Kentucky-American Water Company, Inc.

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

Financial Statements

As of and for the years ended December 31, 2013 and 2012

Independent Auditor's Report

To the Board of Directors and Stockholder 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, 2013 and 2012, and the related statements of income, of changes in common stockholder's equity and of cash flows for the years then ended.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kentucky-American Water Company at December 31, 2013 and 2012, 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 14, 2014

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KENTUCKY-AMERICAN WATER COMPANY
Balance Sheets
December 31, 2013 and 2012
(Dollars in thousands)

Assets

	2013	2012
Property, plant and equipment		
Utility plant - at original cost, net of accumulated depreciation	$ 519,037	$ 495,913
Utility plant acquisition adjustments	234	243
Nonutility property	250	250
Total property, plant and equipment	519,521	496,406
Current assets		
Cash and cash equivalents	209	384
Accounts receivable	5,249	4,344
Allowance for uncollectible accounts	(1,052)	(715)
Unbilled revenues	4,965	3,705
State income tax receivable	284	394
Materials and supplies	638	855
Deferred income taxes	382	275
Other	351	420
Total current assets	11,026	9,662
Regulatory and other long-term assets		
Regulatory assets	13,812	11,731
Prepaid pension expense	2,134	2,028
Other	150	136
Total regulatory and other long-term assets	16,096	13,895
Total assets	$ 546,643	$ 519,963

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

KENTUCKY-AMERICAN WATER COMPANY
Balance Sheets
December 31, 2013 and 2012
(Dollars in thousands)

Capitalization and Liabilities

	2013	2012
Capitalization		
Common stockholder's equity	$ 163,769	$ 159,214
Long-term debt, excluding current portion		
Preferred stock with mandatory redemption requirements	4,500	4,500
Long-term debt	195,749	187,890
Total capitalization	364,018	351,604
Current liabilities		
Notes payable - affiliated company	20,174	11,023
Accounts payable	4,510	7,184
Accrued interest	2,090	2,024
Accrued taxes, including federal income taxes of $43 in 2013 and $2,741 in 2012	106	4,596
Refunds due to customers	1,189	601
Other	3,374	3,253
Total current liabilities	31,443	28,681
Regulatory and other long-term liabilities		
Deferred income taxes	65,290	57,403
Advances for construction	12,192	11,922
Deferred investment tax credits	709	794
Regulatory liability - cost of removal	15,763	14,034
Regulatory liability - debt extinguishment	22	152
Accrued postretirement benefit expense	656	604
Other tax liabilities	2,522	2,908
Other	73	71
Total regulatory and other long-term liabilities	97,227	87,888
Contributions in aid of construction	53,955	51,790
Commitments and contingencies (See Note 17)	-	-
Total capitalization and liabilities	$ 546,643	$ 519,963

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

KENTUCKY-AMERICAN WATER COMPANY
Statements of Income
For the Years Ended December 31, 2013 and 2012
(Dollars in thousands)

	2013	2012
Operating revenues	$ 83,618	$ 85,960
Operating expenses		
Operation and maintenance	33,028	34,055
Depreciation	11,566	10,043
Amortization	1,822	1,756
General taxes	5,058	4,914
Total operating expenses	51,474	50,768
Operating income	32,144	35,192
Other income (expenses)		
Interest on long-term debt	(11,905)	(11,709)
Interest on short-term debt to affiliated company	(46)	(57)
Allowance for other funds used during construction	778	675
Allowance for borrowed funds used during construction	363	317
Amortization of debt issuance costs	(89)	(74)
Other, net	(81)	(76)
Total other expenses	(10,980)	(10,924)
Income before income taxes	21,164	24,268
Provision for income taxes	8,398	9,664
Net income	12,766	14,604
Dividends on preferred stock	-	40
Net income available to common stockholder	$ 12,766	$ 14,564

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

KENTUCKY-AMERICAN WATER COMPANY
Statements of Cash Flows
December 31, 2013 and 2012
(Dollars in thousands)

