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, 2019 and 2018

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, 2019 and 2018, and the related statements of income, cash flows, and 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, 2019 and 2018, 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, 2020

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

(Dollars in thousands)

Assets

	2019	2018
Property, plant and equipment, net		
Utility plant - at original cost, net of accumulated depreciation of $176,451 and $162,471 at December 31, 2019 and 2018, respectively	$ 646,852	$ 607,302
Utility plant acquisition adjustments	431	194
Non-utility property, net of accumulated depreciation	250	250
Total property, plant and equipment	647,533	607,746
Current assets		
Cash	642	1,192
Accounts receivable	6,353	6,682
Allowance for uncollectible accounts	(1,056)	(1,049)
Unbilled utility revenues	4,447	4,169
Receivable from affiliated companies	6,642	—
State income tax receivable	973	893
Materials and supplies	869	844
Current regulatory assets	139	—
Other current assets	1,038	425
Total current assets	20,047	13,156
Regulatory and other long-term assets		
Regulatory assets	17,179	13,818
Operating lease right-of-use assets	6	—
Goodwill	576	—
Prepaid pension expense	677	1,169
Prepaid postretirement benefit expense	429	—
Other long-term assets	86	78
Total regulatory and other long-term assets	18,953	15,065
Total assets	$ 686,533	$ 635,967

(Dollars in thousands)

Capitalization and Liabilities

Capitalization	**2019**	**2018**
Common stockholder's equity	$ 220,875	$ 205,927
Long-term debt	221,614	205,696
Preferred stock with mandatory redemption requirements	2,250	2,250
Total capitalization	444,739	413,873
Current liabilities		
Notes payable - affiliated company	21,787	18,439
Accounts payable	11,943	3,727
Accounts payable - affiliated company	5,821	1,284
Taxes accrued	6,682	6,578
Interest accrued	1,745	2,152
Refunds due to customers	788	728
Advances for Construction - Current	1,344	1,094
Other current liabilities	4,128	5,163
Total current liabilities	54,238	39,165
Regulatory and other long-term liabilities		
Advances for Construction	9,605	10,023
Deferred income taxes, net	50,569	44,287
Deferred investment tax credits	215	293
Regulatory liability - cost of removal	14,632	18,222
Other regulatory liabilities	37,595	38,647
Accrued postretirement expense	—	343
Operating lease liability	5	—
Other long-term liabilities	104	86
Total regulatory and other long-term liabilities	112,725	111,901
Contributions in aid of construction	74,831	71,028
Commitments and contingencies (see Note 16)	—	—
Total capitalization and liabilities	$ 686,533	$ 635,967

KENTUCKY-AMERICAN WATER COMPANY
Notes to Financial Statements
December 31, 2019 and 2018
(Dollars in thousands)

	2019	2018
Operating revenues	$ 98,931	$ 92,759
Operating expenses (income)		
Operation and maintenance	36,986	35,104
Depreciation	15,433	14,216
Amortization	2,622	2,527
General taxes	7,067	7,924
Loss/(gain) on asset dispositions and purchases	—	(1,955)
Total operating expenses, net	62,108	57,816
Operating income	36,823	34,943
Other income (expenses)		
Interest, net	(12,697)	(12,354)
Interest on short-term debt - affiliated company	(560)	(277)
Allowance for other funds used during construction	1,331	762
Allowance for borrowed funds used during construction	629	384
Amortization of debt expense	(99)	(119)
Non-operating benefit costs, net	417	484
Other, net	(62)	4
Total other expenses	(11,041)	(11,116)
Income before income taxes	25,782	23,827
Provision for income taxes	5,712	4,446
Net income	$ 20,069	$ 19,381
Net income available to common stockholder	$ 20,069	$ 19,381

The accompanying notes are an integral part of these financial statements

KENTUCKY-AMERICAN WATER COMPANY
Notes to Financial Statements
December 31, 2019 and 2018
(Dollars in thousands)

