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RECEIVED

SEP 27 2018

PUBLIC SERVICE
COMMISSION

September 27, 2018

HAND DELIVERED

Gwen R. Pinson
Executive Director
Kentucky Public Service Commission
211 Sower Blvd
Frankfort, KY 40601

Re: Kentucky American Water Audited Financial Statements

Dear Ms. Pinson:

In conformity with 807 KAR 5:006 Section 4(3), enclosed please find the audit report for Kentucky American Water's 2017 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

Enclosure
010311.003026/7777691.1

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, 2017 and 2016

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, 2017 and 2016, 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, 2017 and 2016, 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 30, 2018

KENTUCKY-AMERICAN WATER COMPANY, INC.
Balance Sheets
December 31, 2017 and 2016
(Dollars in thousands)

Assets

	2017	2016
Property, plant and equipment, net		
Utility plant - at original cost, net of accumulated depreciation of $148,346 and $135,238 at December 31, 2017 and 2016, respectively	$ 589,097	$ 571,635
Utility plant acquisition adjustments, net	202	210
Non-utility property, net	250	250
Total property, plant and equipment	589,549	572,095
Current assets		
Cash	539	439
Accounts receivable	6,934	7,380
Allowance for uncollectible accounts	(825)	(876)
Unbilled revenues	4,561	4,405
Federal income tax receivable - affiliated company	3,057	761
State income tax receivable	580	213
Materials and supplies	815	758
Other current assets	367	341
Total current assets	16,028	13,421
Regulatory and other long-term assets		
Regulatory assets	12,464	17,061
Goodwill	-	21
Prepaid pension expense	1,606	1,921
Other long-term assets	63	101
Total regulatory and other long-term assets	14,133	19,104
Total assets	$ 619,710	$ 604,620

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

KENTUCKY-AMERICAN WATER COMPANY, INC.
Balance Sheets
December 31, 2017 and 2016
(Dollars in thousands)

Capitalization and Liabilities

Capitalization	**2017**	**2016**
Common stockholder's equity	$ 198,661	$ 186,819
Long-term debt	205,694	200,708
Preferred stock with mandatory redemption requirements	2,250	2,250
Total capitalization	406,605	389,777
Current liabilities		
Notes payable - affiliated company	8,318	19,650
Accounts payable	3,039	3,733
Accounts payable - affiliated company	1,815	6
Taxes accrued, including income taxes	5,773	4,620
Interest Accrued	2,146	2,098
Refunds due to customers	683	591
Other current liabilities	5,106	6,183
Total current liabilities	26,880	36,881
Regulatory and other long-term liabilities		
Advances for construction	11,761	12,196
Deferred income taxes, net	46,538	82,728
Deferred investment tax credits	372	455
Regulatory liabilities	58,756	17,849
Reg liability - cost of removal	19,094	17,849
Other regulatory liabilities	39,662	-
Accrued pension expense	-	-
Accrued postretirement benefit expense	745	701
Other	377	219
Deferred revenue	301	-
Other tax liabilities	67	154
Other long-term liabilities	9	65
Total regulatory and other long-term liabilities	118,549	114,148
Contributions in aid of construction	67,676	63,814
Commitments and contingencies (see Note 15)	-	-
Total capitalization and liabilities	$ 619,710	$ 604,620

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

KENTUCKY-AMERICAN WATER COMPANY, INC.
Statements of Income
December 31, 2017 and 2016
(Dollars in thousands)

	2017	2016
Operating revenues	$ 98,313	$ 95,348
Operating expenses (income)		
Operation and maintenance	34,492	34,505
Depreciation	13,672	12,816
Amortization	2,463	2,177
General taxes	6,134	6,334
Gain on asset dispositions and purchases	(6,533)	(25)
Total operating expenses, net	50,228	55,807
Operating income	48,085	39,541
Other income (expenses)		
Interest, net	(12,376)	(12,092)
Allowance for other funds used during construction	628	1,093
Allowance for borrowed funds used during construction	259	492
Amortization of debt expense	(111)	(108)
Other, net	(26)	(153)
Total other expenses	(11,626)	(10,768)
Income before income taxes	36,459	28,773
Provision for income taxes	15,376	11,003
Net income	$ 21,083	$ 17,770
Dividends on preferred stock	-	-
Net income available to common stockholder	$ 21,083	$ 17,770

