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American Water Works Company, Inc.  
Form 10-Q  
November 02, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

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)

|  |                     |
|--|---------------------|
| Delaware                                 | 51-0063696          |
| (State or other jurisdiction of          | (I.R.S. Employer    |
| incorporation or organization)           | Identification No.) |
| 1025 Laurel Oak Road, Voorhees, NJ       | 08043               |
| (Address of principal executive offices) | (Zip Code)          |

(856) 346-8200

(Registrant's telephone number, including area code)

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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 Accelerated filer

Non-accelerated filer Smaller reporting company

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 as of October 27, 2016                          |
|--|---|
| Common Stock, \$0.01 par value per share | 178,003,367 shares  |
|  | (excludes 3,721,496 treasury shares as of October 27, 2016) |

TABLE OF CONTENTS

AMERICAN WATER WORKS COMPANY, INC.

Quarterly REPORT ON FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2016

INDEX

|  |    |
|--|----|
| <u>FORWARD LOOKING STATEMENTS</u>  | 1  |
| <u>PART I. FINANCIAL INFORMATION</u>   | 3  |
| <u>ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS</u>   | 3  |
| <u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u> | 24 |
| <u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>                            | 37 |
| <u>ITEM 4. CONTROLS AND PROCEDURES</u>   | 37 |
| <u>PART II. OTHER INFORMATION</u>  | 38 |
| <u>ITEM 1. LEGAL PROCEEDINGS</u>   | 38 |
| <u>ITEM 1A. RISK FACTORS</u>   | 41 |
| <u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>                           | 42 |
| <u>ITEM 3. DEFAULTS UPON SENIOR SECURITIES</u>   | 42 |
| <u>ITEM 4. MINE SAFETY DISCLOSURES</u>   | 42 |
| <u>ITEM 5. OTHER INFORMATION</u>   | 42 |
| <u>ITEM 6. EXHIBITS</u>  | 43 |
| <u>SIGNATURES</u>  | 44 |
| <u>EXHIBIT INDEX</u>   | 45 |



## FORWARD-LOOKING STATEMENTS

We have made statements in Part I, Item 2—Management’s Discussion and Analysis of Financial Condition and Results of Operations and in other sections of this Quarterly Report on Form 10-Q (“Form 10-Q”), that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and the Private Securities Litigation Reform Act of 1995. In some cases, these forward-looking statements can be identified by words with prospective meanings such as “intend,” “plan,” “estimate,” “believe,” “anticipate,” “expect,” “predict,” “project,” “assume,” “forecast,” “outlook,” “future,” “objective,” “potential,” “continue,” “seek to,” “may,” “can,” “should,” “will” and “could” or the negative of such terms or other variations or similar expressions. Forward-looking statements may relate to, among other things, our future financial performance, including our adjusted operation and maintenance (“O&M”) efficiency ratio, cash flows, our growth and portfolio optimization strategies, our projected capital expenditures and related funding requirements, our ability to repay debt, our projected strategy to finance current operations and growth initiatives, the impact of legal proceedings and potential fines and penalties, business process and technology improvement initiatives, trends in our industry, regulatory or legal developments or rate adjustments, including rate case filings, filings for infrastructure surcharges and filings to address regulatory lag.

Forward-looking statements are predictions based on our current expectations and assumptions regarding future events. They are not guarantees or assurances of any outcomes, financial results or levels of activity, performance or achievements, and you are cautioned not to place undue reliance upon them. These forward-looking statements are subject to a number of estimates and assumptions, and known and unknown risks, uncertainties and other factors. Our actual results may vary materially from those discussed in the forward-looking statements included herein as a result of the following important factors:

- the decisions of governmental and regulatory bodies, including decisions to raise or lower rates;
- the timeliness of regulatory commissions’ actions concerning rates, permitting and other decisions;
- changes in customer demand for, and patterns of use of, water, such as may result from conservation efforts;
- changes in laws, governmental regulations and policies, including environmental, health and safety, water quality and public utility regulations and policies;
- weather conditions, patterns, events or natural disasters, including drought or abnormally high rainfall, strong winds, coastal and intercoastal flooding, earthquakes, landslides, hurricanes and tornados;
- the outcome of litigation and government action related to the Freedom Industries chemical spill in West Virginia, including matters pertaining to the recently announced binding global agreement in principle to settle claims related to this chemical spill;
- our ability to appropriately maintain current infrastructure, including our technology systems, and manage expansion of our business;
- our ability to obtain permits and other approvals for projects;
- changes in our capital requirements;
- our ability to control operating expenses and to achieve efficiencies in our operations;
- the intentional or unintentional actions of a third party, including contamination of our water supplies or water provided to our customers, and attacks on, or infiltration of or other disruptions to, our computer systems or other critical infrastructure;
- our ability to obtain adequate and cost-effective supplies of chemicals, electricity, fuel, water and other raw materials that are needed for our operations;
- our ability to successfully meet growth projections for our business and capitalize on growth opportunities, including our ability to, among other things, acquire and integrate water and wastewater systems into our regulated operations, and enter into contracts and other agreements with, or otherwise obtain, new customers in our market-based businesses;

cost overruns relating to improvements in or the expansion of our operations;

our ability to maintain safe work sites;

our exposure to liabilities related to environmental laws and similar matters resulting from, among other things, the provision of water services to customers in the natural gas exploration and production market;

changes in general economic, business and financial market conditions;

1

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- access to sufficient capital on satisfactory terms and when and as needed to support operations and capital expenditures;
- fluctuations in interest rates;
- restrictive covenants in or changes to the credit ratings on our current or future debt that could increase our financing costs or affect our ability to borrow, make payments on debt or pay dividends;
- fluctuations in the value of benefit plan assets and liabilities that could increase our cost and funding requirements;
- changes in federal or state income tax laws, including tax reform, the availability of tax credits and tax abatement programs, and our ability to utilize our U.S. and state net operating loss carryforwards;
- migration of customers into or out of our service territories;
- the use by municipalities of the power of eminent domain or other authority to condemn our systems;
- difficulty in obtaining, or the inability to obtain, insurance at acceptable rates and on acceptable terms and conditions;
- the incurrence of impairment charges related to our goodwill or other assets;
- labor actions, including work stoppages and strikes;
- ability to retain and attract qualified employees; and
- civil disturbances or terrorist threats or acts, or public apprehension about future disturbances or terrorist threats or acts.

These forward-looking statements are qualified by, and should be read together with, the risk factors and other statements contained in our Annual Report on Form 10-K for the year ended December 31, 2015 (“Form 10-K”), and in this Form 10-Q, and investors should refer to such risk factors and other statements in evaluating such forward-looking statements. Any forward-looking statements we make speak only as of the date this Form 10-Q was filed with the United States Securities and Exchange Commission. Except as required by the federal securities laws, we do not have any obligation, and we specifically disclaim any undertaking or intention, to publicly update or revise any forward-looking statements, whether as a result of new information, future events, changed circumstances or otherwise. New factors emerge from time to time, and it is not possible for us to predict all such factors. Furthermore, it may not be possible to assess the impact of any such factor on our businesses, either viewed independently or together, or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statement. The foregoing factors should not be construed as exhaustive.

## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

American Water Works Company, Inc. and Subsidiary Companies

Consolidated Balance Sheets (Unaudited)

(In millions, except share and per share data)

|   | September 30,<br>2016 | December 31,<br>2015 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>                               |                       |                      |
| Property, plant and equipment               | \$ 19,376             | \$ 18,504            |
| Accumulated depreciation                    | (4,817 )              | (4,571 )             |
| Property, plant and equipment, net          | 14,559                | 13,933               |
| Current assets:                             |                       |                      |
| Cash and cash equivalents                   | 46                    | 45                   |
| Restricted funds                            | 23                    | 21                   |
| Accounts receivable, net                    | 302                   | 255                  |
| Unbilled revenues                           | 285                   | 267                  |
| Materials and supplies                      | 40                    | 38                   |
| Other                                       | 105                   | 31                   |
| Total current assets                        | 801                   | 657                  |
| Regulatory and other long-term assets:      |                       |                      |
| Regulatory assets                           | 1,223                 | 1,271                |
| Goodwill                                    | 1,313                 | 1,302                |
| Other                                       | 75                    | 78                   |
| Total regulatory and other long-term assets | 2,611                 | 2,651                |
| <b>TOTAL ASSETS</b>                         | <b>\$ 17,971</b>      | <b>\$ 17,241</b>     |

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



## American Water Works Company, Inc. and Subsidiary Companies

## Consolidated Balance Sheets (Unaudited)

(In millions, except share and per share data)

|  | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
| <b>CAPITALIZATION AND LIABILITIES</b>  |                       |                      |
| Capitalization:  |                       |                      |
| Common stock (\$0.01 par value, 500,000,000 shares authorized, 181,720,136<br>and 180,907,483 shares issued, respectively) | \$ 2                  | \$ 2                 |
| Paid-in-capital  | 6,388                 | 6,351                |
| Accumulated deficit  | (839 )                | (1,073 )             |
| Accumulated other comprehensive loss   | (99 )                 | (88 )                |
| Treasury stock, at cost (3,721,496 and 2,625,112 shares, respectively)   | (214 )                | (143 )               |
| Total common stockholders' equity  | 5,238                 | 5,049                |
| Long-term debt   | 5,842                 | 5,862                |
| Redeemable preferred stock at redemption value   | 11                    | 12                   |
| Total long-term debt   | 5,853                 | 5,874                |
| Total capitalization   | 11,091                | 10,923               |
| Current liabilities:   |                       |                      |
| Short-term debt  | 951                   | 628                  |
| Current portion of long-term debt  | 53                    | 54                   |
| Accounts payable   | 135                   | 126                  |
| Accrued liabilities  | 530                   | 493                  |
| Taxes accrued  | 45                    | 26                   |
| Interest accrued   | 96                    | 62                   |
| Other  | 118                   | 144                  |
| Total current liabilities  | 1,928                 | 1,533                |
| Regulatory and other long-term liabilities:  |                       |                      |
| Advances for construction  | 300                   | 349                  |
| Deferred income taxes, net   | 2,524                 | 2,310                |
| Deferred investment tax credits  | 23                    | 24                   |
| Regulatory liabilities   | 403                   | 402                  |
| Accrued pension expense  | 342                   | 342                  |
| Accrued postretirement benefit expense   | 72                    | 169                  |
| Other  | 90                    | 68                   |
| Total regulatory and other long-term liabilities   | 3,754                 | 3,664                |
| Contributions in aid of construction   | 1,198                 | 1,121                |
| Commitments and contingencies (see Note 9)   |                       |                      |
| <b>TOTAL CAPITALIZATION AND LIABILITIES</b>  | <b>\$ 17,971</b>      | <b>\$ 17,241</b>     |

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

## American Water Works Company, Inc. and Subsidiary Companies

## Consolidated Statements of Operations (Unaudited)

(In millions, except per share data)

|   | For the Three<br>Months Ended<br>September 30, |        | For the Nine<br>Months Ended<br>September 30, |         |
|---|--|--------|---|---------|
|   | 2016   | 2015   | 2016  | 2015    |
| Operating revenues                                    | \$930  | \$896  | \$2,500                                       | \$2,376 |
| Operating expenses:                                   |  |        |   |         |
| Operation and maintenance                             | 432  | 364    | 1,131   | 1,024   |
| Depreciation and amortization                         | 119  | 111    | 350   | 327     |
| General taxes   | 65   | 60     | 195   | 184     |
| Gain on asset dispositions and purchases              | (5 )   | —      | (8 )  | (2 )    |
| Total operating expenses, net                         | 611  | 535    | 1,668   | 1,533   |
| Operating income                                      | 319  | 361    | 832   | 843     |
| Other income (expense):                               |  |        |   |         |
| Interest, net   | (81 )  | (77 )  | (242 )  | (228 )  |
| Other, net  | 5  | 3      | 14  | 9       |
| Total other income (expense)                          | (76 )  | (74 )  | (228 )  | (219 )  |
| Income from continuing operations before income taxes | 243  | 287    | 604   | 624     |
| Provision for income taxes                            | 95   | 113    | 237   | 247     |
| Net income attributable to common stockholders        | \$148  | \$174  | \$367   | \$377   |
| Basic earnings per share:                             |  |        |   |         |
| Net income attributable to common stockholders        | \$0.83   | \$0.97 | \$2.06  | \$2.10  |
| Diluted earnings per share:                           |  |        |   |         |
| Net income attributable to common stockholders        | \$0.83   | \$0.96 | \$2.05  | \$2.09  |
| Weighted-average common shares outstanding:           |  |        |   |         |
| Basic   | 178  | 179    | 178   | 179     |
| Diluted   | 178  | 180    | 179   | 180     |
| Dividends declared per common share                   | \$0.375  | \$0.34 | \$0.75  | \$0.68  |

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

American Water Works Company, Inc. and Subsidiary Companies

Consolidated Statements of Comprehensive Income (Unaudited)

(In millions)

|  | For the Three<br>Months Ended<br>September 30, |        | For the Nine<br>Months Ended<br>September 30, |        |
|--|--|--------|---|--------|
|  | 2016   | 2015   | 2016  | 2015   |
| Net income attributable to common stockholders               | \$ 148   | \$ 174 | \$ 367  | \$ 377 |
| Other comprehensive income (loss), net of tax:               |  |        |   |        |
| Pension amortized to periodic benefit cost:                  |  |        |   |        |
| Actuarial loss, net of tax of \$1 for the three months and   |  |        |   |        |
| \$3 for the nine months                                      | 1  | 1      | 4   | 4      |
| Foreign currency translation adjustment                      | —  | —      | —   | (1 )   |
| Unrealized loss on cash flow hedges, net of tax of \$(3) and |  |        |   |        |
| \$0 for the three months and \$(10) and \$0 for the nine     |  |        |   |        |
| months   | (4 )   | —      | (15 )   | —      |
| Net other comprehensive income (loss)                        | (3 )   | 1      | (11 )   | 3      |
| Comprehensive income attributable to common stockholders     | \$ 145   | \$ 175 | \$ 356  | \$ 380 |

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

## American Water Works Company, Inc. and Subsidiary Companies

## Consolidated Statements of Cash Flows (Unaudited)

(In millions)

|   | For the Nine<br>Months Ended<br>September 30, |         |
|---|---|---------|
|   | 2016  | 2015    |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                   |   |         |
| Net income  | \$367   | \$377   |
| Adjustments to reconcile to net cash flows provided by operating activities:  |   |         |
| Depreciation and amortization   | 350   | 327     |
| Deferred income taxes and amortization of investment tax credits              | 223   | 236     |
| Provision for losses on accounts receivable                                   | 18  | 22      |
| Gain on asset dispositions and purchases                                      | (8 )  | (2 )    |
| Pension and non-pension postretirement benefits                               | 43  | 46      |
| Other non-cash, net   | (48 )   | (40 )   |
| Changes in assets and liabilities:  |   |         |
| Receivables and unbilled revenues   | (83 )   | (147 )  |
| Pension and non-pension postretirement benefit contributions                  | (42 )   | (40 )   |
| Accounts payable and accrued liabilities                                      | 184   | 69      |
| Other assets and liabilities, net   | (79 )   | 8       |
| Net cash provided by operating activities                                     | 925   | 856     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                   |   |         |
| Capital expenditures  | (928 )  | (791 )  |
| Acquisitions  | (29 )   | (176 )  |
| Proceeds from sale of assets and securities                                   | 5   | 5       |
| Removal costs from property, plant and equipment retirements, net             | (62 )   | (74 )   |
| Net funds restricted  | —   | (9 )    |
| Net cash used in investing activities   | (1,014)                                       | (1,045) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                   |   |         |
| Proceeds from long-term debt  | 2   | 564     |
| Repayments of long-term debt  | (20 )   | (88 )   |
| Proceeds from short-term borrowings with maturities greater than three months | —   | 60      |
| Repayments of short-term borrowings with maturities greater than three months | —   | (60 )   |
| Net short-term borrowings with maturities less than three months              | 322   | (70 )   |
| Proceeds from issuances of employee stock plans and DRIP                      | 22  | 32      |
| Advances and contributions for construction, net of refunds of \$17 and       |   |         |
| \$17, respectively  | 16  | 20      |
| Debt issuance costs   | (1 )  | (7 )    |
| Dividends paid  | (194 )  | (178 )  |
| Anti-dilutive stock repurchase  | (65 )   | (39 )   |
| Tax benefit realized from equity compensation                                 | 8   | 7       |
| Net cash provided by financing activities                                     | 90  | 241     |

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|   |       |       |
|---|-------|-------|
| Net increase in cash and cash equivalents                               | 1     | 52    |
| Cash and cash equivalents as of beginning of period                     | 45    | 23    |
| Cash and cash equivalents as of end of period                           | \$46  | \$75  |
| Non-cash investing activity:  |       |       |
| Capital expenditures acquired on account but unpaid as of end of period | \$182 | \$195 |

