Exhibit No.: ______________
Issue(s): Environmental Cost Adjustment Mechanism (ECAM)// Tank Painting// Accrual Accounting and Rate Case Matching Principle// Service Company Labor Expense Adjustment// Service Company “Reasonableness Test”// Short-Term Incentive Compensation (“AIP”)// Long-Term Incentive Compensation (“LTIP”)// Income Tax Expense/Normalization Violation// General Ratemaking Principles// Atrazine Settlement// Pension Trackers// Insurance Other Than Group
Witness/Type of Exhibit: Hyneman/Surrebuttal
Sponsoring Party: Public Counsel
Case No.: WR-2015-0301

SURREBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2015-0301

March 4, 2016

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water	)	
Company's Request for Authority to	)	Case No. WR-2015-0301
Implement a General Rate Increase for	)	Case No. SR-2015-0302
Water and Sewer Service Provided in	)	
Missouri Service Areas.	)	

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Charles R. Hyneman, of lawful age and being first duly sworn, deposes and states:

1. My name is Charles R. Hyneman. I am the Chief Public Utility Accountant for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

Charles R. Hyneman, C.P.A.
Chief Public Utility Accountant

Subscribed and sworn to me this 4th day of March 2016.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI

JERENE A. BUCKMAN
My Commission Expires
August 23, 2017
Cole County
Commission #13754037

Jerene A. Buckman
Notary Public

My Commission expires August 23, 2017.

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SURREBUTTAL TESTIMONY

OF

CHARLES HYNEMAN
MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2015-0301

I. INTRODUCTION

Q. Please state your name, title and business address.

A. Charles R. Hyneman, Chief Public Utility Accountant, Office of the Public Counsel ("OPC" or "Public Counsel"), P.O. Box 2230, Jefferson City, Missouri 65102.

Q. Are you the same Charles Hyneman who filed direct and rebuttal testimonies in WR-2015-0301?

A. I am.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of this rebuttal testimony is to provide the OPC response to the February 11, 2016 revenue requirement rebuttal testimonies of Missouri Public Service Commission ("Commission") Staff and Missouri American Water Company ("MAWC") witnesses regarding certain issues.

II. ENVIRONMENTAL COST ADJUSTMENT MECHANISM ("ECAM")

Q. Does OPC have concerns with Staff witness Mark Oligschlaeger's rebuttal testimony on MAWC's proposal to include another single-issue ratemaking mechanism, an ECAM, in this rate case?

A. Yes. Mr. Oligschlaeger filed Staff policy testimony concerning MAWC's proposed ECAM that only addressed the mechanics of an ECAM. He did not make any recommendation to the Commission as to whether Staff supports or opposes the ECAM. He did not state the Commission should approve the ECAM nor did he say the Commission should not approve the ECAM.

OPC does have a concern with this approach by Staff of not making a recommendation to the Commission on a major policy issue in a rate case. OPC's concern is heightened given the fact that Staff recently opposed mechanisms similar to the ECAM in Kansas City Power & Light Company's ("KCPL") 2014 rate case. Staff has not explained the basis or rationale for its change in position from general "opposition" to "non-opposition" to newly created single-issue ratemaking mechanisms.

Q. **Have you read Section 386.266.1 through 386.266.4, the state statute ("ECAM statute") that allows for the use of an ECAM?**

A. Yes, I have.

Q. **Have you also read Commission Rule 4 CSR240-50.050, Environmental Cost Adjustment Mechanism ("ECAM Rule") which provides in detail the Commission's standards for an ECAM?**

A. Yes, I have.

Q. Do you have a concern that the ECAM Rule exceeds the scope of the ECAM Statute?

A. Yes, I do as it pertains to the types of costs covered in an ECAM in accordance with the ECAM statute. I will discuss this concern later in this section of my surrebuttal testimony.

Q. Does Staff consider an ECAM to be a single-issue ratemaking mechanism?

A. Yes. Mr. Oligschlaeger states at page 3 line 8 that "(a)n ECAM is a single-issue ratemaking mechanism."

Q. Are single-issue ratemaking mechanisms illegal in the state of Missouri except when specifically authorized by state law?

A. Yes, that is my understanding.

Q. Why are single-issue ratemaking mechanisms generally illegal in the state of Missouri?

A. As I explained in my rebuttal testimony, single-issue ratemaking mechanisms are generally illegal in Missouri because they allow rate increases for a single expense without knowing whether other changes in expense and revenue negate the need for the increase. This results in rates that are not just and reasonable and are detrimental to the interests of utility ratepayers. Most if not all single-issue ratemaking mechanisms employed by Missouri utilities contain little or no significant ratepayer protections and have the effect of protecting only the interests of utility shareholders at the expense of utility ratepayers.