	2013	2012
Cash flows from operating activities		
Net income	$ 12,766	$ 14,604
Adjustments		
Depreciation and amortization	13,388	11,799
Amortization of debt issuance costs	89	74
Deferred income tax expense (benefit)	7,734	(1,861)
Amortization of deferred investment tax credits	(85)	(85)
Provision for losses on accounts receivable	1,092	597
Allowance for other funds used during construction	(778)	(675)
Pension and non-pension post retirement benefits	1,766	2,002
Deferred programmed maintenance expense	(2,131)	(824)
Other, net	(605)	1,097
Changes in assets and liabilities		
Accounts receivable and unbilled revenues	(2,859)	(823)
Federal income tax-affiliated company	(2,698)	6,369
Other current assets	400	740
Pension and non-pension post retirement benefits contribution	(1,871)	(2,697)
Accounts payable	(1,051)	(128)
Accrued taxes	(1,792)	1,529
Other current liabilities	875	(669)
Net cash provided by operating activities	24,240	31,049
Cash flows from investing activities		
Capital expenditures	(36,900)	(19,906)
Removal costs from property, plant and equipment retirements, net of salvage	(86)	(1,238)
Net cash used in investing activities	(36,986)	(21,144)
Cash flows from financing activities		
Proceeds from issuance of long-term debt to affiliated company	7,859	-
Debt issuance costs	(32)	(87)
Net borrowings (repayments) of short-term borrowings-affiliated company	9,151	(486)
Advances and contributions for construction, net of refunds of $1,187 in 2013 and $1,025 in 2012	3,884	2,958
Capital contributions	-	4,000
Redemption of preferred stock	-	(1,446)
Dividends paid	(8,291)	(14,742)
Net cash provided by (used in) financing activities	12,571	(9,803)
Net (decrease) increase in cash and cash equivalents	(175)	102
Cash and cash equivalents at beginning of year	384	282
Cash and cash equivalents at end of year	$ 209	$ 384
Cash paid (received) during the year for:		
Interest, net of capitalized amount	$ 11,970	$ 11,857
Income taxes, net of refunds of $0 in 2013 and $504 in 2012	$ 3,710	$ (504)
Non-cash investing activity		
Capital expenditures acquired on account but unpaid as of year end	$ 2,512	$ 4,101
Non-cash financing activity		
Capital contribution (See Note 13)	$ 80	$ 78

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

KENTUCKY-AMERICAN WATER COMPANY
Statements of Capitalization
December 31, 2013 and 2012
(Dollars in thousands, except per share amounts)

	Call Price Per Share	2013	2012
Stockholder's equity			
Common stock - no par value, authorized 2,000,000 shares 1,567,391 shares issued and outstanding in 2013 and 2012		$ 36,569	$ 36,569
Paid-in capital		78,926	78,846
Retained earnings		48,274	43,799
Total common stockholder's equity		163,769	159,214
Long-term debt			
Preferred stocks - $100 par value			
Cumulative preferred stocks with mandatory redemption requirements:			
8.47% series, 45,000 shares outstanding in 2013 and 2012 due for redemption 2036	$ 100.00	4,500	4,500
General mortgage bonds:			
6.96% series due 2023		7,000	7,000
7.15% series due 2027		7,500	7,500
6.99% series due 2028		9,000	9,000
Notes payable to affiliate:			
4.00% series due 2037		7,859	-
5.05% series due 2037		20,000	20,000
6.593% series due 2037		47,000	47,000
6.25% series A due 2039		45,390	45,390
5.625% series B due 2039		26,000	26,000
5.375% series due 2040		26,000	26,000
Total long-term debt and mandatory redeemable preferred stock		200,249	192,390
Total capitalization		$ 364,018	$ 351,604

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

KENTUCKY-AMERICAN WATER COMPANY
Statements of Changes in Common Stockholder's Equity
December 31, 2013 and 2012
(Dollars in thousands, except per share amounts)

	Common Stock			Paid-in		Retained		Total
	Shares	Par Value		Capital		Earnings		
Balance at December 31, 2011	1,567,391	$	36,569	$	74,768	$	43,937	$ 155,274
Net income	-		-		-		14,604	14,604
Capital contributions	-		-		4,078		-	4,078
Preferred stock dividends	-		-		-		(40)	(40)
Common stock dividends	-		-		-		(14,702)	(14,702)
Balance at December 31, 2012	1,567,391	$	36,569	$	78,846	$	43,799	$ 159,214
Net income	-		-		-		12,766	12,766
Capital contributions	-		-		80		-	80
Common stock dividends	-		-		-		(8,291)	(8,291)
Balance at December 31, 2013	1,567,391	$	36,569	$	78,926	$	48,274	$ 163,769

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

Note 1: Organization and Operation

Kentucky-American Water Company (the "Company") provides water service to approximately 126,000 (unaudited) customers and wastewater service to approximately 700 (unaudited) customers. These services are provided in 10 (unaudited) counties in the state of Kentucky. As a public utility operating in Kentucky, the Company functions under rules and regulations prescribed by the Kentucky Public Service Commission (the "Commission"). The Company is a wholly-owned subsidiary of American Water Works Company, Inc. ("AWW").