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

KENTUCKY-AMERICAN WATER COMPANY, INC.
Statements of Cash Flows
December 31, 2017 and 2016
(Dollars in thousands)

	2017	2016
Cash flows from operating activities		
Net income	$ 21,083	$ 17,770
Adjustments		
Depreciation and amortization	16,135	14,993
Amortization of debt expense	111	108
Provision for deferred income taxes	7,771	7,140
Amortization of deferred investment tax credits	(83)	(85)
Provision for losses on accounts receivable	682	921
Allowance for other funds used during construction	(628)	(1,093)
Gain on asset acquisitions and dispositions	(6,533)	(25)
Pension and non-pension postretirement benefits	1,114	1,216
Deferred programmed maintenance expense	(900)	(1,536)
Other, net	831	(131)
Changes in assets and liabilities		
Accounts receivable and unbilled revenues	(388)	(1,966)
Federal income tax from affiliated company	(2,296)	(3,293)
State income taxes due to affiliated company	(367)	(37)
Other current assets	(83)	108
Pension and non-pension postretirement benefit contributions	(798)	(1,050)
Accounts payable	(639)	476
Accounts receivable and payable - affiliated company	1,242	(622)
Accrued Interest	48	-
Accrued taxes	1,153	3,500
Other current liabilities	(487)	269
Net cash provided by operating activities	36,968	36,663
Cash flows from investing activities		
Capital expenditures	(31,743)	(34,741)
Acquisitions	-	(15)
Removal costs from property, plant and equipment retirements, net of salvage of $102 in 2017 and $193 in 2016	(1,250)	(2,639)
Proceeds from the disposition of property, plant and equipment	6,527	-
Net cash used in investing activities	(26,466)	(37,395)
Cash flows from financing activities		
Proceeds from issuance of long-term debt - affiliated company	5,000	5,000
Net borrowings (repayments) of notes payable - affiliated company	(11,332)	(4,975)
Debt issuance costs	(52)	(53)
Advances and contributions, net of refunds of $1,429 and $851 in 2017 and 2016, respectively	5,418	7,269
Capital contributions by stockholder	5,000	10,000
Dividends paid	(14,436)	(16,270)
Net cash provided by (used in) financing activities	(10,402)	971
Net increase in cash	100	239
Cash at beginning of year	439	200
Cash at end of year	$ 539	$ 439
Cash paid (received) during the year for:		
Interest, net of capitalized amount	$ 12,170	$ 11,956
Income taxes	$ (6,338)	$ 6,634
Non-cash investing activity		
Capital expenditures acquired on account but unpaid as of year end	$ 1,423	$ 1,475
Non-cash financing activity		
Dividends accrued	$ -	$ -
Capital contributions by stockholder (see Note 11)	$ 21	$ 42

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, 2017 and 2016
(Dollars in thousands)

	Common Stock		Paid-in	Retained	
	Shares	Par Value	Capital	Earnings	Total
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
Preferred stock dividends	-	-	-	-	-
Dividends	-	-	-	(12,242)	(12,242)
Balance at December 31, 2016	1,567,391	$ 36,569	$ 89,117	$ 61,133	$ 186,819
Net income	-	-	-	21,083	21,083
Capital contributions	-	-	5,021	-	5,021
Cummulative effect of change					-
in accounting principle	-	-	-	174	174
Preferred stock dividends	-	-	-	-	-
Dividends	-	-	-	(14,436)	(14,436)
Balance at December 31, 2017	1,567,391	$ 36,569	$ 94,138	$ 67,954	$ 198,661

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, assumptions and judgements that affect the Company's financial condition, results of operations and cash flows. Actual results could differ from these estimates, judgements and assumptions. The Company considers its critical accounting estimates to include: the application of regulatory accounting principles and the related determination and estimation of regulatory assets and liabilities; assumptions used in impairment testing of goodwill and other long-lived assets, including regulatory assets; revenue recognition and the estimates used in the calculation of unbilled revenue; accounting for income taxes and the recently enacted Tax Cuts and Jobs Act (the "TCJA"); benefit plan assumptions; and the judgements and estimates used in the determining loss contingencies. The Company's critical accounting estimates that are particularly sensitive to change in the near term are amounts reported for regulatory assets and liabilities, goodwill, income taxes, benefit plan assumptions and contingency-related obligations.