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

## American Water Works Company, Inc. and Subsidiary Companies

## Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

(In millions)

|  | Common<br>Stock | Par<br>Value | Paid-in-Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Loss | Treasury<br>Stock<br>At<br>Cost | Total<br>Stockholders'<br>Equity |          |
|--|-----------------|--------------|-----------------|------------------------|---|---------------------------------|----------------------------------|----------|
| Balance as of December 31, 2015                | 180.9           | \$ 2         | \$ 6,351        | \$ (1,073)             | (\$ (88))                                     | (2.6)                           | \$ (143)                         | \$ 5,049 |
| Net income attributable to common stockholders | —               | —            | —               | 367                    | —   | —                               | —                                | 367      |
| Direct stock reinvestment and purchase plan    | —               | —            | 4               | —                      | —   | —                               | —                                | 4        |
| Employee stock purchase plan                   | —               | —            | 5               | —                      | —   | —                               | —                                | 5        |
| Stock-based compensation activity              | 0.8             | —            | 28              | —                      | —   | (0.1)                           | (6)                              | 22       |
| Repurchases of common stock                    | —               | —            | —               | —                      | —   | (1.0)                           | (65)                             | (65)     |
| Net other comprehensive income (loss)          | —               | —            | —               | —                      | (11)  | —                               | —                                | (11)     |
| Dividends                                      | —               | —            | —               | (133)                  | —   | —                               | —                                | (133)    |
| Balance as of September 30, 2016               | 181.7           | \$ 2         | \$ 6,388        | \$ (839)               | (\$ (99))                                     | (3.7)                           | (\$ (214))                       | \$ 5,238 |

|   | Common<br>Stock | Par<br>Value | Paid-in-Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Loss | Treasury<br>Stock<br>At<br>Cost | Total<br>Stockholders'<br>Equity |          |
|---|-----------------|--------------|-----------------|------------------------|---|---------------------------------|----------------------------------|----------|
| Balance as of December 31, 2014                     | 179.5           | \$ 2         | \$ 6,302        | \$ (1,296)             | (\$ (82))                                     | (0.2)                           | (\$ (11))                        | \$ 4,915 |
| Cumulative effect of change in accounting principle | —               | —            | —               | (8)                    | —   | —                               | —                                | (8)      |
| Net income attributable to common stockholders      | —               | —            | —               | 377                    | —   | —                               | —                                | 377      |

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Direct stock reinvestment and

|                                   |       |      |          |           |   |        |       |                       |
|-----------------------------------|-------|------|----------|-----------|---|--------|-------|-----------------------|
| purchase plan                     | —     | —    | 3        | —         | — | —      | —     | 3                     |
| Employee stock purchase plan      | —     | —    | 4        | —         | — | —      | —     | 4                     |
| Stock-based compensation activity | 1.1   | —    | 40       | (1        | ) | —      | (0.1) | (7 ) 32               |
| Repurchases of common stock       | —     | —    | —        | —         | — | —      | (0.8) | (39 ) (39 )           |
| Net other comprehensive income    |       |      |          |           |   |        |       |                       |
| (loss)                            | —     | —    | —        | —         | 3 | —      | —     | 3                     |
| Dividends                         | —     | —    | —        | (122      | ) | —      | —     | (122 )                |
| Balance as of September 30, 2015  | 180.6 | \$ 2 | \$ 6,349 | \$ (1,050 | ) | \$ (79 | )     | (1.1)\$ (57 )\$ 5,165 |

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



American Water Works Company, Inc. and Subsidiary Companies

Notes to Consolidated Financial Statements (Unaudited)

(Unless otherwise noted, in millions, except per share data)

Note 1: Basis of Presentation

The unaudited consolidated financial statements provided in this report include the accounts of American Water Works Company, Inc. and all of its subsidiaries (collectively, “American Water” or the “Company”) in which a controlling interest is maintained after the elimination of intercompany accounts and transactions. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial reporting and with the rules and regulations for reporting on Form 10-Q. Accordingly, they do not contain certain information and disclosures required by GAAP for comprehensive financial statements. In the opinion of management, all adjustments necessary for a fair statement of the financial position as of September 30, 2016 and results of operations and cash flows for all periods presented have been made. All adjustments are of a normal, recurring nature, except as otherwise disclosed.

The Consolidated Balance Sheet as of December 31, 2015 is derived from the Company's audited consolidated financial statements as of December 31, 2015. The unaudited financial statements and notes included in this report should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2015 (“Form 10-K”) which provides a more complete discussion of the Company's accounting policies, financial position, operating results and other matters. 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.

Note 2: New Accounting Pronouncements

The following accounting standard was adopted by the Company as of September 30, 2016:

| Standard  | Description  | Date of Adoption | Application | Effect on the Consolidated Financial Statements (or Other Significant Matters)                                  |
|---|--|------------------|-------------|---|
| Accounting for Fees Paid in a Cloud Computing Arrangement | Clarified accounting guidance for fees paid in a cloud computing arrangement. Software license elements in a cloud computing arrangement should be accounted for | January 1, 2016  | Prospective | Adoption of this standard did not impact the Company's results of operations, financial position or cash flows. |

consistent with other software licenses. A cloud computing arrangement without a software license is accounted for as a service contract.

The following recently issued accounting standards are not yet required to be adopted by the Company as of September 30, 2016:

| Standard  | Description   | Date of Adoption                          | Application                              | Effect on the Consolidated Financial Statements (or Other Significant Matters)   |
|---|---|---|--|--|
| Simplification of Employee Share-Based Payment Accounting                     | Simplified accounting and disclosure requirements for share-based payment awards. The updated guidance addresses: (i) the recognition of excess tax benefits and deficiencies; (ii) the classification of excess tax benefits and taxes paid on the Consolidated Statements of Cash Flows; (iii) election of an accounting policy for forfeitures; and (iv) the amount an employer can withhold to cover income taxes and still qualify for equity classification.  | January 1, 2017; early adoption permitted | Alternative transition methods available | The cumulative effect to retained earnings prior to 2017 is expected to be an increase of approximately \$23, with an offsetting decrease to deferred income taxes, net. The Company does not expect to early adopt. |
| Revenue from Contracts with Customers   | Provided new accounting guidance for revenue recognition replacing most existing guidance, including industry-specific guidance. Upon adoption, a company will recognize revenue for the transfer of goods or services to customers equal to the amount it expects to be entitled to receive for those goods or services. The guidance also requires additional disclosures about the nature, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments. | January 1, 2018; early adoption permitted | Alternative transition methods available | The Company is evaluating the effect on the financial statements, related disclosures and method of adoption. The Company does not expect to early adopt.  |
| Classification of Certain Cash Receipts and Cash Payments on the Statement of | Provided guidance on the presentation and classification in the statement of cash flow for the following cash receipts and payments: (i) debt prepayment or debt extinguishment costs; (ii)   | January 1, 2018; early adoption permitted | Retrospective                            | The Company is evaluating the effect on the Statements of Cash Flows and the timing of adoption.   |

|                              |  |   |                        |   |
|------------------------------|--|---|------------------------|---|
| Cash Flows                   | settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; (iii) contingent consideration payments made after a business combination; (iv) proceeds from the settlement of insurance claims; (v) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (vi) distributions received from equity method investees; (vii) beneficial interests in securitization transactions; and (viii) separately identifiable cash flows and application of the predominance principle. |   |                        |   |
| Accounting for Leases        | Updated the accounting and disclosure guidance for leasing arrangements. Under this guidance, a lessee will be required to recognize the following for all leases, excluding short-term leases, at the commencement date: (i) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (ii) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the guidance, lessor accounting is largely unchanged.  | January 1, 2019; early adoption permitted | Modified retrospective | The Company is evaluating the effect on the financial statements, related disclosures and the timing of adoption. |
| Measurement of Credit Losses | Updated the accounting guidance on reporting credit losses for financial assets held at amortized cost basis and available-for-sale debt securities. Under this guidance, expected credit losses are required to be measured based on historical experience, current conditions, and reasonable and supportable  | January 1, 2020; early adoption permitted | Modified retrospective | The Company is evaluating the effect on the financial statements, related disclosures and the timing of adoption. |

forecasts that affect the collectability of the reported amount of financial assets. Also, this guidance requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a direct write-down.

### Note 3: Acquisitions

During the nine months ended September 30, 2016, the Company incurred \$24 in acquisition costs for ten closed acquisitions of various regulated water and wastewater systems. Assets acquired, principally utility plant, totaled \$30. Liabilities assumed totaled \$17. The Company recorded additional goodwill of \$11 associated with two of its acquisitions, which is reported in its Regulated Businesses segment and is expected to be fully deductible for tax purposes. The Company recognized a bargain purchase gain of \$1 associated with two of its acquisitions, which was deferred as a regulatory liability. Also, our Regulated Businesses made a non-escrowed deposit of \$5 related to the acquisition of the McKeesport, Pennsylvania's wastewater system.

## Note 4: Stockholders' Equity

## Accumulated Other Comprehensive Loss

The following table presents changes in accumulated other comprehensive loss by component, net of tax, for the nine months ended September 30, 2016 and 2015, respectively:

|   | Defined Benefit Plans |              |              |             | Loss on  | Accumulated   |
|---|-----------------------|--------------|--------------|-------------|----------|---------------|
|   | Employee              | Amortization | Amortization | Foreign     | Cash     | Other         |
|   | Benefit Plan          | Prior        | of Actuarial | Currency    | Flow     | Comprehensive |
|   | Funded Status         | Service Cost | Loss         | Translation | Hedges   | Loss          |
| Beginning balance as of January 1, 2016 | \$(126)               | \$ 1         | \$ 36        | \$ 2        | \$ (1 )  | \$ (88 )      |
| Other comprehensive loss before         |                       |              |              |             |          |               |
| reclassifications                       | —                     | —            | —            | —           | (15 )    | (15 )         |
| Amounts reclassified from accumulated   |                       |              |              |             |          |               |
| other comprehensive loss                | —                     | —            | 4            | —           | —        | 4             |
| Net other comprehensive income (loss)   | —                     | —            | 4            | —           | (15 )    | (11 )         |
| Ending balance as of September 30, 2016 | \$(126)               | \$ 1         | \$ 40        | \$ 2        | \$ (16 ) | \$ (99 )      |
| Beginning balance as of January 1, 2015 | \$(116)               | \$ 1         | \$ 31        | \$ 3        | \$ (1 )  | \$ (82 )      |
| Other comprehensive loss before         |                       |              |              |             |          |               |
| reclassifications                       | —                     | —            | —            | (1 )        | —        | (1 )          |
| Amounts reclassified from accumulated   |                       |              |              |             |          |               |
| other comprehensive loss                | —                     | —            | 4            | —           | —        | 4             |
| Net other comprehensive income (loss)   | —                     | —            | 4            | (1 )        | —        | 3             |
| Ending balance as of September 30, 2015 | \$(116)               | \$ 1         | \$ 35        | \$ 2        | \$ (1 )  | \$ (79 )      |

The Company does not reclassify the amortization of defined benefit pension cost components from accumulated other comprehensive loss directly to net income in its entirety. These accumulated other comprehensive income (loss) components are included in the computation of net periodic pension cost. (See Note 8)

The amortization of the loss on cash flow hedges is reclassified to net income attributable to common stockholders during the period incurred and is included in interest, net in the accompanying Consolidated Statements of Operations. (See Note 6)

## Anti-dilutive Stock Repurchase Program

In February 2015, the Company's Board of Directors authorized an anti-dilutive stock repurchase program, which allowed the Company to purchase up to 10.0 shares of its outstanding common stock over an unrestricted period of time. During the nine months ended September 30, 2016, the Company repurchased 1.0 shares of common stock in the open market at an aggregate cost of \$65 under the program. As of September 30, 2016, there were 6.8 shares of common stock available for repurchase under the program.

#### Note 5: Stock Based Compensation

##### Stock Options

During the nine months ended September 30, 2016, the Company granted non-qualified stock options to certain employees under the Company's 2007 Omnibus Equity Compensation Plan (the "2007 Plan"). Stock options have a maximum term of seven years, are granted with exercise prices equal to the fair market value of the Company's common stock on the date of grant, vest ratably over a three-year service period beginning January 1 of the year of the grant and generally are subject to the employee's continued employment with the Company. Stock options granted are valued using the Black-Scholes option-pricing model.

The following table presents the weighted-average assumptions used in the Black-Scholes option-pricing model and the resulting weighted-average grant date fair value per share of stock options granted during the nine months ended September 30, 2016:

|                                 |         |
|---------------------------------|---------|
| Dividend yield                  | 2.09 %  |
| Expected volatility             | 15.89 % |
| Risk-free interest rate         | 1.15 %  |
| Expected life (years)           | 4.0     |
| Exercise price                  | \$65.26 |
| Grant date fair value per share | \$6.61  |

The grant date fair value is amortized through expense over the requisite service period using the straight-line method. As of September 30, 2016, \$2 of total unrecognized compensation cost related to the non-vested stock options is expected to be recognized over the weighted-average period of 1.7 years.

The table below summarizes stock option activity for the nine months ended September 30, 2016:

|  | Shares<br>(in<br>thousands) | Weighted-<br>Average Exercise<br>Price (per share) | Weighted-<br>Average Remaining<br>Life (years) | Aggregate<br>Intrinsic<br>Value |
|--|-----------------------------|--|--|---------------------------------|
| Options outstanding as of January 1, 2016    | 1,187                       | \$ 39.70   | 3.9  | \$ 24                           |
| Granted                                      | 341                         | 65.26  |  |                                 |
| Forfeited or expired                         | (49 )                       | 58.90  |  |                                 |
| Exercised                                    | (431 )                      | 32.85  |  |                                 |
| Options outstanding as of September 30, 2016 | 1,048                       | \$ 49.96   | 4.4  | \$ 26                           |
| Exercisable as of September 30, 2016         | 491                         | \$ 40.26   | 3.0  | \$ 17                           |

The following table summarizes additional information regarding stock options exercised for the nine months ended September 30, 2016 and 2015:

|                    | 2016  | 2015  |
|--------------------|-------|-------|
| Intrinsic value    | \$ 16 | \$ 16 |
| Exercise proceeds  | 14    | 25    |
| Income tax benefit | 6     | 5     |

#### Restricted Stock Units (“RSUs”)

During the nine months ended September 30, 2016, the Company granted RSUs, both with and without performance conditions, to certain employees and RSUs without performance conditions to non-employee directors under the 2007 Plan. The RSUs without performance conditions generally vest ratably over a three-year service period beginning January 1 of the year of grant and are valued at the market value of the Company’s common stock on the date of grant. The RSUs with performance conditions include those with internal performance measures, and separately, certain market thresholds, and vest ratably over a three-year performance period beginning January 1 of the year of grant (the “Performance Period”). Distribution of the performance shares is contingent upon the achievement of internal



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performance measures and, separately, certain market thresholds, over the Performance Period. The RSUs with internal performance measures are valued at the market value of the Company's common stock on the date of grant. The RSUs granted with market conditions are valued using the Monte Carlo simulation model.

The following table presents the weighted-average assumptions used in the Monte Carlo simulation model for RSUs with market conditions granted during the nine months ended September 30, 2016:

|                                 |         |
|---------------------------------|---------|
| Expected volatility             | 15.90%  |
| Risk-free interest rate         | 0.91 %  |
| Expected life (years)           | 3.0     |
| Grant date fair value per share | \$77.16 |

12

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During 2013, the Company granted selected employees RSUs with performance conditions (the “2013 RSUs”) comprised of internal performance measures and, separately, market thresholds expressed in the form of a relative total shareholder return. An aggregate of 128 thousand of the 2013 RSUs vested in January 2016. The terms of the 2013 RSUs specified that, so long as the participant continued to be employed by the Company during the Performance Period and to the extent the performance conditions were achieved, the RSUs would vest at target; if the performance conditions were surpassed, up to 175% of the target number of shares would be distributed; and to the extent that the performance thresholds were not met, the award would be forfeited. In January 2016, an additional 74 thousand RSUs were granted and immediately vested because performance thresholds associated with the 2013 RSUs were exceeded.

The table below summarizes RSU activity for the nine months ended September 30, 2016:

|   | Shares<br>(in<br>thousands) | Weighted-Average<br>Grant Date Fair<br>Value (per share) |
|---|-----------------------------|--|
| Non-vested total as of January 1, 2016    | 436                         | \$ 46.97   |
| Granted                                   | 143                         | 69.73  |
| Performance share adjustment              | 74                          | 39.89  |
| Vested (a)                                | (251 )                      | 42.60  |
| Forfeited                                 | (24 )                       | 60.84  |
| Non-vested total as of September 30, 2016 | 378                         | \$ 56.19   |

(a) Includes 202 thousand shares related to the 2013 RSUs and 49 thousand shares related to RSUs without performance conditions that vested during the nine months ended September 30, 2016.

The following table summarizes additional information regarding RSUs issued during the nine months ended September 30, 2016 and 2015:

|                    | 2016  | 2015  |
|--------------------|-------|-------|
| Intrinsic value    | \$ 17 | \$ 17 |
| Income tax benefit | 2     | 2     |

The grant date fair value of the restricted stock awards that vest ratably and have market and/or performance and service conditions are amortized through expense over the requisite service period using the graded-vesting method. RSUs that have no performance conditions are amortized through expense over the requisite service period using the straight-line method. As of September 30, 2016, \$5 of total unrecognized compensation cost related to the non-vested RSUs is expected to be recognized over the weighted-average remaining life of 1.1 years.