	2019		2018	
Cash flows from operating activities				
Net income	$	20,069	$	19,381
Adjustments:				
Depreciation and amortization		18,055		16,743
Amortization of debt expense		99		119
Provision for deferred income taxes		5,356		(2,650)
Amortization of deferred investment tax credits		(78)		(79)
Provision for losses on accounts receivable		680		1,068
Allowance for other funds used during construction		(1,331)		(762)
Loss/(gain) on asset dispositions and acquisitions		—		(1,955)
Pension and non-pension postretirement benefits		109		296
Deferred programmed maintenance expense		(2,711)		(2,117)
Other, net		169		3,375
Changes in assets and liabilities:				
Accounts receivable and unbilled revenues		(541)		(138)
Federal income tax from affiliated company		(1)		2,450
State income taxes		(80)		(313)
Other current assets		(636)		(87)
Pension and non-pension postretirement benefit contributions		(453)		(355)
Other non-cash net		42		51
Accounts payable		1,863		1,383
Accounts receivable and payable - affiliated company		(2,130)		130
Accrued interest		(407)		6
Accrued taxes		104		805
Other current liabilities		(1,681)		(2,209)
Net cash provided by operating activities		36,498		35,142
Cash flows from investing activities				
Capital expenditures		(46,999)		(32,881)
Acquisitions		(1,576)		(770)
Removal costs from property, plant and equipment retirements, net		(6,494)		(3,458)
Proceeds from the disposition of property, plant and equipment		—		2,059
Net cash used in investing activities		(55,069)		(35,050)
Cash flows from financing activities				
Proceeds from issuance of long-term debt		16,000		—
Net borrowings (repayments) of notes payable - affiliated company		3,348		10,121
Debt issuance costs		(803)		(60)
Advances and contributions, net of refunds of $1,349 and $1,505 in 2019 and 2018, respectively		4,533		2,647
Capital contributions by stockholder		9,300		—
Dividends paid		(14,357)		(12,147)
Net cash provided by financing activities		18,021		561
Net (decrease)/increase in cash and restricted funds		(550)		653
Cash and restricted funds at beginning of year		1,192		539
Cash and restricted funds at end of year		642	$	1,192
Cash paid (received) during the year for:				
Interest, net of capitalized amount	$	12,470	$	11,960
Income taxes	$	3,440	$	(998)
Non-cash investing activity				
Capital expenditures acquired on account but unpaid as of year end	$	7,073	$	767
Non-cash financing activity				
Capital contributions by stockholder (See Note 12)	$	(39)	$	32

The accompanying notes are an integral part of these financial statements

KENTUCKY-AMERICAN WATER COMPANY
Notes to Financial Statements
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(Dollars in thousands)

	Common Stock		Paid-in	Retained	
	Shares	**Par Value**	**Capital**	**Earnings**	**Total**
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
Net income				20,068	20,068
Capital contributions			9,260		9,260
Cumulative effect of change in accounting principle				(25)	(25)
Dividends				(14,357)	(14,357)
Balance at December 31, 2019	1,567,391	$ 36,569	$ 103,430	$ 80,874	$ 220,873

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 that management make estimates, assumptions and judgments that could affect the Company's financial condition, results of operations and cash flows. Actual results could differ from these estimates, assumptions and judgments. The Company considers its critical accounting estimates to include (i) the application of regulatory accounting principles and the related determination and estimation of regulatory assets and liabilities, (ii) revenue recognition and the estimates used in the calculation of unbilled revenue, (iii) accounting for income taxes and (iv) the estimates and judgments used in 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 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.

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 $8,387 and $7,312 as of December 31, 2019 and 2018, 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, 2019 and 2018 respectively. The remaining useful lives range from 21 to 26 years.

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.

Cash and Cash Equivalents and Restricted Funds

Substantially all of the Company's cash is invested in interest-bearing accounts. The company had $642 and $1,192 at December 31, 2019 and 2018 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 reserves accounts that exceed a certain number of days outstanding.

Unbilled Revenues

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

Leases

The Company has operating involving real property, including facilities, utility assets, vehicles, and equipment. The Company determines if an arrangement is a lease at inception. Operating leases are included in operating lease right-of-use ("ROU") assets, accrued liabilities and operating lease liabilities on the Balance Sheets. The Company has made an accounting policy election not to include operating leases with a lease term of twelve months or less.