Regulation

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 approve accounting treatments, long-term financing programs and cost of capital, capital expenditures, O&M expenses, taxes, transactions and affiliate relationships, reorganizations and mergers, and acquisitions, along with imposing certain penalties or granting certain incentives. Due to timing and other differences in the collection of utility revenue, an incurred cost that would otherwise be charged as an expense could be deferred as a regulatory asset if it is probable that such cost is recoverable through future rates. Conversely, GAAP requires the creation 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 are 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 utility plant are capitalized and include costs such as materials, direct labor, payroll taxes and benefits, indirect items such as engineering and supervision, transportation and an allowance for funds used during construction ("AFUDC"). Costs for repairs, maintenance and minor replacements are charged to O&M expense as incurred.

The cost of property, plant and equipment is depreciated using the straight-line average remaining life using the composite method. The Company records depreciation in conformity with amounts approved by the Commission after regulatory review of the information the Company submits to support its estimates of the assets' remaining useful lives.

When units of property, plant and equipment are replaced, retired or abandoned, the recorded value is credited against 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 costs incurred to acquire and internally develop computer software for internal use are capitalized as a unit of property. The carrying value of these costs amounted to $7,150 and $8,528 as of December 31, 2017 and 2016, respectively.

Nonutility property consists primarily of buildings and equipment utilized by the Company for internal operations. This property is stated at cost, net of accumulated depreciation, which is calculated using the straight-line method over the useful lives of the assets.

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, 2017 and 2016. The remaining useful lives range from 23 to 28 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 from customers. 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 generally writes off accounts when they become uncollectible or are over a certain number of days outstanding.

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 $0 and $21 of goodwill at December 31, 2017 and 2016, 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 second step requires an allocation of fair value to the individual assets and liabilities using purchase price allocation accounting guidance in order to determine the implied fair value of goodwill. If the implied fair value of goodwill is less than the carrying amount for the reporting unit, an impairment loss is recorded as a reduction to goodwill and a charge to operating expense. Application of the goodwill impairment test requires management judgment, including the identification of reporting units and determining the fair value of the reporting unit. Management estimates fair value using a combination of a discounted cash flow analysis and market multiples analysis. Significant assumptions used in these fair value analyses include discount and growth rates and projected terminal values.

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 2017, 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, 2017.

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 the contributions represent 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 in aid of construction was \$2,057 and \$1,817 for the years ended December 31, 2017 and 2016, respectively. For the years ended December 31, 2017 and 2016, 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 bill 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. The Company provides deferred income taxes 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 expected to be in effect when these temporary differences are projected to reverse. 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 as of December 31, 2017:

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 the following 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 the 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 interests in securitization transactions; and (viii) and separately identifiable cash flows and application of the predominance principle. The guidance is effective December 31, 2017 for the Company and has been adopted on a retrospective basis. The adoption of this standard did not impact the Company's 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 statements of cash flows. The amended guidance requires that the statements of cash flows explain the change during the period in the total of 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 statements of cash flows. The guidance is effective December 31, 2017 for the Company and has been adopted on a retrospective basis. The adoption of this standard did not impact the Company's cash flows.

The following recently issued accounting standards have not yet been adopted by the Company at December 31, 2017:

Revenue from Contracts with Customers

In May 2014, the FASB issued a new revenue recognition standard that will replace existing revenue recognition guidance in GAAP, including most 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, 2017 for the Company. The Company plans to early adopt January 1, 2018 on a modified retrospective basis. The adoption will not result in material impact to the financial statements as there are no material changes to the timing or recognition of revenue.

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, 2017 for the Company. The Company plans to early adopt January 1, 2018 on a prospective basis. The update could result in more acquisitions being accounted for as asset acquisitions. The effect on the Company's financial statements will be dependent on the acquisitions that close subsequent to adoption.

Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost

In March 2017, the FASB issued guidance that updates the authoritative guidance which requires the service cost component of net periodic benefit cost to be presented in the same income statement line item(s) as other employee compensation costs arising from services rendered during the period. The remaining components of net period benefit cost are required to be presented separately from the service cost component in an income statement line item outside of operating income. Also, the guidance only allows for the service cost component to be eligible for capitalization. The updated guidance does not impact the accounting for net periodic benefit costs as regulatory assets or liabilities. The new standard is effective January 1, 2018 for the Company. The Company plans to adopt January 1, 2018 on a retrospective basis for the presentation of net periodic benefit cost components in the income statement and on a prospective basis for the capitalization of net periodic benefit cost components in total assets. The Company expects to reclassify net periodic benefit costs, other than the service cost component to Other, net in its Statements of Income. The Company does not expect the adoption to have a material impact on its financial statements.

Accounting for Leases

In February 2016, the FASB issued guidance that changed the accounting and disclosure guidelines for leasing arrangements. Under the new guidance, lessee's 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. The Company plans to early adopt January 1, 2019 on a modified retrospective basis. The Company is currently evaluating the effect on its financial statements.

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, 2021 for the Company. Early adoption is permitted, but not before January 1, 2017 for the Company. The Company is currently evaluating the effect on the financial statements and related disclosures, as well as the timing of 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. The Company is currently evaluating the effect on the financial statements and related disclosures, as well as the timing of adoption.

Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

In January 2018, the FASB issued guidance that permits entities to reclassify tax effects stranded in accumulated other comprehensive income as a result of the Tax Cuts and Jobs Act to retained earnings. 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 currently evaluating the effect on its financial statements as well as the timing of adoption.

(Dollars in thousands)

Reclassifications

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

Note 3: Acquisitions

The Company had no acquisitions during 2017.

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.

Note 4: Utility Plant

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

	Range of Remaining Useful Life	2017	2016
Land and other non-depreciable assets	-	$ 9,878	$ 9,786
Sources of supply	42 to 72 Years	58,773	56,197
Treatment and pumping	28 to 46 Years	127,829	126,677
Transmission and distribution	38 to 82 Years	336,306	322,722
Services, meters and fire hydrants	27 to 65 Years	128,625	123,858
General structures and equipment	5 to 57 Years	55,153	51,148
Wastewater	5 to 50 Years	8,388	7,548
Construction work in progress	-	12,491	8,937
		737,443	706,873
Less: Accumulated depreciation		(148,346)	(135,238)
Utility Plant - at original cost, net		$ 589,097	$ 571,635

The provision for depreciation expressed as a percentage of the aggregate average depreciable asset balances was 2.44% and 2.40% in 2017 and 2016, 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 are as follows:

(Dollars in thousands)

	2017	2016
Income taxes recoverable through rates	$ -	$ 4,056
Debt and preferred stock expense	1,475	1,496
Bluegrass water project	1,313	1,370
Programmed maintenance expense	9,033	8,869
Other	643	1,270
Regulatory assets	$ 12,464	$ 17,061

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 represent amounts that are expected to be refunded to customers in future rates, items deferred pending Commission guidance, or amounts recovered from customers in advance of incurring the costs.

The components of regulatory liabilities as of December 31 are as follows:

(Dollars in thousands)

	2017	2016
Income taxes recoverable through rates	$ 39,662	$ -
Removal costs recovered through rates	19,094	17,849
Regulatory liabilities	$ 58,756	$ 17,849

Income taxes recovered through rates relate to deferred taxes that will likely be refunded to the Company's customers. On December 22, 2017, the Tax Cuts and Jobs Act (the "TCJA") was signed into law, which, among other things, enacted significant and complex changes to the Internal Revenue Code of 1986, including a reduction in the maximum U.S. federal corporate income tax rate from 35% to 21% as of January 1, 2018. The TCJA created significant excess deferred taxes that the Company believes should be refunded to customers. Since these are significant refundable amounts, the Company believes it is probable these amounts will be refunded to customers through future rates, and as such the amounts are recorded to a regulatory liability.

