American Water Capital Corp.
Form S-4/A
May 06, 2008
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**As filed with the Securities and Exchange Commission on May 6, 2008.**

**Registration No. 333-148284**

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# Amendment No. 1 to

# Form S-4

REGISTRATION STATEMENT UNDER

THE SECURITIES ACT OF 1933

# AMERICAN WATER CAPITAL CORP.

# AMERICAN WATER WORKS COMPANY, INC.

**(Exact name of registrant as specified in its charter)**

| | | |
|---|---|---|
| **Delaware** | **522300** | **22-3732448** |
| **Delaware** | **4941** | **51-0063696** |

| (State or other jurisdiction of incorporation or organization) | (Primary Standard Industrial Classification Code Number) | (I.R.S. Employer Identification Number) |
|---|---|---|

**1025 Laurel Oak Road**

**Voorhees, NJ 08043**

**(856) 346-8200**

**(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)**

| | |
|---|---|
| **Donald L. Correll** | **George W. Patrick, Esq.** |
| **President and Chief Executive Officer** | **Vice President and Secretary** |
| **American Water Works Company, Inc.** | **American Water Capital Corp.** |
| **1025 Laurel Oak Road** | **1025 Laurel Oak Road** |
| **Voorhees, NJ 08043** | **Voorhees, NJ 08043** |
| **(856) 346-8200** | **(856) 346-8200** |

**(Name and address, including zip code, and telephone number, including area code, of agent for service)**

***Copies to:***

| | |
|---|---|
| **William V. Fogg, Esq.** | **George W. Patrick, Esq.** |
| **Cravath, Swaine & Moore LLP** | **Senior Vice President, General Counsel and Secretary** |
| **Worldwide Plaza** | **American Water Works Company, Inc.** |
| **825 Eighth Avenue** | **1025 Laurel Oak Road** |
| **New York, NY 10019** | **Voorhees, NJ 08043** |
| **(212) 474-1000** | **(856) 346-8200** |

Approximate date of commencement of proposed sale of the securities to the public: As soon as practicable after this Registration Statement becomes effective.

If the securities being registered on this Form are being offered in connection with the formation of a holding company and there is compliance with General Instruction G, check the following box. ¨

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

**CALCULATION OF REGISTRATION FEE**

| **Title of Each Class of Securities to be Registered** | **Amount to be Registered** | **Proposed Maximum Offering Price per Unit** | **Proposed Maximum Aggregate Offering Price** | **Amount of Registration Fee** |
|---|---|---|---|---|
| 6.085% Senior Notes due 2017 | $ 750,000,000 | 100% | $ 750,000,000 | $ 23,025(1) |
| 6.593% Senior Notes due 2037 | $ 750,000,000 | 100% | $ 750,000,000 | $ 23,025(1) |
| Support Agreement (2) | (2) | (2) | (2) | (3) |

(1) Calculated pursuant to Rule 457(f) of the Securities Act.
(2) The American Water Works Company, Inc. Support Agreement is offered as a component of the 6.085% Senior Notes due 2017 and the 6.593% Senior Notes due 2037 for no additional consideration.
(3) No further fee is payable pursuant to Rule 457(n).

**The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until this Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.**

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**The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting and offer to buy these securities in a nay state where the offer or sale is not permitted.**

**Subject to Completion, Dated May 6, 2008**

**Prospectus**

# American Water Capital Corp.

# American Water Works Company, Inc.

## Offer to Exchange

| 6.085% Senior Notes due 2017 | 6.593% Senior Notes due 2037 |
|---|---|
| For a Like Principal Amount of New | For a Like Principal Amount of New |
| 6.085% Senior Notes due 2017 | 6.593% Senior Notes due 2037 |

We are offering to exchange up to (i) $750,000,000 aggregate principal amount of new 6.085% Senior Notes due 2017, which we refer to as the new 2017 notes, for a like principal amount of the outstanding 6.085% Senior Notes due 2017, which have certain transfer restrictions, which we refer to as the original 2017 notes and (ii) $750,000,000 aggregate principal amount of new 6.593% Senior Notes due 2037, which we refer to as the new 2037 notes and, together with the new 2017 notes, as the new notes, for a like principal amount of the outstanding 6.593% Senior Notes due 2037, which have certain transfer restrictions, which we refer to as the original 2037 notes and, together with the original 2017 notes, as the original notes. The original notes and the new notes are collectively referred to in this prospectus as the notes. The new notes will be free of the transfer restrictions that apply to the original notes that you currently hold, but will otherwise have substantially the same terms as the outstanding original notes and will be issued under the same indenture. The new notes will not trade on any established exchange.

**This offer will expire at 5:00 p.m., New York City time, on , 2008, unless we extend it.**

Each broker-dealer that receives new notes for its own account pursuant to this exchange offer must acknowledge that it will deliver a prospectus in connection with any resale of such new notes. The letter of transmittal accompanying this prospectus states that by so acknowledging and by delivering a prospectus, a broker-dealer will not be deemed to admit that it is an underwriter within the meaning of the Securities Act of 1933, as amended. This prospectus, as it may be amended or supplemented from time to time, may be used by a broker-dealer in connection with resales of new notes received in exchange for outstanding original notes where such outstanding original notes were acquired by such broker-dealer as a result of market-making activities or other trading activities. We have agreed that, starting on the expiration date and for a period ending upon the earlier of the 180th day after the expiration of this exchange offer or such time as such broker-dealers no longer own any original notes, we will make this prospectus available to any broker-dealer for use in connection with any such resale. See Plan of Distribution.

**SEE RISK FACTORS BEGINNING ON PAGE 11 TO READ ABOUT IMPORTANT FACTORS YOU SHOULD CONSIDER IN CONNECTION WITH THIS EXCHANGE OFFER.**

**NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY OTHER REGULATORY BODY HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR PASSED ON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.**

Prospectus dated , 2008.

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**You should rely only on the information contained in this prospectus prepared by or on behalf of us. We have not authorized anyone to provide you with information that is different. We are not making an offer of these securities in any state where the offer is not permitted. You should not assume that the information contained in this prospectus is accurate as of any date other than the date on the front cover of this prospectus.**

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## WHERE YOU CAN FIND MORE INFORMATION

We have filed with the Securities and Exchange Commission, which we refer to as the SEC, a registration statement on Form S-4 under the Securities Act of 1933, as amended, which we refer to as the Securities Act, with respect to the this exchange offer. This prospectus, which constitutes part of the registration statement, does not contain all of the information set forth in the registration statement. For further information about us and the securities we propose to exchange in this exchange offer, we refer you to the registration statement and the exhibits and schedules filed as a part of the registration statement. Statements contained in this prospectus as to the contents of any contract or other document filed as an exhibit to the registration statement are not necessarily complete. If a contract or document has been filed as an exhibit to the registration statement, we refer you to the copy of the contract or document that has been filed. The registration statement may be inspected without charge at the principal office of the SEC in Washington, D.C. and copies of all or any part of the registration statement may be inspected and copied at the SEC s Public Reference Room at 100 F Street, N.E. Washington, D.C. 20549. The SEC s toll-free number is 1-800-SEC-0330. In addition, the SEC maintains a website (http://www.sec.gov) that contains reports, proxy and information statements and other information regarding registrants that file electronically with the SEC.

We are subject to the information and periodic reporting requirements of the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act, and are required to file periodic reports, proxy statements and other information with the SEC. The periodic reports and other information that we file with the SEC will be available for inspection and copying at the SEC s public reference facilities and on the website of the SEC referred to above.

## INDUSTRY AND MARKET DATA

Unless otherwise indicated, information contained in this prospectus concerning the water and wastewater industry, its segments and related markets and our general expectations concerning such industry and its segments and related markets are based on management estimates. Such estimates are derived from publicly available information released by third-party sources, as well as data from our internal research and on assumptions made by us based on such data and our knowledge of such industry and markets, which we believe to be reasonable. We have estimated the number of people served by our water and wastewater systems (i) by multiplying the number of residential water and wastewater connections by average people per household based on 2000 United States Census data by state (average people per household varies by state but is generally between 2.4 to 3.0 individuals per household); (ii) by adjusting for weather fluctuations, for some other customer classes, including commercial customers, and for bulk water sales and (iii) by reconciling drinking water and wastewater connections to avoid double counting population served where the same user has both drinking water and wastewater service. In some instances, population estimates for our Non-Regulated Businesses are based on either (i) specific population estimates from the client or (ii) population estimates based on the average volume of water processed by the applicable facilities. While we are not aware of any misstatements regarding the industry or similar data presented herein, such data involve risks and uncertainties and are subject to change based on various factors, including those discussed under the heading Risk Factors in this prospectus.

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**FORWARD-LOOKING STATEMENTS**

We have made statements under the captions Summary, Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations, Business and in other sections of this prospectus that are forward-looking statements. In some cases, these forward-looking statements can be identified by words with prospective meanings such as intend, plan, estimate, believe, anticipate, expect, predict, p forecast, outlook, future, potential, continue, may, can, should and could and similar expressions. Forward-looking statements m among other things, our future financial performance, our growth strategies, our ability to repay debt, our ability to finance current operations and growth initiatives, trends in our industry, regulatory or legal developments or rate adjustments.

Forward-looking statements are predictions based on our current expectations and assumptions regarding future events. They are not guarantees of any outcomes, financial results or levels of performance, and you are cautioned not to place undue reliance upon them. These forward-looking statements are subject to a number of risks and uncertainties, and new risks and uncertainties of which we are not currently aware or which we do not currently perceive may arise in the future from time to time. Should any of these risks or uncertainties materialize, or should any of our expectations or assumptions prove incorrect, then our results may vary materially from those discussed in the forward-looking statements herein. Factors that could cause actual results to differ from those discussed in forward-looking statements include, but are not limited to, the factors discussed under the caption Risk Factors and the following factors:

- weather conditions, patterns or events, including drought or abnormally high rainfall;
- changes in general economic, business and financial market conditions;
- changes in laws, governmental regulations and policies, including environmental, health and water quality and public utility regulations and policies;
- the decisions of governmental and regulatory bodies, including decisions to raise or lower rates;
- the timeliness of regulatory commissions actions concerning rates;
- migration into or out of our service territories;
- our ability to obtain permits for expansion projects;
- changes in customer demand for, and patterns of use of, water, such as may result from conservation efforts;
- the availability of adequate and cost-effective supplies of chemicals, electricity, fuel, water and other raw materials that are needed for our operations;
- our ability to successfully acquire and integrate water and wastewater systems that are complementary to our operations and the growth of our business;
- our ability to manage the expansion of our business;

our ability to control operating expenses and to achieve efficiencies in our operations;

access to sufficient capital on satisfactory terms;

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;

changes in our credit rating;

changes in capital requirements;

the incurrence of impairment charges;

difficulty in obtaining insurance at acceptable rates and on acceptable terms and conditions;

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- ability to retain and attract qualified employees;
- cost overruns relating to improvements or the expansion of our operations; and
- civil disturbance or terrorist threats or acts or public apprehension about future disturbances or terrorist threats or acts.

Any forward-looking statements we make speak only as of the date of this prospectus. Except as required by law, we do not have any obligation, and we specifically disclaim any undertaking or intention, to update any forward-looking statements, whether as a result of new information, future events or otherwise.

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## PROSPECTUS SUMMARY

*This summary highlights information contained elsewhere in this prospectus. It may not contain all the information that is important to you. You should carefully read this entire prospectus, including the section captioned Risk Factors and the consolidated financial statements and notes to the consolidated financial statements, before making an investment decision. For the definition of certain terms used in this prospectus, please refer to the definitions set forth in the Glossary.*

### Our Company

Founded in 1886, American Water Works Company, Inc., which we refer to, together with its subsidiaries, as American Water or the Company, is the largest investor-owned United States water and wastewater utility company, as measured both by operating revenue and population served. Our nearly 7,000 employees provide approximately 15.6 million people with drinking water, wastewater and other water-related services in 32 states and Ontario, Canada.

Our primary business involves the ownership of regulated water and wastewater utilities that provide water and wastewater services to residential, commercial and industrial customers, treating and delivering over one billion gallons of water per day. Our subsidiaries that provide these services are generally subject to economic regulation by state Public Utility Commissions, which we refer to as state PUCs, in the states in which they operate. In 2007, we generated $2,214.2 million in total operating revenue, representing approximately four times the operating revenue of the next largest investor-owned company in the United States water and wastewater business, $15.1 million in operating income, which includes $509.3 million of impairment charges relating to continuing operations, and a net loss of $342.8 million. Our Regulated Businesses, operating in 20 states in the United States, generated 89.8% of our total operating revenue in 2007.

We also provide services that are not subject to economic regulation by state PUCs. Our Non-Regulated Businesses include our Contract Operations Group, our Applied Water Management Group and our Homeowner Services Group. In 2007, our Non-Regulated Businesses generated $242.7 million in operating revenue, prior to inter-segment eliminations.

### Our Industry

The United States water and wastewater industry has two main segments: (i) utility, which involves supplying water and wastewater services to customers, and (ii) general services, which involves providing water and wastewater-related services, including engineering, consulting and sales of water infrastructure and distribution products, such as pipes, to water and wastewater utilities and other consumers on a fee-for-service contract basis.

The utility segment includes municipal systems, which are owned and operated by local governments, and investor-owned systems. Government-owned systems make up the vast majority of the United States water and wastewater utility segment, accounting for approximately 84% of all United States community water systems and approximately 98% of all United States community wastewater systems.

The utility segment is characterized by high barriers to entry, including high capital spending requirements. Investor-owned water and wastewater utilities also face regulatory approval processes in order to do business, which may involve obtaining relevant operating approvals, including certificates of public convenience and necessity (or similar authorizations), pursuant to which state PUCs grant investor-owned utilities the right to provide service within an authorized service area. The utility segment of the United States water and wastewater

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industry is highly fragmented, with approximately 53,000 community water systems and approximately 16,000 community wastewater facilities, according to the United States Environmental Protection Agency, or EPA, and therefore presents opportunities for consolidation. Larger utilities, such as ours, that have greater access to capital are generally more capable of making mandated and other necessary infrastructure upgrades to water and wastewater systems.

**Our Strengths**

We believe that we are distinguished by the following key competitive strengths:

***Market leader with broad national footprint and strong local presence.*** We are the largest and most geographically diversified investor-owned water and wastewater utility company in the United States. Our scale provides us with a competitive advantage in procuring goods and services reliably and economically. Our geographic scope enables us to capitalize effectively on growth opportunities across our service areas, while helping to insulate us from adverse conditions relating to regulatory environments, weather and economic conditions in any one geographic area. Also, our active community involvement supports customer satisfaction.

***Regulated Businesses provide financial stability*****.** Our Regulated Businesses provide a high degree of financial stability because (i) high barriers to entry insulate us from competitive pressures, (ii) economic regulation promotes predictability in financial planning and long-term performance through the rate-setting process and (iii) our largely residential customer base promotes consistent operating results.

***Experience in securing appropriate rates of return and promoting constructive regulatory frameworks.*** We seek appropriate rates of return on our investment and a return of our investment and recovery of prudently incurred operating expenses from state PUCs in the form of rate increases, which we refer to as rate relief. We have a strong track record of providing reliable service at cost-effective rates, which has generally allowed us to maintain positive relations with regulators. We have generally been granted rate relief in a timely manner after application.

***Significant growth opportunities with a low risk business profile.*** We believe we are well positioned to benefit from favorable industry dynamics in the water and wastewater sectors, which provide significant opportunities for future growth in both our Regulated Businesses and complementary Non-Regulated Businesses.

- We intend to invest capital prudently to enable us to continue to provide essential services to our customers in the water and wastewater utility industry and to municipalities in meeting the capital challenges of making substantial required infrastructure upgrades.

- Our Regulated Businesses provide a large platform on which to grow both organically and through consolidation from among the numerous water and wastewater systems in the United States.

- Our national footprint increases our ability to make opportunistic investments in non-regulated businesses that are complementary to our Regulated Businesses.

***Experienced senior management team***. Our three senior managers have an average of 27 years of experience in the utilities industry. Our 14 state presidents have an average of 25 years of experience in the utilities industry.

***Industry leader in water quality, testing and research.*** We are experts in water quality testing, compliance and treatment and have established and own industry-leading water testing facilities. Our technologically advanced quality control and testing laboratory in Belleville, Illinois is certified in 23 states and Puerto Rico.

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**Our Strategy**

Our goal is to consistently provide customers with safe, high quality drinking water and reliable water and wastewater services. Our business strategies include:

- continuing to prudently invest in regulated water and wastewater infrastructure projects;
- earning an appropriate rate of return on our investments from state PUCs;
- growing our Regulated Businesses through acquisitions; and
- continuing to pursue public/private partnerships, including O&M and military contracts and services, and other non-regulated businesses that are complementary to our Regulated Businesses.

**The Transactions**

American Water is currently an indirect majority-owned subsidiary of RWE Aktiengesellschaft, a stock corporation incorporated in the Federal Republic of Germany whose shares are publicly listed on the Frankfurt and Düsseldorf stock exchanges and other German stock exchanges as well as on the Zurich stock exchange, which we refer to as RWE. RWE is one of Europe s leading electricity and gas companies and supplies 20 million customers with electricity and 10 million customers with gas in Germany, the United Kingdom and Central and Eastern Europe. On November 4, 2005, RWE announced its intention to exit its water activities in the United States and the United Kingdom to focus on its core European electricity and gas business and has since then completed the divestiture of its water business in the United Kingdom. As a part of this strategy, RWE intends to fully divest its ownership of American Water through the consummation of one or more public offerings of common stock of American Water as soon as reasonably practicable, subject to market conditions, which we refer to as the RWE Divestiture. On April 28, 2008, our initial public offering was consummated pursuant to which RWE Aqua Holdings, GmbH, a direct wholly-owned subsidiary of RWE, sold approximately 36% of our outstanding common stock. On September 28, 2007, Thames Water Aqua US Holdings, Inc., at the time an indirect wholly owned subsidiary of RWE, which we refer to as Thames US Holdings, was merged with and into American Water with American Water being the surviving entity, which we refer to as the Merger.

On September 20, 2007, American Water Capital Corp., our wholly owned financing subsidiary, which we refer to as AWCC or the issuer, issued $1,750.0 million of debt to RWE, which we refer to as the RWE redemption notes, which was used to fund the early redemption of $1,750.0 million of preferred stock held by RWE. In addition, on October 22, 2007 we used the net proceeds from the issuance of the original notes, to fund the repayment of $1,286.0 million aggregate principal amount of RWE redemption notes and $206.0 million (including after tax gains of $2.2 million, net of $1.4 million of tax) aggregate principal amount of other debt owed to RWE, which we refer to as the RWE notes.

On November 7, 2007, we effected a 160,000-for-1 stock split.

In December 2007 we used the net proceeds from the issuance of approximately $415.0 million of commercial paper and $49.0 million of excess cash to fund the repayment of approximately $464.0 million of RWE redemption notes.

These transactions, together with the non-cash equity contribution to the Company by RWE of $100.0 million of debt of our subsidiaries held by RWE on March 29, 2007, the $550.0 million cash equity contribution to the Company by RWE on March 29, 2007, which was used to pay down $232.5 million of short-term debt and the remainder used for general working capital purposes, and the cash equity contribution to the Company by RWE of $266.0 million on December 21, 2007, which was used to pay down $266.0 million of commercial paper, are collectively referred to as the Refinancing. The Refinancing, the Merger and the 160,000-for-1 split of common stock are collectively referred to in this prospectus as the Transactions.

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**Organizational Structure**

American Water is currently a direct majority-owned subsidiary of RWE Aqua Holdings GmbH, a limited liability company organized under the laws of the Federal Republic of Germany and a direct wholly owned subsidiary of RWE. The following chart sets forth our organizational structure:

**Our Executive Offices**

We are a corporation incorporated under the laws of Delaware. Our principal executive offices are located at 1025 Laurel Oak Road, Voorhees, NJ 08043. Our telephone number is (856) 346-8200. Our internet address is www.amwater.com. **The information contained on or accessible from our website does not constitute a part of this prospectus and is not incorporated by reference herein.**

American Water and its logos are our trademarks. Other service marks, trademarks and trade names referred to in this prospectus are the property of their respective owners.

**Recent Developments**

On December 21, 2007, our subsidiary, New Jersey American Water, signed an agreement with the city of Trenton, New Jersey to purchase the assets of the city s water system located in Ewing, Hamilton, Hopewell and Lawrence townships, which will add approximately 39,000 customers to our Regulated Businesses. The purchase price is $100 million, and the agreement was approved by the Trenton City Council. The agreement requires approval by various regulatory agencies, including the New Jersey Board of Public Utilities. We can provide no assurances that the agreement will be approved.

On April 11, 2008, the Company entered into an agreement to issue through AWCC $110 million of 6.25% senior notes due 2018 and $90 million of 6.55% senior notes due 2023 in a private placement to be consummated on May 15, 2008, the proceeds of which will be used to refinance outstanding short term indebtedness of AWCC and for general corporate purposes.

In April and May 2008, the Company redeemed an aggregate of $144.7 million of long-term auction rate debt of its subsidiaries with interest rates ranging from 6.48% to 10% per annum and maturities ranging from 2021 to 2032.

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## SUMMARY OF THE TERMS OF THE EXCHANGE OFFER

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| Background | On October 22, 2007, we completed a private placement of (i) $750,000,000 aggregate principal amount of the original 2017 notes and (ii) $750,000,000 aggregate principal amount of the original 2037 notes. In connection with that private placement, we entered into an exchange and registration rights agreement in which we agreed to, among other things, complete an exchange offer for the original notes. |
| The Exchange Offer | We are offering to exchange our new notes for a like principal amount of our outstanding original notes. Original notes may only be tendered in principal amounts of $2,000 or in integral multiples of $1,000 principal amount in excess thereof. See The Exchange Offer Terms of the Exchange. |
| Resale of New Notes | Based upon the position of the staff of the SEC as described in previous no-action letters, we believe that each series of new notes issued pursuant to the exchange offer in exchange for original notes may be offered for resale, resold and otherwise transferred by you without compliance with the registration and prospectus delivery provisions of the Securities Act, *provided* that:<br>you are acquiring the new notes in the ordinary course of your business;<br>you have not engaged in, do not intend to engage in, and have no arrangement or understanding with any person to participate in a distribution of the new notes; and<br>you are not our affiliate as defined under Rule 405 of the Securities Act.<br>We do not intend to apply for listing of the new notes on any securities exchange or to seek approval for quotation through an automated quotation system. Accordingly, there can be no assurance that an active market will develop upon completion of the exchange offer or, if developed, that such market will be sustained or as to the liquidity of any market. Each participating broker-dealer that receives new notes for its own account pursuant to the exchange offer in exchange for original notes that were acquired as a result of market-making or other trading activity, may be a statutory underwriter and must acknowledge that it will deliver a prospectus meeting the requirements of the Securities Act, which may be the prospectus for the exchange offer so long as it contains a plan of distribution with respect to the resale transactions, in connection with any resale of new notes. See Plan of Distribution. |

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| Consequences If You Do Not Exchange Your Original Notes | Original notes that are not tendered in the exchange offer or are not accepted for exchange will continue to bear legends restricting their transfer. You will not be able to offer or sell such original notes:<br><br>except pursuant to an exemption from the requirements of the Securities Act; or<br><br>unless the original notes are registered under the Securities Act.<br><br>After the exchange offer is closed, we will no longer have an obligation to register the original notes, except for some limited exceptions. See Risk Factors Risks Relating to the Notes and the Exchange Offer If you fail to exchange your original notes, they will continue to be restricted securities and may become less liquid. |
| Expiration Date | The exchange offer will expire at 5:00 p.m., New York City time, on , 2008, unless we extend the exchange offer. See The Exchange Offer Expiration Date; Extensions; Amendments. |
| Exchange Date; Issuance of New Notes | The date of acceptance for exchange of each series of original notes is the exchange date, which will be the first business day following the expiration date of the exchange offer. We will issue new notes in exchange for original notes tendered and accepted in the exchange offer promptly following the exchange date. See The Exchange Offer Terms of the Exchange. |
| Certain Conditions to the Exchange Offer | The exchange offer is subject to certain customary conditions, which we may waive. See The Exchange Offer Conditions to the Exchange Offer. |
| Special Procedures for Beneficial Holders | If you beneficially own original notes that are registered in the name of a broker, dealer, commercial bank, trust company or other nominee and you wish to tender in the exchange offer, you should contact such registered holder promptly and instruct such person to tender on your behalf. If you wish to tender in the exchange offer on your own behalf, you must, prior to completing and executing the letter of transmittal and delivering your original notes, either arrange to have the original notes registered in your name or obtain a properly completed bond power from the registered holder. The transfer of registered ownership may take a considerable time. See The Exchange Offer Procedures for Tendering. |
| Withdrawal Rights | You may withdraw your tender of original notes at any time before the exchange offer expires. See The Exchange Offer Withdrawal of Tenders. |

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| Accounting Treatment | We will not recognize any gain or loss for accounting purposes upon the completion of the exchange offer. The expenses of the exchange offer that we pay will increase our deferred financing costs in accordance with generally accepted accounting principles. See The Exchange Offer Accounting Treatment. |
| Certain Tax Consequences | The exchange pursuant to the exchange offer generally will not be a taxable event for U.S. Federal income tax purposes. See United States Federal Income Tax Considerations. |
| Use of Proceeds | We will not receive any proceeds from the exchange or the issuance of new notes in connection with the exchange offer. See Use of Proceeds. |
| Exchange Agent | Wells Fargo Bank, National Association is serving as exchange agent in connection with the exchange offer. See The Exchange Offer Exchange Agent. |

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## SUMMARY OF THE TERMS OF THE NOTES

*Other than the obligation to conduct an exchange offer, the new notes will have the same financial terms and covenants as the original notes, which are as follows:*

| | |
|---|---|
| Issuer | American Water Capital Corp. |
| Securities Offered | $750,000,000 aggregate principal amount of 6.085% Senior Notes due 2017, which we refer to as the new 2017 notes; and $750,000,000 aggregate principal amount of 6.593% Senior Notes due 2037, which we refer to as the new 2037 notes, collectively referred to as the new notes. |
| Maturity Date | The new 2017 notes will mature on October 15, 2017; and the new 2037 notes will mature on October 15, 2037. |
| Interest Payment Dates | April 15 and October 15 of each year, beginning April 15, 2008. |
| Support Agreement | The new notes will have the benefit of a support agreement from American Water, pursuant to which American Water has agreed to pay to any debt investor or lender any principal or interest owed by the issuer to such debt investor or lender that the issuer fails to pay on a timely basis, referred to herein as the support agreement. |
| Ranking | The new notes will be the issuer s unsecured senior obligations and will: |

- rank equal in right of payment to all of the issuer s existing and future unsecured obligations that are not, by their terms, expressly subordinated in right of payment to the notes;
- rank senior in right of payment to all of the issuer s future obligations that are, by their terms, expressly subordinated in right of payment to the notes; and
- rank effectively junior in right of payment to all of our future secured indebtedness to the extent of the value of the assets securing such indebtedness.

Similarly, the obligations of American Water under the support agreement will be unsecured senior obligations of the support provider and will:

- rank equal in right of payment to all existing and future unsecured obligations of American Water that are not, by their terms, expressly subordinated in right of payment to such obligations;

rank senior in right of payment to any future obligations of American Water that are, by their terms, expressly subordinated in right of payment to such obligations; and

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| | rank (i) effectively junior in right of payment to any secured indebtedness of American Water to the extent of the value of the assets securing such indebtedness and (ii) structurally junior in right of payment to any liabilities of the applicable American Water subsidiaries. |
| | As of December 31, 2007, on a pro forma basis after giving effect to the Transactions (other than the non-cash equity contributions to the Company by RWE, which are each reflected in the historical balance sheet, and excluding the effect of the initial public offering): |
| | The issuer would have had \$3,019.4 million of senior indebtedness, including (i) \$1,212.0 million of currently outstanding senior notes, other than the notes, (ii) \$1,500.0 million of the notes, (iii) \$86.9 million of other senior indebtedness and (iv) \$220.5 million of commercial paper and no subordinated indebtedness; |
| | the support provider would have had no indebtedness other than its obligations under the support agreement with respect to the issuer s indebtedness; and |
| | the subsidiaries of the support provider (other than the issuer) would have had approximately \$5,016.1 million of indebtedness and other liabilities. |
| Optional Redemption | We may redeem the new notes, in whole or in part, at any time at a redemption price equal to the greater of the principal amount of the notes and the make-whole price described under the heading Description of the Notes Optional Redemption by the Issuer. |
| Repurchase Right of Holders Upon a Change in Control | Upon the occurrence of both (i) a change of control of American Water and (ii) a downgrade of the notes below an investment grade rating by each of Moody s Investors Service, Inc. and Standard & Poor s Ratings Services within a specified period, you will have the right to require us to repurchase the new notes of each series at a price equal to 101% of the aggregate principal amount of notes repurchased plus accrued and unpaid interest, if any, on the notes repurchased, to the date of purchase. See Description of the Notes Change of Control. |
| Certain Covenants | The indenture governing the new notes contains certain covenants that, among other things, limit our ability to: |
| | create or assume liens; and |
| | enter into sale and leaseback transactions. |
| | These limitations are subject to a number of significant exceptions. See Description of the Notes Certain Covenants. |

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| Absence of a Public Market | The new notes will generally be freely transferable but will be issues of securities for which there is currently no established market. Accordingly, there can be no assurance as to the development or liquidity of any market for the new notes. |
| Risk Factors | See the section entitled Risk Factors in this prospectus for a description of certain of the risks you should consider before deciding to participate in the exchange offer. |
| Governing Law | The indenture and the new notes are governed by, and construed in accordance with, the laws of the State of New York. |

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## RISK FACTORS

*In considering whether to participate in this exchange offer, you should carefully consider these risk factors together with all of the other information included in this prospectus, including the information contained in the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements included elsewhere in this prospectus and the notes thereto. If any of the following risks actually occurs, our business, financial condition, operating results and prospects could be adversely affected, which in turn could adversely affect your investment in the notes.*

### Risks Related to Our Industry and Business

***Our utility operations are heavily regulated. Decisions by state PUCs and other regulatory agencies can significantly affect our business and results of operations.***

Our Regulated Businesses provide water and wastewater services to our customers through subsidiaries economically regulated by state PUCs. Economic regulation affects the rates we charge our customers and has a significant effect on our business and results of operations. Generally, the state PUCs authorize us to charge rates that they determine are sufficient to recover our prudently incurred operating expenses, to enable us to finance the addition of new, or the replacement of existing, water and wastewater infrastructure and to allow us the opportunity to earn what they determine to be an appropriate rate of return on our invested capital and a return of our invested capital.