Note 6: Long-Term Debt

The following long-term debt was issued during the nine months ended September 30, 2016:

| Company                           | Type                                  | Rate  | Maturity | Amount |
|-----------------------------------|---------------------------------------|-------|----------|--------|
|                                   | Private activity bonds and government |       |          |        |
| Other American Water subsidiaries | funded debt—fixed rate                | 1.36% | 2026     | \$ 2   |

The following long-term debt was retired through sinking fund provisions, optional redemptions or payment at maturity during the nine months ended September 30, 2016:

| Company                           | Type                                   | Rate        | Maturity  | Amount |
|-----------------------------------|--|-------------|-----------|--------|
|                                   | Private activity bonds and government  |             |           |        |
| American Water Capital Corp. (a)  | funded debt—fixed rate                 | 1.79%-2.90% | 2021-2031 | \$ 1   |
|                                   | Private activity bonds and government  |             |           |        |
| Other American Water subsidiaries | funded debt—fixed rate                 | 0.00%-5.30% | 2016-2041 | 18     |
| Other American Water subsidiaries | Mandatorily redeemable preferred stock | 8.49%       | 2036      | 1      |
| Total retirements and redemptions |  |             |           | \$ 20  |

(a) American Water Capital Corp., which is a wholly owned subsidiary of the Company, has a support agreement with the Company that, under certain circumstances, is the functional equivalent of a guarantee. This indebtedness is considered “debt” for purposes of this support agreement.

The Company has four forward starting swap agreements with an aggregate notional amount of \$300 to reduce interest rate exposure on debt expected to be issued in 2017. The forward starting swap agreements terminate in December 2017 and have an average fixed rate of 2.20%. The Company has designated the forward starting swap agreements as cash flow hedges and the initial fair value, in addition to any subsequent changes in fair value, are recognized in accumulated other comprehensive loss. Upon termination, the cumulative gain or loss recorded in accumulated other comprehensive loss will be amortized through interest, net over the term of the issued debt.

The Company has an interest rate swap to hedge \$100 of its 6.085% fixed-rate debt maturing in 2017. The Company pays variable interest of six-month LIBOR plus 3.422% and the interest rate swap matures with the fixed-rate debt in 2017. The Company has designated the interest rate swap as a fair value hedge accounted for at fair value with gains or losses, as well as the offsetting gains or losses on the hedged item, recognized in interest, net. The net loss recognized by the Company was \$1 for the three and nine months ended September 30, 2016 and 2015.

The Company has employed interest rate swaps to fix the interest cost on a portion of its variable-rate debt with an aggregate notional amount of \$8. The Company has designated these instruments as economic hedges accounted for at fair value with gains or losses recognized in interest, net. The gain recognized by the Company was de minimis for the three and nine months ended September 30, 2016 and 2015.

No ineffectiveness was recognized for the three and nine months ended September 30, 2016 and 2015 related to hedging instruments.

The following table provides a summary of the gross fair value for the Company’s derivative asset and liabilities, as well as the location of the asset and liability balances in the Consolidated Balance Sheets:

| Derivative Instruments | Derivative Designation | Balance Sheet Classification | September 30, 2016 | December 31, 2015 |
|------------------------|------------------------|------------------------------|--------------------|-------------------|
| Asset Derivative       |                        |                              |                    |                   |
| Interest rate swap     | Fair value hedge       | Other long-term assets       | \$ 1               | \$ 2              |

## Liability Derivatives

|                        |                                 |                             |       |      |
|------------------------|---------------------------------|-----------------------------|-------|------|
| Forward starting swaps | Cash flow hedge                 | Other long-term liabilities | \$ 25 | \$ — |
| Interest rate swap     | Economic hedge (non-designated) | Other long-term liabilities | 1     | 1    |

## Note 7: Income Taxes

During the third quarter the Company reduced its gross liability for unrecognized tax benefits by \$68 related to the Company's change in tax accounting method for repair and maintenance costs on its utility plant. This change had no impact on the Company's estimated effective tax rate. Previously established tax positions were netted with net operating losses.

Note 8: Pension and Other Postretirement Benefits

On July 31, 2016, the other postretirement benefit plan was remeasured to reflect an announced plan amendment, which capped benefits for certain non-union plan participants. The remeasurement included a \$156 reduction in future benefits payable to plan participants, \$60 increase in the fair value of plan assets and \$127 increase in actuarial losses, which resulted in a \$89 reduction to the net accrued postretirement benefit obligation. The plan amendment will be amortized over 10.02 years, the average future working lifetime to full eligibility age for all plan participants. The following table provides the significant assumptions related to the Company's other postretirement benefit plan:

|  | September<br>30, 2016  | December<br>31, 2015                                       |
|--|--|--|
| Weighted-average assumptions used to determine benefit obligations |  |  |
| Discount rate  | 3.66%  | 4.67%  |
| Expected return on plan assets                                     | 5.37%  | 5.20%  |
| Medical trend  | 6.50% in<br>2016 and<br>graded<br>from<br>7.00% in<br>2017 to<br>5.00% in<br>2021+ | graded<br>from<br>6.50% in<br>2015 to<br>5.00% in<br>2021+ |

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

|   | For the<br>Three<br>Months<br>Ended |                          | For the<br>Nine<br>Months<br>Ended |                          |
|---|-------------------------------------|--------------------------|------------------------------------|--------------------------|
|   | September<br>30,<br>2016            | September<br>30,<br>2015 | September<br>30,<br>2016           | September<br>30,<br>2015 |
| Components of net periodic pension benefit cost         |                                     |                          |                                    |                          |
| Service cost  | \$8                                 | \$9                      | \$24                               | \$28                     |
| Interest cost   | 20                                  | 19                       | 60                                 | 56                       |
| Expected return on plan assets                          | (24)                                | (24)                     | (72)                               | (73)                     |
| Amortization of actuarial loss                          | 7                                   | 6                        | 21                                 | 19                       |
| Net periodic pension benefit cost                       | \$11                                | \$10                     | \$33                               | \$30                     |
| Components of net periodic other postretirement benefit |                                     |                          |                                    |                          |
| cost  |                                     |                          |                                    |                          |
| Service cost  | \$3                                 | \$3                      | \$9                                | \$10                     |

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|  |      |      |      |      |
|--|------|------|------|------|
| Interest cost                                  | 7    | 7    | 22   | 22   |
| Expected return on plan assets                 | (7 ) | (6 ) | (20) | (19) |
| Amortization of prior service credit           | (3 ) | —    | (4 ) | (1 ) |
| Amortization of actuarial loss                 | 1    | 1    | 3    | 4    |
| Net periodic other postretirement benefit cost | \$1  | \$5  | \$10 | \$16 |

The Company contributed \$25 to its defined benefit pension plans in the first nine months of 2016 and expects to contribute \$8 during the remainder of 2016. In addition, the Company contributed \$17 for the funding of its other postretirement plans in the first nine months of 2016 and does not expect to make any additional contributions during the remainder of 2016.

Note 9: Commitments and Contingencies

Commitments

On March 29, 2016, Pennsylvania-American Water Company (“PAWC”) entered into an asset purchase agreement with the Sewer Authority of the City of Scranton (“SSA”) to acquire substantially all of the wastewater collection and treatment system assets of the SSA’s system for a total stated purchase price of \$195, which includes approximately \$38 in assumed cash to be transferred at closing. The SSA is currently subject to a consent decree with the U.S. Environmental Protection Agency (“EPA”) and the Pennsylvania Department of Environmental Protection (“PaDEP”), which requires the SSA to complete significant upgrades to its sewer system at an estimated cost of \$140. As a part of the purchase, PAWC will be required to cause the consent decree to be amended to allow it to assume the obligations and liabilities of the SSA thereunder. The Pennsylvania Public Utility Commission approved the acquisition on October 6, 2016 and will determine recovery of the investment and the related ratemaking treatment in PAWC’s next general rate case proceeding. The amendment of the consent decree is subject to the consent of the EPA, PaDEP, the U.S. Department of Justice and the U.S. District Court for the Middle District of Pennsylvania. The Company is working to close this transaction in the fourth quarter of 2016.

## Contingencies

The Company is routinely involved in legal actions in the normal conduct of its business. As of September 30, 2016, the Company has accrued approximately \$136 of probable loss contingencies and has estimated that the maximum amount of losses associated with reasonably possible loss contingencies is \$48. For certain matters, the Company is unable to estimate possible losses.

### West Virginia Elk River Freedom Industries Chemical Spill

#### Background

On January 9, 2014, a chemical storage tank owned by Freedom Industries, Inc. leaked two substances, 4-methylcyclohexane methanol, or MCHM, and PPH/DiPPH, a mix of polyglycol ethers, into the Elk River near the West Virginia-American Water Company (“WVAWC”) Kanawha Valley Treatment Plant (“KVTP”) intake in Charleston, West Virginia. After having been alerted to the leak of MCHM by the West Virginia Department of Environmental Protection, WVAWC took immediate steps to gather more information about MCHM, augment its treatment process as a precaution, and begin consultations with federal, state and local public health officials. As soon as possible after it was determined that the augmented treatment process would not fully remove the MCHM, a joint decision was reached in consultation with the West Virginia Bureau for Public Health to issue a “Do Not Use” order for all of its approximately 93,000 customer accounts in parts of nine West Virginia counties served by the KVTP. The order addressed the use of water for drinking, cooking, washing and bathing, but did not affect continued use of water for sanitation and fire protection. Over the next several days, WVAWC and an interagency team of state and federal officials engaged in extensive sampling and testing to determine if levels of MCHM were below one part per million (1 ppm), a level that the U.S. Centers for Disease Control and Prevention (“CDC”) and the EPA indicated would be protective of public health. Beginning on January 13, 2014, based on the results of the continued testing, the Do Not Use order was lifted in stages to help ensure the water system was not overwhelmed by excessive demand, which could have caused additional water quality and service issues. By January 18, 2014, none of WVAWC’s customers were subject to the Do Not Use order, although CDC guidance suggesting that pregnant women avoid consuming the water until the chemicals were at non-detectable levels remained in place. In addition, based on saved samples taken on or before January 18, 2014, PPH/DiPPH was no longer detected in the water supply as of January 18, 2014. On February 21, 2014, WVAWC announced that all points of testing throughout its water distribution system indicated that levels of MCHM were below 10 parts per billion (10 ppb). The interagency team established 10 ppb as the “non-detect” level of MCHM in the water distribution system based on the measurement capabilities of the multiple laboratories used. WVAWC continued to work with laboratories to test down to below 2 ppb of MCHM and announced on March 3, 2014, that it had cleared the system to below this level.

To date, there are 73 pending cases against WVAWC with respect to this matter in the U.S. District Court for the Southern District of West Virginia or West Virginia Circuit Courts in Kanawha, Boone and Putnam counties. Fifty-three of the state court cases naming WVAWC, and one case naming both WVAWC and American Water Works Service Company, Inc. (“AWWSC,” and together with WVAWC and the Company, the “American Water Defendants”) were removed to the United States District Court for the Southern District of West Virginia. On December 17, 2015, the federal district court entered orders remanding 52 of the previously removed cases back to the West Virginia Circuit Courts for further proceedings (two of the previously removed cases had been dismissed in the interim). Following that order, seven additional cases were filed against WVAWC in West Virginia Circuit Courts in Kanawha and Putnam counties with respect to this matter, and, as discussed below, on September 16, 2016, four new individual complaints were filed against WVAWC in West Virginia Circuit Court in Kanawha County.

Additionally, investigations with respect to the matter have been initiated by, among other agencies, the U.S. Attorney’s Office for the Southern District of West Virginia, the West Virginia Attorney General, and the Public



Service Commission of West Virginia (the “PSC”). As a result of the U.S. Attorney’s Office investigation, Freedom Industries and six former Freedom Industries employees (three of whom also were former owners of Freedom Industries) pled guilty to violations of the federal Clean Water Act.

The Company believes that the causes of action asserted against the American Water Defendants in these cases are without merit. A summary of the proceedings associated with the Freedom chemical spill is set forth below.

#### Federal Court Litigation

Four of the cases pending before the federal district court were consolidated for purposes of discovery, and an amended consolidated class action complaint for those cases (the “Federal action”) was filed on December 9, 2014 by several plaintiffs who allegedly suffered economic losses, loss of use of property and tap water or other specified adverse consequences as a result of the Freedom Industries chemical spill, on behalf of a purported class of all persons and businesses supplied with, using, or exposed to water contaminated with crude MCHM and provided by WVAWC in Logan, Clay, Lincoln, Roane, Jackson, Boone, Putnam, and Kanawha Counties and the Culloden area of Cabell County, West Virginia as of January 9, 2014. The amended consolidated complaint names several individuals and corporate entities as defendants, including the American Water Defendants.

The plaintiffs seek unspecified damages for alleged business or economic losses; unspecified damages or a mechanism for recovery to address a variety of alleged costs, loss of use of property, personal injury and other consequences allegedly suffered by purported class members; punitive damages and certain additional relief, including the establishment of a medical monitoring program to protect the purported class members from an alleged increased risk of contracting serious latent disease.

On April 9, 2015, the court in the Federal action denied a motion to dismiss all claims against the Company for lack of personal jurisdiction. A separate motion to dismiss filed by AWWSC and WVAWC (and joined by the Company) asserting various legal defenses in the Federal action was resolved by the court on June 3, 2015. The court dismissed three causes of action but denied the motion to dismiss with respect to the remaining causes of actions and allowed the plaintiffs to continue to pursue the various claims for damages alleged in their amended consolidated complaint.

On July 6, 2015, the plaintiffs in the Federal action filed a motion seeking certification of a class defined to include persons who resided in dwellings served by the KVTP on January 9, 2014, persons who owned businesses served by the KVTP on January 9, 2014, and hourly employees who worked for such businesses. The plaintiffs sought a class-wide determination of liability against the American Water Defendants, among others, and of damages to the three groups of plaintiffs as a result of the “Do Not Use” order issued after the Freedom Industries chemical spill.

On October 8, 2015, the court in the Federal action granted in part and denied in part the plaintiffs’ class certification motion. The court certified a class addressing the alleged fault of Eastman Chemical Company, the manufacturer of MCHM, for tort claims and the alleged fault of the American Water Defendants for tort and breach of contract claims, as well as the comparative fault of Freedom Industries. However, the court granted the joint motion by defendants to exclude certain expert testimony, disallowing the testimony of plaintiffs’ economic damages experts, and denied class certification as to any damages, including punitive damages. Thus, determination or quantification of damages, if any, would be made in subsequent proceedings on an individual basis.

On December 17, 2015, the court in the Federal action originally entered a scheduling order that provided for the trial on class issues to begin in July 2016. During the first week of January 2016, three additional cases were filed against one or more of the American Water Defendants, as well as others, in the U.S. District Court for the Southern District of West Virginia with respect to this matter. On March 25, 2016, the court in the Federal action entered an order extending the schedule for events through briefing related to dispositive motions and expert challenges and noting that further events in the case would be set by additional orders to be issued by the court in due course. On May 10, 2016, each of the parties in the Federal action filed motions for summary judgment and motions to exclude experts, followed by responses on June 3, 2016 and final reply memoranda on June 16, 2016. On July 7, 2016, the court in the Federal action rescheduled the trial to begin on October 25, 2016, but the court delayed the start of the trial pending ongoing settlement negotiations between the parties, and has since granted a continuance of the trial until December 5, 2016. See “ – WVAWC Binding Global Agreement in Principle to Settle Claims” below.

Court-directed mediations were held at the end of September 2015 and June 2016 with the assistance of private mediators. Representatives of the American Water Defendants, Eastman Chemical, and the plaintiffs in both the Federal action and the state actions, as well as insurance carriers for certain of the defendants, participated in these mediation sessions. No resolution was reached.

On September 26, 2016, the court in the Federal action granted the Company’s motion for summary judgment and its renewed motion to dismiss all claims against it for lack of personal jurisdiction. The court in the Federal action examined the factual claims asserted by the plaintiffs and held that the plaintiffs failed to provide any evidence that the Company committed a tortious act in connection with the Freedom Industries chemical spill. Also, the court in the Federal action held that it had no personal jurisdiction over the Company, since there was no evidence of a tortious act, and the relationship between the Company and WVAWC was that of a typical parent and subsidiary. As a result

of this decision, the Company is no longer a defendant in the Federal action, although the plaintiffs' claims against AWWSC and WVAWC remain.

On September 27, 2016, the court in the Federal action denied competing motions filed by the plaintiffs and WVAWC for summary judgment on the plaintiffs' breach of contract claims against WVAWC. The court in the Federal action stated that the implementation of the Do Not Use order and the delivery of water containing MCHM subject to such an order constituted a breach of WVAWC's contract with customers. However, the court denied the plaintiffs' motion for summary judgment because the court identified genuine issues of fact to be decided by a jury with respect to WVAWC's assertion that its contractual performance was impracticable due to the lack of available information as to the contaminants in the water after the Freedom Industries chemical spill, the unexpected nature of Freedom Industries' criminal negligence and the resulting contamination of the water supply, and WVAWC's lack of fault for Freedom Industries' actions in causing the chemical spill.

On October 6, 2016, the court in the Federal action granted the American Water Defendants' motion for summary judgment related to the members of the class comprised of hourly employees who worked for businesses served by the KVTP on January 9, 2014. The court stated that these class members, who were not customers of WVAWC, did not have a "sufficiently close nexus" to WVAWC to give rise to a "special relationship" that would allow them to recover lost wages absent physical injury or property damage. This ruling does not impact the remaining class members.