ROU assets represent the right to use an underlying asset for the lease term and the lease liabilities represent the obligation to make lease payments arising from the lease. ROU assets and lease liabilities are generally recognized at the commencement date based on the present value of discounted lease payments over the lease term. As most of the Company's leases do not provide an implicit rate, the Company uses its incremental borrowing rate based on the information available at the commencement date in determining the present value of discounted lease payments. The implicit rate is used when readily determinable. ROU assets also include any upfront lease payments and excludes lease incentives. The Company's lease terms may include options to extend or terminate the lease when it is reasonably certain that the option will be exercised. Lease expense is recognized on a straight-line basis over the lease term.

The Company has lease agreements with lease components (e.g., fixed payments including rent, real estate taxes and insurance costs) and non-lease components (e.g., common-area maintenance costs), which are generally accounted for separately; however, the Company accounts for the lease and non-lease components as a single lease component for certain leases. Certain lease agreements include variable rental payments adjusted periodically for inflation. Additionally, the Company applies a portfolio approach to effectively account for the ROU assets and lease liabilities. The Company's lease agreements do not contain any material residual value guarantees or material restrictive covenants.

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 ratemaking 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 $2,423 and $2,297 for the years ended December 31, 2019 and 2018, respectively. For the years ended December 31, 2019 and 2018, 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*, 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 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.

The Company recognizes accrued interest and penalties related to tax positions as a component of income tax expense. See Note 10-Income Taxes for additional information.

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 accounting standards were adopted by the Company in 2019:

Accounting for Leases

On January 1, 2019, the Company adopted Accounting Standards Update 2016-02, Leases (Topic 842), and all related amendments. Under this guidance, a lessee is 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 guidance, lessor accounting is largely unchanged. A package of optional transition practical expedients allows an entity not to reassess under the new guidance: (i) 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 early adopted January 1, 2019 on a modified retrospective basis. See Note 15-Leases

The following recently issued accounting standards have not yet been adopted by the Company at December 31, 2019:

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, 2022 for the Company. Early adoption is permitted, but not before January 1, 2019 for the Company. The Company plans to early adopt January 1, 2020 on a modified retrospective basis. The standard will not have a material impact on the Financial Statements.

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. The standard will not have a material impact on the Financial Statements.

Simplifying the Accounting for Income Taxes

In December 2019, the FASB issued guidance that simplified the accounting for income taxes by removing certain exceptions and by adding certain requirements. The guidance removes exceptions related to the incremental approach for intra-period tax allocation, the requirement to recognize a deferred tax liability for changes in ownership of a foreign subsidiary or equity method investment, and the general methodology for calculating income taxes in an interim period when the year-to-date loss exceeds the anticipated loss. The guidance adds requirements to reflect changes to tax laws or rates in the annual effective tax rate computation in the interim period in which the changes were enacted, to recognize franchise or other similar taxes that are partially based on income as an income-based tax and any incremental amounts as non-income-based tax, and to evaluate when a step up in the tax basis of goodwill should be considered part of the business combination in which the book goodwill was originally recognized and when it should be considered a separate transaction. The new standard is effective January 1, 2022 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)

Reclassifications

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

Note 3: Revenue Recognition

Disaggregated Revenues

Presented in the table below are operating revenues disaggregated for the year ended December 31, 2019:

	Revenue from Contracts with Customers	Other Revenues Not from Contracts with Customers (a)	Total Operating Revenues
Water Service:			
Residential	$ 52,893	$ —	$ 52,893
Commercial	23,955	—	23,955
Industrial	2,638	—	2,638
Fire Service	6,702	—	6,702
Public and other	8,446	—	8,446
Sales for resale	1,246	—	1,246
Total water services	95,880	—	95,880
Wastewater services:			
Residential	472	—	472
Commercial	148	—	148
Industrial	8	—	8
Public and other	28	—	28
Total wastewater services	656	—	656
Miscellaneous utility charges	2,259	—	2,259
Lease contract revenue	—	136	136
Total operating revenues	$ 98,795	$ 135	$ 98,931

(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.