Q. Does OPC believe that the types of costs considered under an ECAM are normal and recurring utility costs?

A. Yes.

Q. Does Staff believe that the types of costs considered under an ECAM normal and recurring utility costs?

A. Yes. Mr. Oligschlaeger states at page 4 line 18: "As a practical matter, because utilities have been operating under and incurring costs associated with environmental laws and regulations for many years…"

Q. Does OPC believe that MAWC needs or deserves to be granted and ECAM?

A. No. OPC witnesses Lena Mantle provided evidence in her rebuttal testimony in this case that MAWC does not need an ECAM in this rate case. Ms. Mantle provides additional evidence in her surrebuttal testimony that it would be wrong for the Commission to approve and ECAM in this rate case.

Q. Based on your understanding of Mr. Oligschlaeger's rebuttal testimony, does it appear Staff believes MAWC needs an ECAM in this rate case?

A. No. Mr. Oligschlaeger notes at page 5 of his rebuttal testimony:

> Q. Is MAWC's request to establish an ECAM in this proceeding premised upon specific anticipated future environmental compliance costs?
>
> A. No. The only costs cited by MAWC that it expects it may seek to charge through future ECAM rate adjustments are expected costs to comply with National Pollutant Discharge Elimination System permit renewals. Per MAWC's response to Staff Data Request No. 0313, incurrence of these costs

> is not expected for a number of years, and MAWC has not provided a projection of the amount of such costs, if incurred.

Q. Do you consider it prudent on the part of MAWC management to include an ECAM in this rate case when it has no costs to include in the ECAM and it does not expect to incur costs eligible to be included in ECAM for "a number of years?"

A. No. I consider this to be imprudent on the part of MAWC management to add another single-issue ratemaking mechanism that it admittedly does not need.

Q. What specific position does the Staff take towards an ECAM for MAWC in this case?

A. Staff witness Oligschlaeger states at page 2 line 18 of this rebuttal testimony that Staff does not oppose the creation of a MAWC ECAM in this case. He also states this Staff "non-opposition" at page 5 line 13 of his testimony.

Q. Doesn't Mr. Oligschlaeger mention conditions at page 2 line 18 of his rebuttal testimony?

A. Yes, but as he notes, these conditions do not apply to the Commission granting MAWC an ECAM in this case but only apply to some future period when MAWC seeks recovery of these costs under an ECAM.

Q. Mr. Oligschlaeger states at page 4 lines 13-21 of his rebuttal testimony that both the ISRS statute and ISRS rule allow for MAWC, under an ECAM, to ignore offsetting environmental cost decreases of the specific environmental costs that will be included in its cost of service in this rate case. Do you agree with his conclusion?

A. No, for several reasons. The primary reason is that there is no Commission restriction in the ECAM statute or ECAM Rule prohibiting the Commission from netting cost increases with cost decreases.

Second, Section 386.266.2 RSMo states the adjustments MAWC seeks outside of a rate case are to reflect "increases or decreases" in its prudently incurred environmental costs." Here, there is a clear requirement for MAWC to net increases and decreases.

Finally, Section 386.266.4(4) RSMo calls for prudence reviews of the costs subject to an ECAM at any time interval. Prudence reviews can be done weekly, monthly, semi-annually, annually or every 18 months. Eighteen months is the maximum period allowed between prudence reviews. I think it would meet anyone's definition of imprudence if a company ignored environmental cost decreases and only included environmental cost increases in an ECAM.

Q. Mr. Oligschlaeger states at page 6 line 13 of his rebuttal testimony that "There is no provision in the ECAM rule or statute that would appear to preclude recovery of labor costs as part of the ECAM..." Is Mr. Oligschlaeger correct?

A. No. The ECAM statute only allows one type of cost (either capital or expense) to be included in an ECAM. That specific cost is a cost limited to MAWC's cost of compliance with environmental laws, regulations, or rules. In the unlikely event a new environmental law, regulation, or rule mandated MAWC to hire a new employee to perform environmental compliance work, then it would not be prudent to include labor costs in an ECAM. For MAWC, it would be highly unlikely given the large employee base of MAWC, its parent company, and its service company for MAWC to have a need to hire additional personnel or be allocated additional costs.

Q. Mr. Oligschlaeger states at page 7 line 1 of his rebuttal testimony that "The ECAM statute and rule allow the Staff and other parties only a very limited period of time to audit and review claimed ECAM cost increases." Is Mr. Oligschlaeger correct?

A. No, he is not correct as it relates to the ECAM statute. The ECAM statute provides no time limitation on Staff or any party to review, examine, and audit any rate increases proposed in an ECAM. The ECAM statute does allow for a prudence review to be done at any time and provides no restrictions whatsoever on the length of time allowed for an ECAM prudence review.

Q. Is Mr. Oligschlaeger correct that the ISRS Rule allows "the Staff and other parties only a very limited period of time to audit and review claimed ECAM cost increases?"