On October 25, 2016, the court in the Federal action dismissed all claims against AWWSC, leaving WVAWC as the remaining American Water Defendant in the lawsuit.

#### West Virginia State Court Litigation

On January 28, 2016, all of the then-filed state court cases were referred to West Virginia's Mass Litigation Panel for further proceedings. On June 6, 2016, plaintiffs filed a second amended consolidated class action complaint. The second amended consolidated class action complaint names only WVAWC as a defendant and alleges claims of, among other things, negligence, public and private nuisance, trespass, strict liability for abnormally dangerous activity, breach of contract, breach of statutory implied warranty, violation of the West Virginia Consumer Credit Protection Act, strict liability for failure to warn, negligent infliction of emotional distress, medical monitoring and punitive damages. On July 6, 2016, the defendants filed an answer in response to these claims. On July 25, 2016, plaintiffs filed a class certification motion seeking certification for liability and damage classes, including businesses and residents who were customers of the KVTP on January 9, 2014, all West Virginia persons who suffered wage loss as a result of the Freedom Industries chemical spill and personal injury and medical monitoring for West Virginia residents within the affected counties that were exposed to contaminated water as a result of the chemical spill.

On September 14, 2016, WVAWC filed a motion to dismiss the second amended consolidated class action complaint. On September 16, 2016, four new individual complaints were filed in West Virginia Circuit Court in Kanawha County stating the same claims as in the second amended consolidated class action complaint but also seeking a judicial determination as to whether the American Water Defendants and Eastman Chemical have insurance coverage under their respective policies for the claims asserted in the complaints. Plaintiffs have also sought to transfer these complaints to the Mass Litigation Panel. The complaints include as defendants all of the insurance carriers identified by Eastman Chemical and the American Water Defendants. West Virginia law generally permits plaintiffs in civil litigation to seek a determination as to whether insurance coverage exists for claims prior to trial on the merits. The American Water Defendants are currently analyzing and considering their responses to the allegations and claims raised in these four complaints.

#### WVAWC Binding Global Agreement in Principle to Settle Claims

On October 31, 2016, the court in the Federal action approved the preliminary principles, terms and conditions of an agreed-upon settlement of claims (the "Settlement") among the American Water Defendants, and all class members, putative class members, claimants and potential claimants (collectively, the "Plaintiffs"), arising out of the Freedom Industries chemical spill. The terms of the Settlement propose a global federal and state resolution of all litigation and potential claims against the American Water Defendants and their insurers. A claimant may elect to opt out of any final settlement agreement, in which case such claimant will not receive any benefit from or be bound by the terms of the Settlement. Under the terms and conditions of the Settlement and any subsequent final settlement agreement, the American Water Defendants have not admitted, and will not admit, any fault or liability for any of the allegations made by the Plaintiffs in any of the actions to be resolved.

The proposed aggregate pre-tax amount of the Settlement is \$126, of which \$65 would be paid by WVAWC, and the remainder would be paid by certain of the Company's general liability insurance carriers. The Company has general liability insurance under a series of policies underwritten by a number of individual carriers. Two of these insurance

carriers, which provide an aggregate of \$50 in insurance coverage to the Company under these policies, were requested, but presently have not agreed, to participate in the Settlement. The Company and WVAWC intend to vigorously pursue their rights to insurance coverage from these non-participating carriers for any losses to be paid by WVAWC in the Settlement. In this regard, WVAWC has filed a lawsuit against one of these carriers alleging that the carrier's failure to agree to participate in the Settlement constitutes a breach of contract, and the Company will pursue mandatory arbitration against the other non-participating carrier.

As a result of these events, WVAWC has determined that a loss contingency with respect to this matter is probable and in the third quarter of 2016 recorded a charge to earnings of \$65 (\$39 after-tax), comprised of the aggregate pre-tax settlement amount of \$126, net of insurance receivables of \$61. Furthermore, under the terms of the Settlement, WVAWC has agreed that it will not seek rate recovery from the Public Service Commission of West Virginia for approximately \$4 in direct response costs expensed in 2014 by WVAWC relating to the Freedom Industries chemical spill as well as for amounts that may be paid by WVAWC under the Settlement.

The preliminary terms of the Settlement intend to establish a two-tier settlement fund for the payment of claims, comprised of (i) a guaranteed fund of \$76, of which \$51 will be contributed by WVAWC, including insurance deductibles, and \$25 would be contributed by one of the Company's general liability insurance carriers, and (ii) a claims-based payment fund of up to \$50, of which up to \$14 would be contributed by WVAWC and \$36 would be contributed by a number of the Company's general liability insurance carriers. Separately, \$25 would be contributed to the guaranteed fund through a settlement by another defendant to the Settlement.

The Company's insurance policies operate under a layered structure where coverage is generally provided in the upper layers after claims have exhausted lower layers of coverage. The \$36 contributed by a number of the Company's general liability insurance carriers to the claims-based fund, as noted above, were from higher layers of the insurance structure than the two insurance carriers that were requested, but presently have not agreed, to participate in the Settlement. Any recovery by WVAWC or the Company from the non-participating carriers would reimburse WVAWC for its contributions to the guaranteed fund.

The court in the Federal action has given the parties 30 days to finalize, and obtain the court's preliminary approval of, the terms of the Settlement. As a result, the court in the Federal action has ordered a continuance of the trial date to December 5, 2016. If preliminary approval of the Settlement is obtained, notice of the terms of the Settlement would then be provided to members of the settlement class. Following the notice period, the court in the Federal action would hold a fairness hearing to consider final approval of the Settlement.

#### PSC General Investigation

On May 21, 2014, the PSC issued an Order initiating a General Investigation into certain matters relating to WVAWC's response to the Freedom Industries chemical spill. Three parties have intervened in the proceeding, including the Consumer Advocate Division of the PSC and two attorney-sponsored groups, including one sponsored by some of the plaintiffs' counsel involved in the civil litigation described above. WVAWC has filed testimony regarding its response to the Freedom Industries chemical spill and is subject to discovery from PSC staff and the intervenors as part of the General Investigation. Several disputes have arisen between WVAWC and the intervenors regarding, among other things, the scope of the discovery and the maintenance of confidentiality with regard to certain WVAWC emergency planning documents. In addition, the intervenors and PSC staff filed expert testimony in support of their assertions that WVAWC did not act reasonably with respect to the Freedom Industries chemical spill, and WVAWC has asserted that some of the testimony is outside the scope of the PSC proceeding. On May 23, 2016, the PSC entered an order setting a procedural schedule and ruling on outstanding motions related to discovery and the scope of testimony. On October 13, 2016, the PSC entered an order continuing the General Investigation hearings until December 2016. On October 18, 2016, an intervening party in the case requested, with no parties objecting, that the hearings be further continued until the first quarter of 2017.

#### Missouri Infrastructure System Replacement Surcharge Litigation

On March 8, 2016, the Western District of the Missouri Court of Appeals ruled that the Missouri Public Service Commission ("MoPSC") did not have statutory authority to issue an order in June 2015 approving an infrastructure system replacement surcharge ("ISRS") for Missouri-American Water Company ("MAWC"), a wholly owned subsidiary of the Company. The court held that the MoPSC's June 2015 order authorizing the ISRS increase was invalid because St. Louis County did not have a population of at least one million residents, as required by the statute. MAWC believes that the MoPSC's June 2015 order authorizing the collection of ISRS revenues was lawful and will continue to challenge the ruling of the Court of Appeals. On June 28, 2016, the Missouri Supreme Court granted MAWC's application to transfer the case from the Court of Appeals to the Missouri Supreme Court, and as a result of that order, the March 8, 2016 ruling of the Court of Appeals has been vacated. Oral argument in this case was heard on November 1, 2016. As of September 30, 2016, the Company has determined the range of reasonably possible loss

associated with this matter to be zero to \$26.

Other than as described in the “Contingencies” subsection of this Note 9, the Company believes that damages or settlements to be paid by the Company, if any, in claims or actions will not, individually or in the aggregate, have a material adverse effect on the Company.

## Note 10: Earnings per Common Share

The following is a reconciliation of the numerator and denominator for basic and diluted earnings per share (“EPS”) calculations:

|  | For the<br>Three<br>Months<br>Ended |        | For the<br>Nine<br>Months<br>Ended |        |
|--|-------------------------------------|--------|------------------------------------|--------|
|  | September<br>30,                    |        | September<br>30,                   |        |
|  | 2016                                | 2015   | 2016                               | 2015   |
| <b>Numerator</b>                                   |                                     |        |                                    |        |
| Net income attributable to common stockholders     | \$ 148                              | \$ 174 | \$ 367                             | \$ 377 |
| <b>Denominator</b>                                 |                                     |        |                                    |        |
| Weighted-average common shares outstanding—Basic   | 178                                 | 179    | 178                                | 179    |
| Effect of dilutive common stock equivalents        | —                                   | 1      | 1                                  | 1      |
| Weighted-average common shares outstanding—Diluted | 178                                 | 180    | 179                                | 180    |

The effect of dilutive common stock equivalents is related to the RSUs and non-qualified stock options granted under the 2007 Plan, and shares purchased under the Company’s Nonqualified Employee Stock Purchase Plan.

## Note 11: Fair Value of Financial Assets and Liabilities

## Fair Value of Financial Instruments

The Company used the following methods and assumptions to estimate its fair value disclosures for financial instruments:

**Current assets and current liabilities**—The carrying amounts reported in the accompanying Consolidated Balance Sheets for current assets and current liabilities, including revolving credit debt, due to the short-term maturities and variable interest rates, 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 portion 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: (i) an average of the Company's own publicly-traded debt securities and (ii) the current market rates for U.S. Utility A 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 of the debt securities including call features, coupon tax treatment and collateral for the Level 3 instruments.

The carrying amounts, including fair value adjustments previously recognized in acquisition purchase accounting and a fair value adjustment related to the Company's interest rate swap fair value hedge (which is classified as Level 2 in the fair value hierarchy), and fair values of the financial instruments were as follows:

|  | Carrying<br>Amount | At Fair Value as of September 30,<br>2016 |            |            | Total |
|--|--------------------|---|------------|------------|-------|
|  |                    | Level<br>1                                | Level<br>2 | Level<br>3 |       |
| Preferred stock with mandatory redemption requirements | \$ 12              | \$—                                       | \$—        | \$ 18      | \$ 18 |
| Long-term debt (excluding capital lease obligations)   | 5,893              | 3,609                                     | 1,441      | 1,978      | 7,028 |

  

|  | Carrying<br>Amount | At Fair Value as of December 31,<br>2015 |            |            | Total |
|--|--------------------|--|------------|------------|-------|
|  |                    | Level<br>1                               | Level<br>2 | Level<br>3 |       |
| Preferred stock with mandatory redemption requirements | \$ 13              | \$—                                      | \$—        | \$ 18      | \$ 18 |
| Long-term debt (excluding capital lease obligations)   | 5,914              | 3,397                                    | 1,419      | 1,941      | 6,757 |

## Recurring Fair Value Measurements

The following table presents assets and liabilities measured and recorded at fair value on a recurring basis and their level in the fair value hierarchy:

|                                       | At Fair Value as of<br>September 30, 2016 |               |            | Total       |
|---------------------------------------|---|---------------|------------|-------------|
|                                       | Level<br>1                                | Level<br>2    | Level<br>3 |             |
| <b>Assets:</b>                        |   |               |            |             |
| Restricted funds                      | \$28                                      | \$—           | \$—        | \$28        |
| Rabbi trust investments               | 13  | —             | —          | 13          |
| Deposits                              | 4   | —             | —          | 4           |
| Mark-to-market derivative asset       | —   | 1             | —          | 1           |
| Other investments                     | 4   | —             | —          | 4           |
| <b>Total assets</b>                   | <b>49</b>                                 | <b>1</b>      | <b>—</b>   | <b>50</b>   |
| <b>Liabilities:</b>                   |   |               |            |             |
| Deferred compensation obligation      | 13  | —             | —          | 13          |
| Mark-to-market derivative liabilities | —   | 26            | —          | 26          |
| <b>Total liabilities</b>              | <b>13</b>                                 | <b>26</b>     | <b>—</b>   | <b>39</b>   |
| <b>Total net assets (liabilities)</b> | <b>\$36</b>                               | <b>\$(25)</b> | <b>\$—</b> | <b>\$11</b> |

|                                     | At Fair Value as of<br>December 31, 2015 |            |            | Total       |
|-------------------------------------|--|------------|------------|-------------|
|                                     | Level<br>1                               | Level<br>2 | Level<br>3 |             |
| <b>Assets:</b>                      |  |            |            |             |
| Restricted funds                    | \$27                                     | \$—        | \$—        | \$27        |
| Rabbi trust investments             | 12                                       | —          | —          | 12          |
| Deposits                            | 1  | —          | —          | 1           |
| Mark-to-market derivative asset     | —  | 2          | —          | 2           |
| Other investments                   | 4  | —          | —          | 4           |
| <b>Total assets</b>                 | <b>44</b>                                | <b>2</b>   | <b>—</b>   | <b>46</b>   |
| <b>Liabilities:</b>                 |  |            |            |             |
| Deferred compensation obligation    | 11                                       | —          | —          | 11          |
| Mark-to-market derivative liability | —  | 1          | —          | 1           |
| <b>Total liabilities</b>            | <b>11</b>                                | <b>1</b>   | <b>—</b>   | <b>12</b>   |
| <b>Total net assets</b>             | <b>\$33</b>                              | <b>\$1</b> | <b>\$—</b> | <b>\$34</b> |

Restricted funds—The Company's restricted funds primarily represent proceeds received from financings for the construction and capital improvement of facilities and from customers for future services under operations and maintenance projects. The proceeds of these financings are held in escrow until the designated expenditures are incurred. Long-term restricted funds of \$4 were included in other long-term assets as of September 30, 2016 and

December 31, 2015.

Rabbi trust investments—The Company's rabbi trust investments consist primarily of equity and fixed income indexed funds from which supplemental executive retirement plan benefits and deferred compensation obligations can be paid. The Company includes these assets in other long-term assets.

Deposits—Deposits include escrow funds and certain other deposits held in trust. The Company includes cash deposits in other current assets.

Deferred compensation obligations—The Company's deferred compensation plans allow participants to defer certain cash compensation into notional investment accounts. The Company includes such plans in other long-term liabilities. The value of the Company's deferred compensation obligations is based on the market value of the participants' notional investment accounts. The notional investments are comprised primarily of mutual funds, which are based on observable market prices.

21

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Mark-to-market derivative asset and liability—The Company utilizes fixed-to-floating interest-rate swaps, typically designated as fair-value hedges, to achieve a level of variable-rate debt as a percentage of total debt. The Company also employs derivative financial instruments in the form of variable-to-fixed interest rate swaps and forward starting interest rate swaps, classified as economic hedges and cash flow hedges, respectively, in order to fix the interest cost on existing or forecasted debt. The Company uses a calculation of future cash inflows and estimated future outflows, which are discounted, to determine the current fair value. Additional inputs to the present value calculation include the contract terms, counterparty credit risk, interest rates and market volatility. The Company includes the mark-to-market derivative assets and liability in other long-term assets and other long-term liabilities, respectively.

Other investments—Other investments primarily represent money market funds used for active employee benefits. The Company includes other investments in other current assets.

