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AUG 13 2019
PUBLIC SERVICE
COMMISSION

August 13, 2019

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 2018 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
010311.003026/8013063.1

Kentucky-American Water Company

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

Financial Statements

As of and for the years ended December 31, 2018 and 2017

pwc

Report of Independent Auditors

To the Board of Directors of
Kentucky-American Water Company

We have audited the accompanying financial statements of Kentucky-American Water Company, which comprise the balance sheets as of December 31, 2018 and 2017, and the related statements of income, of cash flows and of changes in common stockholder's equity 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.

Auditors' 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 as of December 31, 2018 and 2017, 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 29, 2019

KENTUCKY-AMERICAN WATER COMPANY
Balance Sheets
For the Years Ended December 31, 2018 and 2017
(Dollars in thousands)

Assets

		2018		2017
Property, plant and equipment, net				
Utility plant - at original cost, net of accumulated depreciation of $162,471 and $148,346 at December 31, 2018 and 2017, respectively	$	607,302	$	589,097
Utility plant acquisition adjustments		194		202
Non-utility property, net of accumulated depreciation		250		250
Total property, plant and equipment		607,746		589,549
Current assets				
Cash		1,192		539
Accounts receivable		6,682		6,934
Allowance for uncollectible accounts		(1,049)		(825)
Unbilled utility revenues		4,169		4,561
Federal income tax receivable - affiliated company		—		3,057
State income tax receivable		893		580
Materials and supplies		844		815
Other current assets		425		367
Total current assets		13,156		16,028
Regulatory and other long-term assets				
Regulatory assets		13,818		12,464
Prepaid pension expense		1,169		1,606
Other long-term assets		78		63
Total regulatory and other long-term assets		15,065		14,133
Total assets	$	635,967	$	619,710

KENTUCKY-AMERICAN WATER COMPANY
Balance Sheets
For the Years Ended December 31, 2018 and 2017
(Dollars in thousands)

Capitalization and Liabilities

Capitalization	**2018**	**2017**
Common stockholder's equity	$ 205,927	$ 198,661
Long-term debt	205,696	205,694
Preferred stock with mandatory redemption requirements	2,250	2,250
Total capitalization	413,873	406,605
Current liabilities		
Notes payable - affiliated company	18,439	8,318
Accounts payable	3,727	3,039
Accounts payable - affiliated company	1,284	1,815
Taxes accrued, including income taxes	6,578	5,773
Interest accrued	2,152	2,146
Refunds due to customers	728	683
Advances for Construction - Current	1,094	1,032
Other current liabilities	5,163	4,074
Total current liabilities	39,165	26,880
Regulatory and other long-term liabilities		
Advances for Construction	10,023	11,761
Deferred income taxes, net	44,287	46,538
Deferred investment tax credits	293	372
Regulatory liability - cost of removal	18,222	19,094
Other regulatory liabilities	38,647	39,662
Accrued postretirement expense	343	745
Other long-term liabilities	86	377
Total regulatory and other long-term liabilities	111,901	118,549
Contributions in aid of construction	71,028	67,676
Commitments and contingencies (see Note 16)	—	—
Total capitalization and liabilities	$ 635,967	$ 619,710

KENTUCKY-AMERICAN WATER COMPANY
Statements of Income
For the Years Ended December 31, 2018 and 2017
(Dollars in thousands)

	2018	2017
Operating revenues	$ 92,759	$ 98,313
Operating expenses (income)		
Operation and maintenance	35,104	34,040
Depreciation	14,216	13,672
Amortization	2,527	2,463
General taxes	7,924	6,134
Gain on asset dispositions and purchases	(1,955)	(6,533)
Total operating expenses, net	57,816	49,776
Operating income	34,943	48,537
Other income (expenses)		
Interest, net	(12,354)	(12,221)
Interest on short-term debt - affiliated company	(277)	(155)
Allowance for other funds used during construction	762	628
Allowance for borrowed funds used during construction	384	259
Amortization of debt expense	(119)	(111)
Non-operating benefit costs, net	484	(452)
Other, net	4	(26)
Total other expenses	(11,116)	(12,078)
Income before income taxes	23,827	36,459
Provision for income taxes	4,446	15,376
Net income	$ 19,381	$ 21,083
Dividends on preferred stock		
Net income available to common stockholder	$ 19,381	$ 21,083

KENTUCKY-AMERICAN WATER COMPANY
Statements of Cash Flows
For the Years Ended December 31, 2018 and 2017
(Dollars in thousands)