Our ability to meet our financial objectives depends upon the rates authorized by the various state PUCs. We periodically file rate increase applications with state PUCs. The ensuing administrative process may be lengthy and costly. We can provide no assurances that our rate increase requests will be granted. Even if approved, there is no guarantee that approval will be given in a timely manner or at a sufficient level to cover our expenses, the recovery of our investment and/or provide us an opportunity to earn an appropriate rate of return on our investment and a return of our investment. If the authorized rates are insufficient to cover operating expenses, to allow for the recovery of our investment and to provide an appropriate return on invested capital, or if the rate increase decisions are delayed, our financial condition, results of operations, cash flow and liquidity may be adversely affected. Even if rates are sufficient, we face the risk that we will not achieve the rates of return on our invested capital and a return of our invested capital that are permitted by the state PUC.

***Our operations and the quality of water we supply are subject to extensive environmental laws and regulations. Our operating costs have increased, and are expected to continue to increase, as a result of complying with environmental laws and regulations. We also could incur substantial costs as a result of violations of or liabilities under such laws and regulations.***

Our water and wastewater operations are subject to extensive United States federal, state and local and, in the case of our Canadian operations, Canadian laws and regulations, that govern the protection of the environment, health and safety, the quality of the water we deliver to our customers, water allocation rights, and the manner in which we collect, treat and discharge wastewater. These requirements include the United States Clean Water Act of 1972, which we refer to as the Clean Water Act, and the United States Safe Drinking Water Act of 1974, which we refer to as the Safe Drinking Water Act, and similar state and Canadian laws and regulations. We are also required to obtain various environmental permits from regulatory agencies for our operations. State PUCs also set conditions and standards for the water and wastewater services we deliver. If we deliver water or wastewater services to our customers that do not comply with regulatory standards, or otherwise violate environmental laws, regulations or permits, or other health and safety and water quality regulations, we could incur substantial fines, penalties or other sanctions or costs or damage to our reputation. In the most serious cases, regulators could force us to discontinue operations and sell our operating assets to another utility or municipality. Given the nature of our business which, in part, involves supplying water for human consumption, any potential non-compliance with, or violation of, environmental laws or regulations would likely pose a more significant risk to us than to an issuer not similarly involved in the water and wastewater industry.

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We incur substantial operating and capital costs on an ongoing basis to comply with environmental laws and regulations and other health and safety and water quality regulations. These laws and regulations, and their enforcement, have tended to become more stringent over time, and new or stricter requirements could increase our costs. Although we may seek to recover ongoing compliance costs in our rates, there can be no guarantee that the various state PUCs or similar regulatory bodies that govern our Regulated Businesses would approve rate increases to recover such costs or that such costs will not adversely and materially affect our financial condition, results of operations, cash flow and liquidity.

We may also incur liabilities under environmental laws and regulations requiring us to investigate and clean up environmental contamination at our properties or at off-site locations where we have disposed of waste or caused adverse environmental impacts. The discovery of previously unknown conditions, or the imposition of cleanup obligations in the future, could result in significant costs, and could adversely affect our financial condition, results of operations, cash flow and liquidity. Such remediation losses may not be covered by our insurance policies and may make it difficult for us to secure insurance in the future at acceptable rates.

***Changes in laws and regulations over which we have no control can significantly affect our business and results of operations.***

Any governmental entity that regulates our operations may enact new legislation or adopt new regulations or policies at any time, and new judicial decisions may change the interpretation of existing legislation or regulations at any time. The individuals who serve as regulators are elected or are political appointees. Therefore, elections which result in a change of political administration or new appointments may also result in changes in the individuals who serve as regulators and the policies of the regulatory agencies that they serve. New laws or regulations, new interpretations of existing laws or regulations, or changes in agency policy, including as a response to shifts in public opinion, or conditions imposed during the regulatory hearing process may affect our business in a number of ways, including the following:

- making it more difficult for us to raise our rates and, as a consequence, to recover our costs or earn our expected rates of return;
- changing the determination of the costs, or the amount of costs, that would be considered recoverable in rate cases;
- changing water quality or delivery service standards or wastewater collection, treatment and discharge standards with which we must comply;
- restricting our ability to terminate our services to customers who owe us money for services previously provided;
- requiring us to provide water services at reduced rates to certain customers;
- restricting our ability to sell assets or issue securities;
- changing regulatory benefits that we expected to receive when we began offering services in a particular area;
- changing or placing additional limitations on change in control requirements relating to any concentration of ownership of our common stock;
- making it easier for governmental entities to convert our assets to public ownership via eminent domain;
- restricting or prohibiting our extraction of water from rivers, streams, reservoirs or aquifers; and

revoking or altering the terms of the certificates of public convenience and necessity (or similar authorizations) issued to us by state PUCs.

Any of these changes or any other changes in laws, regulations, judicial decisions or agency policies applicable to us may have an adverse effect on our business, financial condition, results of operations, cash flow and liquidity.

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***Weather conditions, natural hazards, availability of water supplies and competing uses may interfere with our sources of water, demand for water services and our ability to supply water to customers.***

Our ability to meet the existing and future water demands of our customers depends on an adequate supply of water. As a general rule, sources of public water supply, including rivers, lakes, streams and groundwater aquifers are held in the public trust and are not owned by private interests. As such, we typically do not own the water that we use in our operations, and the availability of our water supply is established through allocation rights and passing-flow requirements set by governmental entities. Passing-flow requirements set minimum volumes of water that must pass through specified water sources, such as rivers and streams, in order to maintain environmental habitats and meet water allocation rights of downstream users. Allocation rights are imposed to ensure sustainability of major water sources and passing flow requirements are most often imposed on source waters from smaller rivers, lakes and streams. These requirements can change from time to time and adversely impact our water supply. Drought, overuse of sources of water, the protection of threatened species or habitats or other factors may limit the availability of ground and surface water.

Governmental restrictions on water use may also result in decreased use of water services, even if our water supplies are sufficient to serve our customers, which may adversely affect our financial condition and results of operations. Seasonal drought conditions that would impact our water services are possible across all of our service areas, and drought conditions currently exist in several areas of the United States. However, these conditions are more prevalent in the Northeast and West where supply capacity is limited and per capita water demand is high. If a regional drought were to occur affecting our service areas and adjacent systems, governmental restrictions may be imposed on all systems within a region independent of the supply adequacy of any individual system. Voluntary restrictions were implemented during certain periods of 2007 in certain parts of the states of Illinois, New Jersey, Pennsylvania and Indiana and a mandatory restriction was implemented, and subsequently rescinded, in Kentucky. Following drought conditions, water demand may not return to pre-drought levels even after restrictions are lifted. Cool and wet weather may also reduce demand for water, thereby adversely affecting our financial condition, results of operations, cash flow and liquidity.

Service interruptions due to severe weather events are possible across all our service areas. These include winter storms and freezing conditions in our colder climate service areas, high wind conditions in our service areas known to experience tornados, earthquakes in our service areas known to experience seismic activity, high water conditions for our facilities located in or near designated flood plains, hurricanes in our coastal service areas and severe electrical storms which are possible across all of our service areas. These weather events may affect the condition or operability of our facilities, limiting or preventing us from delivering water or wastewater services to our customers, or requiring us to make substantial capital expenditures to repair any damage. Any interruption in our ability to supply water or to collect, treat and properly dispose of wastewater, or any costs associated with restoring service, could adversely affect our financial condition and results of operations. Furthermore, losses from business interruptions or damage to our facilities might not be covered by our insurance policies and such losses may make it difficult for us to secure insurance in the future at acceptable rates.

***Declining residential per customer water usage may reduce our long-term revenues, financial condition and results of operations.***

Increased water conservation, including through the use of more efficient household fixtures and appliances among residential consumers, combined with declining household sizes in the United States, has contributed to a trend of declining residential per customer water usage. Our Regulated Businesses are heavily dependent upon revenue generated from rates we charge to our residential customers for the volume of water they use. The rate we charge for our water is regulated by state PUCs and we may not unilaterally adjust our rates to reflect demand. Declining usage will have a negative impact on our long-term operating revenues if we are unable to secure rate increases or to grow our residential customer base to the extent necessary to offset the residential usage decline.

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***Risks associated with the collection, treatment and disposal of wastewater may impose significant costs.***

The wastewater collection, treatment and disposal operations of our subsidiaries are subject to substantial regulation and involve significant environmental risks. If collection or sewage systems fail, overflow or do not operate properly, untreated wastewater or other contaminants could spill onto nearby properties or into nearby streams and rivers, causing damage to persons or property, injury to aquatic life and economic damages, which may not be recoverable in rates. This risk is most acute during periods of substantial rainfall or flooding, which are the main causes of sewer overflow and system failure. Liabilities resulting from such damage could adversely and materially affect our business, results of operations and financial condition. Moreover, in the event that we are deemed liable for any damage caused by overflow, our losses might not be covered by insurance policies, and such losses may make it difficult for us to secure insurance in the future at acceptable rates.

***Our Regulated Businesses require significant capital expenditures to maintain infrastructure and expand our rate base and may suffer if we fail to secure appropriate funding to make investments, or if we suffer delays in completing major capital expenditure projects.***

The water and wastewater utility business is capital intensive. In addition to our acquisition strategy, we invest significant amounts of capital to add, replace and maintain property, plant and equipment. In 2007, we invested $758.6 million in net Company-funded capital improvements. We expect the level of capital expenditures necessary to maintain the integrity of our systems to increase in the future. We fund these projects from cash generated from operations, borrowings under our revolving credit facility and commercial paper programs and the issuance of long-term debt and equity securities. We can provide no assurances that we will be able to access the debt and equity capital markets or do so on favorable terms.

RWE has certain registration rights with respect to future issuances of our equity securities and, subject to lock-up provisions, intends to fully divest its ownership of American Water as soon as reasonably practicable, subject to market conditions. The registration rights agreement to be entered into with RWE will impose certain restrictions on our ability to issue equity securities in amounts beyond specified thresholds without RWE s consent. Future sales of our common stock by RWE, as well as the restrictions in the registration rights agreement, may make it more difficult or costly for us to raise additional equity in the future. Furthermore, if we are unable to raise sufficient equity, we can provide no assurances that we will be able to access the debt capital markets, or do so on favorable terms.

In addition, we believe that our dividend policy with respect to our common stock could limit, but not preclude, our ability to pursue growth. In particular, this limitation could be significant, for example, with respect to large acquisitions and growth opportunities that require cash investments in amounts greater than our operating subsidiaries available cash or external financing resources. In order to fund construction expenditures, acquisitions (including tuck-in acquisitions) and principal and interest payments on our indebtedness, and pay dividends at the level currently anticipated under our dividend policy, we expect that we will need additional financing. However, we intend to retain sufficient cash from operating activities after the distribution of dividends to fund a portion of our capital expenditures. For further discussion of our acquisition strategy, see Business Our Regulated Businesses Acquisitions.

If we are unable to obtain sufficient capital, we may fail to maintain our existing property, plant and equipment, realize our capital investment strategies, meet our growth targets and successfully expand the rate base upon which we are able to earn future returns on our investment and a return of our investment. Even if we have adequate resources to make required capital expenditures, we face the additional risk that we will not complete our major capital expenditures on time, as a result of construction delays or other obstacles. Each of these outcomes could adversely affect our financial condition and results of operations. We also face the risk that after we make substantial capital expenditures, the rate increases granted to us by state PUCs may not be sufficient to recover our prudently incurred operating expenses and to allow us the opportunity to earn an appropriate rate of return on our invested capital and a return of our invested capital.

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***The failure of, or the requirement to repair, upgrade or dismantle, any of our dams may adversely affect our financial condition and results of operations.***

We own a total of 99 dams. A failure of any of those dams could result in injuries and property damage downstream for which we may be liable. The failure of a dam would also adversely affect our ability to supply water in sufficient quantities to our customers and could adversely affect our financial condition and results of operations. Any losses or liabilities incurred due to a failure of one of our dams might not be covered by insurance policies or be recoverable in rates, and such losses may make it difficult for us to secure insurance in the future at acceptable rates.

We also are required from time to time to repair or upgrade the dams that we own. The cost of such repairs can be and has been material. We might not be able to recover such costs through rates. The inability to recover these higher costs or regulatory lag in the recovery of such costs can affect our financial condition, results of operations, cash flow and liquidity.

The federal and state agencies that regulate our operations may adopt rules and regulations requiring us to dismantle our dams. Federal and state agencies are currently considering rules and regulations that could require us to strengthen or dismantle one of our dams on the Carmel River in California due to safety concerns related to seismic activity. Any requirement to strengthen or dismantle this dam could result in substantial costs that may adversely affect our financial condition and results of operations. We are currently engaged in negotiations with federal and state agencies and local stakeholders on a plan to maintain our existing Carmel River dams or to share the costs of dismantling one of them with those federal and state agencies and local stakeholders. These negotiations could be delayed or abandoned.

***Any failure of our network of water and wastewater pipes and water reservoirs could result in losses and damages that may affect our financial condition and reputation.***

Our operating subsidiaries distribute water and wastewater through an extensive network of pipes and store water in reservoirs located across the United States. A failure of major pipes or reservoirs could result in injuries and property damage for which we may be liable. The failure of major pipes and reservoirs may also result in the need to shut down some facilities or parts of our network in order to conduct repairs. Such failures and shutdowns may limit our ability to supply water in sufficient quantities to our customers and to meet the water and wastewater delivery requirements prescribed by governmental regulators, including state PUCs with jurisdiction over our operations, and adversely affect our financial condition, results of operations, cash flow, liquidity and reputation. Any business interruption or other losses might not be covered by insurance policies or be recoverable in rates, and such losses may make it difficult for us to secure insurance in the future at acceptable rates.

***Contamination of our sources of water could result in service interruptions and human exposure to hazardous substances and subject our subsidiaries to civil or criminal enforcement actions, private litigation and clean-up obligations.***

Our water supplies are subject to contamination, including contamination from naturally-occurring compounds, chemicals in groundwater systems, pollution resulting from man-made sources, such as perchlorate and methyl tertiary butyl ether (MTBE), and possible terrorist attacks. In the event that our water supply is contaminated, we may have to interrupt the use of that water supply until we are able to substitute the supply of water from another water source, including, in some cases, through the purchase of water from a third-party supplier. 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. If we are unable to substitute water supply in a cost-effective manner, our financial condition, results of operations, cash flow, liquidity and reputation may be adversely affected. We might not be able to recover costs associated with treating or decontaminating water supplies through rates, or such recovery may not occur in a timely manner. Moreover, we could be held liable for environmental damage as well as damages arising from toxic tort or other lawsuits or

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criminal enforcement actions or other consequences arising out of human exposure to hazardous substances in our drinking water supplies.

***Our liquidity and earnings could be adversely affected by increases in our production costs, including the cost of chemicals, electricity, fuel or other significant materials used in the water and wastewater treatment process.***

We incur significant production costs in connection with the delivery of our water and wastewater services. Our production costs are driven by inputs such as chemicals used to treat water and wastewater as well as electricity and fuel, which are used to operate pumps and other equipment used in water treatment and delivery and wastewater collection, treatment and disposal. We also incur production costs for waste disposal. For 2007, production costs accounted for 12.8% of our total operating costs. These costs can and do increase unexpectedly and in substantial amounts, as occurred in California during 2001 and Illinois during 2007 when the cost of electricity rose substantially.

Our Regulated Businesses might not be able to recover increases in the costs of chemicals, electricity, fuel, other significant inputs or waste disposal through rates, or such recovery may not occur in a timely manner. Our Non-Regulated Businesses may not be able to recover these costs in contract prices or other terms. The inability to recover these higher costs can affect our financial condition, results of operations, cash flow and liquidity.

***Our reliance on third-party suppliers poses significant risks to our business and prospects.***

We contract with third parties for goods and services that are essential to our operations, such as maintenance services, pipes, chemicals, electricity, water, gasoline, diesel and other materials. We are subject to substantial risks because of our reliance on these suppliers. For example:

- our suppliers may not provide raw materials that meet our specifications in sufficient quantities;
- our suppliers may provide us with water that does not meet applicable quality standards or is contaminated;
- our suppliers may face production delays due to natural disasters or strikes, lock-outs or other such actions;
- one or more suppliers could make strategic changes in the lines of products and services they offer; and
- some of our suppliers are small companies which are more likely to experience financial and operational difficulties than larger, well-established companies, because of their limited financial and other resources.

As a result of any of these factors, we may be required to find alternative suppliers for the raw materials and services on which we rely. Accordingly, we may experience delays in obtaining appropriate raw materials and services on a timely basis and in sufficient quantities from such alternative suppliers at a reasonable price, which could interrupt services to our customers and adversely affect our revenues, financial condition, results of operations, cash flow and liquidity.

***Risks associated with potential acquisitions or investments may adversely affect us.***

We will continue to seek to acquire or invest in additional regulated water or wastewater systems, including by acquiring systems in markets in the United States, where we do not currently operate our Regulated Businesses, and through tuck-ins. We will also continue to seek to enter into public/private partnerships, including O&M, military and design, build and operate, which we refer to as DBO, contracts and services that complement our businesses. These transactions may result in:

- incurrence of debt and contingent liabilities;

failure to have or to maintain effective internal control over financial reporting;

fluctuations in quarterly results;

exposure to unknown risk and liabilities, such as environmental liabilities; and

other acquisition-related expenses.

We may also experience difficulty in obtaining required regulatory approvals for acquisitions, and any regulatory approvals we obtain may require us to agree to costly and restrictive conditions imposed by regulators. Future sales of our common stock by RWE, as well as the restrictions in the registration rights agreement to be entered into with RWE, may make it more difficult or costly for us to raise additional equity to fund an acquisition or to issue shares as consideration in connection with an acquisition. We may not identify all significant risks when conducting due diligence for the transaction, and we could be exposed to potential liabilities for which we will not be indemnified. There may be difficulties integrating new businesses, including bringing newly acquired businesses up to the necessary level of regulatory compliance. The demands of identifying and transitioning newly acquired businesses or pursuing investment opportunities may also divert management s attention from other business concerns and otherwise disrupt our business. Any of these risks may adversely affect our financial condition, results of operations and cash flows.

***We have recorded a significant amount of goodwill, and we may never realize the full value of our intangible assets causing us to record impairments that may negatively affect our results of operations.***

Our total assets include substantial goodwill. At December 31, 2007, our goodwill totaled $2,457.0 million. The goodwill is associated primarily with the acquisition of American Water by an affiliate of RWE in 2003 and the acquisition of E Town Corporation in 2001, representing the excess of the purchase price the purchaser paid over the fair value of the net tangible and intangible assets acquired. Goodwill is recorded at fair value on the date of an acquisition and, in accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, or SFAS No. 142, is reviewed annually or more frequently if changes in circumstances indicate the carrying value may not be recoverable. Annual impairment reviews are performed in the fourth quarter. We have been required to reflect, as required by SFAS No. 142 and other applicable accounting rules, a non-cash charge to operating results for goodwill impairment in the amounts of $396.3 million in 2005, $227.8 million in 2006 and $509.3 million in 2007. These amounts include impairments relating to discontinued operations.

Our annual goodwill impairment test is conducted during the fourth quarter. We have processes to monitor for interim triggering events. During the third quarter of 2007, as a result of our debt being placed on review for a possible downgrade and the anticipated sale of a portion of the Company in the initial public offering, management determined at that time that it was appropriate to update its valuation analysis before the next scheduled annual test.

Based on this assessment, we performed an interim impairment test and recorded an impairment charge to goodwill of our Regulated Businesses in the amount of $243.3 million in the third quarter of 2007. The decline was primarily due to a slightly lower long-term earnings forecast caused by updated customer demand and usage expectations and expectations for timing of capital expenditures and rate recovery.

We completed our annual goodwill impairment test for 2007 and recorded an additional goodwill impairment charge to the Regulated Businesses reporting unit in the amount of $266.0 million during the fourth quarter of 2007. We determined that an impairment had occurred based upon new information regarding our market value. We incorporated this indicated market value into our valuation methodology and, based on those results, an additional impairment to our carrying value was recorded.

We may be required to recognize additional impairments in the future, depending on, among other factors, the market value of our common stock and its value relative to our book equity at the consummation of the initial public offering or the level over a period of time of the trading price of our stock since our initial public offering.

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Other factors that could necessitate an impairment would include a decline over a period of time in valuation multiples of comparable water utilities and a decline in our forecasted results in our business plan, such as changes in rate case results or capital investment budgets or changes in our interest rates. Further recognition of impairments of a significant portion of goodwill would negatively affect our results of operations and total capitalization, the effect of which could be material and could make it more difficult for us to secure financing on attractive terms and maintain compliance with our debt covenants.

Based on the initial public offering price, we have determined that it is probable we will record an impairment to goodwill when we report results for the quarter ended March 31, 2008. Whether such an impairment to goodwill is recognized will depend on an analysis of the factors described above. The size of any such impairment to goodwill, if any, cannot be determined at this time.

***Our Regulated Businesses compete with other regulated utilities, as well as strategic and financial buyers, for acquisition opportunities, which may hinder our ability to grow our business.***

We compete with other regulated utilities, as well as strategic and financial buyers, for acquisition opportunities, including tuck-ins. Our competitors may impede our growth by purchasing water utilities near our existing operations, thereby preventing us from acquiring them. Competing utilities and strategic and financial buyers have challenged, and may in the future challenge, our applications for new service territories. Our growth could be hindered if we are not able to compete effectively for new territories with other companies or strategic and financial buyers that have lower costs of operations or that can submit more attractive bids.

***The assets of our Regulated Businesses are subject to condemnation through eminent domain.***

Municipalities and other government subdivisions have historically been involved in the provision of water and wastewater services in the United States, and organized movements may arise from time to time in one or more of the service areas in which our Regulated Businesses operate to convert our assets to public ownership and operation through the governmental power of eminent domain. Should a municipality or other government subdivision seek to acquire our assets through eminent domain, we may resist the acquisition. Contesting an exercise of condemnation through eminent domain may result in costly legal proceedings and may divert the attention of the affected Regulated Business s management from the operation of its business.

The last sale of one of our water and wastewater systems under threat of condemnation occurred in 2003 in California. On March 1, 2007, our subsidiary, California American Water Company, was served by the San Lorenzo Valley Water District with court papers seeking to condemn our water and wastewater system in Felton, California, which serves approximately 1,300 customers. If a municipality or other government subdivision succeeds in acquiring the assets of one or more of our Regulated Businesses through eminent domain, there is a risk that we will not receive adequate compensation for the business, that we will not be able to keep the compensation, or that we will not be able to divest the business without incurring significant one-time charges.

***In order to consummate the proposed RWE Divestiture, we and RWE were required to obtain approvals from thirteen state PUCs. There can be no guarantee that some state PUC approvals already granted to us will not be appealed, withdrawn, modified or stayed.***

To consummate the proposed RWE Divestiture, we and RWE obtained regulatory approvals from state PUCs in 13 states. The state PUC approval in Illinois has been appealed, and there can be no guarantee that the state PUC approval in Illinois will not be overturned. Moreover, some of our existing state PUC approvals may be withdrawn or altered in the future by the state PUCs since they retain authority to withdraw or modify their prior decisions. There also can be no guarantee that, in conjunction with an appeal or otherwise, a stay or other form of injunctive relief will not be granted by a state PUC or reviewing court.

In addition, two of the regulatory approvals that we and RWE obtained expire 24 months from April 22, 2008, the date of effectiveness of the registration statement for the initial public offering, and another approval

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expires 36 months from that date. If RWE does not fully divest its ownership of American Water within 24 or 36 months of the effectiveness of the registration statement for the initial public offering, then we and RWE may be required to seek an extension of such approvals, as applicable, which process may result in delays, costs and the imposition of additional conditions on us or on RWE.

***In order to obtain the state PUC approvals to consummate the proposed RWE Divestiture we were required to accept certain conditions and restrictions that could increase our costs.***

Some of the regulatory approvals contain conditions and restrictions, including reporting obligations; obligations to maintain appropriate credit worthiness; restrictions on changes of control; prohibitions on the pass-through of our initial Sarbanes-Oxley Act compliance costs; prohibitions on the pass-through of costs of the Transactions; service quality and staffing level requirements; and the maintenance of specific collective bargaining agreements and retirement and certain other post employment benefit programs. These conditions and restrictions could increase our costs and adversely affect our business.

***Our Non-Regulated Businesses, through American Water (excluding its regulated subsidiaries), provide performance guarantees and other forms of financial security to our public-sector clients that could be claimed by our clients or potential clients if we do not meet certain obligations.***

Under the terms of some of our indebtedness and some of our agreements with the municipalities and other governmental entities, which we serve pursuant to O&M contracts, American Water (excluding its regulated subsidiaries) provides guarantees of the performance of our Non-Regulated Businesses, including financial guarantees or deposits to ensure performance of certain obligations. At December 31, 2007, we had guarantees and deposits totaling approximately $475.3 million, and this amount is likely to increase if our Non-Regulated Businesses grow. The presence of these contingent liabilities may adversely affect our financial condition and make it more difficult for us to secure financing on attractive terms. In addition, if the obligor on the guaranteed instrument fails to perform certain obligations to the satisfaction of the party that holds the guarantee, that party may seek to enforce the guarantee against us or proceed against the deposit. In that event, our financial condition, results of operations, cash flow and liquidity could be adversely affected.

***We operate a number of water and wastewater systems under O&M contracts and face the risk that the owners of those systems may fail to maintain those systems, which will negatively affect us as the operators of the systems.***

We operate a number of water and wastewater systems under O&M contracts. Pursuant to these contracts, we operate the system according to the standards set forth in the applicable contract, where it is generally the responsibility of the owner to undertake capital improvements. In some cases, we may not be able to convince the owner to make needed improvements in order to maintain compliance with applicable regulations. Although violations and fines incurred by water and wastewater systems may be the responsibility of the owner of the system under these contracts, those non-compliance events may reflect poorly on us as the operator of the system and damage our reputation, and in some cases, may result in liability to the same extent as if we were the owner.

***Our Non-Regulated Businesses are party to long-term contracts to operate and maintain water and wastewater systems under which we may incur costs in excess of payments received.***

Some of our Non-Regulated Businesses enter into long-term contracts pursuant to which they agree to operate and maintain a municipality s or other party s water or wastewater treatment and delivery facilities in exchange for an annual fee. Our Non-Regulated Businesses are generally subject to the risk that costs associated with operating and maintaining the facilities may exceed the fees received from the municipality or other contracting party. In addition, directly or through our non-regulated subsidiaries, we often guarantee our Non-Regulated Businesses obligations under those contracts. Losses under these contracts or guarantees may adversely affect our financial condition, results of operations, cash flow and liquidity.

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***We rely on our IT systems to assist with the management of our business and customer and supplier relationships, and a disruption of these systems could adversely affect our business.***

Our IT systems are an integral part of our business, and a serious disruption of our IT systems could significantly limit our ability to manage and operate our business efficiently, which in turn could cause our business and competitive position to suffer and cause our results of operations to be reduced. We depend on our IT systems to bill customers, process orders, provide customer service, manage construction projects, manage our financial records, track assets, remotely monitor certain of our plants and facilities and manage human resources, inventory and accounts receivable collections. Our IT systems also allow us to purchase products from our suppliers and bill customers on a timely basis, maintain cost-effective operations and provide service to our customers. Our IT systems are vulnerable to damage or interruption from:

- power loss, computer systems failures and internet, telecommunications or data network failures;
- operator negligence or improper operation by, or supervision of, employees;
- physical and electronic loss of customer data or security breaches, misappropriation and similar events;
- computer viruses;
- intentional acts of vandalism and similar events; and
- hurricanes, fires, floods, earthquakes and other natural disasters.