Note 2: Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("U.S. GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The Company considers benefit plans assumptions, the value of long-lived assets, including regulatory assets and liabilities, revenue recognition and accounting for income taxes to be its critical accounting estimates. The Company's significant estimates that are particularly sensitive to change in the near term are amounts reported for pension and other postemployment benefits and contingency-related obligations.

Regulation

The Company is subject to regulation by the Commission and the local governments of the State of Kentucky (collectively the "Regulators"). These Regulators have allowed recovery of costs and credits which the Company has recorded as regulatory assets and liabilities. Accounting for future recovery of costs and credits as regulatory assets and liabilities is in accordance with authoritative guidance provided by U.S. GAAP. Regulated utilities defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that those costs and credits will be recognized in the rate making process in a period different from the period in which they would have been reflected in operations by a market based company. These deferred regulatory assets and liabilities are then reflected in the statement of income in the period in which the costs and credits are reflected in the rates charged for service.

Property, Plant and Equipment

Property, plant and equipment consist primarily of utility plant. Additions to utility plant and replacements of retirement units of property are capitalized. Costs include material, direct labor and such indirect items as engineering and supervision, payroll taxes and benefits, transportation and an allowance for funds used during construction. Repairs and maintenance are charged to current operations.

Note 2 (continued):

When units of property are replaced, retired or abandoned, the recorded value thereof is credited to the asset account and charged to accumulated depreciation. To the extent the Company recovers cost of removal or other retirement costs through rates, a regulatory asset or liability may occur where timing differences exist between when the Company incurs costs of removal and when the Company recovers such costs in rates. Removal costs, net of salvage, are recorded as reductions to the regulatory liability or an increase to the regulatory asset, as applicable.

The cost of utility property, plant and equipment is depreciated using the straight-line average remaining life using the composite method.

Computer software is either purchased or internally developed and their costs are capitalized as a unit of property. The carrying value of these assets amounts to $8,892 at December 31, 2013 and $2,884 at December 31, 2012. The 2013 increase was primarily due to the implementation of new billing and asset management systems.

Utility plant acquisition adjustments represent the difference between the fair value of plant at the date of purchase and its original cost when first devoted to public service (less accumulated depreciation) and are amortized to expense over the remaining useful lives of the corresponding purchased plant assets. Amortization of utility plant acquisition adjustments was $9 and $8 for 2013 and 2012, respectively. The remaining lives range from 27 to 32 years.

Cash and Cash Equivalents

Substantially all of the Company's cash is invested in interest-bearing accounts. The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents. There were no cash equivalents held at December 31, 2013 or 2012.

Accounts Receivable

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

Allowance for Uncollectible Accounts

Allowance for uncollectible accounts are maintained for estimated probable losses resulting from the Company’s inability to collect receivables. Accounts that are outstanding longer than the payment terms are considered past due. A number of factors are considered in determining the allowance for uncollectible accounts, including the length of time receivables are past due and previous loss history. The Company writes-off accounts when they become uncollectible.

Note 2 (continued):

Materials and Supplies

Materials and supplies are stated at the lower of cost or net realizable value. Cost is determined using the average cost method.

Advances for Construction and Contributions in Aid of Construction

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

Advances which 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 they represent non-investor supplied funds.

The Company depreciates utility plant funded by contributions and amortizes its contribution balance as a reduction to depreciation expense, producing a result which is functionally equivalent to reducing the original cost of the utility plant for the contributions. Amortization of contributions was $1,548 and $1,465 for the years ended December 31, 2013 and 2012, respectively. For the years ended December 31, 2013 and 2012, non-cash advances and contributions received were $0 and $7, respectively.

Recognition of Revenues

Revenues are recognized as water and wastewater services are provided and include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the date of the meter reading associated with the latest customer invoice to the end of the accounting period. Other operating revenues are recognized when services are performed.

The Company accounts for sales tax collected from customers and remitted to taxing authorities on a net basis.

Income Taxes

AWW and its subsidiaries participate in a consolidated federal income tax return for U.S. tax purposes. Members of the consolidated group are charged with the amount of federal income tax expense determined as if they filed separate returns. Federal income tax expense for financial reporting purposes is provided on a separate return basis.

