

American Water Works Company, Inc.

Form 10-Q

November 02, 2011

[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2011

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file: number 001-34028

AMERICAN WATER WORKS COMPANY, INC.

(Exact name of registrant as specified in its charter)

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<p>Delaware (State or other jurisdiction of incorporation or organization)</p> <p>1025 Laurel Oak Road, Voorhees, NJ (Address of principal executive offices)</p>	<p>51-0063696 (I.R.S. Employer Identification No.)</p> <p>08043 (Zip Code)</p>
<p>(856) 346-8200 (Registrant's telephone number, including area code)</p>	

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☒ Yes ☐ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☒ No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at October 27, 2011
Common Stock, \$0.01 par value per share	175,516,248 shares

Table of Contents

TABLE OF CONTENTS

AMERICAN WATER WORKS COMPANY, INC.

REPORT ON FORM 10-Q

FOR THE QUARTER ENDED September 30, 2011

INDEX

<u>PART I. FINANCIAL INFORMATION</u>	1
<u>ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS</u>	1
<u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	21
<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	35
<u>ITEM 4. CONTROLS AND PROCEDURES</u>	35
<u>PART II. OTHER INFORMATION</u>	36
<u>ITEM 1. LEGAL PROCEEDINGS</u>	36
<u>ITEM 1A. RISK FACTORS</u>	36
<u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	36
<u>ITEM 3. DEFAULTS UPON SENIOR SECURITIES</u>	36
<u>ITEM 4. [REMOVED AND RESERVED]</u>	36
<u>ITEM 5. OTHER INFORMATION</u>	36
<u>ITEM 6. EXHIBITS</u>	37
<u>SIGNATURES</u>	38
<u>EXHIBITS INDEX</u>	39
EXHIBIT 31.1	
EXHIBIT 31.2	
EXHIBIT 32.1	
EXHIBIT 32.2	
EXHIBIT 101	

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****American Water Works Company, Inc. and Subsidiary Companies****Consolidated Balance Sheets (Unaudited)****(In thousands, except per share data)**

	September 30, 2011	December 31, 2010
ASSETS		
Property, plant and equipment		
Utility plant at original cost, net of accumulated depreciation of \$3,299,029 at September 30 and \$3,134,094 at December 31	\$ 10,647,307	\$ 10,241,342
Nonutility property, net of accumulated depreciation of \$161,955 at September 30 and \$142,902 at December 31	140,537	142,554
Total property, plant and equipment	10,787,844	10,383,896
Current assets		
Cash and cash equivalents	15,621	13,112
Restricted funds	46,864	94,066
Utility customer accounts receivable	184,235	145,747
Allowance for uncollectible accounts	(17,426)	(17,474)
Unbilled utility revenues	142,302	132,876
Other receivables, net	62,934	74,028
Income taxes receivable	134	6,473
Materials and supplies	30,491	27,743
Assets of discontinued operations	943,155	927,423
Other	71,151	46,788
Total current assets	1,479,461	1,450,782
Regulatory and other long-term assets		
Regulatory assets	997,511	980,911
Restricted funds	19,729	26,718
Goodwill	1,195,510	1,195,585
Other	58,678	48,354
Total regulatory and other long-term assets	2,271,428	2,251,568
TOTAL ASSETS	\$ 14,538,733	\$ 14,086,246

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

Table of Contents**American Water Works Company, Inc. and Subsidiary Companies****Consolidated Balance Sheets (Unaudited)****(In thousands, except per share data)**

	September 30, 2011	December 31, 2010
CAPITALIZATION AND LIABILITIES		
Capitalization		
Common stock (\$.01 par value, 500,000 shares authorized, 175,508 and 174,996 shares outstanding at September 30 and December 31, respectively)	\$ 1,755	\$ 1,750
Paid-in-capital	6,173,781	6,156,675
Accumulated deficit	(1,848,338)	(1,959,235)
Accumulated other comprehensive loss	(68,555)	(71,446)
Treasury stock	0	(19)
Common stockholders' equity	4,258,643	4,127,725
Preferred stock without mandatory redemption requirements	4,547	4,547
Total stockholders' equity	4,263,190	4,132,272
Long-term debt		
Long-term debt	5,361,531	5,394,135
Redeemable preferred stock at redemption value	21,984	22,135
Total capitalization	9,646,705	9,548,542
Current liabilities		
Short-term debt	408,998	228,502
Current portion of long-term debt	8,949	36,092
Accounts payable	190,556	191,973
Taxes accrued, including income taxes of \$0 at September 30 and December 31	47,962	37,053
Interest accrued	103,184	60,465
Liabilities of discontinued operations	388,157	384,595
Other	232,208	182,317
Total current liabilities	1,380,014	1,120,997
Regulatory and other long-term liabilities		
Advances for construction	394,956	397,164
Deferred income taxes	1,235,554	1,088,121
Deferred investment tax credits	29,813	30,969
Regulatory liabilities	309,822	296,121
Accrued pension expense	340,951	421,408
Accrued postretirement benefit expense	212,357	215,217
Other	36,965	42,151
Total regulatory and other long-term liabilities	2,560,418	2,491,151
Contributions in aid of construction	951,596	925,556
Commitments and contingencies (See Note 9)		