Such damages or interruptions may result in physical and electronic loss of customer or financial data, security breaches, misappropriation and similar events. In addition, the lack of redundancy for certain of our IT systems, including billing systems, could exacerbate the impact on the Company of any of the foregoing events.

In addition, we may not be successful in developing or acquiring technology that is competitive and responsive to the needs of our business and we might lack sufficient resources to make the necessary investments in technology to allow us to continue to operate at our current level of efficiency.

***Our indebtedness could affect our business adversely and limit our ability to plan for or respond to changes in our business, and we may be unable to generate sufficient cash flow to satisfy our liquidity needs.***

As of December 31, 2007, after giving effect to the Transactions, our pro forma indebtedness (including preferred stock with mandatory redemption requirements) was $5,016.1 million, and our working capital, defined as current assets less current liabilities, was in a deficit position. Our indebtedness could have important consequences, including:

- limiting our ability to obtain additional financing to fund future working capital or capital expenditures;
- exposing us to interest rate risk with respect to the portion of our indebtedness that bears interest at a variable rate, including $169.6 million of our auction-rate debt that resets to higher interest rates in the event of a failed auction;
- limiting our ability to pay dividends on our common stock or make payments in connection with our other obligations;

- likely requiring that a portion of our cash flow from operations be dedicated to the payment of the principal of and interest on our debt, thereby reducing funds available for future operations, acquisitions, dividends on our common stock or capital expenditures;

- limiting our ability to take advantage of significant business opportunities, such as acquisition opportunities, and to react to changes in market or industry conditions; and

- placing us at a competitive disadvantage compared to those of our competitors that have less debt.

In order to meet our capital expenditure needs, we may be required to make additional borrowings under our credit facilities or be required to issue new debt securities in the capital markets. We can provide no assurances that we will be able to access the debt capital markets or do so on favorable terms. If new debt is added to our current debt levels, the related risks we now face could intensify limiting our ability to refinance existing debt on favorable terms.

We will depend primarily on operations to fund our expenses and to pay the principal and interest on our outstanding debt. Our ability to meet our expenses thus depends on our future performance, which will be affected by financial, business, economic, competitive, legislative, regulatory and other factors beyond our control. If we do not have enough money to pay the principal and interest on our outstanding debt, we may be required to refinance all or part of our existing debt, sell assets, borrow additional funds or sell additional equity. If our business does not generate sufficient cash flow from operations or if we are unable to incur indebtedness sufficient to enable us to fund our liquidity needs, we may be unable to plan for or respond to changes in our business that would prevent us from maintaining or increasing our business and cause our operating results and prospects to be affected adversely.

***Our failure to comply with restrictive covenants under our credit facilities could trigger prepayment obligations.***

Our failure to comply with the restrictive covenants under our credit facilities could result in an event of default, which, if not cured or waived, could result in us being required to repay or refinance (on less favorable terms) these borrowings before their due date. If we are forced to repay or refinance (on less favorable terms) these borrowings, our results of operations and financial condition could be adversely affected by increased costs and rates. In 2007, we were not in compliance with reporting covenants contained in some of the debt agreements of our subsidiaries. Such defaults under the reporting covenants were caused by our delay in producing our quarterly and audited annual consolidated financial statements. We have obtained all necessary waivers under the agreements. We can provide no assurance that we will comply in the future with all our reporting covenants and will not face an event of default under our debt agreements, or that such default will be cured or waived.

***Work stoppages and other labor relations matters could adversely affect our results of operations.***

Currently, approximately 3,600 employees, or approximately 51% of our total workforce, are unionized and represented by 18 different unions. Approximately one-third of our 75 union collective bargaining agreements expire annually, with 18 agreements covering 759 employees scheduled to expire before the end of 2008. We might not be able to renegotiate labor contracts on terms that are favorable to us and negotiations or dispute resolutions undertaken in connection with our labor contracts could be delayed or become subject to the risk of labor actions or work stoppages. Labor actions, work stoppages or the threat of work stoppages and our failure to obtain favorable labor contract terms during renegotiations may all adversely affect our financial condition, results of operations, cash flow and liquidity.

***We currently have material weaknesses in internal control over financial reporting. If we fail to remedy our material weaknesses or otherwise maintain effective internal control over financial reporting, we may not be able to report our financial results accurately or on a timely basis. Any inability to report and file our financial results in an accurate and timely manner could harm our business and adversely impact your investment in the notes.***

As a public company, we are required to comply with the Sarbanes-Oxley Act and other rules and regulations that govern public companies. In particular, we are required to certify our compliance with Section 404 of the Sarbanes-Oxley Act for the year ended December 31, 2009, which requires us to perform system and process evaluation and testing of our internal control over financial reporting to allow management and our registered public accounting firm to report on the effectiveness of our internal control over financial reporting. Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed to provide reasonable

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assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles. However, from 2003 to April 28, 2008, we were an indirect wholly owned subsidiary of RWE, a stock corporation incorporated in the Federal Republic of Germany, and were not required to maintain a system of internal control consistent with the requirements of the SEC and the Sarbanes-Oxley Act, nor to prepare our own financial statements. As a public reporting company, we are required, among other things, to maintain a system of effective internal control over financial reporting suitable to prepare our publicly reported financial statements in a timely and accurate manner, and also to evaluate and report on such system of internal control.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company s annual or interim financial statements will not be prevented or detected on a timely basis. In connection with the preparation of our consolidated financial statements as of December 31, 2006, we and our independent registered public accountants have identified the following material weaknesses in our internal control over financial reporting:

- Inadequate internal staffing and skills;
- Inadequate controls over financial reporting processes;
- Inadequate controls over month-end closing processes, including account reconciliations;
- Inadequate controls over maintenance of contracts and agreements;
- Inadequate controls over segregation of duties and restriction of access to key accounting applications; and
- Inadequate controls over tax accounting and accruals.

We have initiated a remediation plan with respect to our material weaknesses, but there can be no assurances that our remediation plan will be effective. For further discussion, see Management s Discussion and Analysis of Financial Condition and Results of Operations Our Internal Control and Remediation Initiatives.

Each of these weaknesses could result in a material misstatement of our annual or interim consolidated financial statements. Moreover, we cannot assure you that we have identified all, or that we will not in the future have additional, material weaknesses, any of which may subject us to additional regulatory scrutiny, and cause future delays in filing our financial statements and periodic reports with the SEC. Any such delays in the filing of our financial statements and periodic reports may result in a loss of public confidence in the reliability of our financial statements and sanctions imposed on us by the SEC. We believe that such misstatements or delays could negatively impact our liquidity, access to capital markets, financial condition and the market value of our common stock or cause a downgrade in the credit ratings of American Water or the issuer. These material weaknesses contributed to our inability to comply with reporting covenants in our debt agreements and those of our subsidiaries, and could hinder our ability to comply with such covenants in the future if we are not successful in remediating such weaknesses.

**Risks Related to the Notes and the Exchange Offer**

***The notes are structurally subordinated to all the obligations of our subsidiaries other than the issuer. The issuer s ability to service its debt is dependent on the performance of our other subsidiaries.***

The notes have been issued by American Water Capital Corp., our finance subsidiary. American Water has signed a support agreement with the issuer. The notes are not guaranteed by any of our subsidiaries and are the obligations only of the issuer and American Water, by virtue of the support agreement. Accordingly, the notes are structurally subordinated to the liabilities, including trade payables, lease commitments and moneys

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borrowed, of American Water s subsidiaries other than the issuer. American Water has no material assets or operations other than equity interests in its subsidiaries, and the issuer has no material assets or operations except for its limited operations as a finance vehicle for our businesses. We expect that payments of interest and principal that the issuer makes on the notes (or that American Water makes pursuant to the support agreement) will be made only to the extent that our operating subsidiaries can distribute cash or other property to American Water and, through American Water, to the issuer.

Although the terms of the notes restrict our ability and the ability of our subsidiaries to incur certain liens and to enter into certain sale and leaseback transactions, the incurrence of other indebtedness or other liabilities by any of our subsidiaries is not prohibited in connection with the notes and could adversely affect our ability to pay our obligations on the notes. As of December 31, 2007, total liabilities of our subsidiaries other than the issuer were $5,146.7 million. As of December 31, 2007, the indebtedness of our subsidiaries other than the issuer, excluding intercompany liabilities and obligations of a type not required to be reflected on a balance sheet in accordance with generally accepted accounting principles, that would effectively have been senior to the notes, was approximately $1,926.0 million. We anticipate that from time to time our subsidiaries will incur additional debt and other liabilities. Any debt incurred by our subsidiaries other than the issuer will be structurally senior to the notes.

We have not agreed to any financial covenants in connection with the notes. Consequently, we are not required in connection with the notes to meet any financial tests, such as those that measure our working capital, interest coverage, fixed charge or net worth, in order to maintain compliance with the terms of the notes.

***Our ability to service our obligations under the notes depends on our ability to receive cash distributions from our operating subsidiaries. There can be no assurance that we will continue to receive such distributions or, if they are received, that they will be in amounts similar to past distributions.***

The issuer is our finance subsidiary and has no substantial assets. We have entered into a support agreement with the issuer pursuant to which we have agreed to pay to any debt investor or lenders of the issuer any principal or interest amounts owed by the issuer to such debt investor or lender that the issuer fails to pay on a timely basis. Because substantially all of our operations are conducted through our subsidiaries other than the issuer, the issuer will not be able to make interest and principal payments on the notes (and we will not be able to fulfill our obligations under the support agreement) unless we receive sufficient cash distributions from our operating subsidiaries and contribute such distributions to the issuer. The distributions received from our operating subsidiaries might not permit the issuer or us to make required payments of interest and principal under the notes or pursuant to the support agreement, as applicable, on a timely basis, or at all.

***If an active trading market does not develop for the new notes you may not be able to resell them.***

Currently, there is no public market for the new notes. If no active trading market develops, you may not be able to resell the new notes at their fair market value or at all. We do not intend to apply for listing of the new notes on any securities exchange or for quotation on any automated quotation system.

The liquidity of any market for the new notes will depend upon various factors, including:

- the number of holders of the new notes;
- the interest of securities dealers in making a market for the new notes;
- our financial performance or prospects; and
- the prospects for companies in our industry generally.

Accordingly, we cannot assure you that a market or liquidity will develop for the new notes.

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***If you fail to exchange your original notes, they will continue to be restricted securities and may become less liquid.***

Original notes that you do not tender or we do not accept will, following the exchange offer, continue to be restricted securities, and you may not offer to sell them except pursuant to an exemption from, or in a transaction not subject to, the Securities Act and applicable state securities laws. We will issue new notes in exchange for the original notes pursuant to the exchange offer only following the satisfaction of the procedures and conditions set forth in The Exchange Offer Procedures for Tendering . Such procedures and conditions include timely receipt by the exchange agent of such original notes and of a properly completed and duly executed letter of transmittal. Because we anticipate that most holders of original notes will elect to exchange such original notes, we expect that the liquidity of the market for each series of the original notes remaining after the completion of the exchange offer will be substantially limited. Any original notes of a series tendered and exchanged in the exchange offer will reduce the aggregate principal amount at maturity of the original notes of that series outstanding. Following the exchange offer, if you did not tender your original notes you generally will not have any further registration rights, and such original notes will continue to be subject to certain transfer restrictions. Accordingly, the liquidity of the market for each series of original notes could be adversely affected.

***Our principal stockholder is in a position to affect our ongoing operations, corporate transactions and other matters, and its interests may conflict with or differ from your interests as a noteholder.***

RWE owns approximately 64% of our common stock. As a result, RWE is able to control the outcome on virtually all matters submitted to a vote of our stockholders, including the election of directors. So long as RWE continues to own a significant portion of the outstanding shares of our common stock, it will continue to be able to significantly influence the election of our directors, subject to compliance with applicable NYSE requirements, our decisions, policies, management and affairs and corporate actions requiring stockholder approval, including the approval of transactions involving a change in control. The interests of RWE and its affiliates may not coincide with the interests of our other stockholders or with your interests as a noteholder.

***We may not be able to repurchase the notes upon a change of control.***

Upon the occurrence of a change of control triggering event, the issuer will be required to offer to repurchase all outstanding notes at 101% of their principal amount plus accrued and unpaid interest. The source of funds for any such purchase of the notes will be available cash, cash generated from our operating subsidiaries (other than the issuer) or other sources, including borrowings, sales of assets or sales of equity. The sources of cash may not be adequate to permit the issuer (or us, pursuant to our obligations under the support agreement) to repurchase the notes upon a change of control triggering event. The issuer s failure to offer to repurchase the notes, or to repurchase notes tendered following a change of control triggering event, will result in a default under the indenture governing the notes, which could lead to a cross-default under the terms of our existing and future indebtedness. For further information, see Description of the Notes.

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## USE OF PROCEEDS

This exchange offer is intended to satisfy our obligations under the exchange and registration rights agreement entered into in connection with the issuance of the original notes. We will not receive any cash proceeds from the issuance of the new notes in the exchange offer. In consideration for issuing the new notes as contemplated by this prospectus, we will receive the original notes in like principal amount. The original notes surrendered and exchanged for the new notes will be retired and canceled and cannot be reissued. Accordingly, the issuance of the new notes will not result in any increase in our indebtedness or capital stock. We used the net proceeds from the issuance of the original notes to fund the repayment of $1,286.0 million aggregate principal amount of RWE redemption notes and $206.0 million (including after tax gains of $2.2 million, net of $1.4 million of tax) aggregate principal amount of RWE notes.

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## RATIO OF EARNINGS TO FIXED CHARGES

American Water s and the issuer s ratio of earnings to fixed charges for each of the periods indicated is as follows:

For purposes of calculating the ratio of earnings to fixed charges, earnings consists of income (loss) from continuing operations before income taxes including the effect of allowance for funds used during construction, which we refer to as AFUDC, plus fixed charges. Fixed charges consist of interest expense, amortization of debt issuance costs, and a portion of rent expense that management believes is representative of the interest component of rental expense. Fixed charges have not been reduced for the effect of AFUDC.

The ratio of earnings to fixed charges was less than 1.00x for the periods indicated in the table below.

| | For the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 |
| **American Water** | | | | | |
| Ratio of Earnings to Fixed Charges (1) | 1.35 | 1.38 | | | |
| Pro Forma Ratio of Earnings to Fixed Charges (2) | | | | | |
| **American Water Capital Corp.** | | | | | |
| Ratio of Earnings to Fixed Charges | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Pro Forma Ratio of Earnings to Fixed Charges | | | | | 1.00 |

(1) For the years ended December 31, 2005, 2006 and 2007, earnings were insufficient to cover fixed charges and there were deficiencies of $224.3 million, $109.1 million and $255.7 million, respectively.

(2) On a pro forma basis after giving effect to the offering of notes, earnings would have been insufficient to cover fixed charges and there would have been a deficiency of $256.8 million for the year ended December 31, 2007.

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## THE EXCHANGE OFFER

### Purpose of the Exchange Offer

In connection with the sale of the original notes, we entered into an exchange and registration rights agreement with the initial purchasers of the original notes, under which we agreed to file and to use our reasonable efforts to have declared effective an exchange offer registration statement under the Securities Act and to consummate an exchange offer.

We are making the exchange offer in reliance on the position of the SEC as set forth in certain no-action letters. However, we have not sought our own no-action letter. Based upon these interpretations by the SEC, we believe that a holder of new notes, but not a holder who is our affiliate within the meaning of Rule 405 of the Securities Act, who exchanges original notes for new notes in the exchange offer, generally may offer the new notes for resale, sell the new notes and otherwise transfer the new notes without further registration under the Securities Act and without delivery of a prospectus that satisfies the requirements of Section 10 of the Securities Act. This does not apply, however, to a holder who is our affiliate within the meaning of Rule 405 of the Securities Act. We also believe that a holder may offer, sell or transfer the new notes only if the holder acquires the new notes in the ordinary course of its business and is not participating, does not intend to participate and has no arrangement or understanding with any person to participate in a distribution of the new notes.

Any holder of the original notes using the exchange offer to participate in a distribution of new notes cannot rely on the no-action letters referred to above. A broker-dealer that acquired original notes directly from us, but not as a result of market-making activities or other trading activities, must comply with the registration and prospectus delivery requirements of the Securities Act in the absence of an exemption from such requirements.

Each broker-dealer that receives new notes for its own account in exchange for original notes, as a result of market-making activities or other trading activities, must acknowledge that it will deliver a prospectus in connection with any resale of such new notes. This prospectus, as it may be amended or supplemented from time to time, may be used by a broker-dealer in connection with resales of new notes received in exchange for original notes where such original notes were acquired by such broker-dealer as a result of market-making activities or other trading activities. The letter of transmittal states that by so acknowledging and delivering a prospectus, a broker-dealer will not be considered to admit that it is an underwriter within the meaning of the Securities Act. We have agreed that starting on the expiration date and for a period ending upon the earlier of the 180th day after the expiration of this exchange offer or such time as such broker-dealers no longer own any original notes, we will make this prospectus available to broker-dealers for use in connection with any such resale. See Plan of Distribution .

Except as described above, this prospectus may not be used for an offer to resell, resale or other transfer of new notes.

The exchange offer is not being made to, nor will we accept tenders for exchange from, holders of original notes in any jurisdiction in which the exchange offer or the acceptance of tenders would not be in compliance with the securities or blue sky laws of such jurisdiction.

### Terms of the Exchange

Upon the terms and subject to the conditions of the exchange offer, we will accept any and all original notes validly tendered prior to 5:00 p.m., New York City time, on the expiration date for the exchange offer. The date of acceptance for exchange of the original notes, and completion of the exchange offer, is the exchange date, which will be the first business day following the expiration date (unless extended as described in this prospectus). We will issue, on or promptly after the exchange date, an aggregate principal amount of (i) up to $750,000,000 of the new 2017 notes for a like principal amount of the outstanding original 2017 notes tendered and accepted in connection with the exchange offer and (ii) up to $750,000,000 of the new 2037 notes for a like principal amount of the outstanding original 2037 notes tendered and accepted in connection with the exchange offer. The new notes issued in connection with the exchange offer will be delivered on the earliest practicable date following the exchange date. Holders may tender some or all of their original notes in connection with the exchange offer, but only in principal amounts of $2,000 or in integral multiples of $1,000 principal amount in excess thereof.

The terms of the new notes will be identical in all material respects to the terms of the respective original notes, except that the new notes will have been registered under the Securities Act and are issued free from any covenant regarding registration, including the payment of additional interest upon a failure to file or have declared effective an exchange offer registration statement or to complete the exchange offer by certain dates. The new notes will evidence the same debt as the original notes and will be issued under the same indenture and entitled to the same benefits under that indenture as the original notes being exchanged. As of the date of this prospectus, $1,500.0 million in aggregate principal amount of the original notes are outstanding, consisting of (i) $750,000,000 aggregate principal amount of the original 2017 notes and (ii) $750,000,000 aggregate principal amount of the original 2037 notes.

In connection with the issuance of the original notes, we have arranged for the original notes originally purchased by qualified institutional buyers and those sold in reliance on Regulation S under the Securities Act to be issued and transferable in book-entry form through the facilities of The Depository Trust Company, which we refer to as DTC, acting as depositary. The new notes will be issued in the form of global notes registered in the name of DTC or its nominee and each beneficial owner s interest in it will be transferable in book-entry form through DTC.

Holders of original notes do not have any appraisal or dissenters rights in connection with the exchange offer. Original notes that are not tendered for exchange or are tendered but not accepted in connection with the exchange offer will remain outstanding and be entitled to the benefits of the indenture under which they were issued, but, subject to certain limited exceptions, will not be entitled to any registration rights under the exchange and registration rights agreement. See Consequences of Failures to Properly Tender Original Notes in the Exchange Offer .

We shall be considered to have accepted validly tendered original notes if and when we have given oral or written notice to the exchange agent. The exchange agent will act as agent for the tendering holders for the purposes of receiving the new notes from us.

If any tendered original notes are not accepted for exchange because of an invalid tender, the occurrence of certain other events described in this prospectus or otherwise, we will return the original notes, without expense, to the tendering holder as quickly as possible after the expiration date.

Holders who tender original notes will not be required to pay brokerage commissions or fees or, subject to the instructions in the letter of transmittal, transfer taxes on exchange of original notes in connection with the exchange offer. We will pay all charges and expenses, other than certain applicable taxes described below, in connection with the exchange offer. See Fees and Expenses .

**Expiration Date; Extensions; Amendments**

The expiration date for the exchange offer is 5:00 p.m., New York City time, on , 2008, unless extended by us in our sole discretion (but in no event to a date later than , 2008), in which case the term expiration date shall mean the latest date and time to which the exchange offer is extended.

We reserve the right, in our sole discretion:

- to delay accepting any original notes, to extend the offer or to terminate the exchange offer if, in our reasonable judgment, any of the conditions described below shall not have been satisfied, by giving oral or written notice of the delay, extension or termination to the exchange agent; or

- to amend the terms of the exchange offer in any manner.

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If we amend the exchange offer in a manner that we consider material, we will disclose such amendment by means of a prospectus supplement, and, if necessary, we will extend the exchange offer for a period of five to ten business days after disclosure of such a material change.

If we determine to make a public announcement of any delay, extension, amendment or termination of the exchange offer, we will do so by making a timely release through an appropriate news agency.

If we delay accepting any original notes or terminate the exchange offer, we promptly will pay the consideration offered, or return any original notes deposited, pursuant to the exchange offer as required by Rule 14e-1(c) under the Exchange Act.

**Interest on the New Notes**

Interest on the new 2017 notes will accrue at a per annum rate of 6.085% from the most recent date to which interest on the original 2017 notes has been paid or, if no interest has been paid, from October 22, 2007. Interest on the new 2037 notes will accrue at a per annum rate of 6.593% from the most recent date to which interest on the original 2037 notes has been paid or, if no interest has been paid, from October 22, 2007.

Interest on the new notes will be paid semiannually to holders of record at the close of business on April 1 and October 1 immediately preceding the interest payment date on April 15 and October 15 of each year, commencing on April 15, 2008 or, if the exchange offer is not consummated by such date, October 15, 2008.

**Conditions to the Exchange Offer**

Notwithstanding any other term of the exchange offer, we will not be required to accept for exchange, or exchange new notes for, any original notes and may terminate the exchange offer as provided in this prospectus before the acceptance of the original notes, if prior to the expiration date:

- any action or proceeding is instituted or threatened in any court or by or before any governmental agency relating to the exchange offer which, in our reasonable judgment, might materially impair our ability to proceed with the exchange offer or materially impair the contemplated benefits of the exchange offer to us, or any material adverse development has occurred in any existing action or proceeding relating to us or any of our subsidiaries;

- any change, or any development involving a prospective change, in our business or financial affairs or any of our subsidiaries has occurred which, in our reasonable judgment, might materially impair our ability to proceed with the exchange offer or materially impair the contemplated benefits of the exchange offer to us;

- any law, statute, rule or regulation is proposed, adopted or enacted, which in our reasonable judgment, might materially impair our ability to proceed with the exchange offer or materially impair the contemplated benefits of the exchange offer to us; or

- any governmental or regulatory approval has not been obtained, which approval we, in our reasonable discretion, consider necessary for the completion of the exchange offer as contemplated by this prospectus.

The conditions listed above are for our sole benefit and may be asserted by us regardless of the circumstances giving rise to any of these conditions. We may waive these conditions in our reasonable discretion in whole or in part at any time and from time to time prior to the expiration date. The failure by us at any time to exercise any of the above rights shall not be considered a waiver of such right, and such right shall be considered an ongoing right which may be asserted at any time and from time to time.

If we determine in our reasonable discretion that any of the conditions are not satisfied, we may:

- refuse to accept any original notes and return all tendered original notes to the tendering holders;
- extend the exchange offer and retain all original notes tendered before the expiration of the exchange offer, subject, however, to the rights of holders to withdraw these original notes (see Withdrawal of Tenders below); or
- waive unsatisfied conditions relating to the exchange offer and accept all properly tendered original notes which have not been withdrawn.

**Procedures for Tendering**

Unless the tender is being made in book-entry form, to tender in the exchange offer, a holder must:

- complete, sign and date the letter of transmittal, or a facsimile of it;
- have the signatures guaranteed if required by the letter of transmittal; and
- mail or otherwise deliver the letter of transmittal or the facsimile, the original notes and any other required documents to the exchange agent prior to 5:00 p.m., New York City time, on the expiration date.

Any financial institution that is a participant in DTC s Book-Entry Transfer Facility system may make book-entry delivery of the original notes by causing DTC to transfer the original notes into the exchange agent s account. To validly tender original notes through DTC, the financial institution that is a participant in DTC will electronically transmit its acceptance through the Automated Tender Offer Program. DTC will then verify the acceptance, execute a book-entry transfer of the tendered original notes into the applicable account of the exchange agent at DTC and then send to the exchange agent confirmation of such book-entry transfer. The confirmation of such book-entry transfer will include an agent s message stating that DTC has received an express acknowledgment from the participant in DTC tendering the original notes that the participant has received and agrees to be bound by the terms of the letter of transmittal and that we may enforce the terms of the letter of transmittal against the participant. A tender of original notes through a book-entry transfer into the exchange agent s account will only be effective if an agent s message or letter of transmittal (or facsimile), with any required signature guarantees and any other required documents are transmitted to and received or confirmed by the exchange agent at its address set forth under the caption Exchange Agent below, prior to 5:00 p.m., New York City time, on the expiration date. Delivery of documents to DTC in accordance with its procedures does not constitute delivery to the exchange agent.

The tender by a holder of original notes will constitute an agreement between us and the holder in accordance with the terms and subject to the conditions set forth in this prospectus and in the letter of transmittal.

The method of delivery of original notes and the letter of transmittal and all other required documents to the exchange agent is at the election and risk of the holders. Instead of delivery by mail, we recommend that holders use an overnight or hand delivery service. In all cases, holders should allow sufficient time to assure delivery to the exchange agent before the expiration date. No letter of transmittal of original notes should be sent to us. Holders may request their respective brokers, dealers, commercial banks, trust companies or nominees to effect the tenders for such holders.

Any beneficial owner whose original notes are registered in the name of a broker, dealer, commercial bank, trust company or other nominee and who wishes to tender should contact the registered holder promptly and instruct such registered holder to tender on behalf of the beneficial owner. If the beneficial owner wishes to tender on that owner s own behalf, the beneficial owner must, prior to completing and executing the letter of transmittal and delivering such beneficial owner s original notes, either make appropriate arrangements to register ownership of the original notes in such beneficial owner s name or obtain a properly completed bond power from the registered holder. The transfer of registered ownership may take considerable time.

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Signatures on letters of transmittal or notices of withdrawal must be guaranteed by an eligible guarantor institution within the meaning of Rule 17Ad-15 under the Exchange Act, unless the original notes tendered pursuant thereto are tendered:

- by a registered holder who has not completed the box entitled Special Issuance Instructions or Special Delivery Instructions on the letter of transmittal; or
- for the account of an eligible guarantor institution.

In the event that a signature on a letter or transmittal or a notice of withdrawal is required to be guaranteed, such guarantee must be by:

- a member firm of a registered national securities exchange or of the Financial Industry Regulatory Authority;
- a commercial bank or trust company having an office or correspondent in the United States; or
- an eligible guarantor institution .

If the letter of transmittal is signed by a person other than the registered holder of any original notes, the original notes must be endorsed by the registered holder or accompanied by a properly completed bond power, in each case signed or endorsed in blank by the registered holder.

If the letter of transmittal or any original notes or bond powers are signed or endorsed by trustees, executors, administrators, guardians, attorneys-in-fact, officers of corporations or others acting in a fiduciary or representative capacity, such persons should so indicate when signing and, unless waived by us, submit evidence satisfactory to us of their authority to act in that capacity with the letter of transmittal.

We will determine all questions as to the validity, form, eligibility (including time of receipt) and acceptance and withdrawal of tendered original notes in our sole discretion. We reserve the absolute right to reject any and all original notes not properly tendered or any original notes whose acceptance by us would, in the opinion of our counsel, be unlawful. We also reserve the right to waive any defects, irregularities or conditions of tender as to any particular original notes either before or after the expiration date. Our interpretation of the terms and conditions of the exchange offer (including the instructions in the letter of transmittal) will be final and binding on all parties. Unless waived, any defects or irregularities in connection with tenders of original notes must be cured within a time period we will determine. Although we intend to request the exchange agent to notify holders of defects or irregularities relating to tenders of original notes, neither we, the exchange agent nor any other person will have any duty or incur any liability for failure to give such notification. Tenders of original notes will not be considered to have been made until such defects or irregularities have been cured or waived. Any original notes received by the exchange agent that are not properly tendered and as to which the defects or irregularities have not been cured or waived will be returned by the exchange agent to the tendering holders, unless otherwise provided in the letter of transmittal, as soon as practicable following the expiration date.

In addition, we reserve the right, as set forth above under the caption Conditions to the Exchange Offer , to terminate the exchange offer.