Certain income and expense items are accounted for in different time periods for financial reporting than for income tax reporting purposes. Deferred income taxes have been provided on the difference between the tax basis of assets and liabilities and the amounts at which they are carried in the financial statements. These deferred income taxes are based on the

Note 2 (continued):

enacted tax rates anticipated to be in effect when such temporary differences are projected to reverse. Anticipated tax rates are the currently enacted tax rates, as the Company is not aware of any tax rate changes. In addition, regulatory assets and liabilities are recognized for the effect on revenues expected to be realized as the tax effects of temporary differences previously flowed through to customers reverse.

Investment tax credits have been deferred and are being amortized to income over the average estimated service lives of the related assets.

Allowance for Funds Used During Construction ("AFUDC")

AFUDC is a non-cash credit to income with a corresponding charge to utility plant, which represents the cost of borrowed funds and a return on equity funds devoted to plant under construction. AFUDC is recorded to the extent permitted by the Regulators.

Environmental Costs

The Company's operations are subject to federal, state, and local requirements relating to environmental protection, and as such the Company periodically becomes subject to environmental claims in the normal course of business. Environmental expenditures that relate to current operations or provide a future benefit are expensed or capitalized as appropriate. Remediation costs that relate to an existing condition caused by past operations are accrued when it is probable that these costs will be incurred and can be reasonably estimated. There were no remediation costs accrued at December 31, 2013 and 2012.

Long-Lived Assets

Long-lived assets and certain identifiable intangible assets held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. If the sum of the future cash flows expected to result from the use of the assets and their eventual disposition is less than the carrying amount of the assets, an impairment loss is recognized. Measurement of an impairment loss would be based on the fair value of the assets. A regulatory asset is charged to earnings if and when future recovery in rates of that asset is no longer probable.

New Accounting Standards

The following recently issued accounting standards have been adopted by the Company and have been included in the results of operations, financial position or footnotes of the accompanying Financial Statements:

Balance Sheet Offsetting

In December 2011, the Financial Accounting Standards Board ("FASB") issued accounting guidance to amend the existing disclosure requirements for offsetting financial assets and liabilities to enhance current disclosures, as well as to improve comparability of balance sheets prepared under U.S. Generally Accepted Accounting Principles ("GAAP") and

Note 2 (continued):

International Financial Reporting Standards ("IFRS"). In January 2013, the FASB issued additional guidance on the scope of these disclosures. The revised disclosure guidance applies to derivative instruments and securities borrowing and lending transactions that are either offset in the financial statements or subject to an enforceable master netting arrangement or similar agreement. The revised disclosure guidance is effective on a retrospective basis for interim and annual periods beginning January 1, 2013. As this guidance provides for additional disclosure requirements only, the adoption of this guidance did not have an impact on the Company's results of operations, financial position or cash flows.

Testing Indefinite-Lived Intangible Assets for Impairment

In July 2012, the FASB updated the accounting guidance related to testing indefinite-lived intangible assets for impairment. This update permits an entity to perform a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test under current guidance. This update is effective for annual and interim impairment tests performed by the Company beginning on January 1, 2013. The adoption of this guidance did not have an impact on the Company's results of operations, financial position or cash flows.

Presentation of an Unrecognized Tax Benefit When a Net Operating Loss ("NOL") or Tax Credit Carryforward Exists

In July 2013, the FASB updated the income tax accounting guidance to resolve diversity in presentation by addressing when an entity should present unrecognized tax benefits on a net basis if there are available NOL or tax credit carryforwards. The update requires an entity to net unrecognized tax benefits against the deferred tax assets for same-jurisdiction NOL or similar tax loss carryforwards or tax credit carryforwards. Gross presentation will be required only if such carryforwards are not available or would not be used by the entity to settle any additional income taxes resulting from disallowance of the uncertain tax position. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The amendments are required to be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application and early adoption are permitted. The Company adopted this guidance effective June 30, 2013.

Inclusion of the Fed Funds Effective Swap Rate as a Benchmark Interest Rate for Hedge Accounting Purposes

In July 2013, the FASB updated the derivatives and hedging accounting guidance to provide for the inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate ("OIS")) as a US benchmark interest rate for hedge accounting purposes, in addition to interest rates on direct Treasury obligations of the US government ("UST") and the London Interbank Offered Rate ("LIBOR"). The amendment also removes the restriction on using different benchmark rates for similar hedges. The update is effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. As the Company has

Note 2 (continued):

not entered into new or redesignated hedging relationships, the adoption of this guidance did not have an impact on the Company's results of operations, financial position or cash flows.