	2018	2017
Cash flows from operating activities		
Net income	$ 19,381	$ 21,083
Adjustments:		
Depreciation and amortization	16,743	16,135
Amortization of debt expense	119	111
Provision for deferred income taxes	(2,650)	7,771
Amortization of deferred investment tax credits	(79)	(83)
Provision for losses on accounts receivable	1,068	682
Allowance for other funds used during construction	(762)	(628)
Gain on asset dispositions and acquisitions	(1,955)	(6,533)
Pension and non-pension postretirement benefits	296	1,114
Deferred programmed maintenance expense	(2,117)	(900)
Other, net	3,375	831
Changes in assets and liabilities:		
Accounts receivable and unbilled revenues	(138)	(388)
Federal income tax from affiliated company	2,450	(2,296)
State income taxes	(313)	(367)
Other current assets	(87)	(83)
Pension and non-pension postretirement benefit contributions	(355)	(798)
Other non-cash net	51	—
Accounts payable	1,383	(639)
Accounts receivable and payable - affiliated company	130	1,242
Accrued interest	6	48
Accrued taxes	805	1,153
Other current liabilities	(2,209)	(487)
Net cash provided by operating activities	35,142	36,968
Cash flows from investing activities		
Capital expenditures	(32,881)	(31,743)
Acquisitions	(770)	—
Removal costs from property, plant and equipment retirements, net	(3,458)	(1,250)
Proceeds from the disposition of property, plant and equipment	2,059	6,527
Net cash used in investing activities	(35,050)	(26,466)
Cash flows from financing activities		
Proceeds from issuance of long-term debt - affiliated company	—	5,000
Net borrowings (repayments) of notes payable - affiliated company	10,121	(11,332)
Debt issuance costs	(60)	(52)
Advances and contributions, net of refunds of $1,505 and $1,429 in 2018 and 2017, respectively	2,647	5,418
Capital contributions by stockholder	—	5,000
Dividends paid	(12,147)	(14,436)
Net cash provided by (used in) financing activities	561	(10,402)
Net increase in cash and restricted funds	653	100
Cash and restricted funds at beginning of year	539	439
Cash and restricted funds at end of year	1,192	$ 539
Cash paid (received) during the year for:		
Interest, net of capitalized amount	$ 11,960	$ 12,170
Income taxes	$ (998)	$ (6,338)
Non-cash investing activity		
Capital expenditures acquired on account but unpaid as of year end	$ 767	$ 1,423
Non-cash financing activity		
Capital contributions by stockholder (see Note 12)	$ 32	$ 21

KENTUCKY-AMERICAN WATER COMPANY
Statements of Changes in Common Stockholder's Equity
For the Years Ended December 31, 2018 and 2017
(Dollars in thousands)

	Common Stock								
	Shares		**Par Value**		**Paid-in Capital**		**Retained Earnings**		**Total**
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
Cumulative effect of change in accounting principle							174		174
Dividends							(14,436)		(14,436)
Balance at December 31, 2017	1,567,391	$	36,569	$	94,138	$	67,954	$	198,661
Net income	—		—		—		19,381		19,381
Capital contributions	—		—		32		—		32
Dividends	—		—		—		(12,147)		(12,147)
Balance at December 31, 2018	1,567,391	$	36,569	$	94,170	$	75,188	$	205,927

Note 1: Organization and Operation

Kentucky-American Water Company (the "Company") provides water and wastewater services 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 judgments that affect the Company's financial condition, results of operations and cash flows. Actual results could differ from these estimates, judgments 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 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 judgments 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, 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 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 repair, maintenance and minor replacements are charged to O&M expense as incurred.

The cost of utility plant is depreciated using the straight-line average remaining life group 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 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 recorded 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 $7,312 and $7,150 as of December 31, 2018 and 2017, respectively.

Nonutility property consists primarily of buildings, equipment and land 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 and $8 for the years ended December 31, 2018 and 2017 respectively. The remaining useful lives range from 22 to 27 years.

Cash

Substantially all of the Company's cash is invested in interest-bearing accounts. The company had $1,192 and $539 at December 31, 2018 and 2017 respectively. The company has no restricted cash.

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.

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 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 in aid of construction was $2,297 and $2,057 for the years ended December 31, 2018 and 2017, respectively. For the years ended December 31, 2018 and 2017, no non-cash advances or contributions were received.