By tendering, each holder represents to us, among other things, that:

- the new notes acquired in connection with the exchange offer are being obtained in the ordinary course of business of the person receiving the new notes, whether or not such person is the holder;
- neither the holder nor any such other person has an arrangement or understanding with any person to participate in the distribution of such new notes; and

neither the holder nor any such other person is our affiliate (as defined in Rule 405 under the Securities Act).

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If the holder is a broker-dealer which will receive new notes for its own account in exchange for original notes, it will acknowledge that it acquired such original notes as the result of market-making activities or other trading activities and it will deliver a prospectus in connection with any resale of such new notes. See Plan of Distribution .

**Guaranteed Delivery Procedures**

A holder who wishes to tender its original notes and:

- whose original notes are not immediately available;
- who cannot deliver the holder s original notes, the letter of transmittal or any other required documents to the exchange agent prior to the expiration date; or
- who cannot complete the procedures for book-entry transfer before the expiration date;

may effect a tender if

- the tender is made through an eligible guarantor institution;
- before the expiration date, the exchange agent receives from the eligible guarantor institution:
  - (i) a properly completed and duly executed notice of guaranteed delivery by facsimile transmission, mail or hand delivery,
  - (ii) the name and address of the holder, and
  - (iii) the certificate number(s) of the original notes and the principal amount of original notes tendered, stating that the tender is being made and guaranteeing that, within three New York Stock Exchange trading days after the expiration date, the letter of transmittal and the certificate(s) representing the original notes (or a confirmation of book-entry transfer), and any other documents required by the letter of transmittal will be deposited by the eligible guarantor institution with the exchange agent; and
- the exchange agent receives, within three New York Stock Exchange trading days after the expiration date, a properly completed and executed letter of transmittal or facsimile, as well as the certificate(s) representing all tendered original notes in proper form for transfer or a confirmation of book-entry transfer, and all other documents required by the letter of transmittal.

**Withdrawal of Tenders**

Except as otherwise provided herein, tenders of original notes may be withdrawn at any time prior to 5:00 p.m., New York City time, on the expiration date.

To withdraw a tender of original notes in connection with the exchange offer, a written or facsimile transmission notice of withdrawal must be received by the exchange agent at its address set forth herein prior to 5:00 p.m., New York City time, on the expiration date. Any such notice of withdrawal must:

specify the name of the person who deposited the original notes to be withdrawn;

identify the original notes to be withdrawn (including the certificate number(s) and principal amount of such original notes);

be signed by the depositor in the same manner as the original signature on the letter of transmittal by which such original notes were tendered (including any required signature guarantees) or be accompanied by documents of transfer sufficient to have the Trustee register the transfer of such original notes into the name of the person withdrawing the tender; and

specify the name in which any such original notes are to be registered, if different from that of the depositor.

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We will determine all questions as to the validity, form and eligibility (including time of receipt) of such notices of withdrawal. Any original notes so withdrawn will be considered not to have been validly tendered for purposes of the exchange offer, and no new notes will be issued unless the original notes withdrawn are validly re-tendered. Any original notes which have been tendered but which are not accepted for exchange or which are withdrawn will be returned to the holder without cost to such holder as soon as practicable after withdrawal, rejection of tender or termination of the exchange offer. Properly withdrawn original notes may be re-tendered by following one of the procedures described above under the caption Procedures for Tendering at any time prior to the expiration date.

**Exchange Agent**

Wells Fargo Bank, National Association has been appointed as exchange agent in connection with the exchange offer. Questions and requests for assistance, requests for additional copies of this prospectus or of the letter of transmittal should be directed to the exchange agent by registered or certified mail to Wells Fargo Bank, N.A., Corporate Trust Operations, MAC N9303-121, P.O. Box 1517, Minneapolis, MN 55480, by overnight courier or regular mail to Wells Fargo Bank, N.A., Corporate Trust Operations, MAC N9303-121, 6th & Marquette Avenue, Minneapolis, MN 55479 or by hand delivery to Wells Fargo Bank, N.A., Corporate Trust Services, 608 2nd Avenue South, Northstar East Building-12th Floor, Minneapolis, MN 55402. The exchange agent s telephone number is (800) 344-5128 and facsimile number is (612) 667-6282.

**Fees and Expenses**

We will not make any payment to brokers, dealers or others soliciting acceptances of the exchange offer. We will pay certain other expenses to be incurred in connection with the exchange offer, including the fees and expenses of the exchange agent and certain accounting and legal fees.

Holders who tender their original notes for exchange will not be obligated to pay transfer taxes. However, if:

- new notes are to be delivered to, or issued in the name of, any person other than the registered holder of the original notes tendered; or
- tendered original notes are registered in the name of any person other than the person signing the letter of transmittal; or
- a transfer tax is imposed for any reason other than the exchange of original notes in connection with the exchange offer;

then the amount of any such transfer taxes (whether imposed on the registered holder or any other person) will be payable by the tendering holder. If satisfactory evidence of payment of such taxes or exemption from them is not submitted with the letter of transmittal, the amount of such transfer taxes will be billed directly to the tendering holder.

**Accounting Treatment**

The new notes will be recorded at the same carrying value as the original notes as reflected in our accounting records on the date of the exchange. Accordingly, we will not recognize any gain or loss for accounting purposes upon the completion of the exchange offer. The expenses of the exchange offer that we pay will increase our deferred financing costs in accordance with generally accepted accounting principles.

**Consequences of Failures to Properly Tender Original Notes in the Exchange Offer**

Issuance of the new notes in exchange for the original notes in the exchange offer will be made only after timely receipt by the exchange agent of such original notes, a properly completed and duly executed letter of transmittal and all other required documents. Therefore, holders of the original notes desiring to tender such

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original notes in exchange for new notes should allow sufficient time to ensure timely delivery. We are under no duty to give notification of defects or irregularities of tenders of original notes for exchange. Original notes that are not tendered or that are tendered but not accepted by us will, following completion of the exchange offer, continue to be subject to the existing restrictions upon transfer thereof under the Securities Act, and, upon completion of the exchange offer, certain registration rights under the exchange and registration rights agreement will terminate. In the event the exchange offer is completed, other than in limited circumstances, we will not be required to register the remaining original notes. Remaining original notes will continue to be subject to the following restrictions on transfer:

- the remaining original notes may be resold only (i) if registered pursuant to the Securities Act, (ii) if an exemption from registration is available, or (iii) if neither such registration nor such exemption is required by law; and

- the remaining original notes will bear a legend restricting transfer in the absence of registration or an exemption.

We do not currently anticipate that we will register the remaining original notes under the Securities Act. To the extent that original notes are tendered and accepted in connection with the exchange offer, any trading market for remaining original notes could be adversely affected. See Risk Factors Risks Relating to the Notes and the Exchange Offer If you fail to exchange your original notes, they will continue to be restricted securities and may become less liquid .

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### UNAUDITED PRO FORMA CONDENSED CONSOLIDATED FINANCIAL INFORMATION

The following unaudited pro forma condensed consolidated financial information have been developed by applying pro forma adjustments to the historical audited consolidated financial statements of American Water appearing elsewhere in this prospectus. See the explanatory note to the unaudited pro forma condensed consolidated financial statements. The unaudited pro forma condensed consolidated statements of operations give effect to the Transactions as if they had occurred on January 1, 2007. The unaudited pro forma condensed consolidated balance sheet gives effect to the adjustment of restricted stock units from liability classified awards to equity classified awards as a result of the initial public offering as if it had occurred on December 31, 2007. The Transactions consist of the following:

- The Merger, comprising:
  - The merger of Thames US Holdings into American Water with American Water being the surviving entity.
- The Refinancing, comprising:
  - The non-cash equity contribution to the Company by RWE of $100.0 million of debt of our subsidiaries held by RWE on March 29, 2007 and the $550.0 million cash equity contribution to the Company by RWE on March 29, 2007, which was used to pay down $232.5 million of short-term debt and the remainder used for general working capital purposes;
  - The $1,750.0 million issuance of RWE redemption notes on September 20, 2007, which was used to fund the early redemption of $1,750.0 million of preferred stock held by RWE;
  - The issuance of $1,500.0 million aggregate principal amount of new senior notes, less issuance costs of $11.7 million on October 22, 2007, which resulted in the repayment of $1,286.0 million aggregate principal amount of RWE redemption notes and $206.0 million of RWE notes;
  - The $8.6 million gain (after tax gains of $5.2 million, net of $3.4 million of tax) on early repayment of RWE notes;
  - The issuance of $415.0 million of commercial paper to fund the partial repayment of $464.0 million of RWE redemption notes with the balance of $49.0 million of the RWE redemption notes repaid with excess cash; and
  - The cash equity contribution to the Company by RWE of $266.0 million on December 21, 2007, which was used to pay down commercial paper.
- The 160,000-for-1 split of common stock effected on November 7, 2007.
- The initial public offering of 58,000,000 shares of our common stock, consummated on April 28, 2008.

The unaudited pro forma condensed consolidated statement of operations adjustments and financial information do not include the $150.0 million equity contribution from RWE on September 27, 2007.

The Company paid approximately $3.0 million in completion bonuses related to the initial public offering to various key members of management. As of December 31, 2007, approximately $2.6 million has been accrued as a portion of the completion bonuses are not contingent on the successful completion of the initial public offering and may be paid as cash bonuses. The unaccrued portion of the completion bonuses has not been reflected in the unaudited pro forma condensed consolidated financial information.

Assumptions underlying the pro forma adjustments are described in the accompanying notes, which should be read in conjunction with these unaudited pro forma condensed consolidated financial statements.

The unaudited pro forma adjustments and financial information:

are based upon available information and certain assumptions that we believe are reasonable under the circumstances;

are presented for informational purposes only;

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- do not purport to represent what our results of operations or financial condition would have been had the Transactions actually occurred on the dates indicated; and

- do not purport to project our results of operations or financial condition for any future period or as of any future date.

The unaudited pro forma condensed consolidated financial statements should be read in conjunction with the information contained in Use of Proceeds, Selected Historical Consolidated Financial Data, Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and related notes thereto appearing elsewhere in this prospectus. All pro forma adjustments and their underlying assumptions are described more fully in the notes to our unaudited pro forma condensed consolidated financial statements.

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

**Unaudited Pro Forma Condensed Consolidated Statement of Operations**

**For the Year Ended December 31, 2007**

| | Historical | Pro forma adjustments | Pro forma |
|---|---|---|---|
| | (In thousands except per share data) | | |
| Operating revenues | $ 2,214,215 | $ | $ 2,214,215 |
| Operating expenses | | | |
| Operation and maintenance | 1,246,479 | 2,540(A) | 1,249,019 |
| Depreciation and amortization | 267,335 | | 267,335 |
| General taxes | 183,253 | | 183,253 |
| Loss (gain) on sale of assets | (7,326) | | (7,326) |
| Impairment charges | 509,345 | | 509,345 |
| Total operating expenses, net | 2,199,086 | 2,540 | 2,201,626 |
| Operating income (loss) | 15,129 | (2,540) | 12,589 |
| Other income (deductions) | | | |
| Interest | (283,165) | (1,705)(B) | (281,232) |
| | | 4,116 (C) | |
| | | (478)(D) | |
| Amortization of debt expense | (4,867) | (544)(B) | (5,411) |
| Other, net | 17,384 | | 17,384 |
| Total other income (deductions) | (270,648) | 1,389 | (269,259) |
| Income (loss) from continuing operations before income taxes | (255,519) | (1,151) | (256,670) |
| Provision for income taxes | 86,756 | (455)(E) | 86,301 |
| Income (loss) from continuing operations | $ (342,275) | $ (696) | $ (342,971) |
| Unaudited pro forma earnings per share: | | | |
| Basic | $ (2.14) | | $ (2.14) |
| Diluted | $ (2.14) | | $ (2.14) |
| Weighted average shares used in calculating earnings per share: | | | |
| Basic | 160,000 | (F) | 160,000 |
| Diluted | 160,000 | (G) | 160,000 |

See accompanying notes to the Unaudited Pro Forma Condensed Consolidated Financial Statements.

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

**Unaudited Pro Forma Condensed Consolidated Balance Sheet**

**December 31, 2007**

| | Historical | Pro forma adjustments | Pro forma |
|---|---|---|---|
| | (in thousands, except per share data) | | |
| ASSETS | | | |
| Property, plant and equipment | | | |
| Utility plant at original cost, net of accumulated depreciation | $ 9,199,909 | $ | $ 9,199,909 |
| Nonutility property, net of accumulated depreciation | 118,052 | | 118,052 |
| Total property, plant and equipment | 9,317,961 | | 9,317,961 |
| Current assets | | | |
| Cash and cash equivalents | 13,481 | | 13,481 |
| Other current assets | 416,873 | | 416,873 |
| Total current assets | 430,354 | | 430,354 |
| Regulatory and other long-term assets | | | |
| Goodwill | 2,456,952 | | 2,456,952 |
| Other regulatory and other long-term assets | 728,805 | | 728,805 |
| Total regulatory and other long-term assets | 3,185,757 | | 3,185,757 |
| TOTAL ASSETS | $ 12,934,072 | $ | $ 12,934,072 |
| CAPITALIZATION & LIABILITIES | | | |
| Capitalization | | | |
| Common stockholders equity | $ 4,542,046 | $ 680(H) | $ 4,542,726 |
| Preferred stock without mandatory redemption requirements | 4,568 | | 4,568 |
| Long-term debt | | | |
| Long-term debt | 4,674,837 | | 4,674,837 |
| Redeemable preferred stock at redemption value | 24,296 | | 24,296 |
| Total capitalization | 9,245,747 | 680 | 9,246,427 |
| Current liabilities | | | |
| Short-term debt and current portion of long-term debt | 316,969 | | 316,969 |
| Other current liabilities | 457,520 | | 457,520 |
| Total current liabilities | 774,489 | | 774,489 |
| Total regulatory and other long-term liabilities | 2,095,449 | (680)(H) | 2,094,769 |
| Contributions in aid of construction | 818,387 | | 818,387 |
| TOTAL CAPITALIZATION AND LIABILITIES | $ 12,934,072 | $ | $ 12,934,072 |

See accompanying notes to the Unaudited Pro Forma Condensed Consolidated Financial Statements.

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

**Notes to the Unaudited Pro Forma Condensed Consolidated Financial Statements**

Explanatory Note: On September 28, 2007, Thames US Holdings was merged with and into American Water, with American Water as the surviving entity. American Water is an indirect majority-owned subsidiary of RWE. The historical consolidated financial statements of American Water represent the consolidated results of the Company, formerly issued under the name Thames Water Aqua US Holdings, Inc. and Subsidiary Companies.

(A) Reflects the granting of 843,869 unvested stock options, 107,025 restricted stock units and 89,921 restricted stock awards to our employees in connection with the initial public offering. The awards were issued under the American Water 2007 Omnibus Equity Compensation Plan and will be recorded as equity awards. The restricted stock units and stock options vest over a 3-year period commencing January 1, 2007 and 566,562 unvested stock options and 71,852 restricted stock units are expected to vest over the three-year period based on our assessment of the probability of achieving performance conditions. The 89,921 restricted stock awards vest over a 3-month period commencing with the pricing of the initial public offering and 89,921 of the awards are expected to vest over the 3-month period. The grant date value of the stock options at issuance was $4.09 using the following assumptions in a Black-Scholes model: $21.50 Exercise Price, 52 1/2 month Expected Term, 2.87% Discount Rate, 29% Volatility, 3.72% Dividend Yield.

(B) The sources and uses of funds in connection with the Refinancing and the related impact on interest expense related to the Transactions are summarized below, which are defined and further discussed elsewhere in this prospectus.

| | Principal | Rate | Interest expense 12 months | Debt expense amortization 12 months |
|---|---|---|---|---|
| | | (In thousands) | | |
| SOURCES: | | | | |
| RWE redemption notes(1) | $ 1,750,000 | 5.72% | 100,122 | |
| Original notes(1) | 1,500,000 | 6.34% | 77,124 | |
| Commercial paper(1) | 415,000 | 5.31% | 22,036 | |
| RWE cash equity contribution(1) | 266,000 | | | |
| Excess cash | 49,026 | | | |
| Total | $ 3,980,026 | | $ 199,282 | |
| USES: | | | | |
| Redeemable preferred stock(1) | $ 1,750,000 | | $ (74,569) | |
| RWE redemption notes(1) | 1,750,000 | | (100,122) | |
| RWE notes(1) | 202,370 | | (9,154) | |
| Commercial paper(1) | 266,000 | | (13,732) | |
| Financing costs | 11,656 | | | $ 544 |
| Total | $ 3,980,026 | | (197,577) | 544 |
| Net increase (decrease) | | | $ (1,705) | $ 544 |

(1) The issuance of $1,750.0 million of RWE redemption notes on September 20, 2007 was used to fund the early redemption of $1,750.0 million of preferred stock held by RWE. The RWE redemption notes were repaid early with $1,286.0 million of the proceeds of the original notes, $415.0 million of commercial paper and $49.0 million of excess cash. $202.4 million of the proceeds of the original notes were used to fund the repayment of $206.0 million (including after tax gains of $2.2 million, net of $1.4 million of tax) of RWE notes. The cash equity contribution to the Company by RWE of $266.0 million on December 21, 2007 was used to

pay down commercial paper.

(C) Reflects the non-cash equity contribution to the Company by RWE of $100.0 million of debt of our subsidiaries held by RWE and the $550.0 million of cash equity contribution to the Company by RWE on March 29, 2007. The cash was used to pay down $232.5 million of short-term debt with the remainder used for general working capital purposes.

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The resulting reduction in interest expense is computed as follows:

| | RWE Notes | Commercial Paper (In thousands) | Total |
|---|---|---|---|
| Principal redemption | $ 100,000 | $ 232,500 | |
| Calculated effective rate | 4.00% | 5.44% | |
| Reduction in interest expense for the year ended December 31, 2007 | $ 989 | $ 3,127(1) | $ 4,116 |

(1) Reflects actual interest accrued from January 1, 2007 to March 27, 2007.

(D) Reflects the amortization of the $8.6 million gain on the early extinguishment of RWE notes, which was recorded as a long term regulatory liability, over the lives of the debt tranches that were repaid.

(E) Represents the reduction in income tax expense resulting from the Transactions at the estimated blended tax rate of 39.6%.

(F) The number of common shares used to compute pro forma basic earnings per common share is 160.0 million, which is the number of shares of our common stock assumed to be outstanding upon the consummation of the initial public offering.

(G) The number of shares used to compute pro forma diluted earnings per share is based on the number of shares of our common stock described in (F) above, plus the potential dilution that could occur if options and restricted stock units granted under the American Water 2007 Omnibus Equity Compensation Plan were exercised or converted into common stock. There are no dilutive incremental common shares included in the calculation of pro forma diluted earnings per share as the potentially dilutive instruments would be antidilutive.

(H) Reflects the adjustment of the restricted stock units from liability-classified awards to equity-classified awards as of the completion of the initial public offering resulting in a reclassification of $0.7 million of current liabilities to additional paid-in capital.

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## SELECTED HISTORICAL CONSOLIDATED FINANCIAL DATA

The following table presents our selected historical consolidated financial data at the dates and for the periods indicated. The statements of operations data for the years ended December 31, 2005, 2006 and 2007 and the balance sheet data as of December 31, 2006 and 2007 have been derived from our audited consolidated financial statements included elsewhere in this prospectus. The historical financial data as of December 31, 2005 have been derived from our audited consolidated financial statements not included in this prospectus. The statement of operations for the years ended December 31, 2003 and 2004, and the financial data as of December 31, 2003 and 2004 have been derived from our historical financial statements, in each case, which are not included in this prospectus.

Our historical consolidated financial data are not necessarily indicative of our future performance or what our financial position and results of operations would have been if we had operated as a separate, stand-alone entity during the periods shown. This financial data should be read in conjunction with, and is qualified in its entirety by reference to, the information in the section in this prospectus entitled Use of Proceeds , Unaudited Pro Forma Condensed Consolidated Financial Information , Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the notes thereto included elsewhere in this prospectus.

| | For the years ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2003 (unaudited) | 2004 | 2005 | 2006 | 2007 |
| | (in thousands, except per share data) | | | | |
| **Statement of operations data(1):** | | | | | |
| Operating revenues | $ 1,890,291 | $ 2,017,871 | $ 2,136,746 | $ 2,093,067 | $ 2,214,215 |
| Operating expenses | | | | | |
| Operation and maintenance | 1,089,071 | 1,121,970 | 1,201,566 | 1,174,544 | 1,246,479 |
| Depreciation and amortization | 210,588 | 225,260 | 261,364 | 259,181 | 267,335 |
| General taxes | 164,677 | 170,165 | 183,324 | 185,065 | 183,253 |
| Loss (gain) on sale of assets(2) | (16,771) | (8,611) | (6,517) | 79 | (7,326) |
| Impairment charges | 3,555 | 78,688 | 385,434 | 221,685 | 509,345 |
| Total operating expenses, net | 1,451,120 | 1,587,472 | 2,025,171 | 1,840,554 | 2,199,086 |
| Operating income (loss) | 439,171 | 430,399 | 111,575 | 252,513 | 15,129 |
| Other income (deductions) | | | | | |
| Interest | (280,501) | (315,944) | (345,257) | (365,970) | (283,165) |
| Amortization of debt expense | (3,872) | (3,377) | (4,367) | (5,062) | (4,867) |
| Other, net(3) | (52,387) | 14,350 | 13,898 | 9,581 | 17,384 |
| Total other income (deductions) | (336,760) | (304,971) | (335,726) | (361,451) | (270,648) |
| Income (loss) from continuing operations before income taxes | 102,411 | 125,428 | (224,151) | (108,938) | (255,519) |
| Provision for income taxes | 60,271 | 66,328 | 50,979 | 46,912 | 86,756 |
| Income (loss) from continuing operations | $ 42,140 | $ 59,100 | $ (275,130) | $ (155,850) | $ (342,275) |
| Income (loss) from continuing operations per basic common share(4) | $ 0.26 | $ 0.37 | $ (1.72) | $ (0.97) | $ (2.14) |
| Income (loss) from continuing operations per common diluted share(4) | $ 0.26 | $ 0.37 | $ (1.72) | $ (0.97) | $ (2.14) |
| Basic weighted average common shares(4) | 160,000 | 160,000 | 160,000 | 160,000 | 160,000 |
| Diluted weighted average common shares(4) | 160,000 | 160,000 | 160,000 | 160,000 | 160,000 |

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| | For the years ended December 31, 2005 | 2006 | 2007 |
|---|---|---|---|
| | (in thousands) | | |
| **Other data:** | | | |
| Cash flows provided by (used in): | | | |
| Operating activities | $ 525,435 | $ 323,748 | $ 473,712 |
| Investing activities | (530,165) | (691,438) | (746,578) |
| Financing activities | (9,049) | 332,367 | 256,593 |
| Construction expenditures | (558,446) | (688,843) | (758,569) |

| | As of December 31, 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| | (unaudited) | | | | |
| **Balance sheet data:** | | | | | |
| Cash and cash equivalents | $ 71,097 | $ 78,856 | $ 65,077 | $ 29,754 | $ 13,481 |
| Utility plant and property, net of depreciation | 7,377,195 | 7,754,434 | 8,101,769 | 8,605,341 | 9,199,909 |
| Total assets | 12,629,354 | 12,728,410 | 12,542,029 | 12,783,059 | 12,934,072 |
| Other short term and long term debt | 5,063,344 | 5,101,891 | 5,030,078 | 4,103,532 | 4,991,806 |
| Redeemable preferred stock | 1,787,777 | 1,775,224 | 1,774,691 | 1,774,475 | 24,296 |
| Total debt | 6,851,121 | 6,877,115 | 6,804,769 | 5,878,007 | 5,016,102 |
| Common stockholder equity | 3,198,144 | 3,129,555 | 2,804,716 | 3,817,397 | 4,542,046 |
| Preferred stock without mandatory redemption requirements | 5,687 | 4,651 | 4,571 | 4,568 | 4,568 |

(1) On September 28, 2007, Thames US Holdings was merged with and into American Water, with American Water as the surviving entity. American Water is an indirect majority-owned subsidiary of RWE. The historical consolidated financial statements of American Water represent the consolidated results of the Company, formerly issued under the name Thames Water Aqua US Holdings, Inc. and Subsidiary Companies.

(2) Represents primarily losses (gains) on sales of publicly traded securities and dispositions of assets not needed in utility operations.

(3) Includes allowance for other funds used during construction, allowance for borrowed funds used during construction and preferred dividends of subsidiaries.

(4) The number of shares used to compute income (loss) from continuing operations per basic share and income (loss) from continuing operations per diluted common share for the fiscal years ended December 31, 2005, 2006 and 2007 is 160.0 million after giving effect to the 160,000-for-1 stock split on November 7, 2007. For the year ended December 31, 2007, there are no dilutive incremental common shares included in diluted earnings per share as all potentially dilutive instruments would be antidilutive.

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## MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The following discussion and analysis of our financial condition and results of operations covers periods prior to the consummation of the Transactions. Accordingly, the discussion and analysis of historical periods does not reflect the significant impact that the Transactions will have on us. You should read the following discussion together with the financial statements and the notes thereto included elsewhere in this prospectus. This discussion contains forward-looking statements that are based on management s current expectations, estimates and projections about our business and operations. The cautionary statements made in this prospectus should be read as applying to all related forward-looking statements whenever they appear in this prospectus. Our actual results may differ materially from those currently anticipated and expressed in such forward-looking statements as a result of a number of factors, including those we discuss under Risk Factors and elsewhere in this prospectus. You should read Risk Factors and Forward-Looking Statements.*

### Overview

Founded in 1886, American Water is the largest investor-owned United States water and wastewater utility company, as measured both by operating revenue and population served. Our nearly 7,000 employees provide approximately 15.6 million people with drinking water, wastewater and other water-related services in 32 states and Ontario, Canada. In 2007, we generated $2,214.2 million in total operating revenue, representing approximately four times the operating revenue of the next largest investor-owned company in the United States water and wastewater business, and $15.1 million in operating income, which includes $509.3 million of impairment charges relating to continuing operations, and a net loss of $342.8 million.

Our primary business involves the ownership of water and wastewater utilities that provide water and wastewater services to residential, commercial and industrial customers. Our Regulated Businesses that provide these services are generally subject to economic regulation by state PUCs in the states in which they operate. The federal government and the states also regulate environmental, health and safety and water quality matters. Our Regulated Businesses currently provide services in 20 states and in 2007 served approximately 3.3 million customers, or connections to our water and wastewater networks. We report the results of this business in our Regulated Businesses segment. In 2007, our Regulated Businesses generated $1,987.6 million in operating revenue, prior to inter-segment eliminations, representing 89.8% of our consolidated operating revenue.

We also provide services that are not subject to economic regulation by state PUCs. Our Non-Regulated Businesses include our:

- Contracts Operations Group, which enters into public/private partnerships, including O&M and DBO contracts for the provision of services to water and wastewater facilities for municipalities, the United States military and other customers;
- Applied Water Management Group, which works with customers to design, build and operate small water and wastewater treatment plants; and
- Homeowner Services Group, which provides services to domestic homeowners to protect against the cost of repairing broken or leaking pipes inside and outside their homes.

We report the results of this business in our Non-Regulated Businesses segment. In 2007, our Non-Regulated Businesses generated $242.7 million in operating revenue, prior to inter-segment eliminations.

*History*

Prior to being acquired by RWE in 2003, we were the largest publicly traded water utility company in the United States. In 2003, we were acquired by RWE and became a private company. Prior to the Merger, Thames US Holdings, formerly an indirect wholly owned subsidiary of RWE, was the holding company for us and our regulated and unregulated subsidiaries throughout the United States and Ontario, Canada.

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Our consolidated statements of operations for the years ended December 31, 2005 and 2006 reflect expense allocations for some central corporate functions historically provided to us by Thames Water Plc, a former subsidiary of RWE, which we refer to as Thames Water, including information systems, human resources, accounting and treasury activities and legal services. These allocations reflected expenses specifically identifiable as relating to our business as well as our share of expenses allocated to us based on capital employed, capital expenditures, headcount, revenues, production volumes, fixed costs, environmental accruals or other methods management considers to be reasonable. During our transition to a separate, stand-alone company, we have developed or obtained additional in-house capabilities related to these functions, and therefore there were no such expense allocations in 2007 from RWE or its affiliates. We and RWE consider these allocations to be a reasonable reflection of our utilization of the services provided by Thames Water. However, our expenses as a separate, stand-alone company may be higher or lower than the amounts reflected in our consolidated statements of operations.

The RWE acquisition resulted in certain changes in our business. For example, our operations and management were managed through Thames Water. Also, we agreed not to file rate cases with some state PUCs for specified periods of time as a condition of the acquisition. As of December 31, 2007, all rate stay-out provisions associated with the RWE acquisition had expired.

As a result of significantly increased costs, our inability to file rate cases and impairment charges, we recorded net losses in the amount of $325.0 million, $162.2 million and $342.8 million for the years ended December 31, 2005, 2006, and 2007 respectively.