The following recently announced accounting standards are not yet required to be adopted by the Company or included in the results of operations, financial position or footnotes of the Company:

Obligations Resulting from Joint and Several Liability Arrangements

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

Service Concession Arrangements

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

(Dollars in thousands, except per share amounts)

Note 2 (continued):

Reclassifications

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

Note 3: Utility Plant

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

	Range of Remaining Useful Lives	2013	2012
Land and other non-depreciable assets	-	9,664	9,664
Sources of supply	34 to 75 Years	51,061	50,494
Treatment and pumping	4 to 53 Years	117,433	113,015
Transmission and distribution	40 to 72 Years	278,368	274,109
Services, meters and fire hydrants	34 to 84 Years	109,542	104,054
General structures and equipment	5 to 52 Years	48,600	43,689
Wastewater assets	5 to 50 Years	4,043	3,837
Construction work in progress	-	20,596	9,560
		639,307	608,422
Less: Accumulated depreciation		(120,270)	(112,509)
		$ 519,037	$ 495,913

The provision for depreciation expressed as a percentage of the aggregate average depreciable asset balances was 2.40% in 2013 and 2.13% in 2012. The Company records depreciation in conformity with amounts approved by state regulators after regulatory review of information the Company submits to support its estimates of the assets remaining lives.

Note 4: Regulatory Assets and Liabilities

Regulatory Assets

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

(Dollars in thousands, except per share amounts)

Note 4 (continued):

The components of regulatory assets are as follows:

	2013	2012
Income taxes recoverable through rates	$ 4,104	$ 4,273
Programmed maintenance expense	5,325	3,628
Debt and preferred stock expense	1,663	1,733
Bluegrass water project	1,541	1,598
Other	1,179	499
	$ 13,812	$ 11,731

The Company has recorded a regulatory asset for the additional revenues expected to be realized as the tax effects of temporary differences reverse. These temporary differences are primarily related to the difference between book and tax depreciation on property placed in service before the adoption by the Commission of full normalization for rate making purposes.

The regulatory asset for income taxes recoverable through rates is net of the reduction expected in future revenues as deferred taxes previously provided, attributable to the difference between the state and federal income tax rates under prior law and the current statutory rates, reverse over the average remaining service lives of the related assets.

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

Debt expense is amortized over the lives of the respective issues. Unamortized debt expense is deferred and amortized to the extent it will be recovered through future service rates. Expenses of preferred stock issues without sinking fund provisions are amortized over the life of the issuance, whereas expenses of issues with sinking fund provisions are charged to operations as shares are retired.

The Company has recorded a regulatory asset for the Bluegrass water project source of supply costs in the amount of $2,283 to be amortized over a forty year period. Approval was granted per the Commission order dated May 9, 2001.

Other regulatory assets are mostly comprised of deferred rate case expense, deferred vacation pay and deferred waste disposal costs.

Regulatory Liabilities

Regulatory liabilities represent amounts that are expected to be refunded to customers in future rates or amounts recovered from customers in advance of incurring the costs.

Note 4 (continued):

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

Debt extinguishment relates to the 4.75% note payable due 2014 issued to AWCC, which was redeemed in October, 2007 by the Company. As agreed with the Regulators, the difference between the book value of the note and the cash consideration required to extinguish it was deferred as a regulatory liability. The regulatory liability of $827 is amortized as a component of net interest expense through 2014.

Note 5: Preferred Stock Without Mandatory Redemption

The Company voluntarily called all of the preferred stock without mandatory redemptions on July 2, 2012 and paid a $6 early call premium which is presented in Other Income-Other, net in the accompanying Statement of Income.

Note 6: Long-Term Debt

The general mortgage bonds are issuable in series. No bonds senior to the general mortgage bonds may be issued so long as the general mortgage bonds are outstanding. Based on the calculation methodology specified by debt agreements, the amount of bonds authorized is limited only to the extent that long-term debt cannot exceed 65% of total capitalization and adjusted net income of the Company must be equal to or greater than 1.5 times the aggregate annual interest charges on all long-term debt of the Company. At December 31, 2013, long-term debt was 57% of total capitalization and net income excluding gains or losses on property sales, amortization of debt issuance costs, interest on long-term debt, and provision for income taxes was 2.8 times the aggregate annual interest charges on all long-term debt. General mortgage bonds are collateralized by utility plant.

The senior notes payable to affiliate are unsecured and were issued to American Water Capital Corporation ("AWCC"), a subsidiary of AWW, for the principal amount. AWCC provided the funding for these notes by issuing senior notes to institutional investors at a price equal to the principal amount.