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

Note 6: Long-Term Debt

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

	Rate	Weighted Average Rate	Maturity Date	2017	2016
Mortgage bonds	6.96%-7.15%	7.03%	2023-2028	$ 23,500	$ 23,500
Variable rate loans					
Notes payable to affiliated company company	3.75%-6.59%	5.77%	2037-2047	182,249	177,249
Cumulative preferred stock with mandatory redemption requirements	8.47%	8.47%	2036	2,250	2,250
Long-term debt				207,999	202,999
Less: Unamortized debt premium, net				55	41
Total long-term debt				$ 207,944	$ 202,958

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, 2017, long-term debt was 51% 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 3.46 times the aggregate annual interest charges on all long-term debt. Mortgage bonds are collateralized by utility plant.

(Dollars in thousands)

The long-term 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 2017, the Company issued $5,000 of long term notes payable to AWCC at a rate of 3.75%, due in 2047.

Maturities of long-term debt, including sinking funds, will amount to $0 in 2018 through 2022, and $207,999 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, 2017 and 2016, 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 $8,318 and $19,650 of outstanding borrowings at December 31, 2017 and 2016, respectively. The weighted average annual interest rates on the borrowings at December 31, 2017 and 2016 were 1.2% and 0.8%, respectively. Short-term debt is presented as notes payable-affiliated company in the Balance Sheets.

Note 8: General Taxes

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

	2017	2016
Gross Receipts	$ 1	$ 6
Property	5,408	5,561
Payroll	531	545
Public Utility Commission Assessment	194	222
General taxes	$ 6,134	$ 6,334

(Dollars in thousands)

Note 9: Income Taxes

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

	2017	2016
State income taxes:		
Current	$ 1,464	$ 1,131
Deferred	562	558
	$ 2,026	$ 1,689
Federal income taxes:		
Current	$ 6,223	$ 2,816
Deferred	7,210	6,583
Amortization of deferred investment tax credits	(83)	(85)
	13,350	9,314
Total income taxes	$ 15,376	$ 11,003

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (the "TCJA"). Substantially all of the provisions of the TCJA are effective for taxable years beginning after December 31, 2017. The TCJA includes significant changes to the Internal Revenue Code of 1986, as amended (the "Code"), including amendments which significantly change the taxation of regulated public utilities. The significant changes that impact the Company included in the TCJA are reductions in the corporate federal income tax rate from 35% to 21%, and several technical provisions including, among others, limiting the utilization of net operating losses ("NOLs") arising after December 31, 2017 to 80% of taxable income with an indefinite carryforward. The specific provisions related to regulated public utilities in the TCJA generally allow for the continued deductibility of interest expense, the elimination of full expensing for tax purposes of certain property acquired after September 27, 2017 and continue certain rate normalization requirements for accelerated depreciation benefits.

Changes in the Code from the TCJA had a material impact on our financial statements in 2017. Under GAAP, specifically Accounting Standards Codification ("ASC") Topic 740, Income Taxes, the tax effects of changes in tax laws must be recognized in the period in which the law is enacted. ASC 740 also requires deferred income tax assets and liabilities to be measured at the enacted tax rate expected to apply when temporary differences are to be realized or settled. Thus, at the date of enactment, the Company's deferred income taxes were re-measured based upon the new tax rate. For the Company's regulated entities, substantially all of the change in deferred income taxes are recorded as either an offset to a regulatory asset or liability because changes are expected to be recovered by or refunded to customers.

The staff of the U.S. Securities and Exchange Commission (the "SEC") has recognized the complexity of reflecting the impacts of the TCJA, and on December 22, 2017 issued guidance in Staff Accounting Bulletin 118 ("SAB 118") which clarifies accounting for income taxes under ASC 740 if information is not yet available or complete and provides for up to a one year period in which to complete the required analyses and accounting. SAB 118 describes three scenarios or buckets associated with a company's status of accounting for income tax reform: (1) a company is complete with its accounting for certain effects of tax reform, (2) a company is able to determine a reasonable estimate for certain effects of tax reform and records that estimate as a provisional amount, or (3) a company is not able to determine a reasonable estimate and therefore continues to apply ASC 740, based on the provisions of the tax laws that were in effect immediately prior to the TCJA being enacted. The Company has made an accounting policy election to apply the guidance under SEC's SAB 118 as allowed by FASB for non-public entities and made a reasonable estimate for the measurement and accounting of certain effects of the TCJA which have been reflected in the December 31, 2017 financial statements. As provided for under SAB 118, the Company has not recorded the impact for certain items under TCJA for which it has not yet been able to gather, prepare and analyze the necessary information in reasonable detail to complete the ASC 740 accounting. For these items, which include the impact of TCJA on state income taxes, the current and deferred income taxes were recognized and measured based on the provisions of the tax laws that were in effect immediately prior to the TCJA being enacted. The current and deferred state taxes are $1,464 and $562 as of December 31, 2017, respectively.