#### Note 12: Segment Information

The Company operates its businesses primarily through one reportable segment, the Regulated Businesses segment. The Company also operates businesses that provide a broad range of related and complementary water and wastewater services in non-regulated markets, which includes four operating segments that individually do not meet the criteria of a reportable segment. These four non-reportable operating segments are collectively presented as our “Market-Based Businesses”. “Other” includes corporate costs that are not allocated to the Company’s operating segments, eliminations of inter-segment transactions, fair value adjustments and associated income and deductions related to acquisitions that have not been allocated to the operating segments for evaluation of performance and allocation of resource purposes. The following tables include the Company’s summarized segment information:

|   | As of or for the Three Months Ended September 30, 2016 |            |              |              |
|---|--|------------|--------------|--------------|
|   | Regulated  |            | Market-Based |              |
|   | Businesses   | Businesses | Other        | Consolidated |
| Operating revenues                                    | \$826  | \$ 109     | \$(5 )       | \$ 930       |
| Depreciation and amortization                         | 111  | 4          | 4            | 119          |
| Total operating expenses, net                         | 521  | 98         | (8 )         | 611          |
| Interest, net   | (64 )  | —          | (17 )        | (81 )        |
| Income from continuing operations before income taxes | 246  | 12         | (15 )        | 243          |
| Provision for income taxes                            | 94   | 5          | (4 )         | 95           |
| Net income attributable to common stockholders        | 152  | 7          | (11 )        | 148          |
| Total assets  | 16,020   | 545        | 1,406        | 17,971       |

As of or for the Three Months Ended September 30, 2015

Regulated Market-Based

|  | Businesses | Businesses | Other | Consolidated |
|--|------------|------------|-------|--------------|
|--|------------|------------|-------|--------------|

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|   |        |        |        |        |
|---|--------|--------|--------|--------|
| Operating revenues                                    | \$781  | \$ 121 | \$(6 ) | \$ 896 |
| Depreciation and amortization                         | 104    | 2      | 5      | 111    |
| Total operating expenses, net                         | 439    | 101    | (5 )   | 535    |
| Interest, net   | (63 )  | —      | (14 )  | (77 )  |
| Income from continuing operations before income taxes | 283    | 20     | (16 )  | 287    |
| Provision for income taxes                            | 109    | 8      | (4 )   | 113    |
| Net income attributable to common stockholders        | 174    | 12     | (12 )  | 174    |
| Total assets (a)                                      | 15,091 | 498    | 1,396  | 16,985 |

As of or for the Nine Months Ended September  
30, 2016

Regulated Market-Based

|   | Businesses | Businesses | Other   | Consolidated |
|---|------------|------------|---------|--------------|
| Operating revenues                                    | \$2,176    | \$ 338     | \$(14 ) | \$ 2,500     |
| Depreciation and amortization                         | 328        | 11         | 11      | 350          |
| Total operating expenses, net                         | 1,385      | 300        | (17 )   | 1,668        |
| Interest, net   | (191 )     | 1          | (52 )   | (242 )       |
| Income from continuing operations before income taxes | 610        | 44         | (50 )   | 604          |
| Provision for income taxes                            | 236        | 18         | (17 )   | 237          |
| Net income attributable to common stockholders        | 374        | 26         | (33 )   | 367          |
| Total assets  | 16,020     | 545        | 1,406   | 17,971       |

As of or for the Nine Months Ended September  
30, 2015

Regulated Market-Based

|   | Businesses | Businesses | Other   | Consolidated |
|---|------------|------------|---------|--------------|
| Operating revenues                                    | \$2,083    | \$ 308     | \$(15 ) | \$ 2,376     |
| Depreciation and amortization                         | 306        | 4          | 17      | 327          |
| Total operating expenses, net                         | 1,291      | 260        | (18 )   | 1,533        |
| Interest, net   | (185 )     | 1          | (44 )   | (228 )       |
| Income from continuing operations before income taxes | 616        | 50         | (42 )   | 624          |
| Provision for income taxes                            | 239        | 19         | (11 )   | 247          |
| Net income attributable to common stockholders        | 377        | 31         | (31 )   | 377          |
| Total assets (a)                                      | 15,091     | 498        | 1,396   | 16,985       |

(a) The information has been revised to reflect the retrospective application of ASU 2015-15 Presentation of Debt Issuance Costs and ASU 2015-17 Income Taxes, which were early adopted in 2015.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read together with the unaudited consolidated financial statements and the notes thereto included elsewhere in this Form 10-Q. This discussion contains forward-looking statements that are based on management's current expectations, estimates and projections about our business, operations and financial performance. The cautionary statements made in this Form 10-Q should be read as applying to all related forward-looking statements whenever they appear in this Form 10-Q. Our actual results may differ materially from those currently anticipated and expressed in such forward-looking statements as result of a number of factors, including those we discuss under "Forward Looking Statements," Part II, Item 1A—Risk Factors, and elsewhere in this Form 10-Q.

### General

American Water Works Company, Inc. ("American Water" or the "Company") is the largest and most geographically diverse investor-owned publicly-traded water and wastewater utility company in the United States, as measured both by operating revenue and population served. Our primary business involves the ownership of water and wastewater utilities that provide water and wastewater services to residential, commercial, industrial and other customers. Our utilities are generally subject to economic regulation by state regulatory agencies in the states in which they operate. We report the financial results of our utilities in our Regulated Businesses segment. We also provide other services through businesses that are not subject to economic regulation by state regulatory agencies. We present the results of these businesses as our "Market-Based Businesses". For further description of our businesses, see Part I, Item 1—Business in our Form 10-K.

You should read the following discussion in conjunction with our Consolidated Financial Statements and related Notes included elsewhere in this Form 10-Q and in our Form 10-K.

### Financial Results

Income attributable to common stockholders was \$148 million, or \$0.83 per diluted share for the third quarter of 2016, a decrease of 13.5%, over the same period in 2015. For the nine months ended September 30, 2016, income attributable to common stockholders was \$367 million, or \$2.05 per diluted share, a decrease of 1.9%, over the same period in 2015.

Included in both the quarter and year-to-date was an after-tax charge of \$39 million, or \$0.22 per diluted share. This after-tax charge resulted from the binding global agreement in principle as to settlement for claims arising out of the January 9, 2014 Freedom Industries, Inc. chemical spill, which was entered into on October 31, 2016. See Note 9—Commitments and Contingencies in the Notes to Consolidated Financial Statements included in Part I, Item 1—Consolidated Financial Statements and Part II, Item 1—Legal Proceedings in this Form 10-Q.

Excluding the impact from this binding global agreement, we continued to experience growth in our Regulated Businesses segment from additional authorized revenue from investment growth, acquisitions and organic growth, partially offset by lower net income in our Market-Based Businesses for both the quarter and year-to-date periods. The lower net income in the Market-Based Businesses was mainly from lower capital upgrade revenue in our Military Services Group compared to the prior year due to the completion of certain large projects in mid-2016 and reduced military base infrastructure budgets in 2016.

See "Comparison of Consolidated Results of Operations" and "Segment Results of Operations" below for further discussion on the consolidated results of operations, as well as our business segments.





## Focusing on Central Themes

For 2016, our focus continues to be anchored on our five central themes: 1) Safety, 2) Customers, 3) People, 4) Growth and 5) Technology and Operational Efficiency. We continue our focus on operating our business responsibly and managing our operating and capital costs in a manner that benefits our customers and produces long-term value for our stockholders. Additionally, we continue to execute on our ongoing strategy that ensures a safe workplace for our employees, emphasizes public safety for our customers and communities, and leverages our human resources, processes and technology innovation to make our business more effective and efficient. The progress that we have made in the first nine months of 2016 with respect to growth and improvement in our operational efficiency ratio is described below.

### Growth—Infrastructure improvements, acquisitions and strategic capital investments

During the first nine months of 2016, we made capital investments of approximately \$905 million, focused in two key areas:

\$876 million of which the majority was in our Regulated Businesses primarily to improve infrastructure; and \$29 million for acquisitions in our Regulated Businesses, which added approximately 7,600 water and wastewater customers.

For the full year of 2016, our total capital investment, including acquisitions, is expected to be in the range of \$1.4 billion to \$1.5 billion, most of which is allocated to improving infrastructure in our Regulated Businesses. Included in this range is the proposed acquisition by Pennsylvania-American Water Company (“PAWC”) of substantially all of the wastewater collection and treatment assets of the Sewer Authority of the City of Scranton (“SSA”). The SSA currently serves approximately 31,000 wastewater customers in the City of Scranton and Dunmore Borough, Pennsylvania. On October 6, 2016, the Pennsylvania Public Utility Commission (the “PaPUC”) approved the acquisition, and will determine recovery of the investment and related ratemaking treatment in PAWC’s next general rate case proceeding. Closing of the transaction remains subject the approvals of the U.S. Environmental Protection Agency, the Pennsylvania Department of Environmental Protection, the U.S. Department of Justice and the U.S. District Court for the Middle District of Pennsylvania. We are working to close this transaction in the fourth quarter of 2016.

On August 2, 2016, we agreed to acquire all of the capital stock of Shorelands Water Company (“Shorelands”) in exchange for an equivalent value of our common stock. The maximum number of shares of our common stock to be exchanged upon closing of this acquisition will be less than 500,000 and will be based upon the average price of our common stock. Shorelands currently provides water service to approximately 11,000 customers in Monmouth County, New Jersey. The closing of this acquisition is subject to the satisfaction of various conditions and compliance by the parties with certain covenants, including obtaining the approval of the New Jersey Board of Public Utilities. The Company is seeking to close the acquisition in the first half of 2017.

On September 9, 2016, PAWC signed an asset purchase agreement to acquire substantially all of the wastewater collection and treatment system assets of the Municipal Authority of the City of McKeesport, Pennsylvania for approximately \$156 million, subject to certain adjustments provided in the agreement. The closing of this acquisition is subject to the satisfaction of various conditions and covenants, including obtaining the approval of the PaPUC. In connection with the execution of the asset purchase agreement, PAWC made a \$5 million non-escrowed deposit to the seller and agreed to pay upon the seller’s request an additional \$2 million as a similar deposit, on or about January 2, 2017. The system currently represents approximately 22,000 wastewater customers. We are seeking to close this acquisition in the first quarter of 2017.

Technology & Operational Efficiency—Continuing Improvement in Adjusted O&M Efficiency Ratio for our Regulated Businesses

We continued to improve on our adjusted O&M efficiency ratio (a non-GAAP measure). Our adjusted O&M efficiency ratio for the twelve months ended September 30, 2016 was 34.9%, compared to 35.8% for the twelve months ended September 30, 2015. The improvement in the 2016 O&M efficiency ratio over this period was attributable to an increase in revenue and the timing of O&M expenses, as we expect higher O&M expenses in the fourth quarter of 2016.

We evaluate our operating performance using this measure because management believes it is a direct measure of the efficiency of our Regulated Businesses' operations. This information is intended to enhance an investor's overall understanding of our operating performance. The O&M efficiency ratio is not a GAAP financial measure and may not be comparable to other companies' operating measures and should not be used in place of the GAAP information provided elsewhere in this report.

Our adjusted O&M efficiency ratio is defined as our regulated O&M expense divided by regulated operating revenues, where both O&M expense and operating revenues were adjusted to eliminate purchased water expenses. Additionally, from the O&M expenses, we excluded the allocable portion of non-O&M support services expenses, mainly depreciation and general taxes that are reflected in the Regulated Businesses segment as O&M costs but for consolidated financial reporting purposes are categorized within other line items in the accompanying Consolidated Statement of Operations, as well as the impacts of the binding global agreement to settle the Freedom Industries chemical spill claims.

The following table provides the calculation and reconciliation that compares O&M and operating revenues, as determined in accordance with GAAP, to those amounts utilized in the calculation of our adjusted O&M efficiency ratio for the twelve months ended September 30, 2016 as compared to the same period in 2015.

| (In millions)  | For the Twelve Months Ended September 30, |          |
|--|---|----------|
|  | 2016                                      | 2015     |
| Total operation and maintenance expenses                             | \$ 1,511                                  | \$ 1,369 |
| Less:  |   |          |
| Operation and maintenance expenses—Market-Based Businesses           | 391                                       | 337      |
| Operation and maintenance expenses—Other                             | (42 )                                     | (53 )    |
| Total operation and maintenance expenses—Regulated Businesses        | 1,162                                     | 1,085    |
| Less:  |   |          |
| Regulated purchased water expenses                                   | 120                                       | 118      |
| Allocation of non-operation and maintenance expenses                 | 29  | 37       |
| Impacts of the binding global agreement in principle                 | 65  | —        |
| Adjusted operation and maintenance expenses—Regulated Businesses (a) | \$ 948                                    | \$ 930   |
| Total operating revenues   | \$ 3,283                                  | \$ 3,108 |
| Less:  |   |          |
| Operating revenues—Market-Based Businesses                           | 464                                       | 409      |
| Operating revenues—Other   | (17 )                                     | (19 )    |
| Total regulated operating revenues—Regulated Businesses              | 2,836                                     | 2,718    |
| Less:  | 120                                       | 118      |

Regulated purchased water  
revenues\*

|  |    |       |    |       |
|--|----|-------|----|-------|
| Adjusted operating<br>revenues—Regulated Businesses<br>(b) | \$ | 2,716 | \$ | 2,600 |
|--|----|-------|----|-------|

|   |      |   |      |   |
|---|------|---|------|---|
| Adjusted operation and<br>maintenance efficiency<br>ratio—Regulated Businesses<br>(a)/(b) | 34.9 | % | 35.8 | % |
|---|------|---|------|---|

\*Calculation assumes purchased water revenues approximate purchased water expenses.

## Regulatory Matters

The table below provides rate authorizations by state, which became effective during the three and nine months ended September 30, 2016. The table depicts annualized incremental revenues resulting from general rate cases, assuming a constant water sales volume, and infrastructure surcharge mechanisms that became effective during the periods:

| (In millions)                              | For the<br>Three Months Ended<br>September 30, 2016 | For the<br>Nine Months Ended<br>September 30, 2016 |
|--|---|--|
| <b>General rate cases by state:</b>        |   |  |
| Kentucky (August 28)                       | \$ 7  | \$ 7   |
| Missouri (July 20 & July 22)               | 5   | 5  |
| West Virginia (February 25)                | —   | 18   |
| California (January 1)                     | —   | 2  |
| Indiana (January 29)                       | —   | 2  |
| <b>Total general rate cases</b>            | <b>\$ 12</b>  | <b>\$ 34</b>                                       |
| <b>Infrastructure surcharges by state:</b> |   |  |
| Pennsylvania (January 1, April 1 & July 1) | \$ 6  | \$ 19  |
| Illinois (January 1 & August 1)            | 6   | 7  |
| New Jersey (June 1)                        | —   | 9  |
| Indiana (May 4)                            | —   | 3  |
| Tennessee (March 15)                       | —   | 2  |
| <b>Total infrastructure surcharges</b>     | <b>\$ 12</b>  | <b>\$ 40</b>                                       |

## Interim Rates Subject to Refund

On April 1, 2016, our Virginia subsidiary implemented interim rates under bond and subject to refund, resulting in additional annualized revenues of \$9 million.

On May 9, 2016, \$2 million in additional annualized revenues of the \$5 million requested in our Iowa rate case, which was filed in April 2016, were also put into effect as interim rates under bond and subject to refund.

## Pending and Filed Rate Cases

On July 1, 2016, our California subsidiary filed a general rate case requesting to increase revenues by \$51 million over three years. This increase includes additional annualized revenue of \$35 million, which is expected to become effective on January 1, 2018 as well as a step rate and attrition rate increase of \$8 million in both 2019 and 2020.

On October 14, 2016, our New Jersey subsidiary filed for an infrastructure surcharge requesting additional revenues of \$10 million.

As of November 2, 2016, including the California filing discussed above, we are awaiting final general rate case orders in five states, requesting additional annualized revenue of \$97 million. We are also awaiting approval from two states, including the New Jersey filing discussed above, for additional annualized surcharges of \$13 million. There is

no assurance that all or any portion of these requests will be granted.

Infrastructure Surcharge Effective After Quarter Close

Additional annualized revenue of \$9 million resulting from infrastructure surcharges in our Pennsylvania subsidiary became effective on October 1, 2016.

## Consolidated Results of Operations

| (In millions)                            | For the Three Months Ended September 30, |       |                             |        | For the Nine Months Ended September 30, |         |                             |        |
|--|--|-------|-----------------------------|--------|---|---------|-----------------------------|--------|
|  | 2016                                     | 2015  | Increase<br>(Decrease)<br>% |        | 2016                                    | 2015    | Increase<br>(Decrease)<br>% |        |
| Operating revenues                       | \$930                                    | \$896 | \$34                        | 3.8    | \$2,500                                 | \$2,376 | \$124                       | 5.2    |
| Operating expenses:                      |  |       |                             |        |   |         |                             |        |
| Operation and maintenance                | 432                                      | 364   | 68                          | 18.7   | 1,131                                   | 1,024   | 107                         | 10.4   |
| Depreciation and amortization            | 119                                      | 111   | 8                           | 7.2    | 350                                     | 327     | 23                          | 7.0    |
| General taxes                            | 65                                       | 60    | 5                           | 8.3    | 195                                     | 184     | 11                          | 6.0    |
| Gain on asset dispositions and purchases | (5 )                                     | —     | (5 )                        | —      | (8 )                                    | (2 )    | (6 )                        | 300.0  |
| Total operating expenses, net            | 611                                      | 535   | 76                          | 14.2   | 1,668                                   | 1,533   | 135                         | 8.8    |
| Operating income                         | 319                                      | 361   | (42)                        | (11.6) | 832                                     | 843     | (11)                        | (1.3 ) |
| Other income (expenses):                 |  |       |                             |        |   |         |                             |        |
| Interest, net                            | (81 )                                    | (77 ) | (4 )                        | 5.2    | (242 )                                  | (228 )  | (14 )                       | 6.1    |
| Other, net                               | 5  | 3     | 2                           | 66.7   | 14                                      | 9       | 5                           | 55.6   |
| Total other income (expenses)            | (76 )                                    | (74 ) | (2 )                        | 2.7    | (228 )                                  | (219 )  | (9 )                        | 4.1    |
| Income from continuing operations before |  |       |                             |        |   |         |                             |        |
| income taxes                             | 243                                      | 287   | (44)                        | (15.3) | 604                                     | 624     | (20)                        | (3.2 ) |
| Provision for income taxes               | 95                                       | 113   | (18)                        | (15.9) | 237                                     | 247     | (10)                        | (4.0 ) |
| Net income attributable to common        |  |       |                             |        |   |         |                             |        |
| stockholders                             | \$148                                    | \$174 | \$(26)                      | (14.9) | \$367                                   | \$377   | \$(10)                      | (2.7 ) |

## Comparison of Consolidated Results of Operations

Operating revenues. For the three months ended September 30, 2016, operating revenues increased primarily due to a:

\$45 million increase in our Regulated Businesses segment primarily due to authorized rate increases to fund investment growth, acquisitions and organic growth when compared to the same period in 2015; and \$12 million decrease in our Market-Based Businesses primarily due to lower revenue from capital upgrade projects in our Military Services Group due to the completion of certain large projects in mid-2016 and reduced military base infrastructure budgets in 2016. Partially offsetting this decrease were incremental revenues from our Homeowner Services and Contract Operations Groups.