TOTAL CAPITALIZATION AND LIABILITIES	\$ 14,538,733	\$ 14,086,246
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The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

American Water Works Company, Inc. and Subsidiary Companies

Consolidated Statements of Operations and Comprehensive Income (Unaudited)

(In thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Operating revenues	\$ 766,450	\$ 748,953	\$ 2,042,520	\$ 1,941,883
Operating expenses				
Operation and maintenance	345,757	346,180	993,434	960,779
Depreciation and amortization	88,424	84,005	263,027	246,759
General taxes	52,587	52,029	161,402	155,772
(Gain) loss on asset dispositions and purchases	(1,635)	211	(1,339)	166
Total operating expenses, net	485,133	482,425	1,416,524	1,363,476
Operating income	281,317	266,528	625,996	578,407
Other income (expenses)				
Interest, net	(78,602)	(74,568)	(233,326)	(231,456)
Allowance for other funds used during construction	3,696	2,482	9,059	6,896
Allowance for borrowed funds used during construction	1,586	1,447	3,988	3,994
Amortization of debt expense	(1,251)	(1,275)	(3,798)	(3,202)
Other, net	13	505	(462)	2,564
Total other income (expenses)	(74,558)	(71,409)	(224,539)	(221,204)
Income from continuing operations before income taxes	206,759	195,119	401,457	357,203
Provision for income taxes	78,354	75,762	157,669	140,642
Income from continuing operations	128,405	119,357	243,788	216,561
Income from discontinued operations, net of tax	9,017	4,757	25,532	11,112
Net income	\$ 137,422	\$ 124,114	\$ 269,320	\$ 227,673
Other comprehensive income, net of tax:				
Pension plan amortized to periodic benefit cost:				
Prior service cost, net of tax of \$28 and \$13 for the three months ended and \$84 and \$38 for the nine months ended, respectively	\$ 44	\$ 20	\$ 131	\$ 59
Actuarial loss, net of tax of \$720 and \$698 for the three months ended and \$2,160 and \$2,094 for the nine months ended, respectively	1,126	1,092	3,378	3,276
Foreign currency translation adjustment	(1,029)	348	(618)	256
Other comprehensive income	141	1,460	2,891	3,591
Comprehensive income	\$ 137,563	\$ 125,574	\$ 272,211	\$ 231,264
Basic earnings per common share: (a)				
Income from continuing operations	\$ 0.73	\$ 0.68	\$ 1.39	\$ 1.24

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Income from discontinued operations, net of tax	\$ 0.05	\$ 0.03	\$ 0.15	\$ 0.06
Net income	\$ 0.78	\$ 0.71	\$ 1.53	\$ 1.30
Diluted earnings per common share: (a)				
Income from continuing operations	\$ 0.73	\$ 0.68	\$ 1.38	\$ 1.24
Income from discontinued operations, net of tax	\$ 0.05	\$ 0.03	\$ 0.14	\$ 0.06
Net income	\$ 0.78	\$ 0.71	\$ 1.53	\$ 1.30
Average common shares outstanding during the period:				
Basic	175,547	174,859	175,426	174,785
Diluted	176,593	175,062	176,422	174,919
Dividends per common share	\$ 0.23	\$ 0.22	\$ 0.90	\$ 0.64

(a) Amounts may not sum due to rounding.

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

Table of Contents**American Water Works Company, Inc. and Subsidiary Companies****Consolidated Statements of Cash Flows (Unaudited)**

(In thousands, except per share data)