(Dollars in thousands)

Note 4: Acquisitions

During 2019, the Company acquired one regulated water system for a total aggregate purchase price of $1,571 plus acquisition costs of $5 for a total cash outlay of $1,576. Assets acquired, principally utility plant, totaled $2.5 million and liabilities assumed totaled $1.5 million. This acquisition was accounted for as a business combination.

Note 5: Utility Plant

Presented in the table below are the major classes of utility plant by category at December 31:

	Range of Remaining Useful Life	2019	2018
Utility Plant:			
Land and other non-depreciable assets	—	$ 9,898	$ 9,883
Sources of supply	42 to 72 Years	59,267	59,058
Treatment and pumping	28 to 46 Years	152,810	133,443
Transmission and distribution	38 to 82 Years	361,587	349,626
Services, meters and fire hydrants	27 to 65 Years	143,196	136,685
General structures and equipment	5 to 57 Years	61,407	57,163
Wastewater	5 to 50 Years	11,325	8,724
Construction work in progress	—	23,813	15,191
		823,303	769,773
Less: Accumulated depreciation		(176,451)	(162,471)
Utility Plant - at original cost, net		$ 646,852	$ 607,302

The provision for depreciation expressed as a percentage of the aggregate average depreciable asset balances was 2.58% and 2.47% in 2019 and 2018, 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.

Provided in the table below is the composition of regulatory assets as of December 31:

	2019	2018
Programmed maintenance expense	12,394	10,312
Debt and preferred stock expense	2,472	1,402
Bluegrass water project	1,199	1,256
Other	1,114	848
Total regulatory assets	$ 17,179	$ 13,818

(Dollars in thousands)

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

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.

Provided in the table below is the composition of regulatory liabilities as of December 31:

	2019	2018
Income taxes recovered through rates	$ 37,595	38,647
Removal costs recovered through rates	14,632	18,222
Regulatory liabilities	$ 52,227	$ 56,869

Income taxes recovered through rates relate to deferred taxes that will 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.

During 2018, the company began to seek to address the impacts of the TCJA. The Company has adjusted customer rates to reflect the lower income tax rate. With respect to excess accumulated deferred income taxes ("EADIT"), Kentucky is amortizing EADIT and crediting customers.

Removal costs recovered through rates are estimated costs to retire assets at the end of their expected useful lives that are recovered through customer rates over the lives of the associated assets.

(Dollars in thousands)

Note 7: Long-Term Debt

Presented in the table below are the components of long-term debt as of December 31:

	Rate	Weighted Average Rate	Maturity Date	2019	2018
Mortgage bonds	6.96%-7.15%	7.03%	2023-2028	$ 23,500	$ 23,500
Variable rate loans					
Notes payable to affiliated company	2.45%-6.59%	4.35%	2037-2049	198,249	182,249
Cumulative preferred stock with mandatory redemption requirements	8.47%	8.47%	2036	2,250	2,250
Long-term debt				223,999	207,999
Unamortized debt premium, net				(135)	(53)
Total long-term debt				$ 223,864	$ 207,946

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, 2019, 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 3.05 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 2019, the Company issued $16,000 of long-term notes payable to AWCC at a rate of 4.15% due in 2049. In 2019, the Company used proceeds from the offering to repay AWCC’s commercial paper obligations and for general corporate purposes.

In 2019, the Company issued long-term notes payable of $45,390 bearing interest of 2.45% with a mandatory purchase date of October 1, 2029 and $26,000 bearing interest of 2.45% with a mandatory purchase date of October 1, 2029. The Issuer loaned the proceeds to American Water Capital Corp. and the Company to: (i) refund $45,390 of its outstanding 6.25% Water Facilities Refunding Revenue Bonds due June 1, 2039 and (ii) refund $26,000 of its outstanding 5.625% Water Facilities Refunding Revenue Bonds due September 1, 2039.

Maturities of long-term debt, including sinking fund payments and capital leases, will amount to $0 in 2020 through 2022, and $7,000 in 2023, and $216,999 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.