For the nine months ended September 30, 2016, operating revenues increased primarily due to a:

\$93 million increase in our Regulated Businesses segment due to authorized rate increases to fund investment growth, acquisitions, organic growth and incremental revenues from surcharges and balancing accounts when compared to the same period in 2015; and \$30 million increase in our Market-Based Businesses with the majority attributable to our acquisition of Keystone Clearwater Solutions LLC, (“Keystone”) in the third quarter of 2015, and incremental revenues from our Homeowner Services and Contract Operations Groups; partially offset by a decrease in our Military Services Group revenues.

Operation and maintenance. For the three months ended September 30, 2016, operation and maintenance expense increased compared to the same period last year, primarily due to a:

\$65 million charge in our Regulated Businesses attributable to the binding global agreement in principle as to settlement of claims arising out of the Freedom Industries chemical spill in West Virginia; and

\$8 million increase in our Regulated Businesses operation and maintenance expenses, including a \$5 million write-off related to timekeeping system costs that were capitalized under construction work in process; partially offset by a

\$6 million of lower expenses in our Market-Based Businesses due to lower capital upgrades in our Military Services Group corresponding with the decreased revenue; partially offset by higher expenses related to growth in our Homeowner Services Group and Contract Operations Groups.

28

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For the nine months ended September 30, 2016, operation and maintenance expense increased primarily due to a:

\$65 million charge in our Regulated Businesses attributable to the binding global agreement in principle as to settlement of claims associated with the Freedom Industries chemical spill in West Virginia;  
\$33 million increase in our Market-Based Businesses with \$17 million attributable to the acquisition of Keystone and the remaining \$16 million primarily due to incremental costs in our Homeowner Services Group and Contract Operations Group corresponding with the increases in operating revenues discussed above; and  
\$6 million increase in our Regulated Businesses operations and maintenance expenses principally due to higher employee-related costs, including higher medical and prescription drug group insurance costs of \$7 million and the write-off related to timekeeping system costs discussed above, partially offset by lower insurance claims and uncollectible accounts expense.

Depreciation and amortization. For the three and nine months ended September 30, 2016, depreciation and amortization expense increased primarily as a result of additional utility plant placed in service. Also, included in the nine months ended September 30, 2016 is incremental depreciation and amortization expense in 2016 resulting from the acquisition of Keystone in the third quarter of 2015.

General Taxes. For the three and nine months ended September 30, 2016, general taxes increased primarily as a result of higher gross receipts taxes in our Regulated Businesses segment.

Other income (expenses). For the three and nine months ended September 30, 2016, other expenses increased principally due to an increase in interest expense from the issuance of incremental long-term debt in the last six months of 2015. Partially offsetting the increase in interest expense for the nine months ended September 30, 2016, were proceeds from the settlement of a contract dispute in our Market-Based Businesses and a favorable outcome associated with the finalization of the Missouri rate case, both of which were recognized in the second quarter of 2016.

## Segment Results of Operations

Our segments are determined based on how we assess our performance and allocate our resources. We evaluate the performance of our segments and allocate resources based on several factors, with the primary measure being net income attributable to common stockholders.

We conduct our business primarily through one reportable segment, our Regulated Businesses segment. We also operate businesses that provide a broad range of related and complementary water and wastewater services in non-regulated markets, which include four operating segments that individually do not meet the criteria of a reportable segment. These four non-reportable segments are presented as our “Market-Based Businesses”.

## Regulated Businesses Segment

The following table summarizes certain financial information for our Regulated Businesses segment:

| For the Three Months<br>Ended September 30, | For the Nine Months Ended<br>September 30, |
|---|--|
|---|--|

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| (In millions)                                     |       |       | Increase   |        |         |         | Increase   |       |
|---|-------|-------|------------|--------|---------|---------|------------|-------|
|   | 2016  | 2015  | (Decrease) | %      | 2016    | 2015    | (Decrease) | %     |
| Operating revenues                                | \$826 | \$781 | \$45       | 5.8    | \$2,176 | \$2,083 | \$93       | 4.5   |
| Operation and maintenance                         | 350   | 277   | 73         | 26.4   | 881     | 814     | 67         | 8.2   |
| Total operating expenses, net                     | 521   | 439   | 82         | 18.7   | 1,385   | 1,291   | 94         | 7.3   |
| Net income attributable to common<br>stockholders | 152   | 174   | (22)       | (12.6) | 374     | 377     | (3)        | (0.8) |

Operating revenues. The following tables and discussions provide explanations for variances related to the three components of operating revenues—water services revenues, wastewater services revenues and other revenues:

| (In millions)                        | For the Three Months Ended<br>September 30, |              |                     |            | For the Nine Months Ended<br>September 30, |                |                     |            |
|--------------------------------------|---|--------------|---------------------|------------|--|----------------|---------------------|------------|
|                                      | 2016  | 2015         | Increase (Decrease) | %          | 2016                                       | 2015           | Increase (Decrease) | %          |
| <b>Billed water services:</b>        |   |              |                     |            |  |                |                     |            |
| Residential                          | \$468                                       | \$435        | \$ 33               | 7.6        | \$1,199                                    | \$1,155        | \$ 44               | 3.8        |
| Commercial                           | 172   | 159          | 13                  | 8.2        | 436  | 417            | 19                  | 4.6        |
| Industrial                           | 38  | 36           | 2                   | 5.6        | 101  | 99             | 2                   | 2.0        |
| Public and other                     | 94  | 89           | 5                   | 5.6        | 253  | 248            | 5                   | 2.0        |
| Other water revenues                 | 16  | 14           | 2                   | 14.3       | 42   | 31             | 11                  | 35.5       |
| <b>Billed water services</b>         | <b>788</b>                                  | <b>733</b>   | <b>55</b>           | <b>7.5</b> | <b>2,031</b>                               | <b>1,950</b>   | <b>81</b>           | <b>4.2</b> |
| Unbilled water services              | (4 )  | 9            | (13 )               | (144.4 )   | 23   | 21             | 2                   | 9.5        |
| <b>Total water services revenues</b> | <b>784</b>                                  | <b>742</b>   | <b>42</b>           | <b>5.7</b> | <b>2,054</b>                               | <b>1,971</b>   | <b>83</b>           | <b>4.2</b> |
| Wastewater services revenues         | 28  | 25           | 3                   | 12.0       | 83   | 73             | 10                  | 13.7       |
| Other revenues                       | 14  | 14           | —                   | —          | 39   | 39             | —                   | —          |
| <b>Total operating revenues</b>      | <b>\$826</b>                                | <b>\$781</b> | <b>\$ 45</b>        | <b>5.8</b> | <b>\$2,176</b>                             | <b>\$2,083</b> | <b>\$ 93</b>        | <b>4.5</b> |

| (In millions)                         | For the Three Months Ended September<br>30, |                |                     |            | For the Nine Months Ended September<br>30, |                |                     |               |
|---------------------------------------|---|----------------|---------------------|------------|--|----------------|---------------------|---------------|
|                                       | 2016  | 2015           | Increase (Decrease) | %          | 2016                                       | 2015           | Increase (Decrease) | %             |
| <b>Billed water services volumes:</b> |   |                |                     |            |  |                |                     |               |
| Residential                           | 55,108                                      | 53,392         | 1,716               | 3.2        | 132,453                                    | 132,771        | (318 )              | (0.2 )        |
| Commercial                            | 25,170                                      | 24,259         | 911                 | 3.8        | 62,273                                     | 61,276         | 997                 | 1.6           |
| Industrial                            | 11,013                                      | 10,869         | 144                 | 1.3        | 29,194                                     | 29,439         | (245 )              | (0.8 )        |
| Public and other                      | 14,512                                      | 14,142         | 370                 | 2.6        | 37,983                                     | 38,867         | (884 )              | (2.3 )        |
| <b>Billed water services volumes</b>  | <b>105,803</b>                              | <b>102,662</b> | <b>3,141</b>        | <b>3.1</b> | <b>261,903</b>                             | <b>262,353</b> | <b>(450 )</b>       | <b>(0.2 )</b> |

For the three months ended September 30, 2016, operating revenues increased primarily due to a:

- \$32 million increase from authorized rate increases, including infrastructure surcharges, primarily to fund investment growth in various states;
- \$5 million reduction in 2015 associated with an application filed by our California subsidiary with the California Public Utility Commission to extend the collection period for certain balancing account revenues;
- \$4 million increase attributable to recent water and wastewater acquisitions coupled with organic growth in existing systems; and
- \$3 million incremental revenues from balancing accounts and surcharges.

For the nine months ended September 30, 2016, operating revenues increased primarily due to a:

- \$69 million increase from authorized rate increases, including infrastructure surcharges, primarily to fund investment growth in various states;

\$14 million increase attributable to recent water and wastewater acquisitions coupled with organic growth in existing systems;

\$8 million increase in revenues from balancing accounts and surcharges; and

\$5 million reduction in 2015 associated with an application filed by our California subsidiary as discussed above; partially offset by a

\$4 million decrease attributable to a decline in consumption in 2016 compared to the same period in 2015.

Operation and maintenance. The following table and discussions provide a detailed explanation of the variances related to the major components of operation and maintenance.

| (In millions)                      | For the Three Months<br>Ended September 30, |              |             |             | For the Nine Months<br>Ended September 30, |              |             |            |
|------------------------------------|---|--------------|-------------|-------------|--|--------------|-------------|------------|
|                                    | 2016  | 2015         | Increase    |             | 2016                                       | 2015         | Increase    |            |
|                                    |   |              | (Decrease)  | %           |  |              | (Decrease)  | %          |
| Production costs                   | \$86  | \$80         | \$6         | 7.5         | \$220                                      | \$216        | \$4         | 1.9        |
| Employee-related costs             | 107   | 105          | 2           | 1.9         | 328  | 321          | 7           | 2.2        |
| Operating supplies and services    | 50  | 49           | 1           | 2           | 149  | 144          | 5           | 3.5        |
| Maintenance materials and supplies | 16  | 14           | 2           | 14.3        | 46   | 50           | (4)         | (8.0)      |
| Customer billing and accounting    | 17  | 16           | 1           | 6.3         | 41   | 45           | (4)         | (8.9)      |
| Other                              | 74  | 13           | 61          | 469.2       | 97   | 38           | 59          | 155.3      |
| <b>Total</b>                       | <b>\$350</b>                                | <b>\$277</b> | <b>\$73</b> | <b>26.4</b> | <b>\$881</b>                               | <b>\$814</b> | <b>\$67</b> | <b>8.2</b> |

For the three months ended September 30, 2016, operation and maintenance increased primarily due to a:

- \$6 million increase in production costs mainly attributable to increased purchased water for our California subsidiary and increased waste disposal costs;
- \$2 million increase in employee-related costs, including the increased costs associated with higher medical and prescription drug group insurance costs of \$2 million, partially offset by a \$2 million decrease in other postretirement benefit plan expenses as a result of plan amendments in the third quarter of 2016;
- \$5 million write-off related to timekeeping system costs that were capitalized under construction work in process;
- \$65 million charge due to the binding global agreement in principle as to settlement of claims associated with the Freedom Industries chemical spill in West Virginia; and
- \$4 million decrease in casualty insurance costs attributable to a decrease in historical claims experience resulting in premium adjustments.

For the nine months ended September 30, 2016, operation and maintenance increased primarily due to a:

- \$3 million increase in purchased water primarily at our California subsidiary;
- \$7 million increase in employee-related costs, including increased costs associated with higher medical and prescription drug group insurance costs of \$7 million, partially offset by a \$2 million decrease in other postretirement benefit plan expenses as a result of plan amendments in the third quarter of 2016;
- \$5 million write-off related to timekeeping system costs that were capitalized under construction work in process;
- \$4 million decrease in maintenance services and supplies mainly due to lower main breaks as a result of milder weather in the first quarter of 2016 compared to the same period in 2015;
- \$4 million decrease in uncollectible expense primarily due to improvements in the aging of our receivables in 2016 compared to 2015 as well as increased collections in 2016 attributable to focused collection efforts;
- \$65 million increase due to the binding global agreement in principle as to settlement of claims associated with the Freedom Industries chemical spill in West Virginia; and
- \$6 million decrease in casualty insurance costs attributable to a decrease in historical claims experience resulting in premium adjustments.

Operating expenses, net. For the three and nine months ended September 30, 2016, operating expenses, net increased principally due to the increase in operating and maintenance expense as explained above, in addition to higher

depreciation and amortization expense of \$7 million and \$22 million, respectively. The increase in depreciation and amortization expense is primarily due to additional utility plant placed in service.

## Market-Based Businesses

The following table summarizes certain financial information for our Market-Based Businesses:

| (In millions)                                     | For the Three Months<br>Ended September 30, |       |            |        | For the Nine Months<br>Ended September 30, |       |            |        |
|---|---|-------|------------|--------|--|-------|------------|--------|
|   |   |       | Increase   |        |  |       | Increase   |        |
|   | 2016  | 2015  | (Decrease) | %      | 2016                                       | 2015  | (Decrease) | %      |
| Operating revenues                                | \$109                                       | \$121 | \$(12)     | (9.9 ) | \$338                                      | \$308 | \$30       | 9.7    |
| Operation and maintenance                         | 92  | 98    | (6 )       | (6.1 ) | 285  | 252   | 33         | 13.1   |
| Total operating expenses, net                     | 98  | 101   | (3 )       | (3.0 ) | 300  | 260   | 40         | 15.4   |
| Net income attributable to common<br>stockholders | 7   | 12    | (5 )       | (41.7) | 26   | 31    | (5 )       | (16.1) |

Operating revenues. For the three months ended September 30, 2016, operating revenues decreased primarily due to a:

\$16 million decrease in the Military Services Group resulting from lower capital upgrades in 2016 compared to 2015 attributable to higher project activity in 2015, the completion of a large project at Fort Polk in mid-2016 and reduced military base infrastructure budgets in 2016; partially offset by a

\$3 million increase in our Homeowner Services Group revenues primarily due to contract growth and the expansion into new geographic areas; and

\$3 million increase in our Contract Operations Group due to contract growth, mostly associated with our contract in Camden, New Jersey.

For the nine months ended September 30, 2016, operating revenues increased due to a:

\$21 million increase resulting from Keystone, which was acquired in the third quarter of 2015;

\$10 million increase in our Homeowner Services Group revenues primarily due to contract growth and the expansion into new geographic areas; and

\$6 million increase in our Contract Operations Group primarily due to contract growth, mostly associated with our contract in Camden, New Jersey; partially offset by a

\$7 million decrease in our Military Services Group revenues primarily due to lower capital upgrades in 2016 partially offset by incremental revenues due to the addition of Vandenberg Air Force Base in 2016.

Operation and maintenance. The following table summarizes information regarding the components of operation and maintenance expense:

| (In millions)          | For the Three Months<br>Ended September 30, |      |            |      | For the Nine Months<br>Ended September 30, |      |            |      |
|------------------------|---|------|------------|------|--|------|------------|------|
|                        |   |      | Increase   |      |  |      | Increase   |      |
|                        | 2016  | 2015 | (Decrease) | %    | 2016                                       | 2015 | (Decrease) | %    |
| Production costs       | \$10  | \$9  | \$1        | 11.1 | \$27                                       | \$27 | \$—        | —    |
| Employee-related costs | 24  | 20   | 4          | 20.0 | 72   | 53   | 19         | 35.8 |

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|                                    |      |      |        |        |       |       |      |      |
|------------------------------------|------|------|--------|--------|-------|-------|------|------|
| Operating supplies and services    | 38   | 53   | (15)   | (28.3) | 128   | 126   | 2    | 1.6  |
| Maintenance materials and supplies | 18   | 14   | 4      | 28.6   | 51    | 41    | 10   | 24.4 |
| Other                              | 2    | 2    | —      | —      | 7     | 5     | 2    | 40.0 |
| Total                              | \$92 | \$98 | \$(6 ) | (6.1 ) | \$285 | \$252 | \$33 | 13.1 |

For the three months ended September 30, 2016, operation and maintenance expense decreased primarily due to a:

\$10 million decrease in our Military Services Group from lower capital upgrades in the third quarter of 2016 compared to 2015; partially offset by a

\$7 million increase mainly associated with contract growth in both our Homeowner Services and Contract Operations Groups corresponding with the increased revenues, as well as incremental claims activity in our Homeowner Services Group.

32

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For the nine months ended September 30, 2016, operation and maintenance expense increased primarily due to a:

- \$17 million increase resulting from Keystone, including \$10 million in employee-related costs and \$6 million in operating supplies and services;
- \$10 million increase in maintenance materials and supplies primarily due to contract growth in our Homeowner Services and Contract Operations Groups, as well as incremental claims expense and additional marketing expenses in our Homeowner Services Group; and
- \$9 million increase in employee-related costs primarily due to the addition of the Vandenberg Air Force Base contract, as well as increased headcount resulting from contract growth in our Homeowner Services and Contract Operations Groups; partially offset by a
- \$4 million decrease in operating supplies and services primarily due to lower capital upgrades in our Military Services Group.