Revenue Recognition

On January 1, 2018, the Company adopted Accounting Standards Codification Topic 606, *Revenue From Contracts With Customers*, and all related amendments (collectively, "ASC 606"), using the modified retrospective approach, applied to contracts which were not completed as of January 1, 2018. Under this approach, periods prior to the adoption date have not been restated and continue to be reported under the accounting standards in effect for those periods.

Under ASC 606, a performance obligation is a promise within a contract to transfer a distinct good or service, or a series of distinct goods and services, to a customer. Revenue is recognized when performance obligations are satisfied and the customer obtains control of promised goods or services. The amount of revenue recognized reflects the consideration to which the Company expects to be entitled to receive in exchange for goods or services. Under ASC 606, a contract's transaction price is allocated to each distinct performance obligation. To determine revenue recognition for arrangements that the Company determines are within the scope of ASC 606, the Company performs the following five steps: (i) identifies the contracts with a customer; (ii) identifies the performance obligations within the contract, including whether any performance obligations are distinct and capable of being distinct in the context of the contracts; (iii) determines the transaction price; (iv) allocates the transaction price to the performance obligations in the contract; (v) recognizes revenue when, or as, the Company satisfies each performance obligation.

Regulated Businesses Revenue

Revenue is generated primarily from water and wastewater services delivered to customers. These contracts contain a single performance obligation, the delivery of water and/or wastewater services, as the promise to transfer the individual good or service is not separately identifiable from other promises within the contracts and, therefore, is not distinct. Customer payments for contracts are generally due within 30 days of billing and none of the contracts with customers have payment terms that exceed one year. Revenues are recognized over time, as services are provided. There are generally no significant financing components or variable consideration. Revenues include amounts billed to customers on a cycle basis and unbilled amounts calculated based on estimated usage from the date of the meter reading associated with the latest customer bill, to the end of the accounting period. The amounts that the Company has a right to invoice are determined by each customer's actual usage, an indicator that the invoice amount corresponds directly to the value transferred to the customer.

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, 2018:

Revenue from Contracts with Customers

In May 2014, the FASB issued a new revenue recognition standard that replaced 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 was effective January 1, 2018 for the Company and has been adopted on a modified retrospective basis. The adoption had no material impact to the consolidated 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 Company early adopted the new standard effective January 1, 2018. The effect on the

Company's consolidated financial statements will be dependent on the acquisitions that close subsequent to adoption. See Note 4: Acquisitions.

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 Company early adopted the new standard effective January 1, 2018. The Company presented in the current period, and reclassified in the prior periods, net periodic benefit costs, other than the service cost component, in non-operating benefit costs, net on the Statements of Income.

Cloud Computing Service Arrangements

In August 2018, the FASB Updated the accounting and disclosure guidance for cloud computing arrangements that are service contracts. Under this guidance, implementation costs incurred in cloud computing arrangements and in developing or obtaining internal-use software follow the same capitalization requirements. The accounting for the service element of the arrangement remains unchanged. The Company early adopted the standard effective September 30, 2018. The adoption had no material impact on the Consolidated Financial Statements.

Reclassifications

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

The following recently issued accounting standards have not yet been adopted by the Company at December 31, 2018:

Accounting for Leases

In December 2018, the FASB updated the accounting and disclosure guidance for leasing arrangements. Under this guidance, a lessee 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. A package of optional transition practical expedients allows an entity not to reassess under the new guidance: (1) whether any existing contracts are or contain leases; (ii) lease classification; and (iii) initial direct costs. Additional optional transition practical expedients are available which allow an entity not to evaluate existing land easements if the easements were not previously accounted for as leases, and to apply the new lease standard at the adoption date and recognize a cumulative-effect adjustment in the opening balance of retained earnings in the period of adoption. 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.

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 impact on the financial statements, as well as the timing of adoption.

Disclosure Requirements for Fair Value Measurement

In August 2018, the FASB updated the disclosure requirements for fair value measurement. The guidance removes the requirements to disclose transfers between Level 1 and Level 2 measurements, the timing of transfers between levels, and the valuation processes for Level 3 measurements. Disclosure of transfers into and out of Level 3 measurements will be required. The guidance adds disclosure requirements for the change in unrealized gains and losses in other comprehensive income for recurring Level 3 measurements, as well as the range and weighted average of significant unobservable inputs used to develop Level 3 measurements. The new standard is effective January 1, 2020 for the Company. Early adoption is permitted. The Company is currently evaluating the impact on the financial statements, as well as the timing of adoption.