In 2013, the Company issued a $7,859 long-term note payable to AWCC, at a rate of 4.00% due in 2037. The proceeds were used to pay down outstanding short-term debt.

(Dollars in thousands, except per share amounts)

Note 6 (continued):

Maturities of long-term debt, including sinking funds, will amount to $0 in 2014 through 2018, and $200,249 thereafter. Preferred stock agreements contain provisions for redemption at various prices on thirty day notice at the Company's discretion. In the event of voluntary liquidation, the 8.47% series is redeemable at $100 per share plus the make-whole premium, together with accrued dividends.

Note 7: Short-Term Debt

The Company maintained a line of credit through AWCC of $30,000 and $25,000 at December 31, 2013 and 2012, respectively. The Company may borrow from, or invest in, the line of credit. No compensating balances are required under the agreements. Funds were primarily used for short-term operating needs. Short-term borrowings are presented as notes payable-affiliated company in the accompanying balance sheets

At December 31, 2013 and 2012, there was $20,174 and $11,023 of short-term borrowings outstanding, respectively. The weighted average annual interest rates on the borrowings at December 31, 2013 and 2012 were 0.40% and 0.50%, respectively.

The Company received cash capital contributions of $4,000 in 2012 from AWW. The proceeds were primarily used to pay down short-term debt.

AWW, through AWCC, has committed to make additional financing available to the Company, as needed, to pay its obligations as they come due.

Note 8: General Taxes

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

	2013	2012
Property	$ 4,419	$ 4,257
Payroll	483	539
Other	156	118
	$ 5,058	$ 4,914

(Dollars in thousands, except per share amounts)

Note 9: Income Taxes

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

	2013	2012
State income taxes:		
Current	$ 578	$ 1,823
Deferred		
Current	(18)	(7)
Non-current	512	(416)
	1,072	1400
Federal income taxes:		
Current	171	9,787
Deferred		
Current	(91)	(38)
Non-current	7,331	(1,400)
Amortization of deferred investment tax credits	(85)	(85)
	7,326	8,264
Total income taxes	$ 8,398	$ 9,664

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

No valuation allowances were required on deferred tax assets at December 31, 2013 and 2012, as management believes it is more likely than not that deferred tax assets will be realized.

As of December 31, 2013 and 2012, the reserve for uncertain tax position is $3,359 and $3,841, respectively, excluding accrued interest and penalties. The Company does not expect a material change in this estimate in the next twelve months. If the Company sustains all of its positions at December 31, 2013 and 2012, an unrecognized tax benefit of $795, excluding interest and penalties, would impact the Company's effective tax rate. The reserve for uncertain tax positions could increase or decrease for things such as the expiration of statutes of limitations, audit settlements, or tax examination activities.

The Company recognizes interest and penalties related to income tax matters in income tax expense. The Company recognized net interest expense (income) and penalties of ($20) and $9 for 2013 and 2012, respectively.

The federal tax years that remain open are 2010 to 2012, with the earliest year's statute expiring in 2014. The Company is subject to state taxes. The state tax returns from 2009 to 2012 are currently open and will not close until the respective statutes of limitations expire. The statute of limitations will begin to expire in 2014.

Note 10: Rate Matters

As necessary, the Company applies to the Commission for changes in the rates charged for service. The revenues requested are based on forecasted sales, operating expenses, and investments for the first full year after the effective dates of the new rates. The Company can provide no assurances that any rate increase request will be granted by the Commission.

The Company filed a petition with the Commission seeking authority to increase its rates and charges for water service on December 28, 2012. The Company requested a $12,318 authorized increase in annualized revenues or 14.64%. On July 27, 2013, the Company placed the proposed rates in effect under bond, per the Commission, subject to refund. On October 25, 2013, the Commission issued an Order authorizing an increase in rates of $6,904 or an 8.08% increase with rates made effective on July 27, 2013. As of December 31, 2013 the Company refunded to the customers money collected from rates in excess of the approved amounts.

Note 11: Employee Benefit Plans

Savings Plan for Employees

The Company maintains a 401(k) savings plan, sponsored by AWW that allows employees to save for retirement on a tax-deferred basis. Employees can make contributions that are invested at their direction in one or more funds. The Company makes matching contributions that are based on a percentage of an employee's contribution, subject to certain limitations. Due to the Company's discontinuing new entrants into the defined benefit pension plan, on January 1, 2006 the Company began providing an additional 5.25% of base pay defined contribution benefit for union employees hired on or after January 1, 2001 and non-union employees hired on or after January 1, 2006. The Company expensed contributions to the plans totaling $338 and $315 for 2013 and 2012, respectively. All of the Company's contributions are invested in one or more funds at the direction of the employee.