Operating expenses, net. The changes for the three months and nine months ended September 30, 2016 are primarily due to the changes in operation and maintenance explained above, as well as higher depreciation and amortization expense attributable to Keystone.

Net income attributable to common stockholders. In addition to the changes for operating income variances explained above, the three months and nine months ended September 30, 2016 include a \$2 million favorable contract settlement dispute.

## Liquidity and Capital Resources

For a general overview of our sources and uses of capital resources, see the introductory discussion in Part II, Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources contained in our Form 10-K.

We fund liquidity needs for capital investment, working capital and other financial commitments through cash flows from operations, public and private debt offerings, commercial paper markets and, if and to the extent necessary, borrowing under the American Water Capital Corp. (“AWCC”) revolving credit facility. We regularly evaluate the capital markets and closely monitor the financial condition of the financial institutions with contractual commitments in our revolving credit facility.

In order to meet our short-term liquidity needs, we, through AWCC, our wholly owned financing subsidiary, issue commercial paper, which is supported by our revolving credit facility. Effective as of March 22, 2016 and under the terms of the revolving credit agreement dated June 30, 2015, AWCC exercised its right to increase its borrowing capacity available under our revolving credit facility from an aggregate maximum of \$1.25 billion to \$1.75 billion. All other terms, conditions and covenants with respect to the existing facility remained unchanged. We incurred \$1 million of issuance costs in connection with the increased lending commitments, which will be amortized over the remaining life of the credit facility. Also on March 22, 2016, AWCC increased the commercial paper program from \$1.0 billion to \$1.6 billion.

As of September 30, 2016, AWCC had no outstanding borrowings and \$89 million of outstanding letters of credit under the revolving credit facility. As of September 30, 2016, AWCC had \$1.661 billion available under the revolving credit facility to fulfill our short-term liquidity needs and to issue letters of credit, which supported \$951 million in outstanding commercial paper. We believe that our ability to access the capital markets, our revolving credit facility

and our cash flows from operations will generate sufficient cash to fund our short-term requirements. However, we can provide no assurances that the lenders will meet their existing commitments to AWCC under the credit facility or that we will be able to access the commercial paper or loan markets in the future on terms acceptable to us or at all.

On March 24, 2016, we entered into three forward starting swap agreements with an aggregate notional amount of \$225 million to reduce interest rate exposure for a portion of the expected refinancing of our 6.085% fixed-rate long-term debt maturing in 2017. These forward starting swap agreements terminate in December 2017 and have an average fixed interest rate of 2.29%. On July 1, 2016, we entered into another forward starting swap agreement with a notional amount of \$75 million at a 30-year fixed rate of 1.92% to reduce the average 30-year fixed rate on the total hedged notional amount of \$300 million to 2.20%. During the three months ended September 30, 2016, the fair value of our forward starting swaps decreased by \$7 million due to lower interest rates. Changes in the fair value of the forward starting swaps will be recognized in accumulated other comprehensive loss until the agreements terminate in December 2017.

## Cash Flows Provided by Operating Activities

Cash flows provided by operating activities primarily result from the sale of water and wastewater services and, due to the seasonality of demand, are generally greater during the third quarter of each fiscal year. The following table provides a summary of the major items affecting cash flows provided by our operating activities:

|   | For the Nine<br>Months Ended<br>September 30, |        |
|---|---|--------|
|   | 2016  | 2015   |
| (In millions)                                       |   |        |
| Net income  | \$ 367  | \$ 377 |
| Add (less):   |   |        |
| Non-cash activities (a)                             | 578   | 589    |
| Changes in working capital (b)                      | 22  | (70 )  |
| Pension and postretirement healthcare contributions | (42 )   | (40 )  |
| Net cash flows provided by operations               | \$ 925  | \$ 856 |

(a) Includes depreciation and amortization, deferred income taxes and amortization of deferred investment tax credits, provision for losses on accounts receivable, gain on asset dispositions and purchases, pension and non-pension postretirement benefits expense and other non-cash, net. Details of each component can be found in the Consolidated Statements of Cash Flows.

(b) Changes in working capital include changes to receivables and unbilled revenues, accounts payable and accrued liabilities, and other current assets and liabilities, net.

For the nine months ended September 30, 2016, the increase in cash flows from operating activities, as compared to the same period in 2015, is primarily due to improvement in our working capital.

The change in working capital was primarily driven by three components: (1) a change in accounts receivable and unbilled revenues resulting from continuous improvement in our Regulated Businesses' collection efforts, as well as decreased receivables in our Military Services Group attributable to lower capital upgrades in 2016 as compared to the same period in 2015; (2) the timing of accounts payable and accrued liabilities; and (3) the accrual for costs associated with the binding global agreement in principle as to settlement of claims related to the Freedom Industries chemical spill in West Virginia.

As a result of our other postretirement benefit plan amendments and the associated remeasurement of the obligation that occurred in the third quarter of 2016, the Company is not expecting to make any additional contributions during the remainder of 2016 and would expect, based on current plan assumptions, to make lower than anticipated contributions in the future.

## Cash Flows Used in Investing Activities

The following table provides information regarding cash flows used in our investing activities:

|   | For the Nine<br>Months Ended<br>September 30, |           |
|---|---|-----------|
|   | 2016  | 2015      |
| (In millions)                               |   |           |
| Capital expenditures                        | \$(928 )                                      | \$(791 )  |
| Acquisitions (a)                            | (29 )   | (176 )    |
| Other investing activities, net (b)         | (57 )   | (78 )     |
| Net cash flows used in investing activities | \$(1,014)                                     | \$(1,045) |

(a) Includes a non-escrowed deposit of \$5 million related to the pending McKeesport acquisition.

(b) Includes removal costs from property, plant and equipment retirements, net, proceeds from sale of assets and net funds restricted.

For the nine months ended September 30, 2016, net capital expenditures increased \$137 million, or 17.3%, primarily due to continued investment across all infrastructure categories, mainly replacement and renewal of transmission and distribution infrastructure in our Regulated Businesses.

The decrease in cash utilized for acquisitions during the first nine months of 2016 compared to the same period in 2015 is principally due to the timing of acquisitions. In the first nine months of 2016 we closed on ten acquisitions for a purchase price of \$24 million, including the purchase in January 2016 of all of the capital stock of Environmental Disposal Corporation, an investor-owned wastewater utility in New Jersey and made a non-escrowed deposit of \$5 million related to the pending McKeesport acquisition. During the nine months ended September 30, 2015, we closed on eight acquisitions, including the purchase of Keystone in July 2015 for \$133 million, the Borough of Haddonfield, New Jersey's water and wastewater systems and the City of Arnold, Missouri's wastewater system.

We are moving forward with our plans to construct a new corporate headquarters to consolidate our support services and certain of our employees in our Market-Based Businesses within a single location. We have selected a site on Camden, New Jersey's waterfront. Assuming the acquisition of the site is completed by the end of 2016, we expect construction to begin in 2017 and to move into the new headquarters in the latter half of 2018. The cost of construction is currently estimated to be up to \$165 million, and is exclusive of any tax incentives that we may receive.

#### Cash Flows Provided by Financing Activities

The following table provides information regarding cash flows provided by our financing activities:

|   | For the Nine<br>Months Ended<br>September 30, |        |
|---|---|--------|
|   | 2016  | 2015   |
| (In millions)                                   |   |        |
| Proceeds from long-term debt                    | \$ 2  | \$ 564 |
| Repayments of long-term debt                    | (20 )   | (88 )  |
| Net proceeds from short-term borrowings         | 322   | (70 )  |
| Dividends paid                                  | (194 )  | (178 ) |
| Anti-dilutive stock repurchases                 | (65 )   | (39 )  |
| Other financing activities, net (a)             | 45  | 52     |
| Net cash flows provided by financing activities | \$ 90   | \$ 241 |

(a) Includes proceeds from issuance of common stock under various employee stock plans and our dividend reinvestment plan, advances and contributions for construction, net of refunds, debt issuance costs and tax benefits realized from equity compensation.

The overall change in the net cash flows provided by financing activities is mainly due to incremental cash outlays for dividends and our anti-dilutive stock repurchase program in 2016. Also, the third quarter of 2015 included a \$550 million issuance of long-term debt of which a portion was used for the repayment of pre-existing long-term debt and short-term borrowings.

#### Credit Facilities and Short-Term Debt

The following table summarizes information as of September 30, 2016 regarding the Company's aggregate credit facility commitments, letter of credit sub-limits and available funds under those revolving credit facilities, as well as outstanding amounts of commercial paper and outstanding borrowings under the respective facilities:

| Credit Facilities | Available Credit | Letter of | Available Letter | Outstanding | Credit Line |
|-------------------|------------------|-----------|------------------|-------------|-------------|
|-------------------|------------------|-----------|------------------|-------------|-------------|

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|                    | Commitment (a) | Facility<br>Capacity (a) | Credit<br>Sub-limit | of Credit<br>Capacity | Commercial<br>Paper | Borrowing (a) |
|--------------------|----------------|--------------------------|---------------------|-----------------------|---------------------|---------------|
| (In millions)      |                |                          |                     |                       |                     |               |
| September 30, 2016 | \$ 1,766       | \$ 1,677                 | \$ 150              | \$ 61                 | \$ 951              | \$ —          |

(a) Includes amounts related to Keystone's revolving credit facility. The total commitment under the revolving credit facility was \$16 million, all of which was available as of September 30, 2016. The weighted-average interest rate on short-term borrowings for the three months ended September 30, 2016 and 2015 was approximately 0.78% and 0.44%, respectively. The weighted-average interest rate on short-term borrowings for the nine months ended September 30, 2016 and 2015 was approximately 0.76% and 0.49%, respectively.

### Capital Structure

The following table provides certain information regarding our capital structure as of each of the dates set forth below:

|   | September 30,<br>2016 |   | December 31,<br>2015 |   |
|---|-----------------------|---|----------------------|---|
| Total common stockholders' equity                                 | 43.3                  | % | 43.5                 | % |
| Long-term debt and redeemable preferred stock at redemption value | 48.4                  | % | 50.6                 | % |
| Short-term debt and current portion of long-term debt             | 8.3                   | % | 5.9                  | % |
|   | 100                   | % | 100                  | % |

## Debt Covenants

Our debt agreements contain financial and non-financial covenants. To the extent that we are not in compliance with these covenants, such an event may create an event of default under the debt agreement and we, or our subsidiaries, may be restricted in the ability to pay dividends, issue new debt or access our revolving credit facility. Our long-term debt indentures also contain a number of covenants that, among other things, limit the Company from issuing debt secured by the Company's assets, subject to certain exceptions. Our failure to comply with any of these covenants could accelerate repayment obligations.

Certain long-term notes and the AWCC revolving credit facility require us to maintain a ratio of consolidated debt to consolidated capitalization (as defined in the relevant documents) of not more than 0.70 to 1.00. As of September 30, 2016, our ratio was 0.57 to 1.00 and therefore we were in compliance with the covenant.

## Security Ratings

Our access to the capital markets, including the commercial paper market, and respective financing costs in those markets, may be directly affected by our securities ratings. We primarily access the debt capital markets, including the commercial paper market, through AWCC. However, we have also issued debt through our regulated subsidiaries, primarily in the form of tax exempt securities or borrowings under state revolving funds, to lower our overall cost of debt.

The following table presents the Company's securities ratings as of September 30, 2016:

|                       | Moody's           | Standard & Poor's |
|-----------------------|-------------------|-------------------|
| Securities            | Investors Service | Ratings Service   |
| Senior unsecured debt | A3                | A                 |
| Commercial paper      | P-2               | A-1               |

A security rating is not a recommendation to buy, sell or hold securities and may be subject to revision or withdrawal at any time by the assigning rating agency, and each rating should be evaluated independently of any other rating. Security ratings are highly dependent upon our ability to generate cash flows in an amount sufficient to service our debt and meet our investment plans. We can provide no assurances that our ability to generate cash flows is sufficient to maintain our existing ratings. None of our borrowings are subject to default or prepayment as a result of a downgrading of these security ratings, although such a downgrading could increase fees and interest charges under our credit facility.

## Dividends

On September 1, 2016, we paid a cash dividend of \$0.375 per share to the Company's stockholders of record as of August 8, 2016.

On October 28, 2016 our Board of Directors declared a quarterly cash dividend payment of \$0.375 per share payable on December 1, 2016 to stockholders of record as of November 9, 2016. Future dividends, declared at the discretion of the Board of Directors, will be dependent upon future earnings, cash flows, financial and legal requirements and other factors.

### Application of Critical Accounting Policies and Estimates

Our financial condition, results of operations and cash flows are impacted by the methods, assumptions and estimates used in the application of critical accounting policies. See Part II, Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies and Estimates in our Form 10-K for a discussion of our critical accounting policies.

### Recent Accounting Pronouncements

See Note 2—New Accounting Pronouncements to the Notes to Consolidated Financial Statements included in Part I, Item 1—Consolidated Financial Statements of this Quarterly Report on Form 10-Q for a description of new accounting standards recently adopted or pending adoption.



### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. For a discussion of our exposure to market risk, refer to Part II, Item 7A—Quantitative and Qualitative Disclosures about Market Risk contained in our Form 10-K. Except as described below, there have been no significant changes to our exposure to market risk since December 31, 2015.

On March 24, 2016, we entered into three forward starting swap agreements with an aggregate notional amount of \$225 million to reduce interest rate exposure on debt expected to be issued in 2017. The forward starting swap agreements terminate in December 2017 and have an average fixed rate of 2.29%. A hypothetical one basis point change in the forward starting swap rates would have resulted in a \$1 million increase or decrease in fair value for the nine months ended September 30, 2016.

On July 1, 2016, we entered into a forward starting swap agreement with a notional amount of \$75 million to reduce interest rate exposure on debt expected to be issued in 2017. The forward starting swap agreement terminates in December 2017 and has a fixed rate of 1.92%. A hypothetical one basis point change in the forward starting swap rates would have resulted in an immaterial increase or decrease in fair value for the nine months ended September 30, 2016.

### ITEM 4. CONTROLS AND PROCEDURES

#### Evaluation of Disclosure Controls and Procedures

American Water maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

Our management, including the Chief Executive Officer and the Chief Financial Officer, conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of September 30, 2016.

Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2016, our disclosure controls and procedures were effective at a reasonable level of assurance.

#### Changes in Internal Control over Financial Reporting

We concluded that there have been no changes in our internal control over financial reporting that occurred during the three months ended September 30, 2016, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act).



## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The following information updates and amends the information provided in our Form 10-K in Part I, Item 3—Legal Proceedings, and in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2016 in Part II, Item 1—Legal Proceedings. Capitalized terms used but not otherwise defined herein have the meanings set forth in our Form 10-K.

#### Alternative Water Supply in Lieu of Carmel River Diversions

##### Regional Desalination Project

The First District Court of Appeal heard oral argument on July 6, 2016 relating to MCWD's appeals of the Void Judgment. On August 18, 2016, the First District Court of Appeal disposed of MCWD's appeals by affirming the Void Judgment. The decision allows MCWD's appeal of the award to Cal Am of attorney's fees and costs in connection with the Void Judgment, which appeal had previously been stayed pending the disposition of MCWD's appeals of the Void Judgment, to proceed. On September 8, 2016, the First District Court of Appeal denied MCWD's petition for rehearing of its August 18, 2016 decision. On September 27, 2016, MCWD filed with the California Supreme Court a petition for review of the First District Court of Appeal's August 18, 2016 decision. This petition remains pending.

##### Monterey Peninsula Water Supply Project

On March 17, 2016, the CPUC's Energy Division issued a notice of further delays to the schedule for the Water Supply Project's environmental review, with environmental certification currently scheduled for completion in November 2017. Because of these delays, on April 18, 2016, parties to the CPUC proceeding filed a joint motion asking the CPUC to issue a separate decision approving particular components of the Water Supply Project, including authorization for Cal Am to enter into a water purchase agreement with local government agencies and authorization to build certain pipeline and related facilities.

On September 15, 2016, the CPUC unanimously approved a decision to authorize Cal Am to (1) enter into a water purchase agreement for the GWR Project through which Cal Am would purchase purified water from the GWR Project and resell that water to Cal Am's customers; and (2) construct a pipeline and pump station facilities and recover the associated costs, upon a showing that the facilities are used and useful and are appropriately sized, up to a maximum of \$50 million. Cal Am is allowed to seek additional cost recovery if construction costs exceed this maximum.

The Santa Cruz Superior Court held a hearing on September 15, 2016 on the merits of MCWD's challenge to the Coastal Commission's October 6, 2015 amendment of the permits to operate the test slant well. Earlier, the Superior Court had stayed certain of MCWD's claims that were repetitive of claims made by MCWD in the Test Slant Well Petitions currently pending on appeal. At the conclusion of the hearing, the Superior Court ruled in favor of Cal Am and denied MCWD's petition with respect to all claims except those currently stayed.

Based on the foregoing, Cal Am estimates that the earliest date by which the entire Water Supply Project could be completed is sometime in 2019. There can be no assurance that Cal Am's application for the Water Supply Project will be approved or that the Water Supply Project will be completed on a timely basis, if ever.