	Nine Months Ended September 30,	
	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 269,320	\$ 227,673
Adjustments		
Depreciation and amortization	263,027	246,759
Provision for deferred income taxes	144,654	146,084
Amortization of deferred investment tax credits	(1,156)	(1,170)
Provision for losses on utility accounts receivable	13,336	15,872
Allowance for other funds used during construction	(9,059)	(6,896)
(Gain) loss on asset dispositions and purchases	(1,339)	166
Pension and non-pension post retirement benefits	53,579	67,007
Other, net	7,301	31,087
Changes in assets and liabilities		
Receivables and unbilled utility revenues	(55,647)	(93,258)
Income taxes receivable	(134)	11,526
Other current assets	(32,689)	(2,559)
Pension and non-pension post retirement benefit contributions	(134,821)	(110,739)
Accounts payable	(14,385)	(6,548)
Taxes accrued, including income taxes	17,289	5,716
Interest accrued	42,626	42,991
Other current liabilities	14,142	13,316
Net cash provided by operating activities	576,044	587,027
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(621,940)	(522,090)
Acquisitions	(6,381)	(1,670)
Proceeds from sale of assets and securities	7,044	150
Removal costs from property, plant and equipment retirements, net	(38,915)	(28,270)
Net restricted funds released	54,191	45,928
Net cash used in investing activities	(606,001)	(505,952)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from long-term debt	12,350	162,541
Repayment of long-term debt	(68,689)	(196,449)
Net borrowings under short-term debt agreements	211,543	78,998
Proceeds from employee stock plan issuances and DRIP	10,363	3,823
Advances and contributions for construction, net of refunds of \$15,142 and \$28,775 at September 30, 2011 and 2010, respectively	15,767	4,975
Change in bank overdraft position	(31,111)	(16,654)
Debt issuance costs	(552)	(5,089)
Redemption of preferred stock	(140)	(150)
Dividends paid	(117,463)	(111,825)
Other financing activities	398	0

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Net cash provided by (used in) financing activities	32,466	(79,830)
Net increase in cash and cash equivalents	2,509	1,245
Cash and cash equivalents at beginning of period	13,112	22,256
Cash and cash equivalents at end of period	\$ 15,621	\$ 23,501
Non-cash investing activity:		
Capital expenditures acquired on account but unpaid at quarter-end	\$ 107,477	\$ 96,383
Non-cash financing activity:		
Long-term debt	\$ 0	\$ 111,000
Dividends accrued	\$ 40,367	\$ 0
Advances and contributions	\$ 16,356	\$ 21,474

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

Table of Contents**American Water Works Company, Inc. and Subsidiary Companies****Consolidated Statement of Changes in Stockholders' Equity (Unaudited)**

(In thousands, except per share data)

	Preferred Stock of Subsidiary Companies Without								
	Common Stock Shares	Par Value	Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock Shares	At Cost	Mandatory Redemption Requirements	Total Stockholders Equity
Balance at December 31, 2010	174,996	\$ 1,750	\$ 6,156,675	\$ (1,959,235)	\$ (71,446)	(1)	\$ (19)	\$ 4,547	\$ 4,132,272
Net income				269,320					269,320
Direct stock reinvestment and purchase plan (DRIP), net of expense of \$14	52	1	1,451						1,452
Employee stock purchase plan (ESPP)	91	1	2,604						2,605
Stock-based compensation activity	369	3	13,051	(593)		1	19		12,480
Other comprehensive income, net of tax of \$2,244					2,891				2,891
Dividends				(157,830)					(157,830)
Balance at September 30, 2011	175,508	\$ 1,755	\$ 6,173,781	\$ (1,848,338)	\$ (68,555)	0	\$ 0	\$ 4,547	\$ 4,263,190

	Preferred Stock of Subsidiary Companies Without								
	Common Stock Shares	Par Value	Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock Shares	At Cost	Mandatory Redemption Requirements	Total Stockholders Equity
Balance at December 31, 2009	174,630	\$ 1,746	\$ 6,140,077	\$ (2,076,287)	\$ (64,677)	0	\$ 0	\$ 4,557	\$ 4,005,416
Net income				227,673					227,673

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Direct stock reinvestment and purchase plan (DRIP), net of expense of \$69	40	0	799						799
Employee stock purchase plan (ESPP)	85	1	1,390		7	127			1,518
Stock-based compensation activity	105	2	9,083	(367)	(7)	(127)			8,591
Subsidiary preferred stock redemption								(10)	(10)
Other comprehensive income, net of tax of \$2,132					3,591				3,591
Dividends				(111,825)					(111,825)
Balance at September 30, 2010	174,860	\$ 1,749	\$ 6,151,349	\$ (1,960,806)	\$ (61,086)	0	\$ 0	\$ 4,547	\$ 4,135,753

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

Table of Contents

American Water Works Company, Inc. and Subsidiary Companies

Notes to Consolidated Financial Statements (Unaudited)

(In thousands, except per share data)

Note 1: Basis of Presentation

The accompanying Consolidated Balance Sheet of American Water Works Company, Inc. and Subsidiary Companies (the "Company") at September 30, 2011, the Consolidated Statements of Operations and Comprehensive Income for the three and nine months ended September 30, 2011 and 2010, the Consolidated Statements of Cash Flows for the nine months ended September 30, 2011 and 2010, and the Consolidated Statement of Changes in Stockholders' Equity for the nine months ended September 30, 2011 and 2010, are unaudited, but reflect all adjustments, which are, in the opinion of management, necessary to present fairly the consolidated financial position, the consolidated changes in stockholders' equity, the consolidated results of operations and comprehensive income, and the consolidated cash flows for the periods presented. All adjustments are of a normal, recurring nature, except as otherwise disclosed. Because they cover interim periods, the unaudited consolidated financial statements and related notes to the consolidated financial statements do not include all disclosures and notes normally provided in annual financial statements and, therefore, should be read in conjunction with the Company's Consolidated Financial Statements and related Notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010. The results of operations for interim periods are not necessarily indicative of the results that may be expected for the year, due primarily to the seasonality of the Company's operations.