In 2005, RWE decided to divest American Water. In March 2006, RWE decided to divest American Water through the sale of shares in one or more public offerings. In order to become a public company once again, we have had to incur substantial initial costs, including costs associated with ensuring adequate internal control over financial reporting in order to achieve compliance with the Sarbanes-Oxley Act. These substantial initial costs will not be recovered in rates charged to our customers. See Our Internal Control and Remediation Initiatives.

We performed valuations of our long-lived assets, investments and goodwill, as of December 31, 2005, 2006 and 2007. As a result of the valuation analyses, we recorded pre-tax charges of $420.4 million and $227.8 million, including impairment charges from discontinued operations, for the years ended December 31, 2005 and 2006, respectively. During the third quarter of 2007, as a result of our debt being placed on review for a possible downgrade and the proposed sale of a portion of the Company in the initial public offering, an interim impairment test was performed, and a pre-tax impairment charge to goodwill of $243.3 million was recorded in the third quarter of 2007. We completed our annual impairment test for 2007 and recorded an additional pre-tax goodwill impairment charge to the Regulated Businesses reporting unit in the amount of $266.0 million during the fourth quarter of 2007. We determined that an impairment had occurred based upon new information regarding our market value. We incorporated this indicated market value into our valuation methodology and, based on those results, an additional pre-tax impairment to our carrying value was recorded. As a result of these impairments, net income was reduced by $388.6 million, $223.6 million and $501.5 million in 2005, 2006 and 2007, respectively.

The Company estimates the fair value of our long-lived assets, investments and goodwill using available market values, discounted cash flow models from our business plan or a combination of market and discounted cash flow values. Annual impairment reviews are performed in the fourth quarter. There are a number of significant assumptions reflected in our valuation analyses. These include market interest rates used for discounting future cash flows, market value assumptions using market valuation multiples of comparable water utilities, information regarding the Company s market value in connection with the initial public offering and revenue and operating income growth assumptions in our business plan. We base these assumptions on our best estimates of the Company s future performance and available market information at the time. Any decline over a period of time in the valuation multiples of comparable water utilities, a decline in the market value of our common stock and its value relative to our book equity or a decline over a period of time of our stock price could result in additional impairments. A decline in our forecasted results in our business plan, such as changes in rate case results or capital investment budgets or an increase in interest rates, may also result in an incremental impairment charge. In accordance with GAAP, the Company reviews goodwill annually, or more frequently, if changes in circumstances indicate the carrying value may not be recoverable. See Critical Accounting Policies and Estimates. Based on the price of our shares in the initial public offering, we have determined that it is probable that we will record an impairment to goodwill when we report results for the quarter ended March 31, 2008. The size of such impairment to goodwill, if any, cannot be determined at this time.

*Our Internal Control and Remediation Initiatives*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles. However, since 2003 and prior to our initial public offering, we were an indirect wholly owned subsidiary of RWE and, as a privately owned company, were not required to maintain a system of internal control consistent with the requirements of the SEC and the Sarbanes-Oxley Act, nor to prepare our own financial statements. As a public reporting company, we are required, among other things, to maintain a system of effective internal control over financial reporting suitable to prepare our publicly reported financial statements in a timely and accurate manner, and also to evaluate and report on such system of internal control. In particular, we are required to certify our compliance with Section 404 of the Sarbanes-Oxley Act for the year ended December 31, 2009, which requires us to perform system and process evaluation and testing of our internal control over financial reporting to allow management and our independent registered public accounting firm to report on the effectiveness of our internal control over financial reporting.

In connection with the preparation of our consolidated financial statements as of December 31, 2006, we and our independent registered public accountants identified the following material weaknesses in our internal control over financial reporting:

- Inadequate internal staffing and skills;
- Inadequate controls over financial reporting processes;
- Inadequate controls over month-end closing processes, including account reconciliations;
- Inadequate controls over maintenance of contracts and agreements;
- Inadequate controls over segregation of duties and restriction of access to key accounting applications; and
- Inadequate controls over tax accounting and accruals.

Since joining the Company in 2006, Donald L. Correll, our Chief Executive Officer, and Ellen C. Wolf, our Chief Financial Officer, have assigned a high priority to the evaluation and remediation of our internal controls, and have taken numerous steps to remediate these material weaknesses and to evaluate and strengthen our other internal controls over financial reporting. Some of the actions taken include:

- Increasing our internal financial staff numbers and skill levels, and using external resources to supplement our internal staff where necessary;
- Implementing detailed processes and procedures related to our period end financial closing processes, key accounting applications and our financial reporting processes;

Implementing or enhancing systems used in the financial reporting processes and month-end close processes;

Conducting extensive training on existing and newly developed processes and procedures as well as explaining to employees Sarbanes-Oxley Act requirements and the value of internal controls;

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- Enhancing our internal audit staff;
- Hiring a director of internal control and a director of taxes;
- Implementing a tracking mechanism and new policy and procedure for approval of all contracts and agreements; and
- Retaining a nationally recognized accounting and auditing firm to assist management in developing policies and procedures surrounding internal controls over financial reporting, to evaluate and test these internal controls and to assist in the remediation of internal control deficiencies.

With respect to the material weaknesses described above, we have initiated a process to clearly delineate our control weaknesses and formulated a remediation plan. We believe that we have made significant progress in remediating several of the identified material weaknesses; however, as our testing procedures have not yet been completed, we can make no assurances as to the success of our remediation efforts. As of December 31, 2007, the Company has incurred $48.9 million to remediate these material weaknesses and to document and test key financial reporting controls. We will need to allocate additional resources to enhance the quality of our staff and to carry out the remediation of these material weaknesses. Based upon our current assessment, we expect to complete the remediation of these material weaknesses during 2008 with an estimated additional cost of approximately $15 million. The Company cannot indicate with certainty that the material weaknesses will be remediated or whether additional costs may be incurred. The Company needs to initiate additional controls and test the effectiveness of controls prior to concluding controls are effective. As a condition to state PUC approval of the RWE Divestiture, we agreed that costs incurred in connection with our initial internal control and remediation initiatives would not be recoverable in rates charged to our customers.

Elements of our remediation activities can only be accomplished over time, and our initiatives provide no assurances that they will result in an effective internal control environment. Our board of directors, in coordination with our audit committee, will continually assess the progress and sufficiency of these initiatives and make adjustments, as necessary.

**Factors Affecting Our Results of Operations**

As the largest investor-owned United States water and wastewater utility company, as measured both by operating revenue and population served, our financial condition and results of operations are influenced by a variety of industry-wide factors, including the following:

- economic utility regulation;
- the need for infrastructure investment;
- compliance with environmental, health and safety standards;
- production costs;
- customer growth;
- an overall trend of declining water usage per customer; and
- weather and seasonality.

Since our acquisition by RWE in 2003, our results of operations have also been significantly influenced by goodwill impairments.

Factors that may affect the results of operations of our Regulated Businesses operating performance are mitigated by state PUCs granting us appropriate rate relief that is designed to allow us to recover prudently incurred expenses and to earn an appropriate rate of return on our investment.

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*Economic Utility Regulation*

Our subsidiaries in the states in which we operate our Regulated Businesses are generally subject to extensive economic regulation by their respective state PUCs. Although specific authority might differ from state to state, in most states, these state PUCs must approve rates, accounting treatments, long-term financing programs, significant capital expenditures and plant additions, transactions between the regulated subsidiary and affiliated entities, reorganizations and mergers and acquisitions, in many instances prior to their completion. Regulatory policies not only vary from state to state, they may change over time. These policies will affect the timing as well as the extent of recovery of expenses and the realized return on invested capital.

Our operating revenue is typically determined by reference to the volume of water supplied to a customer multiplied by a price-per-gallon set by a tariff approved by the relevant state PUC. The process to obtain approval for a change in rates, or rate case, involves filing a petition with the state PUC on a periodic basis as determined by our capital expenditures needs and our operating costs. Rate cases and other rate-related proceedings can take several months to a year or more to complete. Therefore, there is frequently a delay, or regulatory lag, between the time one of our regulated subsidiaries makes a capital investment or incurs an operating expense increase and when those costs are reflected in rates. The management team at each of our regulated subsidiaries works to minimize regulatory lag.

Our results of operations are significantly affected by rates authorized by the state PUCs in the states in which we operate, and we are subject to risks and uncertainties associated with rate stay-outs and delayed or inadequate rate recovery. In addition to general rate case filings, we generate revenues through other cost recovery procedures. For example, some states in which we operate allow utility subsidiaries to recover system infrastructure replacement costs without the necessity of filing a full rate proceeding. Since infrastructure replacement is a significant element of capital expenditures made by our subsidiaries, such programs can reduce regulatory lag.

Currently, Pennsylvania, Illinois, Missouri, Indiana, New York, California and Ohio have allowed the use of these infrastructure surcharges. These surcharges adjust periodically based on qualified capital expenditures being completed or anticipated in a future period. These surcharges are typically reset to zero when new base rates are effective and incorporate the costs of these infrastructure expenditures. We anticipate an increase in revenues of approximately $6.9 million in 2008, assuming constant sales volumes, as a result of these infrastructure surcharges.

Also, some of the states in which we operate permit pass-through provisions that allow for an increase in certain operating costs, such as purchased power and property taxes to be passed on to and recovered from the customers outside of a general rate proceeding.

Some states have permitted use of some form of forecast or forward looking test year instead of historical data to set rates. Examples of these states include Hawaii, Illinois, Kentucky, Ohio, Pennsylvania, New York and California. In addition, a number of states in which we operate have allowed the utility to update historical data for some changes that occur for some limited period of time subsequent to the historical test year. This allows the utility to take account of some more current costs or capital investments in the rate-setting process. Examples of these states include New Mexico, Texas, Missouri, Iowa, Virginia, Maryland, Tennessee, West Virginia, New Jersey and Arizona.

Another regulatory mechanism to address issues of regulatory lag includes the ability, in some circumstances, to recover in rates a return on utility plant before it is actually in service, instead of capitalizing an allowance for funds used during construction. Examples of states that have allowed such recovery include Texas, Pennsylvania, Ohio, Kentucky and California.

The infrastructure surcharge, pass-through provisions, the forward looking test year and the allowance of a return on utility plant before it is actually in service, are examples of mechanisms that present an opportunity to

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limit the risks associated with regulatory lag. We employ each of these mechanisms as part of our rate case management program to ensure efficient recovery of our costs and investment and to ensure positive short-term liquidity and long-term profitability.

In addition, some states have permitted us to seek pre-approval of certain capital projects and/or associated costs. In this pre-approval process, the PUCs assess the prudency of the project and/or the project financing.

As a condition to our acquisition by RWE in 2003, we agreed not to file rate cases in some of the states where our Regulated Businesses operate. All rate stay-out provisions associated with the RWE acquisition have expired. As of December 31, 2007 we are awaiting final orders for two general rate cases that were filed in 2006, requesting $10.9 million in total additional annual revenues. General rate cases filed in eight states in 2007, requesting $100.8 million in additional annualized revenues, are also pending final orders as of December 31, 2007. During 2007, we received authorizations for $145.9 million of additional annualized revenues from rates, assuming constant sales volumes. In addition, we expect to continue to receive additional revenues through infrastructure replacement surcharges. There is no assurance that the complete amount, or any portion thereof, of any requested increases will be granted.

*Infrastructure Investment*

The water and wastewater utility industry is highly capital intensive. From 2007 to 2011, we estimate that Company-funded capital investment will total between $4,000 and $4,500 million. We anticipate spending between $770 and $950 million yearly on Company-funded capital investment for the foreseeable future, depending upon the timing of major capital projects. Our capital investment includes both infrastructure renewal programs, where we replace existing infrastructure, as needed, and construction of facilities to meet new customer growth. From 2007 to 2011, we estimate we will invest approximately $1,700 million to replace aging infrastructure including mains, meters, and supply and treatment facilities. We estimate that we will invest approximately $1,300 million in facilities to serve new customer growth over this same period. In addition, we estimate that complying with water quality standards and other regulatory requirements will require approximately $700 million of investment. Projects to enhance system reliability, security and efficiency, or to meet other needs are projected to account for approximately an additional $500 million of investment over this same period.

These capital investments are needed on an ongoing basis to comply with existing and new regulations, renew aging treatment and network assets, provide capacity for new growth and enhance system reliability, security and quality of service. The need for continuous investment presents a challenge due to the potential for regulatory lag, or the delay in recovering our operating expenses and earning an appropriate rate of return on our invested capital and a return of our invested capital. Because the decisions of state PUCs and the timing of those decisions can have a significant impact on the operations and earnings of our Regulated Businesses, we maintain a rate case management program guided by the goals of obtaining efficient recovery of costs of capital and utility operation and maintenance costs, including costs incurred for compliance with environmental, health and safety and water quality regulation. As discussed above under Economic Utility Regulation, we pursue methods to minimize the adverse impact of regulatory lag and have worked with state PUCs and legislatures to implement a number of approaches to achieve this result, including promoting the implementation of forms of forward-looking test years and infrastructure surcharges.

*Compliance with Environmental, Health and Safety Standards*

Our water and wastewater operations are subject to extensive United States federal, state and local and, in the case of our Canadian operations, Canadian laws and regulations, governing the protection of the environment, health and safety, the quality of the water we deliver to our customers, water allocation rights, and the manner in which we collect, treat and discharge wastewater. These requirements include the Safe Drinking Water Act, the Clean Water Act and similar state and Canadian laws and regulations. We are also required to obtain various environmental permits from regulatory agencies for our operations. State PUCs also set conditions and standards for the water and wastewater services we deliver. We incur substantial costs associated with compliance with environmental, health and safety and water quality regulation to which our Regulated Businesses are subject.

Environmental, health and safety and water quality regulations are complex and change frequently, and the overall trend has been that they have become more stringent over time. We face the risk that as newer or stricter standards are introduced, they could increase our operating expenses. In the past, we have generally been able to recover expenses associated with compliance for environmental, health and safety standards, but this recovery is affected by regulatory lag and the corresponding uncertainties surrounding rate recovery.

*Production Costs*

Our water and wastewater services require significant production inputs and result in significant production costs. These costs include fuel and power, which is used to operate pumps and other equipment, purchased water and chemicals used to treat water and wastewater. We also incur production costs for waste disposal. For 2007, production costs accounted for approximately 12.8% of our total operating costs. Price increases associated with these inputs impact our results of operations until rate relief is granted.

*Customer Growth*

Customer growth in our Regulated Businesses is driven by (i) organic population growth within our authorized service areas and (ii) by adding new customers to our regulated customer base by acquiring water and wastewater utility systems through acquisitions. Generally, we add customers through tuck-ins of small water and/or wastewater systems, typically serving fewer than 10,000 customers, in close geographic proximity to where we currently operate our Regulated Businesses. We also seek large acquisitions that allow us to acquire multiple water and wastewater utility systems in our existing markets and markets where we currently do not operate our Regulated Businesses. During 2005, 2006 and 2007, we had cash outflows of $5.0 million, $12.5 million and $15.9 million, respectively, for acquisitions of water and wastewater systems which allowed us to expand our regulated customer base. Our most recent significant acquisition was the 2002 purchase of the water and wastewater assets of Citizens Communications Company, adding approximately 300,000 customers in six states in which we had existing operations. We intend to continue to expand our regulated footprint geographically by acquiring water and wastewater systems in our existing markets and some markets in the United States where we do not currently operate our Regulated Businesses. Our experienced development team evaluates potential acquisition targets across the country, particularly in higher-growth areas. Before entering new markets, we will evaluate the regulatory environment to ensure that we will have the opportunity to achieve an appropriate return on our investment while maintaining our high standards for quality, reliability and compliance with environmental, health and safety and water quality standards. These acquisitions may include large acquisitions of companies that have operations in multiple markets. For further information, see Our Business Our Regulated Businesses Acquisitions .

*Declining Water Usage Per Customer*

Increased water conservation, including through the use of more efficient household fixtures and appliances among residential consumers, combined with declining household sizes in the United States, has contributed to a trend of declining water usage per residential customer.

The average annual change in residential water usage per customer from January 1998 through December 2007 (as a percentage of January 1998 usage) in the larger states served by our Regulated Businesses ranged from 0.66% per year in New Jersey at the low end to as high as 1.63% per year in West Virginia.

Because the characteristics of residential water use are driven by many factors, including socio-economic and other demographic characteristics of our service areas, climate, seasonal weather patterns and water rates,

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these declining trends vary by state and service area and change over time. The trend of declining residential water usage per customer is higher in the predominantly rural states served by our Regulated Businesses. We do not believe that the trend in any particular state or region will have a disproportionate impact on our results of operations.

Our Regulated Businesses are heavily dependent upon operating revenue generated from rates we charge to our residential customers for the volume of water they use. Declining usage will have a negative impact on our long-term operating revenues if we are unable to secure rate increases or to grow our residential customer base to the extent necessary to offset the residential usage decline.

*Water Supply*

Our ability to meet the existing and future water demands of our customers depends on an adequate supply of water. Drought, governmental restrictions, overuse of sources of water, the protection of threatened species or habitats or other factors may limit the availability of ground and surface water. Also, customer usage of water is affected by weather conditions, in particular during the summer. Our water systems experience higher demand in the summer due to the warmer temperatures and increased usage by customers for lawn irrigation and other outdoor uses. Summer weather that is cooler and wetter than average generally serves to suppress customer water demand, and can have a downward effect on our operating revenue and operating income. Conversely, when weather conditions are extremely dry and even if our water supplies are sufficient to serve our customers, our systems may be affected by drought-related warnings and/or water usage restrictions imposed by governmental agencies, purchase supply allocation and mandatory conservation measures. All of the above conditions serve to reduce customer demand and operating revenues. These restrictions may be imposed at a regional or state level and may affect our service areas regardless of our readiness to meet unrestricted customer demands. We employ a variety of measures to ensure that we have adequate sources of water supply, both in the short term and over the long term. For additional detail concerning these measures, see Business Our Regulated Businesses Overview of Networks, Facilities and Water Supply.

The geographic diversity of our service areas tends to mitigate some of the effect of weather extremes. In any given summer, some areas are likely to experience drier than average weather while other areas will experience wetter than average weather.

*Goodwill Impairment*

At December 31, 2007, our goodwill totaled $2,457.0 million. The goodwill is associated primarily with the acquisition of American Water by an affiliate of RWE in 2003 and the acquisition of E Town Corporation in 2001, representing the excess of the purchase price the purchaser paid over the fair value of the net tangible and intangible assets acquired. Our annual goodwill impairment test is completed during the fourth quarter of each calendar year. We also have processes to monitor for interim triggering events. As required by applicable accounting rules and principles, we were required to reflect a non-cash charge to operating results for goodwill impairment in the amounts of $396.3 million in 2005, $227.8 million in 2006 and $509.3 million in 2007. These amounts include impairments relating to discontinued operations.

During the third quarter of 2007, as a result of our debt being placed on review for a possible downgrade and the proposed sale of a portion of the Company in the initial public offering, management determined at that time it was appropriate to update its valuation analysis before the next scheduled annual test. Based on this assessment, we performed an interim impairment test and recorded an impairment charge to goodwill to our Regulated Businesses in the amount of $243.3 million. The decline was primarily due to a slightly lower long-term earnings forecast caused by updated customer demand and usage expectations and expectations for timing of capital expenditures and rate recovery.

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We completed our annual goodwill impairment test for 2007 and recorded an additional goodwill impairment charge to the Regulated Businesses reporting unit in the amount of $266.0 million during the fourth quarter of 2007. We determined that an impairment had occurred based upon new information regarding our market value. We incorporated this indicated market value into our valuation methodology and, based on those results, an additional impairment to our carrying value was recorded.

We may be required to recognize additional impairments in the future due to, among other things, the market value of our stock, a decline in our forecasted results as compared to the business plan and, changes in interest rates or a change in rate case results. Further recognition of additional material impairments of goodwill would negatively affect our results of operations and total capitalization, the effect of which could be material and could make it more difficult for us to secure financing on effective terms and maintain compliance with our debt covenants. Based on the initial public offering price, we have determined that it is probable we will record an impairment to goodwill when we report results for the quarter ended March 31, 2008. Whether such an impairment to goodwill is recognized will depend on an analysis of the factors described above. The size of any such impairment to goodwill, if any, cannot be determined at this time.

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**Results of Operations**

The following table sets forth our consolidated statement of operations data for the years ended December 31, 2005, 2006 and 2007:

| | For the years ended December 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| | (In thousands, except per share data) | | |
| Operating revenues | $ 2,136,746 | $ 2,093,067 | $ 2,214,215 |
| Operating expenses: | | | |
| Operation and maintenance | 1,201,566 | 1,174,544 | 1,246,479 |
| Depreciation and amortization | 261,364 | 259,181 | 267,335 |
| General taxes | 183,324 | 185,065 | 183,253 |
| Loss (gain) on sale of assets | (6,517) | 79 | (7,326) |
| Impairment charges | 385,434 | 221,685 | 509,345 |
| Total operating expenses, net | 2,025,171 | 1,840,554 | 2,199,086 |
| Operating income (loss) | 111,575 | 252,513 | 15,129 |
| Other income (deductions): | | | |
| Interest | (345,257) | (365,970) | (283,165) |
| Allowance for other funds used during construction | 5,810 | 5,980 | 7,759 |
| Allowance for borrowed funds used during construction | 2,420 | 2,652 | 3,449 |
| Amortization of debt expense | (4,367) | (5,062) | (4,867) |
| Preferred dividends of subsidiaries | (227) | (215) | (225) |
| Other, net | 5,895 | 1,164 | 6,401 |
| Total other income (deductions) | (335,726) | (361,451) | (270,648) |
| Income (loss) from continuing operations before income taxes | (224,151) | (108,938) | (255,519) |
| Provision for income taxes | 50,979 | 46,912 | 86,756 |
| Income (loss) from continuing operations | (275,130) | (155,850) | (342,275) |
| Income (loss) from discontinued operations, net of tax | (49,910) | (6,393) | (551) |
| Net income (loss) | $ (325,040) | $ (162,243) | $ (342,826) |
| Net income (loss) per common share: | | | |
| Basic | | | |
| Income (loss) from continuing operations | $ (1.72) | $ (0.97) | $ (2.14) |
| Income (loss) from discontinued operations, net of tax | $ (0.31) | $ (0.04) | (0.00) |
| Net income (loss) | $ (2.03) | $ (1.01) | $ (2.14) |
| Diluted | | | |
| Income (loss) from continuing operations | $ (1.72) | $ (0.97) | $ (2.14) |
| Income (loss) discontinued operations, net of tax | $ (0.31) | $ (0.04) | (0.00) |

| | | | |
|---|---|---|---|
| Net income (loss) | $ (2.03) | $ (1.01) | $ (2.14) |
| Average common shares outstanding during the period: | | | |
| Basic | 160,000 | 160,000 | 160,000 |
| Diluted | 160,000 | 160,000 | 160,000 |

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The following table summarizes certain financial information for our Regulated and Non-Regulated Businesses for the periods indicated (without giving effect to inter-segment eliminations):

| | For the years ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | 2006 | | 2007 | |
| | Regulated Businesses | Non-Regulated Businesses | Regulated Businesses | Non-Regulated Businesses | Regulated Businesses | Non-Regulated Businesses |
| | | | (In thousands) | | | |
| Operating revenues | $ 1,836,061 | $ 310,771 | $ 1,854,618 | $ 248,451 | 1,987,565 | 242,678 |
| Adjusted EBIT[1] | $ 469,921 | $ (106) | $ 468,701 | $ (4,725) | 500,088 | 23,579 |

(1) Adjusted EBIT is defined as earnings before interest and income taxes from continuing operations. Management evaluates the performance of its segments and allocates resources based on several factors, of which the primary measure is Adjusted EBIT. Adjusted EBIT does not represent cash flows for periods presented and should not be considered as an alternative to cash flows as a source of liquidity. Adjusted EBIT as defined by the Company may not be comparable with Adjusted EBIT as defined by other companies.

Our primary business involves the ownership of water and wastewater utilities that provide water and wastewater services to residential, commercial and industrial customers. As such, our results of operations are significantly impacted by rates authorized by the state PUCs in the states in which we operate. The table below details the annualized revenue increases (assuming constant sales volumes) resulting from rate authorizations, including distribution infrastructure and other surcharges, granted in 2005, 2006 and 2007.

| | Annualized Rate Increases Granted During the years | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| **State** | | | |
| New Jersey | $ | $ | $ 56.2 |
| Pennsylvania | 5.8 | 8.0 | 40.6 |
| Missouri | | 6.8 | 24.0 |
| Illinois | | 0.9 | 1.7 |
| Indiana | 0.9 | 1.8 | 14.0 |
| California | 8.4 | 15.1 | 0.5 |
| West Virginia | 10.0 | | |
| Other | 9.9 | 8.7 | 21.9 |
| Total | $ 35.0 | $ 41.3 | $ 158.9 |

The change in annualized rate increases granted between 2006 and 2007 can be attributed to the removal of the stay-out provisions and increased investment in our regulated infrastructure programs.

***Comparison of Results of Operations for the Years Ended December 31, 2007 and 2006***

***Operating revenues***. Our consolidated operating revenues increased $121.1 million, or 5.8%, from $2,093.1 million for 2006 to $2,214.2 million for 2007. An increase in operating revenues for our Regulated Businesses of $132.9 million in 2007 was somewhat offset by a decrease in operating revenues for our Non-Regulated Businesses of $5.8 million. The increase in the Regulated Businesses operating revenues was primarily due to rate increases of approximately $61.9 million obtained through general rate cases in New Jersey, Ohio, Arizona, California and other states. In addition, rate increases obtained through infrastructure related provisions in Pennsylvania, Missouri, Illinois and Indiana, totaled approximately $15.5 million. Water service operating revenues also increased due to growth of 0.7% in our Regulated Businesses customer base through small acquisitions in our service areas and through growth in existing service areas. Water sales volume associated

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with existing customers increased by 1.5% in 2007 compared to the prior year due to drier weather mainly in our Mid-Atlantic states.

The following table sets forth the percentage of Regulated Businesses operating revenues and water sales volume by customer class:

| | For the years ended December 31, | | | |
|---|---|---|---|---|
| | Operating Revenues | | Water Sales Volume | |
| **Customer Class** | **2006** | **2007** | **2006** | **2007** |
| Water service: | | | | |
| Residential | 57.5% | 57.6% | 52.1% | 52.8% |
| Commercial | 19.6% | 19.4% | 22.0% | 21.9% |
| Industrial | 5.0% | 4.8% | 10.6% | 10.6% |
| Public and other | 12.4% | 12.5% | 15.3% | 14.7% |
| Other water revenues | 1.6% | 1.9% | | |
| Total water revenues | 96.1% | 96.2% | 100.0% | 100.0% |
| Wastewater service | 3.9% | 3.8% | | |
| | 100.0% | 100.0% | | |

*Water Services* Water service operating revenues from residential customers for 2007 amounted to $1,146.1 million, a 7.3% increase over 2006, primarily due to rate increases and changes in sales volume. The volume of water sold to residential customers increased by 2.9% in 2007 to 223.4 billion gallons, from 217.2 billion gallons in 2006, largely as a result of favorable weather conditions in the Mid-Atlantic states and a 0.7% increase in the residential customer base.

Water service operating revenues from commercial water customers for 2007 amounted to $385.3 million, a 6.2% increase over 2006, primarily due to rate increases and changes in sales volume. The volume of water sold to commercial customers increased by 1.6% in 2007 to 93.0 billion gallons, from 91.6 billion gallons in 2006, driven by favorable weather conditions and partially offset by a decline in the number of commercial customers.

Water service operating revenues from industrial customers amounted to $94.7 million in 2007, a 2.9% increase over 2006, primarily due to rate increases and changes in sales volume. The volume of water sold to industrial customers increased by 0.5% in 2007 to 44.6 billion gallons, from 44.4 billion gallons in 2006.

Water service operating revenues from public and other customers increased $17.4 million for 2007 to $247.6 million from $230.2 million for 2006, mainly due to rate increases and changes in sales volume. Revenues from municipal governments for fire protection services and customers requiring special private fire service facilities totaled $99.3 million for 2007, an increase of $0.8 million over the same period of 2006. Revenues generated by sales to governmental entities and resale customers for 2007 totaled $148.3 million, an increase of $16.6 million from 2006.

*Wastewater Services* Our subsidiaries provide wastewater services in 11 states. Operating revenues from these services increased by 4.7% to $75.6 million for 2007. The increase reflects a growth of 0.4% in the number of wastewater customers served but is primarily due to increases in rates charged to customers in states where we have wastewater operations (principally Arizona, Hawaii, and New Jersey).