##### West Virginia Elk River Freedom Industries Chemical Spill

To date, there are 73 pending cases against WVAWC with respect to the Freedom Industries chemical spill in the U.S. District Court for the Southern District of West Virginia or in West Virginia Circuit Courts in Kanawha, Boone and Putnam Counties. Additionally, investigations with respect to this matter have been initiated by, among other authorities, the U.S. Chemical Safety and Hazard Investigation Board (the “CSB”) and the Public Service Commission of West Virginia (the “PSC”).

#### Federal Court Litigation

On December 17, 2015, the court in the Federal action originally entered a scheduling order that provided for the trial on class issues to begin in July 2016. On May 10, 2016, each of the parties in the Federal action filed motions for summary judgment and motions to exclude experts, followed by responses on June 3, 2016 and final reply memoranda on June 16, 2016. On July 7, 2016, the court in the Federal action rescheduled the trial to begin on October 25, 2016, but the court delayed the start of the trial pending ongoing settlement negotiations between the parties, and has since granted a continuance of the trial until December 5, 2016. See “ – WVAWC Binding Global Agreement in Principle to Settle Claims” below.

On September 26, 2016, the court in the Federal action granted the Company's motion for summary judgment and its renewed motion to dismiss all claims against it for lack of personal jurisdiction. The court in the Federal action examined the factual claims asserted by the plaintiffs and held that the plaintiffs failed to provide any evidence that the Company committed a tortious act in connection with the Freedom Industries chemical spill. Also, the court in the Federal action held that it had no personal jurisdiction over the Company, since there was no evidence of a tortious act, and the relationship between the Company and WVAWC was that of a typical parent and subsidiary. As a result of this decision, the Company is no longer a defendant in the Federal action.

On September 27, 2016, the court in the Federal action denied competing motions filed by the plaintiffs and WVAWC for summary judgment on the plaintiffs' breach of contract claims against WVAWC. The court in the Federal action stated that the implementation of the Do Not Use order and the delivery of water containing MCHM subject to such an order constituted a breach of WVAWC's contract with customers. However, the court denied the plaintiffs' motion for summary judgment because the court identified genuine issues of fact to be decided by a jury with respect to WVAWC's assertion that its contractual performance was impracticable due to the lack of available information as to the contaminants in the water after the Freedom Industries chemical spill, the unexpected nature of Freedom Industries' criminal negligence and the resulting contamination of the water supply, and WVAWC's lack of fault for Freedom Industries' actions in causing the chemical spill.

On October 6, 2016, the court in the Federal action granted the American Water Defendants' motion for summary judgment related to the members of the class comprised of hourly employees who worked for businesses served by the KVTP on January 9, 2014. The court stated that these class members, who were not customers of WVAWC, did not have a "sufficiently close nexus" to WVAWC to give rise to a "special relationship" that would allow them to recover lost wages absent physical injury or property damage. This ruling does not impact the remaining class members.

On October 25, 2016, the court in the Federal action dismissed all claims against AWWSC, leaving WVAWC as the remaining American Water Defendant in the lawsuit.

#### West Virginia State Court Litigation

On January 28, 2016, all of the then-filed state court cases were referred to West Virginia's Mass Litigation Panel for further proceedings. On June 6, 2016, plaintiffs filed a second amended consolidated class action complaint. The second amended consolidated class action complaint names only WVAWC as a defendant and alleges claims of, among other things, negligence, public and private nuisance, trespass, strict liability for abnormally dangerous activity, breach of contract, breach of statutory implied warranty, violation of the West Virginia Consumer Credit Protection Act, strict liability for failure to warn, negligent infliction of emotional distress, medical monitoring and punitive damages. On July 6, 2016, the defendants filed an answer in response to these claims. On July 25, 2016, plaintiffs filed a class certification motion seeking certification for liability and damage classes, including businesses and residents who were customers of the KVTP on January 9, 2014, all West Virginia persons who suffered wage loss as a result of the Freedom Industries chemical spill and personal injury and medical monitoring for West Virginia residents within the affected counties that were exposed to contaminated water as a result of the chemical spill.

On September 14, 2016, WVAWC filed a motion to dismiss the second amended consolidated class action complaint. On September 16, 2016, four new individual complaints were filed in West Virginia Circuit Court in Kanawha County stating the same claims as in the second amended consolidated class action complaint but also seeking a judicial determination as to whether the American Water Defendants and Eastman Chemical Company, the manufacturer of MCHM, have insurance coverage under their respective policies for the claims asserted in the complaints. Plaintiffs have also sought to transfer these complaints to the Mass Litigation Panel. The complaints include as defendants all of the insurance carriers identified by Eastman Chemical and the American Water Defendants. West Virginia law generally permits plaintiffs in civil litigation to seek a determination as to whether insurance coverage exists for

claims prior to trial on the merits. The American Water Defendants are currently analyzing and considering their responses to the allegations and claims raised in these four complaints.

#### WVAWC Binding Global Agreement in Principle to Settle Claims

On October 31, 2016, the court in the Federal action approved the preliminary principles, terms and conditions of an agreed-upon settlement of claims (the "Settlement") among the American Water Defendants, and all class members, putative class members, claimants and potential claimants (collectively, the "Plaintiffs"), arising out of the Freedom Industries chemical spill. The terms of the Settlement propose a global federal and state resolution of all litigation and potential claims against the American Water Defendants and their insurers. A claimant may elect to opt out of any final settlement agreement, in which case such claimant will not receive any benefit from or be bound by the terms of the Settlement. Under the terms and conditions of the Settlement and any subsequent final settlement agreement, the American Water Defendants have not admitted, and will not admit, any fault or liability for any of the allegations made by the Plaintiffs in any of the actions to be resolved.

The proposed aggregate pre-tax amount of the Settlement is \$126 million, of which \$65 million would be contributed by WVAWC, and the remainder would be contributed by certain of the Company's general liability insurance carriers. The Company has general liability insurance under a series of policies underwritten by a number of individual carriers. Two of these insurance carriers, which provide an aggregate of \$50 million in insurance coverage to the Company under these policies, were requested, but presently have not agreed, to participate in the Settlement. The Company and WVAWC will vigorously pursue their rights to insurance coverage from these non-participating carriers for any contributions by WVAWC to the Settlement. In this regard, WVAWC has filed a lawsuit against one of these carriers alleging that the carrier's failure to agree to participate in the Settlement constitutes a breach of contract, and the Company will pursue mandatory arbitration against the other non-participating carrier. Despite these efforts, the Company may not ultimately be successful in obtaining full or further reimbursement under these insurance policies for amounts that WVAWC may be required to contribute to the Settlement.

The preliminary terms of the Settlement intend to establish a two-tier settlement fund for the payment of claims, comprised of (i) a guaranteed fund of \$76 million, of which \$51 million will be contributed by WVAWC, including insurance deductibles, and \$25 million would be contributed by one of the Company's general liability insurance carriers, and (ii) a claims-based payment fund of up to \$50 million, of which up to \$14 million would be contributed by WVAWC and \$36 million would be contributed by a number of the Company's general liability insurance carriers. Separately, \$25 million would be contributed to the guaranteed fund through a settlement by another defendant to the Settlement.

As a result of these events, the Company has recorded a charge to earnings, net of insurance receivables, of \$65 million (\$39 million after-tax) in the third quarter of 2016. The Company intends to fund WVAWC's contributions to the Settlement through existing sources of liquidity, although no contribution by WVAWC will be required unless and until the terms of the Settlement are finally approved by the court in the Federal action. Furthermore, under the terms of the Settlement, WVAWC has agreed that it will not seek rate recovery from the Public Service Commission of West Virginia for approximately \$4 million in direct response costs expensed in 2014 by WVAWC relating to the Freedom Industries chemical spill as well as for amounts paid by WVAWC under the Settlement.

The Company's insurance policies operate under a layered structure where coverage is generally provided in the upper layers after claims have exhausted lower layers of coverage. The \$36 million contributed by a number of the Company's general liability insurance carriers to the claims-based fund, as noted above, were from higher layers of the insurance structure than the two insurance carriers that were requested, but presently have not agreed, to participate in the Settlement. Any recovery by WVAWC or the Company from the non-participating carriers would reimburse WVAWC for its contributions to the guaranteed fund.

The court in the Federal action has given the parties 30 days to finalize, and obtain the court's preliminary approval of, the terms of the Settlement. As a result, the court in the Federal action has ordered a continuance of the trial date to December 5, 2016. If preliminary approval of the Settlement is obtained, notice of the terms of the Settlement would then be provided to members of the settlement class. Following the notice period, the court in the Federal action would hold a fairness hearing to consider final approval of the Settlement. There can be no assurance that the court in the Federal action will provide its approval as to any agreement negotiated between the parties reflecting the terms of the Settlement.

#### PSC General Investigation

On May 23, 2016, the PSC entered an order setting a procedural schedule and ruling on outstanding motions related to discovery and the scope of testimony. On October 13, 2016, the PSC entered an order to postpone the General Investigation hearings until December 2016. On October 18, 2016, an intervening party in the case requested, with no parties objecting, that the hearings be rescheduled until the first quarter of 2017.

CSB Investigation

The CSB has been investigating the Freedom Industries chemical spill and related events since shortly after January 9, 2014. The CSB is an independent investigatory agency with no regulatory mandate or ability to issue fines or citations; rather, the CSB can only issue recommendations for further action. On September 28, 2016, the CSB issued and adopted its investigation report in which it recommended that the Company conduct additional source water protection activities. The Company provided written comments to the CSB's report suggesting that the recommendation made to the Company would be better directed to the U.S. Environmental Protection Agency in order to promote industry-wide implementation of the CSB's recommendation.



## ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A—Risk Factors in our Form 10-K, and in our other public filings, which could materially affect our business, financial condition or future results. Other than as set forth below, there have been no material changes from risk factors previously disclosed in Part I, Item 1A—Risk Factors in our Form 10-K.

On April 1, 2016, we experienced a non-cybersecurity-related firmware failure of an information technology storage device utilized for our core business functions. Our water and wastewater systems were not impacted by this event. We implemented our disaster recovery activities and were able to utilize all financial systems and established internal control procedures for the quarter and month ended March 31, 2016. The foregoing should be read in conjunction with the risk factor set forth in Part I, Item 1A—Risk Factors in our Form 10-K entitled “We rely on technology to facilitate the management of our business and customer and supplier relationships, and a disruption of these systems could adversely affect our business.”

The following risk factor contained in our Form 10-K is hereby amended and restated in its entirety, as follows:

Contamination of our sources of water or water service provided to our customers could result in service limitations and interruptions and exposure to substances not typically found in potable water supplies, and could subject us and our subsidiaries to reduction in usage and other responsive obligations, government enforcement actions, damage to our reputation and private litigation.

The water supplies that flow into our treatment plants or are delivered through our distribution system, or the water service that is provided to our customers, are subject to contamination, including, by among other items, contamination from naturally-occurring compounds, chemicals in groundwater systems, pollution resulting from man-made sources (such as perchlorate, methyl tertiary butyl ether, lead and other materials, chemical spills or other accidents that result in contaminants entering the water source), and possible terrorist attacks. If one of our water supplies or the water service provided to our customers is contaminated, depending on the nature of the contamination, we may have to take responsive actions that could include, among other things (1) continuing limited use of the water supply under a “Do Not Use” protective order that enables continuation of basic sanitation and essential fire protection, or (2) interrupting the use of that water supply. If service is disrupted, our financial condition, results of operations, cash flows, liquidity and reputation may be adversely affected. In addition, we may incur significant costs in order to treat the contaminated source through expansion of our current treatment facilities, or development of new treatment methods. We may be unable to recover costs associated with treating or decontaminating water supplies through rates, or recovery of these costs may not occur in a timely manner. Moreover, we could be subject to claims for damages arising from government enforcement actions or toxic tort or other lawsuits arising out of interruption of service or human exposure to hazardous substances in our drinking water and water supplies.

In this regard, on January 9, 2014, a chemical storage tank owned by Freedom Industries, Inc. leaked two substances into the Elk River near the WVAWC treatment plant intake in Charleston, West Virginia. On October 31, 2016, the U.S. District Court for the Southern District of West Virginia approved the preliminary principles, terms and conditions of the Settlement with respect to claims arising out the Freedom Industries chemical spill. Under the terms of the Settlement, WVAWC has agreed that it will not seek rate recovery from the Public Service Commission of West Virginia for amounts paid by WVAWC under the Settlement.

Government investigations relating to the Freedom Industries chemical spill have been initiated, state laws have been enacted, state and federal legislatures are considering changes to existing laws or rules associated with new laws, and there are 73 currently pending lawsuits against WVAWC and, in a few cases, against us or our affiliates. While American Water and WVAWC believe that WVAWC has responded appropriately to, and has no responsibility for, the Freedom Industries chemical spill, and American Water and WVAWC believe that WVAWC and other affiliates

have valid, meritorious defenses to the lawsuits, WVAWC has incurred, and will continue to incur, defense costs that may not be recoverable. An adverse outcome in one or more of the lawsuits could have a material adverse effect on the Company's financial condition, results of operations, cash flows, liquidity and reputation. WVAWC and American Water are unable to predict the outcome of the ongoing government investigations or any legislative initiatives that might affect water utility operations. See Item 3—Legal Proceedings and our subsequent quarterly reports for additional information regarding this matter.

Since we engage in the business of providing water service to our customers, contamination of the water supply, or the water service provided to our customers, can result in substantial injury or damage to our customers, employees or others and we could be exposed to substantial claims and litigation. Such claims could relate to, among other things, personal injury, loss of life, business interruption, property damage, pollution, and environmental damage and may be brought by our customers or third parties. Litigation and regulatory proceedings are subject to inherent uncertainties and unfavorable rulings can and do occur. Negative impacts to our reputation may occur even if we are not liable for any contamination or other environmental damage or the consequences arising out of human exposure to contamination or hazardous substances in the water or water supplies. Pending or future claims against us could have a material adverse impact on our business, financial condition, results of operations and cash flows.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In February 2015, the Board of Directors authorized an anti-dilutive stock repurchase program to mitigate the dilutive effect of shares issued through the Company's dividend reinvestment, employee stock purchase and executive compensation activities. The program allows the Company to purchase up to 10 million shares of its outstanding common stock over an unrestricted period of time in the open market or through privately negotiated transactions. The program is conducted in accordance with Rule 10b-18 of the Exchange Act, and, to facilitate these repurchases, the Company entered into a Rule 10b5-1 stock repurchase plan with a third-party broker, which allows the Company to repurchase shares of its common stock at times when it otherwise might be prevented from doing so under insider trading laws or because of self-imposed trading blackout periods. Subject to applicable regulations, the Company may elect to amend or cancel the program or the stock repurchase parameters at its discretion to manage dilution.

The Company did not repurchase shares of common stock during three months ended September 30, 2016. From April 1, 2015, the date repurchases under the anti-dilutive stock repurchase program commenced, through September 30, 2016, the Company repurchased an aggregate of 3,250,000 shares of common stock under the program.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

None.

**ITEM 5. OTHER INFORMATION**

None.

ITEM 6. EXHIBITS

Exhibit

Number Exhibit Description

- 3.1 Restated Certificate of Incorporation of American Water Works Company, Inc. (incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q, File No. 001-34028, filed November 6, 2008).
- 3.2 Amended and Restated Bylaws of American Water Works Company, Inc. (incorporated by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q, File No. 001-34028, filed August 5, 2015).
- \*31.1 Certification of Susan N. Story, President and Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act.
- \*31.2 Certification of Linda G. Sullivan, Executive Vice President and Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act.
- \*\*32.1 Certification of Susan N. Story, President and Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act.
- \*\*32.2 Certification of Linda G. Sullivan, Executive Vice President and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act.
- \*101 The following financial statements from American Water Works Company, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2016, filed with the Securities and Exchange Commission on November 2, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Comprehensive Income; (iv) the Consolidated Statements of Cash Flows; (v) the Consolidated Statements of Changes in Stockholders' Equity; and (vi) the Notes to Consolidated Financial Statements.

\*Filed herewith.

\*\*Furnished herewith.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 2nd day of November, 2016.

AMERICAN WATER WORKS COMPANY, INC.  
(REGISTRANT)

By /s/ SUSAN N. STORY  
Susan N. Story

President and Chief Executive Officer  
  
(Principal Executive Officer)

By /s/ LINDA G. SULLIVAN  
Linda G. Sullivan

Executive Vice President and Chief Financial Officer  
  
(Principal Financial Officer)

By /s/ MELISSA K. WIKLE  
Melissa K. Wikle

Vice President and Controller  
  
(Principal Accounting Officer)

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- 3.2 Amended and Restated Bylaws of American Water Works Company, Inc. (incorporated by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q, File No. 001-34028, filed August 5, 2015).
- \*31.1 Certification of Susan N. Story, President and Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act.
- \*31.2 Certification of Linda G. Sullivan, Executive Vice President and Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act.
- \*\*32.1 Certification of Susan N. Story, President and Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act.
- \*\*32.2 Certification of Linda G. Sullivan, Executive Vice President and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act.
- \*101 The following financial statements from American Water Works Company, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2016, filed with the Securities and Exchange Commission on November 2, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Comprehensive Income; (iv) the Consolidated Statements of Cash Flows; (v) the Consolidated Statements of Changes in Stockholders' Equity; and (vi) the Notes to Consolidated Financial Statements.

\*Filed herewith.

\*\*Furnished herewith.