Certain reclassifications for discontinued operations (see Note 13) and to present amortization associated with removal costs as depreciation and amortization have been made to conform previously reported data to the current presentation.

Note 2: New Accounting Pronouncements

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

Revenue arrangements with Multiple Deliverables

In October 2009, the Financial Accounting Standards Board ("FASB") issued authoritative guidance that amends existing guidance for identifying separate deliverables in a revenue-generating transaction where multiple deliverables exist, and provides guidance for allocating and recognizing revenue based on those separate deliverables. The guidance is expected to result in more multiple-deliverable arrangements being separable than under current guidance. This guidance is effective for the Company beginning on January 1, 2011 and is required to be applied prospectively to new or significantly modified revenue arrangements. The adoption of this guidance did not have a significant impact on the Company's results of operations, financial position or cash flows.

Business Combinations

In December 2010, the FASB clarified the requirements for reporting of pro forma revenue and earnings disclosures for business combinations. The accounting update specifies that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments also expand the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The amendments are effective for the Company for business combinations finalized after January 1, 2011. As this guidance clarifies and provides for additional disclosure requirements only, the adoption of this guidance has not had an impact on the Company's results of operations, financial position or cash flows.

Intangibles - Goodwill

In December 2010, the FASB issued authoritative guidance that modifies step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. The update requires that for those reporting units, an entity is required to perform step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that impairment may exist. Existing authoritative guidance requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that

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would more likely than not reduce the fair value of a reporting unit below its carrying amount. This guidance is effective for the Company beginning on January 1, 2011. The adoption of this update did not have a significant impact on the Company's results of operations, financial position or cash flows.

Table of Contents

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

Fair Value Measurements

In May 2011, the FASB issued updated accounting guidance related to fair value measurements and disclosures that result in common fair value measurements and disclosures between U.S. GAAP and International Financial Reporting Standards. This new guidance amends current fair value measurement and disclosure guidance to increase transparency around valuation inputs and investment categorization. This guidance is effective for interim and annual periods beginning after December 15, 2011. The new guidance is to be adopted prospectively and early adoption is not permitted. The Company 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.

Comprehensive Income

In June 2011, the FASB issued new guidance on the presentation of comprehensive income. The new guidance allows an entity to present components of net income and other comprehensive income in one continuous statement, referred to as the statement of comprehensive income, or in two separate, but consecutive statements. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. While the new guidance changes the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under current accounting guidance. On October 21, 2011, the FASB tentatively decided to propose delaying the effective date of the presentation requirements for reclassification adjustments in the new guidance. This new guidance on the presentation of comprehensive income is effective for fiscal years and interim periods beginning after December 15, 2011. As the Company already presents the components of net income and other comprehensive income in one continuous statement, the adoption of the new guidance will not have an impact on its results of operations, financial position or cash flows.

Testing Goodwill for Impairment

In September 2011, the FASB updated the accounting guidance related to testing goodwill for impairment. This update permits an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test that is currently in place. Under the new guidance, an entity will not be required to calculate the fair value of a reporting unit unless the entity determines, based on the qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. This update is effective for annual and interim goodwill impairment tests performed in fiscal years beginning after December 15, 2011; however, 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.

Note 3: Goodwill

At December 31, 2010, the Company's goodwill totaled \$1,250,692. During the first quarter of 2011, with the pending sale of the Company's regulated businesses in Arizona, New Mexico and Texas, the Company allocated \$46,465 of goodwill to discontinued operations, and reclassified all prior periods for that effect. In the second quarter of 2011, the Company classified its Ohio subsidiary as held for sale and allocated an additional \$8,642 of goodwill to discontinued operations. At September 30, 2011, the Company's goodwill of continuing operations totaled \$1,195,510.