Note 12: Postretirement Benefits

Pension Benefits

The Company participates in a Company funded defined benefit pension plan sponsored by AWW covering eligible employees hired before January 1, 2006. Benefits under the plan are based on the employees' years of service and compensation. The pension plan was closed for most employees hired on or after January 1, 2006. Union employees hired on or after January 1, 2001 had their accrued benefit frozen and will be able to receive this benefit as a lump sum upon termination or retirement. Union employees hired on or after January 1, 2001 and non-union employees hired on or after January 1, 2006 are provided with a 5.25% of base pay defined contribution plan. Pension cost of the Company is based on an allocation from AWW of the total cost related to the plan. The allocation is based upon the Company's participants' pensionable earnings as a percentage of AWW's total plan pensionable earnings. Information

Note 12 (continued):

regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company was allocated costs of $1,044 and $1,219 for 2013 and 2012, respectively.

AWW's funding practice is to contribute at least the greater of the minimum amount required by the Employee Retirement Income Security Act of 1974 or the normal cost. Further, AWW will consider additional contributions if needed to avoid “at risk” status and benefit restrictions under the Pension Protection Act of 2006. AWW may also consider increased contributions based on other financial requirements and the plan’s funded position. Pension contributions of the Company are based on an allocation from AWW of the total contributions related to the plan. Contributions are allocated to the Company from AWW based upon the Company’s participants’ pensionable earnings as a percentage of AWW’s total plan pensionable earnings. The Company made contributions to the AWW plan of $1,149 in 2013 and $1,914 in 2012. The Company expects to contribute $619 to the AWW plan in 2014.

Postretirement Benefits Other Than Pensions

The Company participates in a Company-funded plan, sponsored by AWW, that provides varying levels of medical and life insurance to eligible retirees and certain health care benefits for retired employees and their dependents. The retiree welfare plans are closed for union employees hired on or after January 1, 2006, and non-union employees hired on or after January 1, 2002.

Costs of the Company are based on an allocation from AWW of the total cost related to the plan. The allocation is based upon the Company’s covered participants as a percentage of AWW’s total plan covered participants. Information regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company was allocated costs of $722 and $783 for 2013 and 2012, respectively.

The Company made contributions to trust funds established for these postretirement benefits of $722 in 2013 and $783 in 2012. The Company’s policy is to fund postretirement benefits costs accrued. The Company expects to contribute $312 to the AWW plan in 2014.

Note 13: Stock Based Compensation

Stock Options and Restricted Stock Units

In 2013 and 2012, AWW granted restricted stock units, both with and without performance conditions, and stock options to certain employees of the Company under the AWW 2007 Omnibus Equity Compensation Plan (“Omnibus Plan”). The restricted stock units without performance conditions vest ratably over the three-year service period beginning January 1 of the year of the grant. The restricted stock units with performance conditions vest ratably over the three year performance period beginning January 1 of each year (the “Performance Period”). Distribution of the performance shares is contingent upon the achievement of certain thresholds over the Performance Period. The thresholds are based on achievement of internal

Note 13 (continued):

performance measures and separately certain market factors over the Performance Periods. The stock options vest ratably over a three year service period beginning January 1, 2013 and 2012, respectively.

The grant date fair value of restricted stock awards with performance conditions is amortized through expense over the requisite service period using the graded-vesting method. The value of stock options and the restricted stock awards without performance conditions at the date of the grant is amortized through expense over the requisite service period using the straight-line method.

Costs of the Company are based on the cost of the Company's employees participating in the AWW Omnibus Plan. The Company recorded compensation expense of $71 and $68, included in operation and maintenance expense, during the years ended December 31, 2013 and 2012, respectively. As the Company does not reimburse the cost of the awards to AWW, the offsetting entry to paid-in-capital is a capital contribution from AWW.

Employee Stock Purchase Plan

Under AWW's Nonqualified Employee Stock Purchase Plan ("ESPP"), the Company's employees can use payroll deductions to acquire AWW common stock at the lesser of 90% of the fair market value of a) the beginning or b) the end of each three-month purchase period. AWW's ESPP is considered compensatory. The Company's costs are based on an allocation from AWW of the total cost for the Company's employees in the plan. Compensation costs of $9 and $10 were included in operation and maintenance expense for the years ended December 31, 2013 and 2012, respectively. As the Company does not reimburse the cost of the awards to AWW, the offsetting entry to paid-in capital is a capital contribution from AWW.