Our Non-Regulated revenues decreased by $5.8 million, or 2.3%, from $248.5 million for 2006, to $242.7 million for 2007. The net decline in revenues is primarily attributable to a $15.8 million decrease in revenues of our Contract Operations Group, partially offset by a $7.4 million increase in revenues of our Homeowner Services Group, and an increase of $3.5 million from our other Non-Regulated Businesses. The decline in revenues of our

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Contract Operations Group includes the effects of having substantially completed the construction of the Lake Pleasant Water Treatment plant, a large water treatment plant in Phoenix, Arizona, during 2006 ($49.5 million recognized in 2006 compared to $5.2 million in 2007). Pursuant to our DBO contract with the city of Phoenix, we served as the lead contractor in connection with the construction of the Lake Pleasant facility, which includes an 80 million gallons-per-day surface water treatment plant and granular activated carbon reactivation system. The Lake Pleasant facility is significantly larger in size and function compared to other projects with which we have been engaged. However, we do not expect the completion of this project to have a material impact on our results of operations. Revenues from that project were partially replaced by new contracts, including a DBO project in Fillmore, California generating $12.2 million of incremental revenues and new military projects generating approximately $10.0 million of revenues. The increase from our Homeowner Services Group represents expansion into new geographic markets (Virginia and Trenton, New Jersey). The increase in our other Non-Regulated Businesses revenues is due to revenues attributable to special projects in 2007.

***Operation and maintenance.*** Our consolidated operation and maintenance expense increased $72.0 million, or 6.1%, from $1,174.5 million for 2006, to $1,246.5 million for 2007.

Operation and maintenance expense by major category was as follows:

| | For the years ended December 31, | |
|---|---|---|
| | 2006 | 2007 |
| | (In thousands) | |
| Production costs | $ 262,450 | $ 282,194 |
| Employee-related costs | 421,287 | 469,504 |
| Operating supplies and services | 297,008 | 298,398 |
| Maintenance materials and services | 96,302 | 112,075 |
| Customer billing and accounting | 55,260 | 39,003 |
| Other | 42,237 | 45,305 |
| Total | $ 1,174,544 | $ 1,246,479 |

Production costs, including fuel and power, purchased water, chemicals and waste disposal increased by 7.5% for 2007 compared to the same period in 2006. The increase was primarily attributable to higher purchased water costs mainly due to increased demand, as well as higher electricity prices as rate freezes resulting from electricity deregulation expired in some states in which we operate.

Employee-related costs including wage and salary, group insurance, and pension expense increased by 11.4% for 2007 compared to the same period in 2006. These costs represented 35.9% and 37.7% of operation and maintenance expense for 2006 and 2007, respectively. The increase in 2007 was due to higher wage, salary and group insurance expenses in our Regulated Businesses, primarily resulting from an increase in the number of employees to enable service enhancements in our Regulated Businesses as well as wage rate increases. This increase was offset by a reduction in pension expense. Pension expense in excess of the amount contributed to the pension plans is deferred by some of our regulated subsidiaries pending future recovery in rates as contributions are made to the plans. The decrease is primarily attributable to lower pension expense in 2007. In addition, pension expense for 2006 included additional pension expense due to curtailment charges and a special transaction benefit charge.

Operating supplies and services include the day-to-day expenses of office operation, legal and other professional services, as well as information systems and other office equipment, facilities rental charges and other miscellaneous expenses. For 2007, these costs increased by 0.5% compared to the same period in 2006. Factors contributing to this overall increase include higher accounting, legal and consulting costs. Our remediation efforts in connection with the Sarbanes-Oxley Act resulted in an increase of $15.1 million for 2007,

as compared to 2006. The Regulated Businesses transportation costs for 2007 increased by $3.2 million due to

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increased vehicle leasing costs and higher gasoline prices. Also costs in 2006 were lower than 2007 due to a reinstatement in 2006 by our Indiana subsidiary of $2.4 million previously disallowed in the regulatory process. Expenses related to the RWE Divestiture were $0.8 million higher for 2007 than 2006 due to higher divestiture support costs.

Offsetting the increase was approximately $48.8 million of expenses associated with the design and build of the Lake Pleasant Water Treatment Plant in Phoenix, Arizona which were included in operating supplies and services for 2006 compared to $5.1 million in 2007. The decrease also reflects Non-Regulated Businesses operating contracts that ended during 2006, and a decline in design and build activity by the Applied Water Management Group of $3.4 million due to a downturn in new home construction. Offsetting these Non-Regulated Businesses decreases was additional expense associated with several contracts, including Fillmore of $12.4 million, and increased military contract expenses of $11.4 million resulting from increased contracted services primarily due to two projects and a $5.0 million loss recorded on one project.

Maintenance materials and services, which include emergency repairs as well as costs for preventive maintenance, increased by 16.4% for 2007 compared to the same period in 2006. This increase was primarily the result of a larger number of main breaks in 2007 compared to 2006 experienced by several of our operating subsidiaries due to winter weather conditions, and increased paving cost for our New Jersey, Missouri, Illinois and Pennsylvania subsidiaries.

Customer billing and accounting expenses decreased by 29.4% for 2007 compared to the same period in 2006 primarily due to lower bad debt expense of $9.2 million in our Regulated Business and $5.8 million in our Non-Regulated Businesses as a result of an increased focus on collection of past due accounts.

Other operation and maintenance expenses include casualty and liability insurance premiums and regulatory costs. These costs increased by 7.3% in 2007 primarily due to an increase in insurance costs for 2007 due to less favorable claims experience compared to 2006. This unfavorable variance was offset by a reduction in regulatory expenses due to the write-off of certain deferred rate case expenses in 2006 associated with our California subsidiary.

***Depreciation and amortization.*** Our consolidated depreciation and amortization expense increased $8.1 million, or 3.1%, from $259.2 million for 2006, to $267.3 million for 2007. The increase was primarily due to property placed in service, net of retirements, of approximately $798.8 million as a result of an increased focus on infrastructure spending mainly in our Regulated Businesses.

***General taxes.*** Our consolidated general taxes expense, which includes taxes for property, payroll, gross receipts and other miscellaneous items, decreased $1.8 million, or 1.0%, from $185.1 million for 2006, to $183.3 million for 2007. The decrease was primarily due to lower taxes for expatriates because employees seconded by Thames Water to American Water were no longer employed by American Water in 2007.

***Loss (gain) on sale of assets.*** Our consolidated loss on sale of assets was $0.1 million for 2006, compared to a gain of $(7.3) million for 2007 due to non-recurring sales of assets not needed in our utility operations in 2007.

***Impairment charges.*** Our consolidated impairment charges were $221.7 million for 2006 and $509.3 million for 2007. The 2006 impairment charge was primarily attributable to higher interest rates in our Regulated Businesses and a change in the potential net realizable value of our Non-Regulated Businesses. The 2007 impairment charges were primarily due to slightly lower long-term earnings caused by updated customer demand and usage expectations and expectations for timing of capital expenditures and rate recovery as well as new information regarding our market value.

***Other income (deductions).*** Interest expense, the primary component of our consolidated other income (deductions), decreased $82.8 million, or 22.6%, from $366.0 million for 2006, to $283.2 million for 2007. The decline was primarily due to the repayment of outstanding debt with new equity contributions from RWE in order to establish a capital structure that is consistent with other regulated utilities and also to meet the capital structure expectations of various state regulatory commissions. This decrease was offset slightly by higher interest expense of our Regulated Businesses of $9.8 million mainly due to increased borrowings to fund capital programs.

***Provision for income taxes.*** Our consolidated provision for income taxes increased $39.9 million, or 85.1%, from $46.9 million for 2006, to $86.8 million for 2007. The increase is due to higher taxable income in 2007 as compared to 2006.

***Net income (loss).*** Our consolidated net loss including results from discontinued operations increased $180.6 million, or 111.3%, from $162.2 million for 2006, to $342.8 million for 2007. The increase is the result of the changes discussed above.

***Comparison of Results of Operations for the Years Ended December 31, 2006 and 2005***

***Operating revenues***. Our consolidated operating revenues decreased $43.6 million, or 2.0%, from $2,136.7 million for 2005 to $2,093.1 million for 2006. A decline in operating revenues associated with our Non-Regulated Businesses was partially offset by an overall increase in operating revenues from our Regulated Businesses.

Operating revenues from our Regulated Businesses increased by $18.6 million in 2006 compared to 2005, even with a 2.0% decline in water sales volume primarily due to weather fluctuations in 2006, as compared to 2005. The increase was primarily due to rate increases obtained through general rate cases in Arizona, California and New York as well as other states totaling $12.4 million. In addition, infrastructure surcharges in Pennsylvania, Missouri, Indiana, Illinois, and Ohio provided $13.7 million in additional operating revenues. Operating revenue also increased due to the addition of approximately 1.6%, or 51,000 customers, in our Regulated Businesses customer base through small acquisitions to our service areas and through growth in existing service areas.

The following table sets forth the percentage of our Regulated Businesses operating revenues and water sales volume by customer class:

| | For the years ended December 31, | | | |
|---|---|---|---|---|
| | Operating Revenues | | Water Sales Volume | |
| | 2005 | 2006 | 2005 | 2006 |
| Water service: | | | | |
| Residential | 58.2% | 57.5% | 52.4% | 52.1% |
| Commercial | 19.3% | 19.6% | 21.9% | 22.0% |
| Industrial | 5.3% | 5.0% | 10.6% | 10.6% |
| Public and other | 12.2% | 12.4% | 15.1% | 15.3% |
| Other water revenues | 1.4% | 1.6% | | |
| Total water revenues | 96.4% | 96.1% | 100.0% | 100.0% |
| Wastewater service | 3.6% | 3.9% | | |
| | 100.0% | 100.0% | | |

*Water Services* Water service operating revenues from residential customers in 2006 amounted to $1,067.9 million, relatively unchanged from 2005, as rate increases offset changes in sales volume. The volume of water sold to residential customers decreased by 2.5% in 2006 to 217.2 billion gallons, from 222.8 billion gallons for 2005, primarily as a result of wetter and cooler weather conditions in some of our larger states, including New Jersey, Pennsylvania and Indiana and decreased usage related to enhanced conservation education, the installation of low-flow appliances and reduced household sizes.

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Water service operating revenues from commercial customers in 2006 amounted to $362.7 million, a 2.5% increase over 2005, primarily due to rate increases offset by changes in sales volume. The volume of water sold to commercial customers decreased by 1.7% in 2006 to 91.6 billion gallons, from 93.2 billion gallons for 2005, driven by a 0.4% decline in our commercial customer base due to economic conditions in our service areas with the remainder primarily attributable to weather conditions.

Water service operating revenues from industrial customers in 2006 amounted to $92.0 million, a 5.4% decrease over 2005, primarily due to changes in sales volume. The volume of water sold to industrial customers decreased by 1.8% in 2006 to 44.4 billion gallons, from 45.2 billion gallons for 2005, driven primarily by the loss of customers due to economic and business conditions in our service areas.

Water service operating revenues from public and other customers for 2006 amounted to $230.2 million, a 3.0% increase over 2005 primarily due to rate increases and changes in sales volume. Water service operating revenues from municipal governments for fire protection services and customers requiring special private fire service facilities for 2006 amounted to $98.5 million, a 9.6% increase from 2005. Water service operating revenues from governmental entities and resale customers amounted to $131.7 million in 2006, a 1.3% decrease from 2005.

*Wastewater Services* Our subsidiaries provide wastewater services in 11 states. Operating revenues from these services increased by 8.9% to $72.2 million for 2006, from $66.3 million for 2005. The increases were attributable to 4.4% growth in the number of wastewater customers served, with the remainder due to rate increases.

Non-Regulated Businesses operating revenues decreased by $62.3 million, or 20.0% from $310.8 million for 2005 to $248.5 million for 2006. The decrease was primarily due to a decline of approximately $63.4 million in operating revenue, representing the effects of the completion of work performed under a contract to design and build the Lake Pleasant Water Treatment Plant in Phoenix, Arizona. The decrease in operating revenues also reflects the cessation of operating contracts in Houston, Texas; Hazelton, Pennsylvania; and Dedham, Massachusetts that ended during fiscal 2006 and the non-renewal of unprofitable contracts in several smaller communities. The discontinuance of these contracts resulted in a decrease of $11.3 million in aggregate revenue in 2006 compared to 2005. Partially offsetting the decrease was $8.7 million of increased revenue related to the expansion into new markets by the Applied Water Management Group and the Homeowner Services Group, as well as $3.7 million of additional revenues from organic growth of existing O&M contracts, including capital improvement projects performed on behalf of Sioux City, Iowa and a new contract in Fillmore, California for a DBO project.

***Operation and maintenance.*** Our consolidated operation and maintenance expense decreased $27.1 million, or 2.3%, from $1,201.6 million for 2005, to $1,174.5 million for 2006.

Operation and maintenance expense by major category was as follows:

| | For the years ended December 31, 2005 | 2006 |
|---|---|---|
| | (In thousands) | |
| Production costs | $ 258,609 | $ 262,450 |
| Employee-related costs | 376,296 | 421,287 |
| Operating supplies and services | 379,878 | 297,008 |
| Maintenance materials and services | 97,139 | 96,302 |
| Customer billing and accounting | 42,793 | 55,260 |
| Other | 46,851 | 42,237 |
| Total | $ 1,201,566 | $ 1,174,544 |

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Production costs, including fuel and power, purchased water, chemicals and waste disposal, increased by 1.5% in 2006 compared to 2005. Increases in chemical prices and energy costs in our Regulated Businesses were the principal drivers of the increase, mitigated by the overall decline in water sales and decreases in costs resulting from reduced Non-Regulated Businesses activities. Energy costs increased due to higher electricity prices as rate freezes resulting from electricity deregulation expired in some states in which we operate. The unit cost of water produced was up 7.3% in 2006 compared to 2005.

Employee-related costs include wage and salary, group insurance, pension expense and expenses related to our long-term incentive plan, which we refer to as the LTIP, for certain key employees. These costs represented 35.8% of operation and maintenance expense in 2006 and increased 12.0% in 2006 as compared to 2005. Wage and salary expenses were up $29.2 million, or 10.0%, in 2006, due to salary increases and workforce additions. The LTIP accounted for $3.1 million of the increase. Group insurance expense, which includes the cost of providing current health care and life insurance benefits as well as the expected cost of providing postretirement benefits, increased 16.0% in 2006 as a result of workforce additions and higher group insurance premiums associated with our active employees. Pension expense increased by 32.9% in 2006 compared to 2005, due to lower than expected returns on plan assets and a decrease in the discount rate actuarial assumption. Additionally, our contributions to a defined contribution plan for employees increased over 2005 as the number of program participants increased.

Operating supplies and services include the day-to-day expenses of office operation, legal and other professional services, as well as information systems and other office equipment and facility rental charges. These costs decreased by 21.8% in 2006 compared to 2005. The expenses in this category include rents, general office expense, and other miscellaneous expenses. A significant factor contributing to the decrease was approximately $63.0 million of expenses associated with the timing of project activity for the design and build of the Lake Pleasant Water Treatment Plant in Phoenix, Arizona. The majority of the project activity occurred during 2005. These Non-Regulated Businesses operating expenses also decreased as a result of the aforementioned operating and maintenance contracts that ended during 2006. These cost reductions were offset by additional expenses related to expansion into new markets by the Applied Water Management Group and Homeowner Services Group, as well as costs associated with several new O&M contracts. These changes resulted in a decrease of $54.0 million in operating supplies and services by our Non-Regulated Businesses in 2006 as compared to 2005.

In addition to the decline in our Non-Regulated Businesses operating supplies and services, there was a decrease in accounting, legal and consulting costs in 2006. A significant portion of the decrease was due to lower management charges allocated from Thames Water of $7.7 million in 2006 as compared to 2005 and a recovery of $2.4 million previously disallowed in the regulatory process for our Indiana subsidiary. During 2005, the Company also recorded $3.5 million in expense relating to a special program established to protect the environment along the central coastal area of California. In addition, there was a decrease of $3.9 million relating to costs incurred in 2005 that were subsequently not allowed to be recovered in rates at our Kentucky subsidiary. These decreases were offset by higher expenses related to the RWE Divestiture of $7.4 million and increased costs related to the Company s compliance with the Sarbanes-Oxley Act of $16.9 million from 2005 to 2006.

Maintenance materials and services, which include emergency repairs as well as costs for preventive maintenance, decreased by 0.9% in 2006 compared to 2005. The cessation of some O&M contracts managed by our Non-Regulated Businesses was the primary reason for this decrease.

Customer billing and accounting expenses increased by 29.1% in 2006 compared to 2005, due to higher uncollectible expense due to a decline in the quality of our customer accounts receivable, increases in postage costs to mail customer bills and an increased number of bills being sent as a result of customer growth.

Other operation and maintenance expenses include casualty and liability insurance premiums and regulatory costs. Total other costs decreased in 2006 by 9.8% from 2005, due to improved claims experience following an increase in 2005. Regulatory costs increased during 2006 due to increased regulatory filings by our subsidiaries.

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***Depreciation and amortization.*** Our consolidated depreciation and amortization expense decreased $2.2 million, or 0.8%, from $261.4 million for 2005, to $259.2 million for 2006. The decrease was primarily due to a write-off in 2005 of $21.6 million associated with an abandoned information technology project. This decrease was offset by an increase in depreciation expense due to property placed in service, net of retirements, of $697.1 million as a result of infrastructure replacement in our Regulated Businesses.

***General taxes.*** Our consolidated general taxes expense, which includes taxes for property, payroll, gross receipts and other miscellaneous items, was relatively unchanged from $183.3 million for 2005 to $185.1 million for 2006. The increase was primarily due to higher gross receipts taxes as a result of increased Regulated Businesses operating revenues. Gross receipts and franchise taxes that vary based on operating revenues were higher by 3.5% in 2006 compared to 2005. Property and capital stock taxes that are assessed on the basis of tax values assigned to assets and capitalization were down 3% in 2006 compared to 2005 due to property tax appeals and dispositions.

***Loss (gain) on sale of assets.*** Our consolidated gain on sale of assets was $(6.5) million for 2005, compared to a loss on sale of assets of $0.1 million for 2006. The decrease in 2006 was primarily due to the fact that 2005 included sales of various properties and investments not needed in our utility operations.

***Impairment charges.*** Our consolidated impairment charges were $385.4 million for 2005 and $221.7 million for 2006. The 2005 impairment charge was primarily the result of a change in our strategic business plan for our Non-Regulated Businesses and lower margins than previously forecasted in our Regulated Businesses. The 2006 impairment charge was primarily attributable to higher interest rates in our Regulated Businesses and a change in the potential net realizable value of our Non-Regulated Businesses.

***Other income (deductions).*** Interest expense, the primary component of our consolidated other income (deductions), increased $20.7 million, or 6.0%, from $345.3 million for 2005 to $366.0 million for 2006. This increase was primarily due to higher interest rates for new debt issuances, mitigated by overall reduced borrowings as a result of repaying outstanding debt with new equity contributions.

***Provision for income taxes.*** Our consolidated provision for income taxes decreased $4.1 million, or 8.0%, from $51.0 million for 2005, to $46.9 million for 2006. This decrease was primarily due to the mix of taxable income by jurisdiction.

***Net income (loss).*** Our consolidated net (loss), including results from discontinued operations, decreased $162.8 million, or 50.1%, from $(325.0) million for 2005, to $(162.2) million for 2006. The decrease was primarily due to the changes discussed above.

**Liquidity and Capital Resources**

Our business is capital intensive and requires considerable capital resources. A portion of these capital resources are provided by internally generated cash flows from operations. When necessary, we obtain funds from external sources in the capital markets and through bank borrowings. Our access to external financing on reasonable terms depends on our credit ratings and current business conditions, including that of the water utility industry in general as well as conditions in the debt or equity capital markets. If these business and market conditions deteriorate to the extent that we no longer have access to the capital markets at reasonable terms, we have access to revolving credit facilities with aggregate bank commitments of $810.0 million that we currently utilize to support our commercial paper programs and to issue letters of credit. See Credit Facilities and Short-Term Debt.

In addition, our regulated utility subsidiaries receive advances and contributions from customers, home builders and real estate developers to fund construction necessary to extend service to new areas. Advances for construction are refundable for limited periods, which vary according to state regulations, as new customers

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begin to receive service or other contractual obligations are fulfilled. Amounts which are no longer refundable are reclassified to contributions in aid of construction. Utility plant funded by advances and contributions is excluded from rate base. Generally, we depreciate contributed property and amortize contributions in aid of construction at the composite rate of the related property. Some of our subsidiaries do not depreciate contributed property, based on regulatory guidelines.

We use our capital resources, including cash, to (i) fund capital requirements, including construction expenditures, (ii) pay off maturing debt, (iii) pay dividends, (iv) fund pension and postretirement welfare obligations and (v) invest in new and existing ventures. We spend a significant amount of cash on construction projects that have a long-term return on investment. Additionally, we operate in rate-regulated environments in which the amount of new investment recovery may be limited, and where such recovery takes place over an extended period of time, as our recovery is subject to regulatory lag. See Business Regulation Economic Regulation. As a result of these factors, our working capital, defined as current assets less current liabilities, was in a net deficit position as of December 31, 2007.

We expect to fund future maturities of long-term debt through a combination of external debt and cash flow from operations. We have no plans to reduce debt significantly.

***Cash Flows from Operating Activities***

Our future cash flows from operating activities will be affected by economic utility regulation; infrastructure investment; inflation; compliance with environmental, health and safety standards; production costs; customer growth; and declining per customer usage of water; and weather and seasonality. See Management s Discussion and Analysis of Financial Condition and Results of Operations Factors Affecting our Results of Operations.

Cash flows from operating activities have been a reliable, steady source of cash flow, sufficient to meet operating requirements and a portion of our capital expenditures requirements. We will seek access to debt and equity capital markets to meet the balance of our capital expenditure requirements. There can be no assurance that we will be able to successfully access such markets on favorable terms or at all. Operating cash flows can be negatively affected by changes in our rate regulatory environments. Taking into account the factors noted above, we also obtain cash from non-operating sources such as the proceeds from debt issuances, customer advances and contributions in aid of construction and equity offerings.

The following table provides a summary of the major items affecting our cash flows from operating activities for the periods indicated:

| | For the years ended December 31, | | |
|---|---|---|---|
| | **2005** | **2006** | **2007** |
| | | **(In thousands)** | |
| Net income (loss) | $ (325,040) | $ (162,243) | $ (342,826) |
| Add (subtract): | | | |
| Non-cash operating activities(1) | 852,373 | 664,060 | 881,013 |
| Changes in working capital(2) | 51,348 | (96,578) | 16,770 |
| Pension and postretirement healthcare contributions | (53,246) | (81,491) | (81,245) |
| Net cash flows provided by operations | $ 525,435 | $ 323,748 | $ 473,712 |

(1) Includes (gain) loss on sale of businesses, depreciation and amortization, impairment charges, removal costs net of salvage, provision for deferred income taxes, amortization of deferred investment tax credits, provision for losses on utility accounts receivable, allowance for other funds used during construction, (gain) loss on sale of assets, deferred regulatory costs, amortization of deferred charges and other non-cash items, net, less pension and postretirement healthcare contributions.

(2) Changes in working capital include changes to accounts receivable and unbilled utility revenue, taxes receivable (including federal income), other current assets, accounts payable, taxes accrued (including federal income), interest accrued and other current liabilities.

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The increase in cash flow from operations during 2007 compared to 2006 was primarily due to improvements in working capital mainly driven by changes in taxes accrued and other current liabilities, slightly offset by changes in accounts receivable and unbilled utility revenues.

The decrease in cash flows from operations during 2006 versus 2005 was primarily the result of higher contributions to pension and postretirement healthcare trusts. Excluding this item, changes in our cash flows from operating activities were generally consistent with changes in the results of operations as adjusted by changes in working capital in the normal course of business.

***Cash Flows from Investing Activities***

Cash flows used in investing activities were as follows for the periods indicated:

| | For the years ended December 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| | | (In thousands) | |
| Construction expenditures | $ (558,446) | $ (688,843) | $ (758,569) |
| Other investing activities, net(1) | 28,281 | (2,595) | 11,991 |
| Net cash flows used in investing activities | $ (530,165) | $ (691,438) | $ (746,578) |

(1) Includes allowances for other funds used during construction, acquisitions, proceeds from the sale of assets and securities, proceeds from the sale of discontinued operations, removal costs from property, plant and equipment retirements, receivables from affiliates, restricted funds and investment in equity investee.

Cash flow used in investing activities increased in 2007 compared to 2006 and in 2006 compared to 2005 as we continued to increase our investment in regulated infrastructure projects. Cash flows used in investing activities will continue to rise as construction expenditures are expected to be approximately $900 to $950 million during 2008. We intend to invest capital prudently to provide essential services to our regulated customer base, while working with regulators in the various states in which we operate to have the opportunity to earn an appropriate rate of return on our investment and a return of our investment.

Our infrastructure investment plan consists of both infrastructure renewal programs, where we replace infrastructure as needed, and major capital investment projects, where we will construct new water and wastewater treatment and delivery facilities. Our projected capital expenditures and other investments are subject to periodic review and revision to reflect changes in economic conditions and other factors.

The following table provides a summary of our historical construction expenditures:

| | For the years ended December 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| | | (In thousands) | |
| Transmission and distribution | $ 238,972 | $ 314,282 | $ 325,333 |
| Treatment and pumping | 137,299 | 133,074 | 185,832 |
| Services, meter and fire hydrants | 84,148 | 132,610 | 179,933 |
| General structures and equipment | 81,516 | 72,892 | 32,336 |
| Sources of supply | 16,511 | 35,985 | 35,135 |
| Total construction expenditures | $ 558,446 | $ 688,843 | $ 758,569 |

Construction expenditures for the periods noted above were partially offset by customer advances and contributions for construction (net of refunds) of $35.8 million, $47.4 million and $52.0 million for the years ended December 31, 2007, 2006 and 2005, respectively. Customer advances and contributions are reflected in net

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cash flows from financing activities. Capital expenditures during the periods noted above were related to the renewal of supply and treatment assets, new water mains and customer service lines, as well as rehabilitation of existing water mains and hydrants.

Construction expenditures for 2007 increased by $69.7 million or 10.1% over 2006. The increase consisted mainly of infrastructure replacements and upgrades to treatment facilities at several plants including Joplin, Missouri, Maricapa County, Arizona, Franklin Township, New Jersey and Champaign, Illinois.

Construction expenditures for 2006 increased by $130.4 million or 23.4% over 2005. Expenditures related to transmission and distribution increased by $75.3 million in 2006 over 2005 and meter and fire hydrant replacements increased by $48.5 million in 2006 compared to 2005. These increases occurred due to an increase in the rate of infrastructure replacement. In addition, treatment plant improvements caused an increase from 2005 to 2006 in the amount of $15.2 million. These improvements are taking place primarily at our Joplin, Missouri, Maricapa County, Arizona and Franklin Township, New Jersey facilities.

An integral aspect of our strategy is to seek growth through tuck-ins and other acquisitions which are complementary to our existing business and support the continued geographical diversification and growth of American Water s operations. Generally, acquisitions are funded initially with short-term debt and later refinanced with the proceeds from long-term debt or equity offerings.

We also conduct ongoing reviews of our existing investments. As a result of these reviews, we sold the operations of various non-regulated water-related businesses over the last two years.

The following provides a summary of the major acquisitions and dispositions affecting our cash flows from investing activities in the periods indicated:

2007:

- We paid approximately $15.9 million for the acquisition of a number of water and wastewater systems, the largest of which was S.J. Services Inc., the parent company of Pennsgrove Water Supply Company, Inc. and South Jersey Water Supply Company, Inc. The purchase price, including acquisition costs, for S.J. Services Inc. was $13.5 million in cash.
- We received approximately $9.7 million in cash proceeds from the sale of a group of assets of the Residuals business.
- We received $16.3 million in cash proceeds from the sale of other assets, including $13.0 million of proceeds on a property in Mansfield, New Jersey owned by a Non-Regulated subsidiary.

2006:

- We paid approximately $12.5 million for the acquisition of water and wastewater systems.
- We received approximately $30.2 million in cash proceeds from the sale of discontinued operations including a group of assets of the Residuals business and the Underground business.

2005:

- We received approximately $15.3 million in cash proceeds from the sale of Engineering s Canadian operations and the assets of Ashbrook Corporation.

On December 21, 2007, New Jersey-American Water, our subsidiary, signed an agreement with the City of Trenton, New Jersey to purchase the assets of the city s water system located in Ewing, Hamilton, Hopewell and Lawrence townships for a purchase price of $100 million. The agreement was approved by the Trenton City Council but requires approval by various regulatory agencies. We can provide no assurances that the agreement will be approved.

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***Cash Flows from Financing Activities***

Our financing activities include the issuance of long-term and short-term debt, primarily through our wholly owned financing subsidiary, AWCC. In addition, we have received capital contributions from RWE and intend to issue equity in the future to maintain an appropriate capital structure, subject to any restrictions in the registration rights agreement to be entered into with RWE. In order to finance new infrastructure, we received customer advances and contributions for construction (net of refunds) of $35.8 million, $47.4 million and $52.0 million for the years ended December 31, 2007, 2006 and 2005, respectively. In connection with the RWE Divestiture, we have made and will continue to make significant changes to our capital structure through debt refinancing and equity offerings.

AWCC issued additional senior notes through private placement offerings totaling $2,117.0 million during 2007. Interest rates ranged from 5.39% to 6.59% and maturities ranged from 7 years to 30 years. RWE made equity contributions to the Company amounting to $1,067.1 million and $1,194.5 million during 2007 and 2006, respectively. The Company used the equity contributions and proceeds from the senior notes to offset loans payable to RWE, to repay outstanding commercial paper and for other corporate purposes.