The Company's annual goodwill impairment test is conducted at November 30 of each calendar year and interim reviews are performed when the Company determines that a triggering event that would more likely than not reduce the fair value of a reporting unit below its carrying value has occurred. With the pending sales in Arizona, New Mexico, Texas and Ohio, the Company assessed fair value, including allocated goodwill, and recorded an impairment of \$561 for allocated Texas goodwill in the first quarter of 2011; this impairment charge is included in the operating results of discontinued operations. (see Note 13)

The following table summarizes the nine-month changes in the Company's goodwill of continuing operations by reporting unit:

	Regulated Unit		Market-Based Unit			Consolidated	
	Cost	Accumulated Impairment	Cost	Accumulated Impairment	Cost	Accumulated Impairment	Total Net
Balance at January 1, 2011	\$ 3,399,884	\$ (2,332,670)	\$ 235,990	\$ (107,619)	\$ 3,635,874	\$ (2,440,289)	\$ 1,195,585

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Reclassifications and other activity	(75)	0	0	0	(75)	0	(75)
Balance at September 30, 2011	\$ 3,399,809	\$ (2,332,670)	\$ 235,990	\$ (107,619)	\$ 3,635,799	\$ (2,440,289)	\$ 1,195,510
Balance at January 1, 2010	\$ 3,399,848	\$ (2,332,670)	\$ 235,715	\$ (107,619)	\$ 3,635,563	\$ (2,440,289)	\$ 1,195,274
Reclassifications and other activity	36	0	275	0	311	0	311
Balance at September 30, 2010	\$ 3,399,884	\$ (2,332,670)	\$ 235,990	\$ (107,619)	\$ 3,635,874	\$ (2,440,289)	\$ 1,195,585

Table of Contents

The Company may be required to recognize an impairment of goodwill in the future due to market conditions or other factors related to the Company's performance. These market events could include a decline over a period of time of the Company's stock price, a decline over a period of time in valuation multiples of comparable water utilities, the lack of an increase in the Company's market price consistent with its peer companies, or decreases in control premiums. A decline in the forecasted results in the Company's business plan, such as changes in rate case results or capital investment budgets or changes in the Company's interest rates, could also result in an impairment charge. Recognition of impairments of a significant portion of goodwill would negatively affect the Company's reported results of operations and total capitalization, the effect of which could be material and could make it more difficult to maintain its credit ratings, secure financing on attractive terms, maintain compliance with debt covenants and meet expectations of the Company's regulators.

Note 4: Stockholders' Equity**Common Stock**

In March 2010, the Company established American Water Stock Direct, a dividend reinvestment and direct stock purchase plan (the "DRIP"). Under the DRIP, stockholders may reinvest cash dividends and purchase additional Company common stock, up to certain limits, through a transfer agent without commission fees. The Company's transfer agent may buy newly issued shares directly from the Company or shares held in the Company's treasury. The transfer agent may also buy shares in the public markets or in privately negotiated transactions. Purchases generally will be made and credited to DRIP accounts once each week. As of September 30, 2011, there were 4,885 shares available for future issuance under the DRIP. The following table summarizes information regarding issuances under the DRIP for the nine months ended September 30, 2011 and 2010:

	2011	2010
Shares of common stock issued	52	40
Cash proceeds received	\$ 1,466	\$ 868

Cash dividend payments made during the three-month periods ending March 31, June 30 and September 30 were as follows:

	Three Months Ended September 30,		Three Months Ended June 30,		Three Months Ended March 31,	
	2011	2010	2011	2010	2011	2010
Dividends per share	\$ 0.23	\$ 0.22	\$ 0.22	\$ 0.21	\$ 0.22	\$ 0.21
Total dividends paid	\$ 40,358	\$ 38,457	\$ 38,580	\$ 36,689	\$ 38,525	\$ 36,679

On September 23, 2011 the Company declared a quarterly cash dividend payment of \$0.23 per share payable on December 1, 2011 to all shareholders of record as of November 18, 2011. As of September 30, 2011, the Company had accrued dividends totaling \$40,367 included in other current liabilities on the accompanying Consolidated Balance Sheets.

Stock Based Compensation

The Company has granted stock option and restricted stock unit awards to non-employee directors, officers and other key employees of the Company pursuant to the terms of its 2007 Omnibus Equity Compensation Plan (the "Plan"). As of September 30, 2011, a total of 10,906 shares are available for grant under the Plan. Shares issued under the Plan may be authorized but unissued shares of Company stock or reacquired shares of Company stock, including shares purchased by the Company on the open market for purposes of the Plan.

The Company recognizes compensation expense for stock awards over the vesting period of the award. The following table presents stock-based compensation expense recorded in operation and maintenance expense in the accompanying Consolidated Statements of Operations and Comprehensive Income for the three and nine months ended September 30, 2011 and 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Stock options	\$ 810	\$ 1,323	\$ 2,438	\$ 3,177

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Restricted stock units	1,275	1,551	4,179	4,437
Employee stock purchase plan	135	94	343	265
Stock-based compensation in operation and maintenance expense	2,220	2,968	6,960	7,879

Table of Contents

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Income tax benefit	(865)	(1,157)	(2,714)	(3,073)
After-tax stock-based compensation expense	\$ 1,355	\$ 1,811	\$ 4,246	\$ 4,806

There were no significant stock-based compensation costs capitalized during the nine months ended September 30, 2011 and 2010, respectively.