(Dollars in thousands)

Note 8: Short-Term Debt

The Company maintained a line of credit through AWCC of $20,000 at December 31, 2019 and 2018 respectively. The Company may borrow from the line of credit assuming loan balance is a credit for both years. No compensating balances are required under the agreements. Funds were primarily used for short-term operating needs. There were $21,787 and $18,439 of outstanding borrowings at December 31, 2019 and 2018, respectively. The weighted average annual interest rate on the borrowings at December 31, 2019 and 2018 were 2.48% and 2.6%, respectively. Short-term debt is presented as notes payable-affiliated company in the Balance Sheets.

Note 9: General Taxes

Presented in the table below are the components of general tax expense for the years ended December 31:

	2019	2018
Property	$ 6,242	$ 7,157
Payroll	589	547
Public Utility Commission assessment	214	220
Total general taxes	$ 7,045	$ 7,924

Note 10: Income Taxes

Presented in the table below are the components of income tax expense for the years ended December 31:

	2019	2018
State Income Tax		
Current	$ (114)	$ 1,437
Deferred	1,303	(277)
Total income taxes	$ 1,189	$ 1,160
Federal income taxes:		
Current	$ 548	$ 5,738
Deferred	4,054	(2,373)
Amortization of deferred investment tax credits	(79)	(79)
	4,523	3,286
Total income taxes	$ 5,712	$ 4,446

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.

The enactment of the TCJA required a re-measurement of the Company’s deferred income taxes that materially impacted its 2017 results of operations and financial position. The portion of this re-measurement related to the Regulated Businesses was substantially offset by a regulatory liability, as the Company believes it is probable that the excess accumulated deferred income taxes (“EADIT”) created by the TCJA will be used to benefit its regulated customers in future rates. The Commission has 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. As of December 31, 2019, the Company has started returning the excess ADIT to its customers.

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.

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.

The primary components of the net deferred tax liability of $50,569 and $44,287 at December 31, 2019 and December 31, 2018 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, 2019 and 2018 as management believes it is more likely than not that deferred tax assets will be realized.

As of December 31, 2019 and 2018, the Company's reserve for uncertain tax positions is $717 and $579 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 $18 and $14 for 2019 and 2018, 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 2016.

For taxable years beginning on or after January 1, 2019, H.B. 487 mandates that all Kentucky taxpayers engaged in a unitary business group with one or more corporations must file a combined report in the state.

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 $410 and $400 for 2019 and 2018, 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 $945 and $698 in 2019 and 2018, 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 $453 and $646 in 2019 and 2018, respectively. The Company expects to contribute $508 to the AWW plan in 2020.

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 benefit of $(836) and $(495) in 2019 and 2018, respectively.

No contributions were made in 2019 and 2018, respectively. No contribution to the plan is required in 2020.

Note 12: Stock-Based Compensation

The Company recorded compensation benefit and expense, respectively of ($39) and $32 included in operation and maintenance expense for the years ended December 31, 2019 and 2018, respectively, for the costs of the Stock Options and Restricted Stock Units and the Employee Stock Purchase Plan.

Stock options and restricted stock unit costs of the Company are based on the cost of the Company's employees participating in the AWW Omnibus Plan. Employee stock purchase plan costs are based on an allocation from AWW of the total cost for the Company's employees in the plan.

Stock Options and Restricted Stock Units
In 2019 and 2018, 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.

Employee Stock Purchase Plan
Under AWW's nonqualified employee stock purchase plan (the "ESPP") that expires in 2027 through which employee participants may use payroll deductions to acquire Company common stock at a discount of 85% of the fair market value of the common stock at the end of the purchase period. AWW's ESPP is considered compensatory.

(Dollars in thousands)

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 that are subsidiaries of AWW 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:

	2019	2018
Included in operation and maintenance expense		
as a charge against income	$ 10,397	$ 9,805
Capitalized primarily in utility plant	4,207	3,772
	$ 14,604	$ 13,577

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 $(135) and $(155) in 2019 and 2018, 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 $51 in 2019 and $102 in 2018, and recorded interest expense on short-term borrowings of $560 in 2019 and $277 in 2018. Interest expense on long-term debt with AWCC amounted to $10,845 and $10,507 in 2019 and 2018, respectively.