(Dollars in thousands)

Note 3: Revenue Recognition

Disaggregated Revenues

The following table provides operating revenues disaggregated for the year ended December 31, 2018:

	Revenue from Contracts with Customers	Other Revenues Not from Contracts with Customers (a)	Total Operating Revenues
Water Service:			
Residential	$ 50,509	$ —	$ 50,509
Commercial	23,147	—	23,147
Industrial	2,933	—	2,933
Fire Service	6,773	—	6,773
Public and other	4,240	—	4,240
Sales for resale	2,035	—	2,035
Total water services	89,637	—	89,637
Wastewater services:			
Residential	403	—	403
Commercial	129	—	129
Industrial	1	—	1
Public and other	19	—	19
Total wastewater services	552	—	552
Miscellaneous utility charges	2,415	—	2,415
Lease contract revenue	—	155	155
Total operating revenues	$ 92,604	$ 155	$ 92,759

(a) Includes revenues associated with alternative revenue programs, lease contracts and intercompany rent which are outside the scope of ASC 606 and accounted for under other existing GAAP.

Note 4: Acquisitions

During 2018, the Company acquired one regulated water system for a total aggregate purchase price of $770. Assets acquired, principally utility plant, totaled $2 million and liabilities assumed totaled $1.3 million.

(Dollars in thousands)

Note 5: Utility Plant

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

	Range of Remaining Useful Life	2018	2017
Utility Plant:			
Land and other non-depreciable assets	—	$ 9,883	$ 9,878
Sources of supply	42 to 72 Years	59,058	58,773
Treatment and pumping	7 to 50 Years	133,443	127,829
Transmission and distribution	38 to 82 Years	349,626	336,306
Services, meters and fire hydrants	23 to 84 Years	136,685	128,625
General structures and equipment	5 to 57 Years	57,163	55,153
Wastewater	5 to 50 Years	8,724	8,388
Construction work in progress	—	15,191	12,491
		769,773	737,443
Less: Accumulated depreciation		(162,471)	(148,346)
Utility Plant - at original cost, net		$ 607,302	$ 589,097

The provision for depreciation expressed as a percentage of the aggregate average depreciable asset balances was 2.47% and 2.44% in 2018 and 2017, respectively.

Note 6: 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:

	2018	2017
Debt and preferred stock expense	1,402	1,475
Bluegrass water project	1,256	1,313
Programmed maintenance expense	10,312	9,033
Other	848	643
Total regulatory assets	$ 13,818	$ 12,464

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.

(Dollars in thousands)

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.

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.

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 were as follows:

	2018	2017
Income taxes recoverable through rates	$ 38,647	39,662
Removal costs recovered through rates	18,222	19,094
Regulatory liabilities	$ 56,869	$ 58,756

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. 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.

(Dollars in thousands)

Note 7: Long-Term Debt

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

	Rate	Weighted Average Rate	Maturity Date	2018	2017
Mortgage bonds	6.96%-7.15%	7.03%	2023-2028	$ 23,500	$ 23,500
Variable rate loans					
Notes payable to affiliated company	3.75%-6.59%	5.77%	2037-2047	182,249	182,249
Cumulative preferred stock with mandatory redemption requirements	8.47%	8.47%	2036	2,250	2,250
Long-term debt				207,999	207,999
Unamortized debt premium, net				(53)	(55)
Total long-term debt				$ 207,946	$ 207,944

The general mortgage bonds are issued in series. No bonds senior to the general mortgage bonds may be issued so long as the general mortgage bonds are outstanding. Based on the calculation methodology specified by the debt agreements, the amount of bonds authorized is limited, as 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, 2018, long-term debt was 50% 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 2.76 times the aggregate annual interest charges on all long-term debt. Mortgage bonds are collateralized by utility plant.

The long-term notes payable to affiliated company 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 fund payments and capital leases, will amount to $0 in 2019 through 2022, and $7,000 in 2023, and $200,999 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 8: Short-Term Debt

The Company maintained a line of credit through AWCC of $20,000 and $40,000 at December 31, 2018 and 2017 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 $18,439 and $8,318 of outstanding borrowings at December 31, 2018 and 2017, respectively. The weighted average annual interest rate on the borrowings at December 31, 2018 and 2017 were 2.6% and 1.2%, respectively. Short-term debt is presented as notes payable-affiliated company in the Balance Sheets.