Table of Contents**Stock Options**

In the first quarter of 2011, the Company granted non-qualified stock options to certain employees under the Plan. The stock options vest ratably over the three-year service period beginning January 1, 2011. These awards have no performance vesting conditions and the grant date fair value is amortized through expense over the requisite service period using the straight-line method. The following table presents the weighted average assumptions used in the pricing model for 2011 grants and the resulting weighted average grant date fair value per share of stock options granted:

Dividend yield	3.25%
Expected volatility	29.32%
Risk-free interest rate	1.93%
Expected life (years)	4.35
Exercise price	\$ 27.08
Grant date fair value per share	\$ 5.14

Stock options granted under the Plan have maximum terms of seven years, vest over periods ranging from one to three years, and are granted with exercise prices equal to the market value of the Company's common stock on the date of grant. As of September 30, 2011, \$4,223 of total unrecognized compensation cost related to the non-vested stock options is expected to be recognized over the weighted-average period of 1.6 years.

The following table summarizes stock option activity for the nine months ended September 30, 2011:

	Shares	Weighted Average Exercise Price (per share)	Weighted Average Remaining Life (years)	Aggregate Intrinsic Value
Options outstanding at January 1, 2011	2,870	\$ 21.38		
Granted	736	27.08		
Forfeited or expired	(38)	22.52		
Exercised	(312)	21.27		
Options outstanding at September 30, 2011	3,256	\$ 22.67	4.57	\$ 24,450
Exercisable at September 30, 2011	1,796	\$ 21.34	3.73	\$ 15,887

The following table summarizes additional information regarding stock options exercised during the nine months ended September 30, 2011 and 2010:

	2011	2010
Intrinsic value	\$ 1,944	\$ 52
Exercise proceeds	\$ 6,645	\$ 1,230

Restricted Stock Units

In the first quarter of 2011, the Company granted restricted stock units to certain employees under the Plan. The restricted stock units vest ratably over the three-year performance period beginning January 1, 2011 (the Performance Period); however, distribution of the shares is contingent upon the achievement of internal performance measures and, separately, certain market thresholds over the Performance Period. The restricted stock units granted with performance and service conditions are valued at the market value of the Company's common stock on the date of grant. The restricted stock units granted with market and service conditions are valued using a Monte Carlo model. Weighted average assumptions used in the Monte Carlo simulation are as follows for the 2011 grants:

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Expected volatility	29.50%
Risk-free interest rate	1.24%
Expected life (years)	3

On May 6, 2011, the Company granted 16 restricted stock units to certain non-employee directors under the Plan. The restricted stock units vested on the date of grant; however, distribution of the shares will be made within 30 days of the earlier of August 12, 2012 or the participant's separation from service. Because these restricted stock units vested on grant date, the total grant date fair value of \$29.28 per share was recorded in operation and maintenance expense included in the expense table above in the second quarter of 2011.

Table of Contents

The grant date fair value of the restricted stock awards that have (a) market or performance conditions, (b) service conditions and (c) vest ratably is amortized through expense over the requisite service period using the graded-vesting method. As of September 30, 2011, \$3,880 of total unrecognized compensation cost related to the non-vested restricted stock units is expected to be recognized over the weighted-average remaining life of 1.0 years.

The following table summarizes restricted stock unit activity for the nine months ended September 30, 2011:

	Shares	Weighted Average Grant Date Fair Value (per share)
Nonvested total at January 1, 2011	479	\$ 22.60
Granted	205	29.95
Distributed	(81)	21.36
Forfeited	(9)	24.13
Undistributed vested awards	(8)	24.17
Nonvested total at September 30, 2011	586	\$ 25.11

The following table summarizes additional information regarding restricted stock units distributed during the nine months ended September 30, 2011 and 2010:

	2011	2010
Intrinsic value	\$ 1,980	\$ 1,179
Income tax benefit	\$ 99	\$ 14

If dividends are declared with respect to shares of the Company's common stock before the restricted stock units are distributed, the Company credits a liability for the value of the dividends that would have been paid if the restricted stock units were shares of Company common stock. When the restricted stock units are distributed, the Company pays the employee a lump sum cash payment equal to the value of the dividend equivalents accrued. The Company accrued dividend equivalents totaling \$593 and \$367 to retained earnings during the nine months ended September 30, 2011 and 2010, respectively.

Employee Stock Purchase Plan

Under the Nonqualified Employee Stock Purchase Plan (the "ESPP"), employees can use payroll deductions to acquire Company 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. As of September 30, 2011 there were 1,622 shares of common stock reserved for issuance under the ESPP. During the nine months ended September 30, 2011, the Company issued 91 shares under the ESPP.

