

American Water Works Company, Inc. and Subsidiary Companies
Notes to Consolidated Financial Statements
December 31, 2004 and 2003
(Dollars in thousands, except per share amounts)

Note 5: Utility Plant

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

	2004	2003
Water plant		
Sources of supply	\$ 429,696	\$ 407,402
Treatment and pumping facilities	1,776,475	1,726,518
Transmission and distribution facilities	3,982,101	3,791,687
Services, meters and fire hydrants	1,453,886	1,356,954
General structures and equipment	668,573	641,888
Wastewater plant	385,612	345,903
Construction work in progress	195,666	133,006
	8,892,009	8,403,358
Less accumulated depreciation	1,995,440	1,830,332
	<u>\$ 6,896,569</u>	<u>\$ 6,573,026</u>

Depreciation expense amounted to \$226,777 in 2004 and \$212,635 in 2003.

Note 6: Employee Benefits

Pension and Other Postretirement Benefits

The Company maintains noncontributory defined benefit pension plans covering substantially all employees of its regulated utility and shared services operations. Benefits under the plans are based on the employee's years of service and compensation. The Company's funding policy is to contribute at least the minimum amount required by the Employee Retirement Income Security Act of 1974. Pension plan assets are invested in a number of investments including equity mutual funds, United States Government securities, guaranteed interest contracts with Principal and Hancock insurance companies and publicly traded bonds.

Pension expense in excess of the amount contributed to the pension plans is deferred by certain regulated subsidiaries pending future recovery in rates charged for utility services as contributions are made to the plans (see Regulatory Assets in Note 2).

The Company also has several unfunded noncontributory supplemental non-qualified pension plans that provide additional retirement benefits to certain employees of the Company and its subsidiaries.

The Company maintains postretirement benefit plans providing varying levels of medical and life insurance to eligible retirees. The adoption of a new accounting standard for other postretirement benefits caused a transition obligation of \$143,391 at January 1, 1993, which prior to the RWE acquisition was being amortized over 20 years. The Company's policy is to fund postretirement benefit costs accrued. Plan assets are invested in equity and bond mutual funds.

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Note 6 (continued):

The obligations of the plans are dominated by obligations for active employees. Because the timing of expected benefit payments is so far in the future and the size of the plan assets are small relative to the Company's assets, the investment strategy is to allocate a large portion of assets to equities, which the Company believes will provide the highest return over the long run. The fixed income assets are invested in long duration debt securities in order to better match the duration of the plan liability.

The liabilities of the pension and other postretirement benefit plans were adjusted to their fair value at the time of the RWE acquisition. The Company periodically conducts an asset liability modeling study to ensure the investment strategy is aligned with the profile of the obligations. The long-term goals are to maximize the plan funded status and minimize contributions and pension expense, while taking into account the potential volatility risks on each of these items.

The expected long-term rate of return on plan assets is based on historical and projected rates of return for current and planned asset classes in the plans' investment portfolios. Assumed projected rates of return for each of the plans' projected asset classes were selected after analyzing historical experience and future expectations of the returns and volatility of the various asset classes. Based on the target asset allocation for each asset class, the overall expected rate of return for the portfolio was developed, adjusted for historical and expected experience of active portfolio management results compared to the benchmark returns and for the effect of expenses paid from plan assets.

The asset allocation for the Company's U.S. pension plans at the end of 2004 and 2003 by asset category, follows:

Asset category	Percentage of Plan Assets At Year End	
	2004	2003
Equity securities	52%	52%
Debt securities	47%	47%
Cash	1%	1%
Total	100%	100%

The Company's other postretirement benefit plans are funded. The asset allocation for the Company's other postretirement benefit plans at the end of 2004 and 2003, by asset category, follows:

Asset category	Percentage of Plan Assets At Year End	
	2004	2003
Equity securities	63%	62%
Debt securities	37%	38%
Total	100%	100%

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Note 6 (continued):