Based on SAB 118, the Company has made a reasonable estimate for the measurement and accounting of certain effects of the TCJA which have been reflected in the December 31, 2017 financial statements. The total re-measurement exclusive of ASC 740 amounts resulting from the gross-up is $31,347. Of that amount, $32,782 was recorded to a regulatory liability. The re-measurement of deferred income taxes at the new federal tax rate increased the 2017 deferred income tax provision by $1,387 for the year ending December 31, 2017. The determination of the impact of the income tax effects of these items and the impacts that have not yet been recorded will require additional analysis of historical records and further interpretation of the TCJA from yet to be issued U.S. Treasury regulations which will require more time, information and resources than currently available to the Company.

The primary components of the net deferred tax liability of $46,538 and $82,728 at December 31, 2017 and December 31, 2016, 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, 2017 and 2016, as management believes it is more likely than not that deferred tax assets will be realized.

As of December 31, 2017 and 2016, the Company's reserve for uncertain tax position is $772 and $1,808, 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 $10 and $11 for 2017 and 2016, 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 2014.

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 $355 and $326 for 2017 and 2016, 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 $957 and $876 for 2017 and 2016, 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 $641 and $626 in 2017 and 2016, respectively. The Company expects to contribute $646 to the AWW plan in 2018.

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 $157 and $340 in 2017 and 2016, respectively.

The Company made contributions to trust funds established for these postretirement benefits of $157 and $481 in 2017 and 2016, respectively. No contribution to the plan is required in 2018.

Note 11: Stock Based Compensation

Stock Options and Restricted Stock Units

In 2017 and 2016, 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

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 $11 and $31 included in operation and maintenance expense, during the years ended

(Dollars in thousands)

December 31, 2017 and 2016, 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 $10 and $11 were included in operation and maintenance expense for the years ended December 31, 2017 and 2016, 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:

	2017	2016
Included in operation and maintenance expense as a charge against income	$ 9,057	$ 9,130
Capitalized primarily in utility plant	2,414	2,252
	$ 11,471	$ 11,382

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 $146 and $65 in 2017 and 2016, 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 $89 in 2017 and $109 in 2016 and interest expense on borrowings of $155 in 2017 and $207 in 2016. Interest expense on long-term debt due to AWCC, net of capitalized amount, was $10,376 in 2017 and $10,144 in 2016.

Accrued interest on the accompanying balance sheets included interest due to AWCC of $1,818 as of December 31, 2017 and $1,770 in 2016.

The Company received capital contributions of $5,000 from AWW in 2017.

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.

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

(Dollars in thousands)

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 AWCC'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:

		At Fair Value as of December 31, 2017			
	Carrying Amount	Level 1	Level 2	Level 3	Total
Preferred stock with mandatory redemption requirements	$ 2,250	$ -	$ -	$ 3,253	$ 3,253
Long-term debt	205,694	-	106,997	141,533	248,530

		At Fair Value as of December 31, 2016			
	Carrying Amount	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

Recurring Fair Value Measurements

As of December 31, 2017 and 2016, 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 $90 in 2017 and $79 in 2016, respectively, which are included in operations and maintenance expense. The operating leases have various expiration dates.

At December 31, 2017, the minimum annual future rental commitments under operating leases that have initial or remaining non-cancelable lease terms in excess of one year are $5 in 2018, $5 in 2019, $4 in 2020, $4 in 2021 and $4 in 2022 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 $5,001 at December 31, 2017.

As of December 31, 2017, the Company has no future annual commitments for service agreements.

The Company is routinely involved in legal actions incident to the normal conduct of its business. At December 31, 2017, 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 30, 2018, 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, 2017.