(Dollars in thousands)

Note 9: General Taxes

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

	2018	2017
Gross receipts and franchise	$ —	$ 1
Property	7,157	5,408
Payroll	547	531
Public Utility Commission assessment	220	194
Total general taxes	$ 7,924	$ 6,134

Note 10: Income Taxes

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

	2018	2017
State Income Tax		
Current	$ 1,437	$ 1,464
Deferred	(277)	562
Total income taxes	$ 1,160	$ 2,026
Federal income taxes:		
Current	$ 5,738	$ 6,223
Deferred	(2,373)	7,210
Amortization of deferred investment tax credits	(79)	(83)
	3,286	13,350
Total income taxes	$ 4,446	$ 15,376

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.

Changes in the Code from the TCJA had a material impact on our financial statements in 2017 and 2018. 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, 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. With respect to excess accumulated deferred income taxes, the Kentucky regulators have considered the issue and have agreed with our overall timeline of passing the excess back to customers beginning no earlier than 2019, when the Company is able to produce the normalization schedule using the average rate assumption (ARAM) method.

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.

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 decreased the 2017 deferred income tax provision by $1,387 for the year ending December 31, 2017. During 2018, the Company continued to refine its estimates made during 2017 based on the new guidance. As a result, Kentucky American Water has recorded approximately $1,220 of an income tax benefit. As of December 31, 2018, the Company has completed its analysis of the estimated impact of the TCJA on its federal and state income taxes based on information available to date. These estimates may be revised in the future for changes in the income tax laws, additional regulatory guidance, changes to forecasted financial conditions, and the tax return filings with the tax authorities.

There are several proposed regulations issued during 2018 providing guidance and clarifications to the TCJA. On March 23, 2018, President Trump signed the Consolidated Appropriations Act of 2018 (the "CAA"). The CAA corrects and clarifies some aspects of the TCJA related to bonus depreciation eligibility. Specifically, property that was acquired, or the construction began, prior to September 27, 2017, is eligible for bonus depreciation. This clarification allowed the Company to benefit from additional bonus depreciation deductions on the 2017 tax return. On November 26, 2018, the U.S. Department of the Treasury released proposed regulations concerning interest expense limitation rules. The TCJA revised and broadened the existing interest expense limitation regulations. The Company has considered all the rules set forth in the proposed regulation including allocated interest expense and interest income based on the relative amounts of the Company's adjusted basis in the assets used in its excepted and non-excepted trades or business, or our Regulated Businesses and Market-Based Businesses. Based on our interpretation of the new guidance, the Company reasonably believes the deductibility of its interest expense will not be limited under the new regulations.

The primary components of the net deferred tax liability of $44,287 and $46,538 at December 31, 2018 and December 31, 2017 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, 2018 and 2017 as management believes it is more likely than not that deferred tax assets will be realized.

As of December 31, 2018 and 2017, the Company's reserve for uncertain tax positions is $579 and $772 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 such things as the expiration of statutes of limitations, audit settlement, or tax examination activities.

The Company recognizes interest and penalties related to income tax matters in income tax expense. The Company recognized interest expense of $14 and $11 for 2018 and 2017, respectively.

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.

On April 13, 2018, the State of Kentucky enacted legislation that decreased the state income tax rate on our taxable income attributable to Kentucky from 6% to 5%, beginning in the 2018 tax year. In addition, beginning in the 2019 tax year, a consolidated return, including all affiliated group members, will be required. The deferred income tax liability for our Kentucky subsidiary was reduced by $1,411, and offset by a regulatory liability, as we believe it is probable of refund in future rates.

Note 11: Employee Benefit Plans

Savings Plan for Employees

The Company maintains a 401(k) Savings Plan, sponsored by AWW, allowing 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 as a defined contribution benefit for union employees hired on or after January 1, 2001 and for non-union employees hired on or after January 1, 2006. The Company expensed contributions to the plans of $400 and $355 for 2018 and 2017, 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 $698 and $957 in 2018 and 2017, 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 $646 and $641 in 2018 and 2017, respectively. The Company expects to contribute $453 to the AWW plan in 2019.

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 for non-union employees hired on or after January 1, 2002.

Costs of the Company are based on an allocation from AWW of the total cost related to the plan. The allocation is based upon the Company's covered participants as a percentage of AWW's total plan covered participants. Information regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company was allocated a benefit of $(495) in 2018 and a cost of $157 in 2017.