Accrued interest expense included amounts due to AWCC of $1,413 and $1,824 for 2019 and 2018, respectively.

The Company received cash capital contributions of $9,300 and $0 from AWW in 2019 and 2018, 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 $14,357 and $12,147 in 2019 and 2018 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.

- 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.

Presented in the table below are carrying amounts and fair values of the financial instruments:

(Dollars in thousands)

		At Fair Value as of December 31, 2019			
	Carrying Amount	**Level 1**	**Level 2**	**Level 3**	**Total**
Preferred stock with mandatory redemption requirements	$ 2,250	—	$ —	$ 3,135	$ 3,135
Long-term debt	221,614	—	129,319	127,052	256,371

		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

Recurring Fair Value Measurements

As of December 31, 2019 and 2018, the Company had immaterial amounts of assets and liabilities measured and recorded at fair value on a recurring basis.

Note 15: Leases

On January 1, 2019, the Company adopted Accounting Standards Update 2016-02, *Leases (Topic 842)*, and all related amendments (collectively, the "Standard"). The Company implemented the guidance in the Standard using the modified retrospective approach and applied the optional transition method, which allowed entities to apply the new Standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Under this approach, prior periods have not been restated and continue to be reported under the accounting standards in effect for those periods. The Standard includes practical expedients, which relate to the identification and classification of leases that commenced before the adoption date, initial direct costs for leases that commenced before the adoption date, the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset and the ability to carry forward accounting treatment for existing land easements.

Adoption of the Standard resulted in the recognition of operating lease right-of-use ("ROU") assets and operating lease liabilities as of January 1, 2019 of approximately $3 thousand and $3 thousand, respectively. The Standard did not materially impact the Company's results of operations and had no impact on cash flows.

Certain operating leases have renewal options ranging from 0 to 6 years. The exercise of lease renewal options is at the Company's sole discretion. Renewal options that the Company was reasonably certain to exercise are included in the Company's ROU assets. Certain operating leases contain the option to purchase the leased property. The operating leases equipment will expire over the next 6 and five years, respectively.

Rental expenses under operating leases were $2,808 and $135 for the years ended December 31, 2019 and 2018, respectively.

Presented in the table below is supplemental cash flow information for the year ended December 31 (in thousands):

	2019
Cash paid for amounts in lease liabilities (a)	$ 3
Right-of-use assets obtained in exchange for new operating lease liabilities	9

(a) Includes operating and financing cash flows from operating and finance leases.

Presented in the table below are the weighed-average remaining lease terms and the weighted-average discount rates for finance and operating leases:

	As of December 31, 2019
Weighted-average remaining lease term:	
Finance lease	none
Operating leases	5.08 years
Weighted-average discount rate:	
Finance lease	none
Operating leases	2.30 %

Presented in the table below are the future maturities of lease liabilities at December 31, 2019 (in thousands):

	Amount
2020	$ 1
2021	1
2022	1
2023	1
2024	1
Thereafter	—
Total lease payments	5
Less imputed interest	—
Total	$ 5

Presented in the table below are the future minimum rental commitments, as of December 31, 2018, under operating leases that have initial or remaining non-cancelable lease terms over the next five years and thereafter (in thousands):

	Amount
2019	$ 7
2020	5
2021	4
2022	4
2023	4
Thereafter	76
Total	$ 100

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 $14,923 at December 31, 2019.

As of December 31, 2019, 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, 2019, 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 30, 2020, 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, 2019.

The Company is monitoring the global outbreak of the novel coronavirus (COVID-19) which first surfaced in December and has since spread globally. It is reasonably possible the Company's operations and results could be negatively affected by the impacts of COVID-19. The extent to which COVID-19 may impact the Company's results will depend on future developments, which are highly uncertain and cannot be predicted, including new information concerning the severity of COVID-19 and the actions taken to contain it or treat its impact, among others.