Note 14: Related Party Transactions

American Water Works Service Company, Inc. ("AWWS"), a subsidiary of AWW, provides certain management services to the Company (administration, accounting, data processing, engineering, etc.) and other operating water companies in the AWW 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, except per share amounts)

	2013	2012
Included in operation and maintenance expense as a charge against income	$ 9,164	$ 9,114
Capitalized primarily in utility plant	2,947	4,582
	$ 12,111	$ 13,696

Note 14 (continued):

The Company provided workspace for certain associates of AWWS. Charges for direct costs and indirect overhead costs associated with these associates are billed to AWWS on an at-cost, not for profit basis, which amounted to $120 in 2013 and $323 in 2012.

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, including debt issuance cost, of $67 in 2013 and $124 in 2012 and interest expense on borrowings of $46 in 2013 and $57 in 2012. Interest expense on long-term debt due to AWCC, net of capitalized amount, was $10,002 in 2013 and $9,806 in 2012.

Accrued interest on the accompanying Balance Sheet included interest due to AWCC of $1,746 and $1,681 as of December 31, 2013 and 2012, respectively.

The Company pays dividends to AWW on a periodic basis. The amount of the dividend is based on a percentage of net income adjusted for certain items.

Note 15: Fair Values of Financial Instruments

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

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

Preferred stock with mandatory redemption requirements and long-term debt: The fair values of preferred stock with mandatory redemption requirements and long-term debt are categorized within the fair value hierarchy based on the inputs that are used to value each instrument. The fair value of long-term debt classified as Level 1 is calculated using quoted prices in active markets. Level 2 instruments are valued using observable inputs and Level 3 instruments are valued using observable and unobservable inputs. The fair values of instruments classified as Level 2 and 3 are determined by a valuation model that is based on a conventional discounted cash flow methodology and utilizes assumptions of current market rates. As a majority of the Company's debts do not trade in active markets, the Company calculated a base yield curve using a risk-free rate (a U.S. Treasury securities yield curve) plus a credit spread that is based on the following two factors: an average of the Company's own publicly-traded debt securities and the current market rates for U.S. Utility A- (BBB+ at December 31, 2012) debt securities. The Company used these yield curve assumptions to derive a base yield for the Level 2 and Level 3 securities. Additionally, the Company adjusted the base yield for specific features

(Dollars in thousands, except per share amounts)

Note 15 (continued):

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 are as follows:

	2013		2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Preferred stock with mandatory redemption requirements	$ 4,500	$ 5,397	$ 4,500	$ 6,065
Long-term debt (excluding capital lease obligations)	$ 195,749	$ 216,847	$ 187,890	$ 224,460

Fair Value Measurements

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

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

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

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

Note 15 (continued):

Recurring Fair Value Measurements

As of December 31, 2013 and 2012, the Company had no assets or liabilities measured and recorded at fair value on a recurring basis.

Note 16: Leases

The Company has entered into operating leases involving certain facilities and equipment. Rental expenses under operating leases were $126 in 2013 and $69 in 2012. The operating leases for equipment expire in 2014 through 2015.

At December 31, 2013, the minimum annual future rental commitments under operating leases that have initial or remaining non-cancelable lease terms in excess of one year are $8 in 2014, $4 in 2015, $1 in 2016, $1 in 2017 and 2018 and $21 thereafter.

Note 17: Commitments and Contingencies

Commitments have been made in connection with certain construction programs. The estimated capital expenditures required under legally binding contractual obligations amounted to $821 at December 31, 2013.

The Company has entered into certain service agreements in excess of one year duration. As of December 31, 2013 the future annual commitments under these agreements are estimated to be $80 in 2014, $65 in 2015 through 2017, with none thereafter.

The Company is also routinely involved in legal actions incident to the normal conduct of its business. For certain matters, the Company is unable to estimate possible losses. The Company believes that damages or settlements, if any, recovered by plaintiffs in such claims or actions will not have a material adverse effect on the Company's results of operations, financial position or cash flows.

Note 18: Subsequent Events

The Company performed an evaluation of subsequent events for the accompanying financial statements through March 14, 2014, the date this report was issued, to determine whether the circumstances warranted recognition and disclosure of those events or transactions in the financial statements as of December 31, 2013.