Table of Contents**Note 5: Long-Term Debt**

The Company primarily issues long-term debt to fund capital expenditures of the regulated subsidiaries. The components of long-term debt are as follows:

	Rate	Weighted Average Rate	Maturity Date	September 30, 2011	December 31, 2010
Long-term debt of American Water Capital Corp. (AWCC) (a)					
Private activity bonds and government funded debt					
Fixed rate	4.85%-6.75%	5.72%	2018-2040	\$ 322,610	\$ 322,610
Senior notes					
Fixed rate	5.39%-10.00%	6.25%	2013-2040	3,089,409	3,117,696
Long-term debt of other subsidiaries					
Private activity bonds and government funded debt					
Fixed rate	0.00%-6.20%	5.07%	2011-2039	1,207,265	1,201,723
Mortgage bonds					
Fixed rate	5.48%-9.71%	7.40%	2011-2039	697,849	730,991
Mandatory redeemable preferred stock	4.60%-9.75%	8.43%	2013-2036	22,707	22,844
Notes payable and other (b)	9.49%-13.96%	11.93%	2013-2026	1,841	5,689
Long-term debt				5,341,681	5,401,553
Unamortized debt discount, net (c)				44,898	51,154
Fair value adjustment to interest rate hedge				5,885	(345)
Total long-term debt				\$ 5,392,464	\$ 5,452,362

(a) A wholly-owned subsidiary of the Company.

(b) Includes capital lease obligations of \$1,319 and \$5,076 at September 30, 2011 and December 31, 2010, respectively.

(c) Includes fair value adjustments previously recognized in acquisition purchase accounting.

The following long-term debt was issued in 2011:

Company	Type	Interest Rate	Maturity	Amount
Other subsidiaries	Private activity bonds and government funded debt fixed rate	0.00%-1.56%	2031	\$ 12,350
Total issuances				\$ 12,350

The following long-term debt was retired through optional redemption, sinking fund provisions or payment at maturity during 2011:

Company	Type	Interest Rate	Maturity	Amount
American Water Capital Corp.	Senior notes fixed rate	6.00%-8.25%	2011-2039	\$ 28,287
Other subsidiaries	Mortgage bonds fixed rate	8.21%-9.71%	2011-2022	33,142
Other subsidiaries	Private activity bonds and government funded debt	0.00%-5.90%	2011-2034	6,876
Other subsidiaries	Mandatory redeemable preferred stock	4.60%-6.00%	2013-2019	140
Other	Capital leases and other			3,871

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Total retirements and redemptions

\$ 72,316

Included in the capital lease redemptions above is a non-cash redemption of \$3,487 associated with a cancelled sublease and a capital lease arrangement.

Table of Contents

Interest income included in interest, net is summarized below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest income	\$ 2,601	\$ 2,531	\$ 7,940	\$ 7,448

In July 2010, the Company entered into an interest-rate swap to hedge \$100,000 of its 6.085% fixed-rate debt maturing 2017. The Company will pay variable interest of six-month LIBOR plus 3.422%. This fixed rate and pay variable rate interest swap is accounted for as a fair value hedge. The swap matures with the fixed-rate debt in 2017. The Company uses a combination of fixed-rate and variable-rate debt to manage interest rate exposure.

At September 30, 2011 and December 31, 2010, the Company had a \$100,000 notional amount variable interest-rate swap fair value hedge outstanding. The following table provides a summary of the derivative fair value balance recorded by the Company and the line item in the Consolidated Balance Sheets in which such amount is recorded:

	September 30, 2011	December 31, 2010
Balance sheet classification:		
Regulatory and other long-term assets		
Other	\$ 5,612	\$ 0
Regulatory and other long-term liabilities		
Other	\$ 0	\$ 898
Long-term debt		
Long-term debt	\$ 5,885	\$ (345)

For derivative instruments that are designated and qualify as fair value hedges, the gain or loss on the hedge instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in current net income. The Company includes the gain or loss on the derivative instrument and the offsetting loss or gain on the hedged item in interest expense as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest, net:				
Gain (loss) on swap	\$ 4,896	\$ 3,228	\$ 6,510	\$ 3,228
Gain (loss) on borrowing	\$ (4,797)	\$ (3,535)	\$ (6,230)	\$ (3,535)
Hedge ineffectiveness	\$ 99	\$ (307)	\$ 280	\$ (307)

Note 6: Short-Term Debt

The components of short-term debt are as follows:

	September 30, 2011	December 31, 2010
Revolving credit lines	\$ 0	\$ 2,734
Commercial paper, net of \$33 and \$10 discount at September 30 and December 31, respectively	389,567	175,290
Bank overdraft	19,431	50,478
Total short-term debt	\$ 408,998	\$ 228,502

Note 7: Income Taxes

The Company's estimated annual effective tax rate for the nine months ended September 30, 2011 was 40.2% compared to 39.7% for the nine months ended September 30, 2010, excluding various discrete items. The Company's actual effective tax rates on continuing operations were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Actual effective tax rate on continuing operations	37.9%	38.8%	39.3%	39.4%

Table of Contents

The actual effective tax rates in all periods presented were less than the estimated annual rates due to various discrete items.

