggregate purchase price of $15. Assets acquired, principally plant, totaled $25 and liabilities assumed totaled $31, goodwill totaled $21. The Company had no acquisitions during 2015.

(Dollars in thousands)

Note 4: Utility Plant

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

	Range of Remaining Useful Life	2016	2015
Utility Plant:			
Land and other non-depreciable assets	-	$ 9,786	$ 9,786
Sources of supply	42 to 72 Years	56,197	53,553
Treatment and pumping	28 to 46 Years	126,677	105,433
Transmission and distribution	38 to 82 Years	322,722	308,017
Services, meters and fire hydrants	27 to 65 Years	123,858	118,517
General structures and equipment	5 to 57 Years	51,148	48,130
Wastewater	5 to 50 Years	7,548	6,870
Construction work in progress	-	8,937	27,262
		706,873	677,568
Less: Accumulated depreciation		(135,238)	(124,096)
		$ 571,635	$ 553,472

The provision for depreciation expressed as a percentage of the aggregate average depreciable asset balances was 2.40% and 2.27% in 2016 and 2015, respectively.

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 debt and preferred stock expense, regulatory assets are included in the Company's rate base and earn a return. The components of regulatory assets were as follows:

	2016	2015
Income taxes recoverable through rates	$ 4,056	$ 3,558
Programmed maintenance expense	8,869	7,789
Debt and preferred stock expense	1,496	1,514
Bluegrass water project	1,370	1,427
Other	1,270	1,000
	$ 17,061	$ 15,288

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 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 fifteen-year period, as authorized by the Commission in their determination of rates charged for service.

Unamortized debt expense is amortized over the lives of the respective issues. Call premiums on the redemption of long-term debt, as well as unamortized debt issuance costs, are deferred and amortized to the extent they will be recovered through future service rates. Expenses of issues with sinking fund provisions are charged to operations as shares are retired.

The Company previously 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 consisted of amounts related to the cost of removal totaling $17,849 and $18,269 at December 31, 2016 and 2015, respectively.

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.

(Dollars in thousands)

Note 6: Long-Term Debt

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

	Rate	Weighted Average Rate	Maturity Date	2016	2015
Mortgage bonds	6.96%-7.15%	7.03%	2023-2028	$ 23,500	$ 23,500
Notes payable to affiliated company	4.00%-6.59%	5.82%	2037-2046	177,249	172,249
Preferred stock with mandatory					
redemption requirements	8.47%	8.47%	2036	2,250	2,250
Long Term Debt				202,999	197,999
Unamortized debt premium, net				(41)	
Total long-term debt				$ 202,958	$ 197,999

Mortgage bonds are issued in series. No bonds senior to the mortgage bonds may be issued so long as they remain 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, 2016, long-term debt was 52% 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 3.4 times the aggregate annual interest charges on all long-term debt. 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.

Maturities of long-term debt, including sinking funds, will amount to $0 in 2017 through 2023, and $202,958 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.

Note 7: Short-Term Debt

The Company maintained a line of credit through AWCC of $40,000 at December 31, 2016 and 2015, 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. There were $21,137 and $26,112 of outstanding borrowings at December 31, 2016 and 2015, respectively. The weighted average annual interest rates on the borrowings at December 31, 2016 and 2015 were 0.8% and 0.5%, respectively. Short-term debt is presented as notes payable-affiliated company in the Balance Sheets.

(Dollars in thousands)

Note 8: General Taxes

Components of general taxes for the years presented in the Statements of Income were as follows:

	2016	2015
Property	$ 5,559	$ 5,327
Payroll	545	557
Other	230	690
	$ 6,334	$ 6,574

Note 9: Income Taxes

Components of income tax expense for the years presented in the Statements of Income were as follows:

	2016	2015
State income taxes:		
Current	$ 1,131	$ 1,124
Deferred	558	767
	1,689	1,891
Federal income taxes:		
Current	$ 2,816	$ 4,402
Deferred	6,583	4,502
Amortization of deferred investment tax credits	(85)	(85)
	9,314	8,819
Total income taxes	$ 11,003	$ 10,710

The primary components of the net deferred tax liability of $82,728 and $75,130 at December 31, 2016 and December 31, 2015, 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, 2016 and 2015, as management believes it is more likely than not that deferred tax assets will be realized.

As of December 31, 2016 and 2015, the Company's reserve for uncertain tax position is $1,808 and $2,787, respectively, excluding accrued interest and penalties. The Company does not expect a material change in this estimate in the next twelve months. The reserve 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 $11 and $7 for 2016 and 2015, respectively, related to interest and penalties on income tax matters in income tax expense.

The Company files income tax returns in the United States federal and state jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal or state tax examinations by tax authorities for years before 2013.

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 $326 and $306 for 2016 and 2015, respectively. All of the Company's contributions are invested in one or more funds at the direction of the employee.

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 an employee's years of service and compensation. The pension plan is closed for all new employees. 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.