The Company made contributions to trust funds established for these postretirement benefits of $0 and $157 in 2018 and 2017, respectively. No contribution to the plan is required in 2019.

Note 12: Stock-Based Compensation

Stock Options and Restricted Stock Units

In 2018 and 2017, AWW granted restricted stock units, both with and without performance conditions and certain market thresholds to certain employees of the Company under the AWW 2017 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.

Costs of the Company are based on the cost of the Company's employees participating in the AWW Omnibus Plan. The Company recorded compensation expense of $17 and $11 included in operation and maintenance expense for the years ended December 31, 2018 and 2017, 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. On July 27, 2018, the ESPP was amended, effective February 5, 2019, to permit employee participants to acquire Company common stock at 85% of the fair market value of the common stock at the end of the 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 $15 and $10 were included in operation and maintenance expense for the years ended December 31, 2018 and 2017, respectively. As the Company does not reimburse the cost of the awards to AWW, the compensation costs is recorded as a capital contribution from AWW.

Note 13: 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:

(Dollars in thousands)

	2018	2017
Included in operation and maintenance expense		
as a charge against income	$ 9,805	$ 9,057
Capitalized primarily in utility plant	3,772	2,414
	$ 13,577	$ 11,471

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 $(155) and $(146) in 2018 and 2017, 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 $102 in 2018 and $89 in 2017, and recorded interest expense on short-term borrowings of $277 in 2018 and $155 in 2017. Interest expense on long-term debt with AWCC amounted to $10,507 and $10,376 in 2018 and 2017, respectively.

Accrued interest expense included amounts due to AWCC of $1,824 and $1,818 for 2018 and 2017, respectively.

The Company received cash capital contributions of $0 and $5,000 from AWW in 2018 and 2017, respectively.

The Company pays dividends to AWW on a quarterly basis. The amount of the dividend is based on a percentage of net income adjusted for certain items. The company paid dividends of $12,147 and $14,436 in 2018 and 2017 respectively.

Note 14: Fair Values of Financial Instruments

Fair Value Measurements

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

- Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access as of the reporting date. Financial assets and liabilities utilizing Level 1 inputs include active exchange-trade equity securities, exchange-based derivatives, mutual funds, and money market funds.

(Dollars in thousands)

- Level 2 - Inputs other than quoted prices included within Level 1 that are directly observable for the asset or liability or indirectly observable through corroboration with observable market data. Financial assets and liabilities utilizing Level 2 inputs include fixed income securities, non-exchanged-based derivatives, commingled investment funds not subject to purchase, and sale restrictions and fair-value hedges.

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

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

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

Preferred stock with mandatory redemption and long-term debt: The fair values of the Company's 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 majority of the Company's debts do not trade in active markets, the Company calculated a base yield curve using a risk-free rate (a U.S. Treasury securities yield curve) plus a credit spread that is based on the following two factors: an average of 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 for Level 2 and Level 3 securities. Additionally, the Company adjusted the base yield for specific features of the debt securities including call features, coupon tax treatment and collateral for the Level 3 instruments.

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

		At Fair Value as of December 31, 2018			
	Carrying Amount	Level 1	Level 2	Level 3	Total
Preferred stock with mandatory redemption requirements	$ 2,250	—	$ —	$ 2,463	$ 2,463
Long-term debt	205,696	—	98,735	133,189	231,924

		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

Recurring Fair Value Measurements

As of December 31, 2018 and 2017, the Company had immaterial amounts of assets and liabilities measured and recorded at fair value on a recurring basis.

Note 15: Leases

The Company has entered into operating leases involving certain equipment and vehicles. Rental expenses under operating leases were $135 and $90 in 2018 and 2017, respectively, which are included in operations and maintenance expense. The operating leases have various expiration dates.

At December 31, 2018, the minimum annual future rental commitments under operating leases that have initial or remaining non-cancelable lease terms in excess of one year are, $7 in year 2019, $5 in 2020, $4 in year 2021, $4 in year 2022, $4 in year 2023 and $76 thereafter.

Note 16: Commitments and Contingencies

Commitments have been made in connection with certain construction programs. The estimated capital expenditures required under legally binding contracts amounted to $7,677 at December 31, 2018.

As of December 31, 2018, 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, 2018, the Company has not identified any loss contingencies that are probable or reasonably possible for existing matters.

Note 17: Subsequent Events

The Company performed an evaluation of subsequent events for the accompanying financial statements through March 29, 2019, 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, 2018.