	Pension Benefits		Other Benefits	
	2004	2003	2004	2003
Change in benefit obligation				
Benefit obligation				
at January 1	\$ 645,173	\$ 547,917	\$ 373,012	\$ 295,982
Service cost	24,271	21,018	11,473	9,317
Interest cost	41,281	37,507	21,657	19,892
Plan participants' contributions	-	-	1,422	1,281
Amendments	969	-	445	1,010
Actuarial gain (loss)	11,986	56,639	(4,187)	59,875
Settlements	-	15	-	-
Special termination benefits	1,460	985	-	-
Benefits paid	(20,232)	(18,908)	(15,752)	(14,345)
Benefit obligation				
at December 31	\$ 704,908	\$ 645,173	\$ 388,070	\$ 373,012
Change in Plan Assets				
Fair value of plan				
assets at January 1	\$ 392,705	\$ 327,044	\$ 182,400	\$ 142,489
Actual return on				
plan assets	35,148	64,691	16,208	27,546
Employer contribution	20,215	19,878	26,484	25,429
Plan participants' contributions	-	-	1,422	1,281
Benefits paid	(20,232)	(18,908)	(15,752)	(14,345)
Fair value of plan				
assets at December 31	\$ 427,836	\$ 392,705	\$ 210,762	\$ 182,400
Funded status				
at December 31	\$ (277,072)	\$ (252,468)	\$ (177,308)	\$ (190,613)
Unrecognized prior service cost	915	-	1,384	1,010
Unrecognized net actuarial (gain) loss	32,004	20,689	40,345	44,835
Net amount recognized	\$ (244,153)	\$ (231,779)	\$ (135,579)	\$ (144,768)
Amounts recognized in the balance sheet consist of:				
Accrued benefit liability	\$ (244,153)	\$ (231,779)	\$ (135,579)	\$ (144,768)
Additional minimum liability	(223)	(44)	-	-
Intangible asset	129	-	-	-
Accumulated other comprehensive income	94	44	-	-
Net amount recognized	\$ (244,153)	\$ (231,779)	\$ (135,579)	\$ (144,768)

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Note 6 (continued):

At December 31, 2004 and 2003, the projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with a projected obligation in excess of plan assets were as follows:

	Projected Benefit Obligation Exceeds the Fair Value of Plans' Assets	
	2004	2003
Projected benefit obligation	\$ 705,000	\$ 645,000
Fair value of plan assets	428,000	393,000

	Accumulated Benefit Obligation Exceeds the Fair Value of Plans' Assets	
	2004	2003
Accumulated benefit obligation	\$ 562,000	\$ 503,000
Fair value of plan assets	428,000	393,000

The accumulated postretirement benefit obligation exceeds plan assets for all of the company's other postretirement benefit plans.

Information about the expected cash flows for the pension and postretirement benefit plans is as follows:

	Pension Benefits	Other Benefits
2005 expected employer contributions		
To plan trusts	\$ 17,978	\$ 27,400
To plan participants	1,397	175

The Company plans to contribute amounts equal to the minimum required contributions in 2005 to the qualified pension plans. The Company plans to contribute its 2005 other postretirement benefit cost to its VEBA trusts.

The following table reflects the net benefits expected to be paid from the plan assets or the Company's assets:

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Note 6 (continued):

	Pension Benefits	Other Benefits	
	Expected Benefit Payments	Expected Benefit Payments	Expected Federal Subsidy Payments
2005	\$ 18,868	\$ 17,226	\$ -
2006	20,626	18,783	1,364
2007	22,307	20,353	1,503
2008	24,384	21,627	1,665
2009	26,925	23,364	1,794
2010 - 2014	180,322	142,510	11,242

Because the above amounts are net benefits, plan participants' contributions have been excluded from the expected benefits.