Additionally, during September 2007, AWCC borrowed $1,750.0 million of RWE redemption notes from RWE. The RWE redemption notes bear interest monthly at the one month London Interbank Offered Rate, which we refer to as LIBOR, plus 22.5 basis points and mature on the earliest of the following to occur (a) March 20, 2009, (b) the date on which the Company and RWE mutually agree to terminate the notes with all accrued and unpaid interest and principal becoming immediately due and payable in full, or (c) the date on which RWE no longer owns more than 80% of the voting rights of the Company. The Company used the proceeds from the RWE redemption notes to redeem $1,750.0 million of its 5.9% mandatory redeemable preferred stock held by RWE.

During October 2007, AWCC issued $750.0 million in new senior notes with a term of 10 years and a fixed interest rate of 6.085% and $750.0 million in new senior notes with a term of 30 years and a fixed interest rate of 6.593%. AWCC used the proceeds to extinguish portions of its debt.

The following long-term debt was issued in 2007:

| **Company** | **Type** | **Interest Rate** | **Maturity** | **Amount (In thousands)** |
|---|---|---|---|---|
| American Water Capital Corp. | RWE notes-variable rate | 5.72% | 2009 | $ 1,750,000 |
| American Water Capital Corp. | Senior notes | 5.39%-6.59% | 2018-2037 | 2,117,000 |
| Other Subsidiaries | State financing authority loans and miscellaneous | 1.00%-1.62% | 2013-2025 | 2,109 |
| Total issuances | | | | $ 3,869,109 |

In 2007, in connection with the acquisition of S.J. Services Inc, we assumed $3.5 million of long-term debt consisting of senior notes and state financing authority loans with interest rates ranging from 0.00% to 9.10% and maturities ranging from 2008 to 2025.

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The following debt and preferred stock with mandatory redemption requirements were retired through extinguishments, optional redemption or payment at maturity in 2007:

| Company | Type | Interest Rate | Maturity | Amount (In thousands) |
|---|---|---|---|---|
| *Long-term debt:* | | | | |
| American Water Capital Corp. | Senior notes-fixed rate | 6.87% | 2011 | $ 28,000 |
| American Water Capital Corp. | RWE notes-fixed rate | 4.00%-6.05% | 2007-2034 | 465,300 |
| American Water Capital Corp. | RWE notes-variable rate | 5.72% | 2009 | 1,750,000 |
| Various Subsidiaries | Senior notes-fixed rate | 7.25%-8.75% | 2007-2028 | 101,531 |
| Various Subsidiaries | Miscellaneous | 0%-10.06% | 2007-2034 | 114,340 |
| *Preferred stock with mandatory redemption requirements* | | | | |
| American Water Works Company | RWE preferred stock-fixed rate | 5.90% | 2012 | 1,750,000 |
| Various Subsidiaries | | 4.60%-8.88% | 2007-2019 | 388 |
| Total extinguishments, retirements & redemptions | | | | $ 4,209,559 |

The following long-term debt was issued in 2006:

| Company | Type | Interest Rate | Maturity | Amount (In thousands) |
|---|---|---|---|---|
| American Water Capital Corp. | Senior notes | 5.39%-5.77% | 2013-2018 | $ 483,000 |
| Missouri-American Water Company | Tax exempt first mortgage bonds | 4.60% | 2036 | 57,480 |
| Indiana-American Water Company | Tax exempt first mortgage bonds | 4.88% | 2036 | 25,770 |
| Other Subsidiaries | State financing authority loans & other | 0%-5.00% | 2019-2026 | 16,248 |
| Total issuances | | | | $ 582,498 |

The following debt was retired through extinguishments, optional redemption or payment at maturity during 2006:

| Company | Type | Interest Rate | Maturity | Amount (In thousands) |
|---|---|---|---|---|
| *Long-term debt:* | | | | |
| American Water Works Company, Inc. | RWE notes | 4.92% | 2006 | $ 150,000 |
| American Water Capital Corp. | RWE notes-fixed rate | 4.00%-6.05% | 2006-2034 | 1,086,500 |
| American Water Capital Corp. | RWE notes-floating rate | 4.02%-4.66% | 2006-2015 | 482,300 |
| Missouri-American Water Company | Mortgage bonds-fixed rate | 5.50%-5.85% | 2006-2026 | 57,565 |
| Indiana-American Water Company | Mortgage bonds-fixed rate | 5.35%-5.90% | 2022-2026 | 27,004 |
| West Virginia-American Water Company | Mortgage bonds-fixed rate | 6.81% | 2006 | 11,000 |
| Other Subsidiaries | | 0%-9.87% | 2006-2034 | 17,564 |
| *Preferred stock with mandatory redemption requirements* | | | | |
| Miscellaneous | | 4.60%-8.80% | 2007-2019 | 538 |
| Total extinguishments, retirements & redemptions | | | | $ 1,832,471 |

From time to time and as market conditions warrant, we may engage in long-term debt retirements via tender offers, open market repurchases or other viable alternatives to strengthen our balance sheets.

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***Credit Facilities and Short-Term Debt***

The components of short-term debt at December 31, 2007 were as follows:

| | 2007 |
|---|---|
| Commercial paper, net of discount | $ 169,267 |
| Book-overdraft | 42,198 |
| Other short-term debt | 9,049 |
| Total short-term debt | $ 220,514 |

AWCC has entered into a one-year $10.0 million committed revolving line of credit with PNC Bank, N.A. This line of credit will terminate on December 31, 2008 unless extended and is used primarily for short-term working capital needs. Interest rates on advances under this line of credit are based on either the prime rate of PNC Bank, N.A. or the applicable LIBOR for the term selected plus 25 basis points. As of December 31, 2007, $9.0 million was outstanding under this revolving line of credit. If this line of credit were not extended beyond its current maturity date of December 31, 2008, AWCC would continue to have access to its $800.0 million unsecured revolving credit facility described below.

On December 21, 2004, AWCC entered into a $550.0 million 364-day unsecured revolving credit facility with RWE. The facility was renewed on October 28, 2006 and was terminated on December 28, 2006. On September 15, 2006, AWCC entered into a new $800.0 million unsecured revolving credit facility syndicated among a group of ten banks. This revolving credit facility, which originally terminated on September 15, 2011, is principally used to support the commercial paper program at AWCC and to provide up to $150.0 million in letters of credit. AWCC had no loans outstanding under the net $800.0 million unsecured revolving credit facility as of December 31, 2007. On September 14, 2007, this revolving credit facility was extended for an additional year by the facility bank group, making the new termination date September 15, 2012.

On December 31, AWCC had the following sub-limits and available capacity under the revolving credit facility and indicated amounts of outstanding commercial paper.

| | Letter of Credit Sublimit (In thousands) | Available Capacity (In thousands) | Outstanding Commercial Paper (Net of Discount) (In thousands) |
|---|---|---|---|
| December 31, 2006 | $ 150,000 | $ 85,986 | $ 321,339 |
| December 31, 2007 | $ 150,000 | $ 60,659 | $ 169,267 |

Interest rates on advances under the revolving credit facility are based on either prime or LIBOR plus an applicable margin based upon our credit ratings, as well as total outstanding amounts under the agreement at the time of the borrowing. The maximum LIBOR margin is 55 basis points.

The revolving credit facility requires us to maintain a ratio of consolidated debt to consolidated capitalization of not more than 0.70 to 1.00. On December 31, 2007, we were in compliance with the ratio.

***Capital Structure***

Our capital structure was as follows:

| | At December 31, 2005 | At December 31, 2006 | At December 31, 2007 |
|---|---|---|---|
| Common stockholder equity and preferred stock without mandatory redemption rights | 29% | 40% | 48% |

| | | | |
|---|---|---|---|
| Long-term debt | 50% | 50% | 49% |
| Short-term debt and current portion of long-term debt | 21% | 10% | 3% |
| | 100% | 100% | 100% |

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As a condition to some PUC approvals of the RWE Divestiture, we have agreed to maintain a capital structure which includes a minimum of 45% common equity at the time of the consummation of the initial public offering. RWE has informed us that if it is determined that we do not meet this ratio at the time of the initial public offering, RWE will contribute cash to us in order to remedy the shortfall. This would be a capital contribution, and no shares would be issued to RWE. The proceeds of any such capital contribution would be used to repay indebtedness.

The changes to capital resource mix during 2006 and 2007 were accomplished through the various financing activities noted above. The capital structure at December 31, 2007 more closely reflects our expected future capital structure.

***Debt Covenants***

Our debt agreements contain financial and non-financial covenants. To the extent that we are not in compliance, we or our subsidiaries may be restricted in our ability to pay dividends, issue debt or access our revolving credit lines. We were in compliance with our reporting covenants as of December 31, 2007. See Risk Factors Risks Related to Our Industry and Business Our failure to comply with restrictive covenants under our credit facilities could trigger repayment obligations.

***Security Ratings***

We primarily access the capital markets, including the commercial paper market, through AWCC. However, we do issue debt at our regulated subsidiaries, primarily in the form of tax exempt securities, to lower overall cost of debt. The following table shows the Company s securities ratings at December 31, 2007:

| Securities | Moody s Investors Service | Standard & Poor s Ratings Service |
|---|---|---|
| Senior unsecured debt | Baa2 | A |
| Commercial paper | P2 | A2 |

On September 19, 2007, Standard & Poor s Ratings Services (S&P) affirmed its A corporate credit rating on both AWCC and American Water, upgraded its rating on the senior unsecured debt of AWCC to A from BBB+ and affirmed its A-2 rating on AWCC s $700.0 million commercial paper program. On November 15, 2007, S&P placed its A- corporate credit ratings on both AWCC and American Water, as well as AWCC s senior unsecured debt credit ratings, on Credit Watch with negative implications. The ratings on American Water and AWCC remain on CreditWatch with negative implications.

On August 28, 2007, Moody s placed both the long-term and short-term ratings of AWCC on review for possible downgrade. On October 12, 2007, Moody s downgraded to Baa2 from Baa1 the senior unsecured issuer rating of AWCC. In addition, Moody s assigned a Baa2 senior unsecured issuer rating to American Water and affirmed AWCC s P-2 short-term rating. The rating outlook for both American Water and AWCC is stable.

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.

None of our borrowings are subject to default or prepayment as a result of a downgrading of securities although such a downgrading could increase fees and interest charges under our credit facilities.

As part of the normal course of business, we routinely enter into contracts for the purchase and sale of water, energy, fuels and other services. These contracts either contain express provisions or otherwise permit us and our counterparties to demand adequate assurance of future performance when there are reasonable grounds for doing so. In accordance with the contracts and applicable contract law, if we are downgraded by a credit

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rating agency, especially if such downgrade is to a level below investment grade, it is possible that a counterparty would attempt to rely on such a downgrade as a basis for making a demand for adequate assurance of future performance. Depending on its net position with a counterparty, the demand could be for the posting of collateral. In the absence of expressly agreed provisions that specify the collateral that must be provided, the obligation to supply the collateral requested will be a function of the facts and circumstances of the Company s situation at the time of the demand. If we can reasonably claim that we are willing and financially able to perform our obligations, it may be possible to successfully argue that no collateral should be posted or that only an amount equal to two or three months of future payments should be sufficient.

*Current Credit Market Position*

Due to recent market developments, including a series of rating agency downgrades of subprime U.S. mortgage-related assets and a decline in the fair value of subprime-related investments, the Company performed an assessment to determine the impact, if any, of current market conditions on the Company s financial position. As of December 31, 2007 there were no investments in subprime mortgage-related assets within the Company s short-term investment balances.

The Company has also performed an assessment of its investments held in trusts, which will be used by the Company to satisfy future obligations under the Company s pension and postretirement benefit plans. Based upon this assessment, it has determined that a de minimis portion of the holdings within the trusts are directly invested in subprime mortgage-related assets or auction rate debt securities. The Company does not believe that any decline in the fair value of these subprime mortgage-related assets or auction rate securities will have a material impact on its results of operations or its future cash funding requirements.

As of December 31, 2007, the Company had issued $169.6 million of auction rate tax-exempt long-term debt (including $24.9 million of variable rate demand bonds, which are periodically repriced to reflect auction rates) that are insured by AAA-rated insurers Ambac Assurance Corporation and MBIA Insurance Corporation. Due to the exposure that these bond insurers have in connection with recent developments in the subprime credit market, rating agencies have put these insurers on review for possible downgrade. Fitch has lowered the credit ratings of Ambac Assurance Corporation from AAA to AA. While these debt instruments are long-term in nature, and only the variable rate demand bonds can be put back to the Company prior to maturity, the interest rates on these instruments are designed to reset periodically through an auction process. In late February 2008, the Company began to experience failed auctions for a portion of these instruments, which had interest rates of 3.65% to 4.90% as of December 31, 2007. When a failed auction occurs on a series of this debt, the Company is required to begin paying a failed-auction interest rate on the instruments. The failed auction interest rate for the majority of the auction rate debt is 10%. Payment of the failed-auction rate interest rates will continue until the Company is able to either successfully remarket these instruments through the auction process or refund and refinance the existing debt through the issuance of an equivalent amount of tax exempt bonds. In April and May 2008, the Company redeemed an aggregate of $144.7 million of long-term auction rate debt of its subsidiaries with interest rates ranging from 6.48% to 10% per annum and maturities ranging from 2021 to 2032.

At this time the Company does not believe recent market developments significantly impact its ability to obtain financing and expects to have access to liquidity in the capital markets on favorable terms. In addition, the Company has access to unsecured revolving credit facilities, which are not as dependent upon general market conditions, with aggregate bank commitments of $810 million, of which a portion is currently committed primarily to backstop the Company s commercial paper program and letters of credit.

*Regulatory Restrictions*

The issuance by the Company or AWCC of long-term debt or equity securities does not require authorization of any state PUC if no guarantee or pledge of the regulated subsidiaries is utilized. However, state PUC authorization is required to issue long-term debt or equity securities at most regulated subsidiaries. Our

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regulated subsidiaries normally obtain the required approvals on a periodic basis to cover their anticipated financing needs for a period of time or in connection with a specific financing.

Under applicable law, our subsidiaries can pay dividends only from retained, undistributed or current earnings. A significant loss recorded at a subsidiary may limit the dividends that these companies can distribute to us.

*Insurance Coverage*

We carry various property, casualty and financial insurance policies with limits, deductibles and exclusions consistent with industry standards. However, insurance coverage may not be adequate or available to cover unanticipated losses or claims. We are self-insured to the extent that losses are within the policy deductible or exceed the amount of insurance maintained. Such losses could have a material adverse effect on our short-term and long-term financial condition and the results of operations and cash flows.

*Contractual Obligations and Commitments*

We enter into obligations with third parties in the ordinary course of business. These obligations, as of December 31, 2007, are set forth in the table below:

| Contractual obligation | Total | Less Than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
|---|---|---|---|---|---|
| | | | (In thousands) | | |
| Long term debt obligations(a) | $ 4,698,219 | $ 96,085 | $ 100,157 | $ 64,699 | $ 4,437,278 |
| Interest on long-term debt(b) | 4,955,887 | 280,696 | 550,115 | 539,506 | 3,585,570 |
| Capital lease obligations(c) | 1,982 | 152 | 363 | 452 | 1,015 |
| Interest on Capital Lease obligations(d) | 1,967 | 206 | 362 | 293 | 1,106 |
| Operating lease obligations(e) | 227,918 | 28,248 | 50,655 | 29,605 | 119,410 |
| Purchase water obligations(f) | 782,084 | 44,678 | 86,641 | 89,803 | 560,962 |
| Other purchase obligations(g) | 86,338 | 86,338 | | | |
| Postretirement benefit plans obligations(h) | 27,352 | 27,352 | | | |
| Pension ERISA minimum funding requirement | 76,000 | 76,000 | | | |
| Preferred stocks with mandatory redemption requirements(i) | 24,643 | 218 | 436 | 2,146 | 21,843 |
| Interest on preferred stocks with mandatory redemption requirements | 30,056 | 2,047 | 4,061 | 4,005 | 19,943 |
| Other obligations(i) | 163,930 | 110,850 | 53,011 | 69 | |
| Total | $ 11,076,376 | $ 752,870 | $ 845,801 | $ 730,578 | $ 8,747,127 |

(a) Represents sinking fund obligations and debt maturities.
(b) Represents expected interest payments on outstanding long-term debt. Amounts reported may differ from actual due to future refinancing of debt.
(c) Represents future minimum payments under noncancelable capital leases.
(d) Represents expected interest payments on noncancelable capital leases.
(e) Represents future minimum payments under noncancelable operating leases, primarily for the lease of motor vehicles, buildings, land and other equipment.
(f) Represents future payments under water purchase agreements for minimum quantities of water.
(g) Represents the open purchase orders as of December 31, 2007, for goods and services purchased in the ordinary course of business.
(h) Represents contributions expected to be made to postretirement benefit plans.
(i) Represents capital expenditures estimated to be required under legal and binding contractual obligations.

*Off-Balance Sheet Arrangements*

From 1997 through 2002, West Virginia-American Water Company, our subsidiary, entered into a series of agreements with various public entities to establish certain joint ventures, commonly referred to as public-private partnerships. West Virginia-American agreed to transfer and convey some of its real and personal property, which we refer to as the transferred facilities, to various public entities, subject to the lien of its General Mortgage Indenture, in exchange for an equal principal amount of industrial development bonds, which we refer to as IDBs, to be issued by the various public entities under a state Industrial Development Bond and Commercial Development Act.

West Virginia-American leased back the transferred facilities under capital leases for a period of 40 years. The leases have payments that approximate the payments required by the terms of the IDBs. In accordance with Financial Accounting Standards Board Interpretation Number 39, *Offsetting of Amounts Related to Certain Contracts*, we have presented the transaction on a net basis in the consolidated financial statements. The carrying value of the transferred facilities was $162.0 million at December 31, 2007.

*Market Risk*

We are exposed to market risk associated with changes in commodity prices, equity prices and interest rates. We use a combination of fixed-rate and variable-rate debt to reduce interest rate exposure. As of December 31, 2007 a hypothetical 10% increase in interest rates associated with variable rate debt would result in a $1.2 million decrease in our pre-tax earnings. Our risks associated with price increases for chemicals, electricity and other commodities are reduced through long-term contracts and the ability to recover price increases through rates.

**Critical Accounting Policies and Estimates**

The application of critical accounting policies is particularly important to our financial condition and results of operations and provides a framework for management to make significant estimates, assumptions and other judgments. Although our management believes that these estimates, assumptions and other judgments are appropriate, they relate to matters that are inherently uncertain. Accordingly, changes in the estimates, assumptions and other judgments applied to these accounting policies could have a significant impact on our financial condition and results of operations as reflected in our consolidated financial statements.

Our financial condition, results of operations and cash flow are impacted by the methods, assumptions and estimates used in the application of critical accounting policies. Management believes that the areas described below require significant judgment in the application of accounting policy or in making estimates and assumptions in matters that are inherently uncertain and that may change in subsequent periods. Our management has reviewed these critical accounting policies, and the estimates and assumptions regarding them, with our Audit Committee. In addition, our management has also reviewed the following disclosures regarding the application of these critical accounting policies with the Audit Committee.

*Regulatory Accounting*

Our regulated utility subsidiaries are subject to regulation by state PUCs and the local governments of the states in which they operate. As such, we account for these regulated operations in accordance with SFAS No. 71, Accounting for the Effects of Certain Types of Regulation, which we refer to as SFAS No. 71, which requires us to reflect the effects of rate regulation in our financial statements. Use of SFAS No. 71 is applicable to utility operations that meet the following criteria: (1) third-party regulation of rates; (2) cost-based rates; and (3) a reasonable assumption that all costs will be recoverable from customers through rates. As of December 31, 2007, we had concluded that the operations of our regulated subsidiaries meet the criteria. If it is concluded in a future period that a separable portion of the businesses no longer meets the criteria, we are required to eliminate

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the financial statement effects of regulation for that part of the business, which would include the elimination of any or all regulatory assets and liabilities that had been recorded in the consolidated financial statements. Failure to meet the criteria of SFAS No. 71 could materially impact our consolidated financial statements as a one-time extraordinary item and through impacts on continuing operations.

Regulatory assets represent costs that have been deferred to future periods when it is probable that the regulator will allow for recovery through rates charged to customers. Regulatory liabilities represent revenues received from customers to fund expected costs that have not yet been incurred. As of December 31, 2007, we have recorded $628.0 million of net regulatory assets within our consolidated financial statements. Also, at December 31, 2007, we had recorded $192.7 million of regulatory liabilities within our consolidated financial statements. See Note 7 of the Notes to Consolidated Financial Statements for further information regarding the significant regulatory assets.

For each regulatory jurisdiction where we conduct business, we continually assess whether the regulatory assets and liabilities continue to meet the criteria for probable future recovery or settlement. This assessment includes consideration of factors such as changes in applicable regulatory environments, recent rate orders to other regulated entities in the same jurisdiction, the status of any pending or potential deregulation legislation and the ability to recover costs through regulated rates.

*Goodwill*

As of December 31, 2007, we had $2,457.0 million of goodwill. The goodwill is associated primarily with the acquisition of American Water by an affiliate of RWE in 2003 and the acquisition of E Town Corporation in 2001, representing the excess of the purchase price over the fair value of the net tangible and intangible assets acquired, and was assigned to reporting units based on the fair values at the date of the acquisition. The Regulated Businesses have been aggregated and deemed a single reporting unit because they have similar economic characteristics. In the Non-Regulated Businesses segment, the business is organized into eight reporting units.

In accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, which we refer to as SFAS 142, goodwill is reviewed annually, or more frequently if changes in circumstances indicate the carrying value may not be recoverable. To test for impairment, we utilize discounted estimated future cash flows and comparable public company market data analyses for the regulated segment to measure fair value for each reporting unit. This calculation is highly sensitive to both the estimated future cash flows of each reporting unit, the discount rate assumed and the change in market data in these calculations. Annual impairment reviews are preformed in the fourth quarter. Application of the goodwill impairment test requires management s judgments, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. In addition, we will consider the market price of our common stock at the initial public offering date or the change over a period of time of our stock price following the consummation of the initial public offering.

For the years ended December 31, 2007, 2006 and 2005, we determined that our goodwill was impaired and recorded impairments of $509.3 million, $227.8 million and $396.3 million, respectively, including impairment charges from discontinued operations (See Note 8 of the Notes to our Consolidated Financial Statements.) Our annual goodwill impairment test is completed during the fourth quarter. We have processes to monitor for interim triggering events. During the third quarter of 2007, as a result of our debt being placed on review for a possible downgrade and the anticipated sale of a portion of the Company in the initial public offering, management determined at that time that it was appropriate to update its valuation analysis before the next scheduled annual test.

Based on this assessment, we performed an interim impairment test and recorded an impairment charge to goodwill to our Regulated Businesses in the amount of $243.3 million in the third quarter of 2007. The decline was primarily due to a slightly lower long-term earnings forecast caused by updated customer demand and usage expectations and expectations for timing of capital expenditures and rate recovery.

We completed our annual goodwill impairment test for 2007 and recorded an additional goodwill impairment charge to the Regulated Businesses reporting unit in the amount of $266.0 million during the fourth quarter of 2007. We determined that an impairment had occurred based upon new information regarding our market value. We incorporated this indicated market value into our valuation methodology and, based on those results, an additional impairment to our carrying value was recorded.

We may be required to recognize additional impairments in the future due to, among other things, the market value of our stock, a decline in our forecasted results as compared to the business plan, changes in interest rates or a change in rate case results. Further recognition of additional material impairments of goodwill would negatively affect our results of operations and total capitalization. It is reasonably possible that further goodwill impairment charges will be required depending upon changes in market conditions or circumstances. Based on the initial public offering price, we have determined that it is probable we will record an impairment to goodwill when we report results for the quarter ended March 31, 2008. Whether such an impairment to goodwill is recognized will depend on an analysis of the factors described above. The size of any such impairment to goodwill, if any, cannot be determined at this time.

*Impairment of Long-Lived Assets*

Long-lived assets, other than goodwill which is discussed above, include land, buildings, equipment and long-term investments. Long-lived assets, other than investments, land and goodwill, are depreciated over their estimated useful lives, and are reviewed for impairment whenever changes in circumstances indicate the carrying value of the asset may not be recoverable. Such circumstances would include items such as a significant decrease in the market price of a long-lived asset, a significant adverse change in the manner in which the asset is being used or planned to be used or in its physical condition, or a history of operating or cash flow losses associated with the use of the asset. In addition, changes in the expected useful life of these long-lived assets may also be an impairment indicator. When such events or changes occur, we estimate the fair value of the asset from future cash flows expected to result from the use and, if applicable, the eventual disposition of the assets and compares that to the carrying value of the asset. If the carrying value is greater than the fair value, an impairment loss is recognized equal to the amount by which the asset s carrying value exceeds its fair value. The key variables that must be estimated include assumptions regarding sales volume, rates, operating costs, labor and other benefit costs, capital additions, assumed discount rates and other economic factors. These variables require significant management judgment and include inherent uncertainties since they are forecasting future events. A variation in the assumptions used could lead to a different conclusion regarding the realizability of an asset and, thus, could have a significant effect on the consolidated financial statements.

The long-lived assets of the regulated utility subsidiaries are grouped on a separate entity basis for impairment testing as they are integrated state-wide operations that do not have the option to curtail service and generally have uniform tariffs. A regulatory asset is charged to earnings if and when future recovery in rates of that asset is no longer probable.

We performed a valuation of long-lived assets, other than investments and goodwill, as of December 31, 2007, 2006, and 2005. As a result of the impairment analyses, we recorded pre-tax charges of $24.0 million including impairments recorded associated with discontinued operations for the year ended December 31, 2005. No impairment charges were recorded in 2007 and 2006. The 2005 impairment primarily resulted from lower than expected growth, slower development compared with original expectations and changes in the value of a building with a carrying value that exceeded its fair value. These charges are included in impairment charges in the statements of operations. The remaining values as of December 31, 2007, 2006 and 2005 were determined to be appropriate.

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The fair values of long-term investments are dependent on the financial performance and solvency of the entities in which we invest, as well as volatility inherent in the external markets. In assessing potential impairment for these investments, we consider these factors and in one case also receive annual appraisals. If such assets are considered impaired, an impairment loss is recognized equal to the amount by which the asset s carrying value exceeds its fair value. We determined the values of long-term investments were appropriate for the years ended December 31, 2007, 2006 and 2005.

*Revenue Recognition*

Revenues of the regulated utility subsidiaries are recognized as water and wastewater services are delivered to customers and include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the date of the latest meter reading to the end of the accounting period. Unbilled revenues as of December 31, 2007 and 2006 were $134.3 million and $123.2 million, respectively. Increases in volumes delivered to the utilities customers and favorable rate mix due to changes in usage patterns in customer classes in the period could be significant to the calculation of unbilled revenue. Changes in the timing of meter reading schedules and the number and type of customers scheduled for each meter reading date would also have an effect on the estimated unbilled revenue; however, since the majority of our customers are billed on a monthly basis, total operating revenues would remain materially unchanged.

Revenue from non-regulated operations is recognized as services are rendered. Revenues from certain construction projects are recognized over the contract term based on the estimated percentage of completion during the period compared to the total estimated services to be provided over the entire contract. Losses on contracts are recognized during the period in which the loss first becomes probable and estimable. Revenues recognized during the period in excess of billings on construction contracts are recorded as unbilled revenue. Billings in excess of revenues recognized on construction contracts are recorded as other current liabilities on the balance sheet until the recognition criteria are met. Changes in contract performance and related estimated contract profitability may result in revisions to costs and revenues and are recognized in the period in which revisions are determined.

*Accounting for Income Taxes*

We participate in a consolidated federal income tax return for United States tax purposes. Members of the consolidated group are charged with the amount of federal income tax expense determined as if they filed separate returns.

We estimate the amount of income tax payable or refundable for the current year and the deferred income tax liabilities and assets that results from estimating temporary differences resulting from the treatment of certain items, such as depreciation, for tax and financial statement reporting. These differences result from the recognition of a deferred tax asset or liability on our consolidated balance sheet and require us to make judgments regarding the probability of the ultimate tax impact of the various transactions we enter into. Based on these judgments we may record tax reserves or adjustments to valuation allowances on deferred tax assets to reflect the expected realization of future tax benefits. Actual income taxes could vary from these estimates and changes in these estimates can increase income tax expense in the period that these changes in estimate occur.

*Accounting for Pension and Postretirement Benefits*

We maintain noncontributory defined benefit pension plans covering eligible employees of our regulated utility and shared service operations. The pension plans have been closed for any employees hired on or after January 1, 2006. Union employees hired on or after January 1, 2001 and non-union employees hired on or after January 1, 2006 will be provided with a 5.25% of base pay defined contribution plan. We also maintain postretirement benefit plans for eligible retirees. The retiree welfare plans are closed for union employees hired

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on or after January 1, 2006. The plans had previously closed for non-union employees hired on or after January 1, 2002. We follow the guidance of SFAS 87, Employers Accounting for Pensions, and SFAS 106, Employers Accounting for Postretirement Benefits Other Than Pensions, when accounting for these benefits. In addition, we adopted the recognition and disclosure requirements of SFAS 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, effective December 31, 2006. See Note 14 of the Notes to Consolidated Financial Statements for further information regarding the accounting for the defined benefit pension plans and postretirement benefit plans.