Note 8: Pension and Other Postretirement Benefits

The following table provides the components of net periodic benefit costs:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Components of net periodic pension benefit cost:				
Service cost	\$ 8,410	\$ 7,669	\$ 25,231	\$ 23,006
Interest cost	17,262	16,901	51,785	50,702
Expected return on plan assets	(18,027)	(14,189)	(54,081)	(42,564)
Amortization of:				
Prior service cost	180	81	541	242
Actuarial loss	4,638	4,476	13,913	13,427
Net periodic pension benefit cost	\$ 12,463	\$ 14,938	\$ 37,389	\$ 44,813

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Components of net periodic other postretirement benefit cost:				
Service cost	\$ 3,484	\$ 3,665	\$ 10,453	\$ 10,997
Interest cost	7,805	8,037	23,414	24,112
Expected return on plan assets	(7,195)	(6,093)	(21,584)	(18,279)
Amortization of:				
Transition obligation	0	43	0	130
Prior service credit	(481)	(295)	(1,443)	(885)
Actuarial loss	1,783	2,040	5,350	6,119
Net periodic other postretirement benefit cost	\$ 5,396	\$ 7,397	\$ 16,190	\$ 22,194

The Company contributed \$114,412 to its defined benefit pension plan in the first nine months of 2011. In October, the Company contributed \$23,199. In addition, the Company contributed \$20,409 for the funding of its other postretirement plans in the first nine months of 2011 and expects to contribute \$6,803 during the balance of 2011.

Note 9: Commitments and Contingencies

The Company is also routinely involved in legal actions incident to the normal conduct of its business. At September 30, 2011, the Company has accrued approximately \$1,300 as probable costs and it is reasonably possible that additional losses could range up to \$12,200 for these matters. 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.

The Company enters into agreements for the provision of services to water and wastewater facilities for the United States military, municipalities and other customers. The Company's military services agreements expire between 2051 and 2060 and have remaining performance commitments as measured by estimated remaining contract revenue of \$2,052,000 at September 30, 2011. The military contracts are subject to customary termination provisions held by the U.S. Federal Government prior to the agreed upon contract expiration. The Company's Operations and Maintenance agreements with municipalities and other customers expire between 2011 and 2048 and have remaining performance commitments as measured by estimated remaining contract revenue of \$1,129,000 at September 30, 2011. Some of the Company's long-term contracts to operate and maintain a municipality's, federal government's or other party's water or wastewater treatment and delivery facilities include responsibility for certain maintenance for some of those facilities, in exchange for an annual fee. Unless specifically required to

perform certain maintenance activities, the maintenance costs are recognized when the maintenance is performed.

Note 10: Environmental Matters

The Company's water and wastewater operations are subject to federal, state, local and foreign 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

Table of Contents

appropriate. Remediation costs that relate to an existing condition caused by past operations are accrued, on an undiscounted basis, when it is probable that these costs will be incurred and can be reasonably estimated. Remediation costs accrued amounted to \$5,500 and \$6,630 at September 30, 2011 and December 31, 2010, respectively. At September 30, 2011, the balance of the accrual relates to a conservation agreement entered into by a subsidiary of the Company with the National Oceanic and Atmospheric Administration (NOAA) requiring the Company to, among other provisions, implement certain measures to protect the steelhead trout and its habitat in the Carmel River watershed in the state of California. The Company has agreed to pay \$1,100 annually from 2010 through 2016, or until the regional desalination project comes on line, whichever is earlier. The Company pursues recovery of incurred costs through all appropriate means, including regulatory recovery through customer rates. The Company's regulatory assets at September 30, 2011 and December 31, 2010 include \$9,540 and \$10,642, respectively, related to the NOAA agreement.

Note 11: Earnings per Common Share

Earnings per share is calculated using the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security. The Company has participating securities related to restricted stock units, granted under the Company's 2007 Omnibus Equity Compensation Plan, that earn dividend equivalents on an equal basis with common shares. In applying the two-class method, undistributed earnings are allocated to both common shares and participating securities. The following is a reconciliation of the Company's income from continuing operations, income from discontinued operations, and net income and weighted average common shares outstanding for calculating basic net earnings per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Basic:				
Income from continuing operations	\$ 128,405	\$ 119,357	\$ 243,788	\$ 216,561
Income from discontinued operations, net of tax	9,017	4,757	25,532	11,112
Net income	137,422	124,114	269,320	227,673
Less: Distributed earnings to common shareholders	40,541	38,580	118,002	112,155
Less: Distributed earnings to participating securities	17	13	52	36
Undistributed earnings	96,864	85,521	151,266	