	Pension Benefits		Other Benefits	
	2004	2003	2004	2003
Weighted-average assumptions used to determine December 31 benefit obligations				
Discount rate	6.00%	6.25%	6.00%	6.25%
Rate of compensation increase	4.75%	4.75%	N/A	N/A
Medical trend	N/A	N/A	graded from 10% in 2005 to 5% in 2010+	graded from 10% in 2004 to 5% in 2009+
Weighted-average assumptions used to determine net periodic cost				
Discount rate	6.25%	6.75%	6.25%	6.75%
Expected return on plan assets	8.75%	8.75%	8.40%	8.40%
Rate of compensation increase	4.75%	4.75%	N/A	N/A
Medical trend	N/A	N/A	graded from 10% in 2004 to 5% in 2009+	graded from 9% in 2003 to 5% in 2007+

Assumed health care cost trend rates have a significant effect on the amounts reported for the other postretirement benefit plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	One-Percentage-Point Increase	One-Percentage-Point Decrease
Effect on total of service and interest cost components	\$ 6,279	\$ (5,034)
Effect on other postretirement benefit obligation	\$ 54,293	\$ (44,472)

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Note 6 (continued):

	2004	2003
Components of net periodic pension benefit cost		
Service cost	\$ 24,271	\$ 21,018
Interest cost	41,281	37,507
Expected return on plan assets	(34,486)	(28,741)
Recognized net actuarial (gain) loss	54	-
Settlement charge/(credit)	9	15
Net periodic pension benefit cost	\$ 31,129	\$ 29,799
Special termination pension benefit charge	\$ 1,460	\$ 985
Components of net periodic other postretirement benefit cost		
Service cost	\$ 11,473	\$ 9,317
Interest cost	21,657	19,892
Expected return on plan assets	(15,895)	(12,505)
Amortization of prior service cost	72	-
Recognized net actuarial (gain) loss	(12)	-
Net periodic other postretirement benefit cost	\$ 17,295	\$ 16,704

The total additional minimum liability for the pension plans has increased from \$44 at December 31, 2003 to \$222 at December 31, 2004. This increase is primarily attributable to a decrease in discount rate from 6.25% to 6.00%

Savings Plans for Employees

The Company maintains 401(k) savings plans that allow employees to save for retirement on a tax-deferred basis. Compensation expense associated with these savings plans was \$3,761 in 2004, and \$3,667 in 2003. Included in the above expenses were the Company's matching contributions to the primary savings plan totaling \$2,879 for 2004 and \$2,916 for 2003. These funds were primarily invested in a retirement trust fund.

Employees' Investment Plan

Upon completion of the Merger, the Company created the Employees' Investment Plan and converted the Employees' Stock Ownership Plan into this plan. Each participating employee can elect to contribute an amount that does not exceed 2% of their wages. In addition to the employee's participation, the Company makes a

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Note 6 (continued):

contribution equivalent to 1/2% of each participant's qualified compensation, and matches 100% of the contribution by each participant. The Company made contributions to the plan totaling \$1,377 for 2004 and \$1,649 for 2003 that were primarily invested in a retirement trust fund. This plan was discontinued as of May 22, 2005.

Note 7: General Taxes

Components of general tax expense for the years presented in the consolidated statement of income and comprehensive income are as follows:

	2004	2003
Gross receipts and franchise	\$ 42,513	\$ 44,046
Property and capital stock	74,234	66,119
Payroll	21,169	21,353
Other general	7,954	6,120
	<u>\$ 145,870</u>	<u>\$ 137,638</u>

Note 8: Income Taxes

Components of income tax expense for the years presented in the consolidated statement of income and comprehensive income are as follows:

	2004	2003
State income taxes		
Current	\$ 17,703	\$ 14,435
Deferred		
Current	(149)	(103)
Non-current	(998)	5,934
	<u>\$ 16,556</u>	<u>\$ 20,266</u>
Federal income taxes		
Current	\$ (6,155)	\$ 2,140
Deferred		
Current	(7,041)	(1,379)
Non-current	99,054	47,227
Amortization of deferred investment tax credits	(1,409)	(1,450)
	<u>\$ 84,449</u>	<u>\$ 46,538</u>