The Company's pension cost 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 $876 and $763 for 2016 and 2015, 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. The Company's pension contributions 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 of $626 and $496 in 2016 and 2015, respectively. The Company expects to contribute $664 to the AWW plan in 2017.

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. 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 number of covered participants as a percentage of AWW's total number of plan covered participants. Information regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company was allocated costs of $340 and $661 in 2016 and 2015, respectively.

The Company made contributions to trust funds established for these postretirement benefits of $481 and $661 in 2016 and 2015, respectively. The Company's policy is to fund postretirement benefits costs annually. The Company expects to contribute $157 to the AWW plan in 2017.

Note 11: Stock Based Compensation

Stock Options and Restricted Stock Units

In 2016 and 2015, AWW granted restricted stock units, both with and without performance conditions and separately, certain market thresholds, and non-qualified 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 and separately, market thresholds, 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 internal performance measures and, separately, certain market thresholds over the Performance Period. The non-qualified stock options vest ratably over a three-year service period beginning January 1 of the year of the grant.

The grant date fair value of restricted stock units that vest ratably and have market and/or performance conditions are amortized through expense over the requisite service period using the graded-vesting method. Restricted stock units without performance conditions and non-qualified stock options are amortized through expense over the requisite service period using the straight-line method

(Dollars in thousands)

The Company's share based compensation plan cost is based on the total cost of the Company's employees and an allocation of costs from employees of American Water Service Company, Inc. who participate in the AWW Omnibus Plan. The Company recorded compensation expense of $31 and $54 included in operation and maintenance expense, during the years ended December 31, 2016 and 2015, 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 either the beginning or 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 $11 and $12 were included in operation and maintenance expense for the years ended December 31, 2016 and 2015, 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 12: Related Party Transactions

American Water Works Service Company, Inc. ("AWWS"), a subsidiary of AWW, provides certain management and operational services to the Company (administration, accounting, communications, data processing, education and training, engineering, financial, health and safety, human resources, information systems, internal audit, legal, operations, procurement, rates, security, risk management, water quality, research and development, etc.) and other operating 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:

	2016	2015
Included in operation and maintenance expense as a charge against income	$ 9,130	$ 8,326
Capitalized primarily in utility plant	2,252	2,088
	$ 11,382	$ 10,414

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 $65 and $61 in 2016 and 2015, respectively.

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 $109 in 2016 and $154 in 2015 and interest expense on borrowings of $207 in 2016 and $99 in 2015. Interest expense on long-term debt due to AWCC, net of capitalized amount, was $10,144 in 2016 and $10,120 in 2015.

Accrued interest on the accompanying balance sheets included interest due to AWCC of $1,770 as of December 31, 2016 and $1,746 in 2015.

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 13: 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 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 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.

(Dollars in thousands)

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 the Company's 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 methodology and utilizes assumptions of current market rates. As 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 debt securities based on an internal quantitative credit assessment of the Company. 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 including call features, coupon tax treatment and collateral.

The carrying amounts and fair values of the financial instruments as of December 31 were as follows:

	Carrying Amount	At Fair Value as of December 31, 2016			
		Level 1	Level 2	Level 3	Total
Preferred stock with mandatory redemption requirements	$ 2,250	$ -	$ -	$ 2,844	$ 2,844
Long-term debt	200,708	-	97,233	140,542	237,775

	Carrying Amount	At Fair Value as of December 31, 2015			
		Level 1	Level 2	Level 3	Total
Preferred stock with mandatory redemption requirements	$ 2,250	$ -	$ -	$ 2,998	$ 2,998
Long-term debt	195,749	-	92,655	140,740	233,395

Recurring Fair Value Measurements

As of December 31, 2016 and 2015, the Company had immaterial amounts of assets and liabilities measured and recorded at fair value on a recurring basis.

Note 14: Leases

The Company has entered into operating leases involving certain facilities and equipment. Rental expenses under operating leases were $79 in 2016 and $56 in 2015, respectively, which are included in operations and maintenance expense. The operating leases have various expiration dates through 2039.

At December 31, 2016, the minimum annual future rental commitments under operating leases that have initial or remaining non-cancelable lease terms in excess of one year are $6 in 2017, $6 in 2018, $5 in 2019, $4 in 2020 and $4 in 2021 and $76 thereafter.

Note 15: 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 $5,666 at December 31, 2016.

The Company has entered into certain service agreements in excess of one-year duration. As of December 31, 2016, the future annual commitments under these agreements are estimated to be $65 in 2017, with none thereafter.

The Company is routinely involved in legal actions incident to the normal conduct of its business. At December 31, 2016, the Company has not identified any loss contingencies that are either probable or reasonably possible.

Note 16: Subsequent Events

The Company performed an evaluation of subsequent events for the accompanying financial statements through March 24, 2017, the date this report was issued and determined that no circumstances warranted recognition and disclosure of those events or transactions in the financial statements as of December 31, 2016.