Under these accounting standards, assumptions are made regarding the valuation of benefit obligations and the performance of plan assets. Delayed recognition in earnings of differences between actual results and expected or estimated results is a guiding principle of these standards. This delayed recognition of actual results allows for a smoothed recognition of costs over the working lives of the employees who benefit under the plans. The primary assumptions are:

Discount Rate The discount rate is used in calculating the present value of benefits, which are based on projections of benefit payments to be made in the future. The objective in selecting the discount rate is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the accumulated benefits when due;

Expected Return on Plan Assets Management projects the future return on plan assets considering prior performance, but primarily based upon the plans mix of assets and expectations for the long-term returns on those asset classes. These projected returns reduce the net benefit costs we record currently;

Rate of Compensation Increase Management projects employees annual pay increases, which are used to project employees pension benefits at retirement; and

Health Care Cost Trend Rate Management projects the expected increases in the cost of health care.

In selecting a discount rate for our pension and postretirement benefit plans, a yield curve was developed for a portfolio containing the majority of United States-issued Aa-graded non-callable (or callable with make-whole provisions) corporate bonds. For each plan, the discount rate was developed as the level equivalent rate that would yield the same present value as using spot rates aligned with the projected benefit payments. The discount rate for determining pension benefit obligations was 6.27%, and the discount rate for determining other post-retirement benefit obligations was 6.20%, at December 31, 2007. The discount rate for determining both the pension obligations and other postretirement benefit obligations was 5.90% and 5.65%, at December 31, 2006 and 2005, respectively.

In selecting an expected return on plan assets, we considered tax implications, past performance and economic forecasts for the types of investments held by the plans. The long-term expected rate of return on plan assets (EROA) assumption used in calculating pension cost was 8.00% for 2007, 8.25% for 2006 and 8.75% for 2005. The weighted average EROA assumption used in calculating other postretirement benefit costs was 7.38% for 2007, 7.95% for 2006, and 8.40% in 2005.

In selecting a rate of compensation increase, we consider past experience in light of movements in inflation rates. Our rate of compensation increase was 4.25% for 2007 and 2006 and 4.75% for 2005.

In selecting health care cost trend rates, we consider past performance and forecasts of increases in health care costs. Our health care cost trend rate used to calculate the periodic cost was 9% in 2007, gradually declining to 5% in 2011 and thereafter.

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Assumed health care cost trend rates have a significant effect on the amounts reported for the other postretirement benefit plans. The health care cost trend rate is based on historical rates and expected market conditions. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

| Change in Actuarial Assumption | Impact on Other Postretirement Benefit Obligation at December 31, 2007 | Impact on 2007 Total Service and Interest Cost Components |
|---|---|---|
| Increase assumed health care cost trend by 1% | $ 57,868 | $ 6,143 |
| Decrease assumed health care cost trend by 1% | $ (48,220) | $ (5,001) |

We will use a discount rate and EROA of 8% and 5.9%, respectively, for estimating our 2007 pension costs. Additionally, we will use a discount rate and expected return on plan assets of 8% and 5.9%, respectively, for estimating our 2007 other postretirement benefit costs.

The assumptions are reviewed annually and at any interim remeasurement of the plan obligations. The impact of assumption changes is reflected in the recorded pension and postretirement benefit amounts as they occur, or over a period of time if allowed under applicable accounting standards. The assumptions are selected to represent the average expected experience over time and may differ in any one year from actual experience due to changes in capital markets and the overall economy. As these assumptions change from period to period, recorded pension and postretirement benefit amounts and funding requirements could also change.

**Recent Accounting Pronouncements**

In December 2007, the Financial Accounting Standards Board, which we refer to as FASB issued Statement of Financial Accounting Standard No. 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51 , which we refer to as SFAS 160. SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 will be effective for us on January 1, 2009. We are currently evaluating the effect, if any, that the adoption of SFAS 160 will have on our results of operations, financial position and cash flows.

Also in December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), Business Combinations , which we refer to as SFAS 141(R). SFAS 141(R), which will significantly change the accounting for business combinations, is effective for business combinations finalized on or after January 1, 2009. We are currently evaluating the effect, if any, that the adoption of SFAS 141(R) will have on our results of operations, financial position and cash flows.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115 , which we refer to as SFAS 159. This standard permits entities to choose to measure many financial instruments and certain other items of fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 is effective for the current year and was adopted by the Company on January 1, 2008. The Company has not elected to exercise the fair value irrevocable option. The adoption of SFAS 159 did not have an impact on the Company s results of operations, financial position or cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R), which we refer to as SFAS 158. This statement requires the recognition of the

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overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. Under SFAS 158, actuarial gains and losses, prior service costs or credits, and transition obligations and assets that have not be recognized in net periodic benefit cost under previous accounting standards will be recognized as a regulatory asset for the portion of the underfunded liability that meets the recovery criteria prescribed in SFAS 71 and as accumulated other comprehensive income, net of tax effects, for that portion of the underfunded liability that does not meet SFAS 71 regulatory accounting criteria. We adopted the recognition and disclosure requirements of the statement on December 31, 2006.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements , which we refer to as SFAS 157. SFAS 157 establishes a common definition for fair value to be applied to U.S. generally accepted accounting principles guidance requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. In February 2008, the FASB issued FASB Staff Position FAS 157-2 which allows a one-year deferral of adoption of SFAS 157 for nonfinancial assets and nonfinancial liabilities (such as intangible assets, property, plant and equipment and goodwill) that are required to be measured at fair value on a non-recurring basis (such as at acquisition or impairment). Accordingly, SFAS 157 will be adopted for the Company s nonfinancial assets and liabilities valued on a non-recurring basis on January 1, 2009. On January 1, 2008, the Company adopted the provisions of SFAS 157 for financial assets and liabilities and nonfinancial assets and liabilities with recurring measurements. The Company s assets and liabilities measured at fair value on a recurring basis during the period were cash and cash equivalents, restricted funds and short-term debt. These assets and liabilities were measured at fair value on the balance sheet date using quoted prices in active markets (level 1 inputs, as defined by SFAS 157). The adoption of SFAS 157 for the Company s financial assets and liabilities did not have a significant effect on the Company s results of operations, financial position or cash flows.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, which we refer to as SAB 108. SAB 108 provides guidance on how prior year misstatements should be considered when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. SAB 108 was effective for the fiscal year ended December 31, 2006.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, which we refer to as FIN 48, an Interpretation of SFAS No. 109, Accounting for Income Taxes. FIN 48 is intended to address inconsistencies among entities with the measurement and recognition in accounting for income tax deductions for financial statement purposes. Specifically, FIN 48 addresses the timing of the recognition of income tax benefits. FIN 48 requires the financial statement recognition of an income tax benefit when we determine that it is more-likely-than-not that the tax position will be sustained. FIN 48 is effective for fiscal years beginning after December 15, 2006. We adopted it as required on January 1, 2007, and it did not have a significant effect on our results of operations or financial position.

During 2006, the Emerging Issues Task Force of the Financial Accounting Standards Board ratified EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (that is, Gross versus Net Presentation), which we refer to as EITF 06-3. The Task Force reached a consensus that the scope of EITF 06-3 includes any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer, and that the presentation of such taxes is an accounting policy that should be disclosed. Our accounting policy is to present these taxes on a net basis (excluded from revenues).

See Note 2 Significant Accounting Policies in the notes to the audited consolidated financial statements for a discussion of new accounting standards recently adopted or pending adoption.

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**BUSINESS**

**Our Company**

Founded in 1886, we are the largest investor-owned United States water and wastewater utility company, as measured both by operating revenue and population served. Our nearly 7,000 employees provide approximately 15.6 million people with drinking water, wastewater and other water-related services in 32 states and Ontario, Canada. In 2007, we generated $2,214.2 million in total operating revenue, representing approximately four times the operating revenue of the next largest investor-owned company in the United States water and wastewater business, and $15.1 million in operating income, which includes $509.3 million of impairment charges relating to continuing operations, and a net loss of $342.8 million.

For 2007, our Regulated Businesses generated $1,987.6 million in operating revenue, which accounted for 89.8% of total operating revenue. For the same period, our Non-Regulated Businesses generated $242.7 million in operating revenue, prior to inter-segment eliminations, which accounted for 11.0% of consolidated operating revenue.

***Our History as a Public Company***

We were founded in 1886 as the American Water Works & Guarantee Company, for the purposes of building and purchasing water systems in McKeesport, Pennsylvania. In 1935, the Company was reorganized under its current name, and in 1947 the common stock of the Company became publicly traded on the New York Stock Exchange. Prior to being acquired by RWE in 2003, we were the largest publicly traded water utility company in the United States.

***Our Acquisition by RWE***

In 2003, we were acquired by RWE and became a private company. The RWE acquisition resulted in certain changes in our business. For example, our operations and management were managed through Thames Water. Also, we agreed not to file rate cases with certain state PUCs for specified periods of time as a condition of the acquisition. All rate stay-out provisions associated with the RWE acquisition have expired. In 2005, RWE decided to divest American Water. In March 2006, RWE decided to divest American Water through the sale of shares in one or more public offerings.

***Corporate & Industry Milestones***

| Year | Event |
|---|---|
| 1886 | Founding of American Water as the American Water Works & Guarantee Company |
| 1935 | Reorganizes as American Water Works Company, Inc. in response to the Public Utility Company Holding Act |
| 1947 | First listing of common stock on the New York Stock Exchange under the symbol AWK |
| 1958 | Acquires operations in Connecticut, Massachusetts and New Hampshire |
| 1962 | Acquires contract operations and water systems in Maryland, Pennsylvania and New Jersey through merger with Northeastern Water Company |
| 1965 | Purchases the water utility assets of Southern Gas and Water Company in West Virginia |
| 1966 | Purchases the water utility assets of California Water & Telephone Company<br><br>Joins Fortune magazine s list of 50 largest United States public utility companies |
| 1969 | Acquires Paradise Valley Water Company in Arizona |
| 1972 | Passage of Clean Water Act |

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| Year | Event |
| --- | --- |
| 1972 | Western Pennsylvania Water Company formed through merger of 17 operating subsidiaries |
| 1974 | Passage of Safe Drinking Water Act |
| 1986 | Acquires operations in New Mexico from Southwest Public Service Company |
| 1989 | Western Pennsylvania Water Company and Keystone Water Company merge to form Pennsylvania American Water Company |
| 1993 | Acquires operations in Indiana, Missouri and Ohio from Avatar Holdings |
| 1996 | Acquires the water service assets of Pennsylvania Gas & Water Company |
| 1998 | Acquires wastewater operations in Hawaii |
| 1999 | Acquires National Enterprises Inc. with operations in Missouri, Illinois, Indiana and New York |
| 2000 | Acquires water utilities in Missouri, Indiana, Illinois and Virginia from United Water Resources |
| 2001 | Acquires Azurix North America Corporation |
| | RWE signs an agreement to acquire the Company |
| 2002 | Acquires water subsidiaries of Citizens Communications Company in Arizona, California, Illinois, Indiana, Ohio and Pennsylvania |
| 2003 | RWE completes acquisition of the Company |
| | RWE combines the Company with the United States operations of Thames Water (including E Town Corporation, Inc.) to form the North American Water reporting unit of RWE Thames Water |
| 2005 | RWE announces its intention to divest the Company |
| 2008 | Initial public offering and listing of our common stock on the New York Stock Exchange with the symbol AWK |

***Regulated Businesses Overview***

Our primary business involves the ownership of water and wastewater utilities that provide water and wastewater services to residential, commercial and industrial customers. Our subsidiaries that provide these services are generally subject to economic regulation by the state PUCs in the states in which they operate. The federal government and the states also regulate environmental, health and safety and water quality matters. We report the results of this business in our Regulated Businesses segment.

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The following charts set forth operating revenue and customers, respectively, for 2007 for the states in which our Regulated Businesses provide services:

**Regulated Businesses Operating Revenue**

**(dollars in millions)**

**Regulated Businesses Customers**

*Non-Regulated Businesses Overview*

We also provide services that are not subject to economic regulation by state PUCs through our Non-Regulated Businesses. Our Non-Regulated Businesses include:

- our Contracts Operations Group, which enters into public/private partnerships, including O&M, and DBO contracts for the provision of services to water and wastewater facilities for municipalities, the United States military and other customers;

- our Applied Water Management Group, which works with customers to design, build and operate small water and wastewater treatment plants;

- our Homeowner Services Group, which provides services to domestic homeowners to protect against the cost of repairing broken or leaking pipes inside and outside their homes; and Terratec Environmental Services Inc., which primarily provides wastewater, residuals, transport, disposal and management services to municipal and industrial customers in Ontario, Canada.

We report the results of these lines of business in our Non-Regulated Businesses segment. For 2007, operating revenue for our Non-Regulated Businesses was $242.7 million, prior to inter-segment eliminations, accounting for 11.0% of total operating revenue for the same period.

**Our Industry**

*Overview*

The United States water and wastewater industry has two main segments: (i) utility, which involves supplying water and wastewater services to consumers, and (ii) general services, which involves providing water- and wastewater-related services to water and wastewater utilities and other customers on a contract basis.

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The utility segment includes municipal systems, which are owned and operated by local governments or governmental subdivisions, and investor-owned systems. Government-owned systems make up the vast majority of the United States water and wastewater utility segment, accounting for approximately 84% of all United States community water systems and approximately 98% of all United States community wastewater systems. Investor-owned water and wastewater systems account for the remainder of the United States water and wastewater community water systems. Growth of service providers in the utility segment is achieved through acquisitions, including tuck-ins, of other water and wastewater systems and organic growth of the population served by such providers.

The utility segment is characterized by high barriers to entry, including high capital spending requirements. Investor-owned water and wastewater utilities also face regulatory approval processes in order to do business, which may involve obtaining relevant operating approvals, including certificates of public convenience and necessity (or similar authorizations) from state PUCs. Investor-owned water and wastewater systems are generally economically regulated by the state PUCs in the states in which they operate. The federal government and the states also regulate environmental, health and safety and water quality matters for both investor-owned and government-owned water and wastewater utilities.

The general services segment includes engineering and consulting companies and numerous other fee-for-service businesses. These include the building and operating of water and wastewater utility systems, system repair services, lab services, sale of water infrastructure and distribution products (such as pipes) and other specialized services. The general services segment is characterized by aggressive competition and market-driven growth and profit margins.

The aging water and wastewater infrastructure in the United States is in constant need of modernization and facilities replacement. Increased regulations to improve water quality and the management of wastewater discharges, which began with passage of the Clean Water Act in 1972 and the Safe Drinking Water Act in 1974, have been among the primary drivers of the need for modernization. The EPA estimates that approximately $277 billion of capital spending will be necessary between 2003 and 2022 to replace aging infrastructure and to comply with quality standards to ensure quality water systems across the United States. In addition, the EPA estimates that approximately $388 billion of capital spending will be necessary between 2000 and 2019 to replace aging infrastructure and ensure quality wastewater systems across the United States.

The following chart sets forth estimated capital expenditure needs through 2022 for United States water systems:

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Capital expenditures related to municipal water supply, treatment and distribution and wastewater collection and treatment facilities are typically funded by water and wastewater rates, taxes or the issuance of bonds. However, raising large amounts of funds is challenging for municipal water utilities, which impacts their ability to increase capital spending. In order to meet their capital spending challenges, many municipalities are examining a combination of privatizations and partnerships with the private sector. Privatization involves a transfer of responsibility for, and ownership of, the utility from the municipality to the private sector. Partnerships between municipalities and the private sector include DBO contracts, own, operate and transfer contracts and own, leaseback and operate contracts. Under these types of contracts, the municipality maintains ownership of the water system and the private sector takes responsibility for managing and operating the system.

***Fragmentation and Consolidation***

The utility segment of the United States water and wastewater industry is highly fragmented, with approximately 53,000 community water systems and approximately 16,000 community wastewater facilities, according to the EPA. As shown in the charts below, the majority of the approximately 53,000 community water systems are very small, serving a population of 500 or less.

The following charts set forth the total United States water industry by system type and the total population served by system type, respectively, for 2005:

| Number of United States Water Systems by Type:* | United States Population Served by Water System Type:* |
|---|---|

This large number of relatively small water and wastewater utilities results in inefficiencies in the marketplace, since smaller utilities may not have the operating expertise, financial and technological capability or economies of scale to provide services or raise capital as efficiently as larger utilities. These inefficiencies may lead to industry consolidation in the future, as the larger investor-owned utilities acquire smaller, local water and wastewater systems. Larger utilities that have greater access to capital are generally more capable of making mandated and other necessary infrastructure upgrades to both water and wastewater systems. In addition, water and wastewater utilities with large customer bases spread across broad geographic regions may more easily absorb the impact of adverse weather, such as droughts, excessive rain and cool temperatures in specific areas. Larger utilities are able to spread overhead expenses over a larger customer base, thereby reducing the costs to serve each customer. Since many administrative and support activities can be efficiently centralized to gain economies of scale and sharing of best practices, companies that participate in industry consolidation have the potential to improve operating efficiencies, lower unit costs and improve service at the same time.

***Water and Wastewater Rates***

Investor-owned water and wastewater utilities generate operating revenue from customers based on rates that are established by state PUCs through a rate-setting process that may include public hearings, evidentiary hearings and the submission by the utility of evidence and testimony in support of the requested level of rates. In evaluating a rate case, state PUCs typically focus on five areas: (i) the amount and prudence of investment in facilities considered used and useful in providing public service; (ii) the operating and maintenance costs and taxes associated with providing the service (typically by making reference to a representative 12-month period of time, known as a test year); (iii) the appropriate rate of return; (iv) the tariff or rate design that allocates operating revenue requirements equitably across the customer base; and (v) the quality of service the utility provides, including issues raised by customers.

For most consumers, water and wastewater bills make up a relatively small percentage of household expenditures compared to other utility services.

The following chart sets forth the relative cost of water in the United States as a percentage of total household utility expenditures:

**Our Strengths**

We believe that we are distinguished by the following key competitive strengths:

***Market leader with broad national footprint and strong local presence.*** We are the largest and most geographically diversified investor-owned water and wastewater utility company in the United States. With operations in 32 states and Ontario, Canada, we serve a population of approximately 15.6 million people, which we estimate is approximately 5 times the population served by the next largest investor-owned water and wastewater company in the United States. Our scale and geographic scope enable us to capitalize effectively on growth opportunities across our service areas, while helping to insulate us from adverse conditions in any one geographic area.

*Regulatory, weather and economic diversity.* State regulatory decisions, regional droughts and floods and local and regional economic downturns can have a major effect on geographically concentrated

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water and wastewater utilities. Our presence in numerous jurisdictions and localities across the United States promotes more stable and predictable financial performance across our overall business.

*Economies of scale.* As the largest investor-owned water and wastewater utility company in the United States, our Regulated Businesses span 375 individual service areas and include approximately 45,000 miles of distribution and collection mains, 84 surface water treatment plants, 623 groundwater treatment plants and 45 wastewater treatment facilities. Our scale and long-standing history with suppliers provide us with a competitive advantage in procuring goods and services reliably and economically, which enables us to provide high quality, cost-effective service to our customers and allows us to economically employ industry experts to serve all our systems. In addition, our experience in operating utilities in many jurisdictions results in the identification and application of best practices across the entire company.

*Active community involvement supports customer satisfaction.* We establish an active presence in the local communities where we operate, supported by strong, ongoing community relations and corporate responsibility. We work closely with these communities to help create detailed water development plans, collaborate on growth initiatives and implement various water infrastructure and conservation projects. We are involved in local charities, schools and community organizations. In 2007, we donated approximately $1.7 million to a wide array of charitable projects in communities that we serve. This strong local presence and community involvement complements our high quality service and helps us to achieve high levels of customer satisfaction. We work with internal and external audiences to develop and support activities that contribute to a responsible business and to achieve high economic, social and environmental standards while balancing the needs of our key stakeholders through a multi-faceted corporate responsibility approach. See Business Community Relations.

***Regulated Businesses provide financial stability.*** Our core Regulated Businesses, which consist of locally managed utility subsidiaries that generally are economically regulated by the states in which they operate, accounted for approximately 89.8% of our consolidated operating revenue in 2007. Our Regulated Businesses provide a high degree of financial stability because (i) high barriers to entry provide limited protection from competitive pressures, (ii) economic regulation promotes predictability in financial planning and long-term performance through the rate-setting process and (iii) our largely residential customer base promotes consistent operating results.

*Barriers to entry.* Generally, water and wastewater utilities operate pursuant to certificates of public convenience and necessity (or similar authorizations) issued by the state PUC in which they operate, which creates a barrier to entry. The requirement to hold such a certificate typically prevents investor-owned water and wastewater utilities from competing with us in our authorized areas. In addition, the high cost of constructing a new water or wastewater system generally inhibits competitive entry into our markets, including by municipal or government-owned utilities, which must either construct new systems or convert our assets to public ownership in order to compete directly with us in our authorized areas. Both of these factors provide a framework that allows us to operate our Regulated Businesses on a predictable and consistent basis.

*Economic regulation.* Economic regulation in the water and wastewater utility industry exists as a substitute for competition. The primary regulatory model used by state PUCs involves a determination of an applicable rate base (consisting of allowed investments made in infrastructure), the recovery of prudently incurred operating expenses and an opportunity to earn an appropriate rate of return on our invested capital and a return of our invested capital. This model allows us to project our return on our investment and a return of our investment and recovery of expenses and promotes predictability in financial planning and long-term performance of our Regulated Businesses.

*Residential customer base.* Residential customers accounted for approximately 91% of the total customers served by our Regulated Businesses and approximately 58% of total operating revenue for our Regulated Businesses in 2007. Residential usage of water tends to be stable because residential customers need water for daily health and sanitary needs regardless of economic or other external factors. In addition, residential customers generally do not have the option of switching to another service provider. For these reasons, residential customers represent a stable customer platform, generating consistent operating results for our company over time and across our geographic service areas.

***Experience in securing appropriate rates of return and promoting constructive regulatory frameworks.*** We seek an appropriate rate of return on our investment and a return of our investment and recovery of prudently incurred operating expenses from state PUCs in the form of rate increases. We have a strong track record of providing reliable service at cost-effective rates, which has typically resulted in high customer satisfaction and has generally allowed us to maintain positive relations with local communities and regulators. We have generally been granted rate relief in a timely manner after application, and prior to our acquisition by RWE we often were successful in securing appropriate rate relief when we filed rate cases. In the period following RWE s acquisition of the Company, as a condition to the approval of the acquisition, we agreed with certain state PUCs that we would not file rate cases for specified periods of time, also known as rate stay-outs. All rate stay-out provisions associated with the RWE acquisition have expired.

A number of states in which our Regulated Businesses operate have adopted efficient rate policies, including some form of single tariff pricing, forward-looking test years, pass-through provisions or infrastructure surcharges. Pennsylvania, New Jersey, West Virginia, Ohio, Indiana and Illinois are examples of states that have adopted a full or partial single rate policy, under which all customers in a state or certain regions within a state are charged utilizing a single rate structure, regardless of which of our individual systems serves them. The single tariff structure is based on costs that are determined on a statewide or intra-state regional basis, thereby moderating the impacts of periodic fluctuations in local costs while lowering administrative costs for us and our customers. In addition, a number of states in which we operate allow utilities to utilize some form of forecast or forward-looking test year. Forward-looking test years and infrastructure surcharges reduce the regulatory lag associated with the traditional method of recovering rates from state PUCs through lengthy rate cases based on historical information. The forward-looking test year mechanism allows us to earn on a more timely basis a return of our current or projected costs and a rate of return on our current or projected invested capital and other known and measurable changes in our business. Pass-through provisions allow for an increase in certain operating costs, such as purchased power and property taxes, to be passed on to, and recovered from, customers outside of a general rate case proceeding. The infrastructure surcharge mechanism allows our rates to be adjusted and charged to customers outside the context of a general rate proceeding for pre-specified portions of our capital expenditures to replace aging infrastructure closer to the time these expenses are incurred. Pennsylvania, Illinois, Missouri, Indiana, New York, California and Ohio are examples of states that have permitted some form of infrastructure surcharge for investments to replace aging infrastructure. These constructive regulatory mechanisms encourage us to maintain a steady capital expenditure program to repair and improve water and wastewater systems as needed by reducing the regulatory lag on the recovery of prudent expenditures.

***Significant growth opportunities with a low risk business profile.*** We believe we are well positioned to benefit from favorable industry dynamics in the water and wastewater sectors, which provide significant opportunities for future growth in both our Regulated Businesses and complementary Non-Regulated Businesses.

*Replacement of aging infrastructure*. The EPA estimates that approximately $277 billion of capital spending will be needed between 2003 and 2022 to replace aging water infrastructure and comply with stricter water quality standards, and the EPA estimates that approximately $388 billion will be needed between 2000 and 2019 to replace aging wastewater infrastructure. We intend to invest capital prudently to enable us to continue to provide essential services to our regulated water and wastewater utility customers.

In addition, approximately 84% of community water systems are owned by municipalities or government entities that have varying access to financial resources and may have less extensive experience with large construction programs. In order to meet their capital spending challenges, we believe that municipalities will increasingly examine a range of strategies, including privatizations and

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partnerships with the private sector. We have successfully developed expertise in managing large capital investment projects and programs as an owner-operator and have an established track record of investing to upgrade, replace and add new pipes, treatment and pumping facilities and other water system infrastructure. In addition, we have experience designing, building and operating water treatment plants, which treat water from major rivers as well as lakes, reservoirs and groundwater sources within the United States. Our experience and resources position us favorably to partner with municipalities to upgrade and manage their infrastructure projects.

- *Fragmented industry provides consolidation opportunities*. With approximately 53,000 community water systems and roughly 16,000 community wastewater systems in the United States, the water and wastewater industry is significantly more fragmented than the other major utility industries. We expect the factors driving industry consolidation to increase in the future. These include economies of scale, environmental regulations, capital investment needs and need for technical and regulatory expertise. With the presence of our Regulated Businesses in 20 states, we have a large platform on which to grow both organically and through consolidation of this fragmented market. Historically, we have been able to successfully identify, acquire and integrate water and wastewater systems.

- *Opportunities for non-regulated growth*. Our expertise and geographic diversity increases our ability to make opportunistic investments in non-regulated businesses that are complementary to our Regulated Businesses. Our national footprint and public/private partnership experience, including O&M, military and DBO contracts and services, position us to participate in existing and emerging non-regulated water businesses. These include contracting for the supply and treatment of water and wastewater with the United States military, for which we operate and maintain the water and wastewater networks at Forts Leavenworth, Sill and Rucker and for which we have been awarded contracts at Fort A.P. Hill and Scott Air Force Base.

***Experienced senior management team.*** Our three senior managers have an average of 27 years of experience in the utilities industry. Donald L. Correll, our President and Chief Executive Officer, Ellen C. Wolf, our Senior Vice President and Chief Financial Officer, and John S. Young, our Chief Operating Officer, have all held senior management positions at publicly traded companies. Our 14 state presidents have an average of 25 years of experience in the utilities industry.

***Industry leader in water quality, testing and research.*** As the largest investor-owned United States water and wastewater utility company, we are experts in water quality testing, compliance and treatment and have established and own industry-leading water testing facilities. Our technologically advanced quality control and testing laboratory in Belleville, Illinois is certified in 23 states and Puerto Rico. Our laboratories and other facilities perform more than one million water quality tests per year.

**Our Strategy**

Our goal is to consistently provide customers with safe, high quality drinking water and reliable water and wastewater services. Our business strategies include:

- continuing to invest prudently in regulated water and wastewater infrastructure projects;

- earning an appropriate rate of return on our investments from state PUCs;

- growing our Regulated Businesses through acquisitions; and

- continuing to pursue public/private partnerships, including O&M and military contracts and services and other non-regulated businesses that are complementary to our Regulated Businesses.

***Continue our prudent investment in regulated infrastructure projects***. We intend to invest capital prudently to enable us to continue to provide essential services to our regulated water and wastewater utility customers, while working with regulators in the various states in which we operate to have the opportunity to earn an appropriate rate of return on our investment and a return of our investment.

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Over the next five years, we estimate that Company-funded capital investment will total between approximately $4,000 and $4,500 million. We anticipate spending between approximately $770 and $950 million yearly on Company-funded capital investment for the foreseeable future, depending upon the timing of major capital projects. Our capital investment includes both infrastructure renewal programs, where we replace existing infrastructure, as needed, and construction of facilities to meet new customer growth. Over the next five years, we estimate we will invest approximately $1,700 million to replace aging infrastructure including mains, meters, and supply and treatment facilities. We estimate that we will invest approximately $1,300 million in facilities to serve new customer growth over this same period. In addition, we estimate that complying with water quality standards and other regulatory requirements will require approximately $700 million of investment over the same period. Projects to enhance system reliability,