A. Yes. ECAM rule paragraph 4(A) allows only 30 days for the Staff's examination of a utility's proposed ECAM adjustment to determine if the proposal is in accordance with requirements of the rule, Section 386.266 RSMo, and the established ECAM. This 30-day examination period would not, under any circumstances, allow for a sufficient review of a proposed ECAM rate increase. This period of time is not sufficient even if the Commission appropriately assigned the burden of proof to the utility and Staff and OPC had ample audit resources immediately available to start the audit on the date the rate increase was filed.

In contrast, Infrastructure System Replacement Surcharge ("ISRS") laws allow Staff 60 days to perform a similar examination of costs sought to be included in the ISRS. This 60-day examination period for the ISRS (which has recently been reduced by the Commission by its allowing for ISRS true-ups) is not a sufficient review period for ISRS costs. This highlights the unreasonableness of a 30-day review period under an ECAM.

Q. Does it appear that the drafters of this ECAM Rule, who recommended a 30-day examination period of a proposed ECAM rate increase, were mindful of the work required to audit ECAM adjustments?

A. No. The rule does not provide auditors with the time required to properly plan an audit, staff the audit, do audit discovery, audit field work, draft an audit report, circulate an audit report for comments, and file the report with the Commission.

Q. Does Public Counsel recommend a solution for the problem in the ECAM Rule related to the insufficient 30-day audit period?

A. First of all it would be a major error for the Commission to allow an ECAM in this rate case. However, if the Commission does so, OPC has a solution for the problematic 30-day ECAM cost review period.

ECAM Rule Paragraph 7 adopts the language in the ECAM statute that prudence audits must be done at a minimum of every 18 months. ECAM Rule Paragraph 7B allows for a 6-month prudence review period. Paragraph 7B also states that the timing and frequency of prudence audits for each ECAM shall be established in the general rate proceeding in which the ECAM is established.

Give these provisions in the ECAM Rule, Public Counsel recommends the Commission order prudence reviews of ECAM costs deferred on MAWC's books from effective date of the Commission's Report and Order in this case - continuing on a quarterly basis - as long as the ECAM is in effect. The parties participating in the prudence audit will be allowed 90-days to complete the prudence audit for the costs deferred by MAWC in that period.

Adopting this revised review time-frame would likely require the Commission to waive 4 CSR 240-50.050(4)(A) as permitted by 4 CSR 240-50.050(12) for good cause shown and after the opportunity for hearing. For the reasons identified above, good cause exists for this waiver.

Q. Mr. Hyneman, do you believe this prudence review schedule will eliminate the need for the 30-day examination period described in Paragraph 4 of the ECAM Rule?

A. Yes. This schedule will eliminate the need for a 30-day ECAM examination and would also prevent a perceived "acceptance" by the Commission of ECAM costs that, due to extreme time constraints, were not addressed in the 30-day ECAM audit. In addition, Public Counsel's proposal would resolve Staff's concern as expressed by Mr. Oligschlaeger at page 7 line 1 of his Rebuttal testimony that Staff and other parties have only a "very limited" period of time to audit and review claimed ECAM cost increases.

Q. At page 7 lines 7-11 of his rebuttal testimony Mr. Oligschlaeger recommends that the Commission impose a condition on MAWC that it shall only include incremental environmental compliance costs in its ECAM filing and that MAWC also must reflect offsetting cost decreases associated with environmental compliance requirements. Does Public Counsel support this condition?

A. Yes. It would be imprudent on the part of MAWC management, as well as potentially contrary to the requirements of the ECAM statute, to only seek recovery of incremental costs in an ECAM and not to reflect all environmental cost decreases. Including this condition will emphasize and clarify what MAWC is already required to do under its ECAM.

Q. At page 7 lines 13-18 of his rebuttal testimony Mr. Oligschlaeger recommends that the Commission impose a condition on MAWC that it shall only include incremental environmental compliance costs in its ECAM filing and only when it incurs a minimum threshold of $500,000 in incremental net environmental compliance costs. Does Public Counsel support this condition?

A. Public Counsel does support a materiality threshold but not at the level proposed by Mr. Oligschlaeger. Paragraph (2)(D) of the ECAM Rule states that the Commission <u>will</u> consider the magnitude (materiality) of the costs. The ECAM Rule does not include a minimum materiality threshold. The $500,000 materiality threshold proposed by Mr. Oligschlaeger is too low.

As noted by Mr. Oligschlaeger, the Missouri Legislature determined the materiality level for MAWC's ISRS costs for just one county in MAWC's service territory should be $1 million. When considered in this context, Mr. Oligschlaeger's proposal of only one- half of this amount for all of MAWC's Missouri service territory is not reasonable. The Public Counsel would defer to the materiality level set by the Missouri Legislature for MAWC's ISRS for MAWC's St. Louis County ratepayers as reasonable for MAWC's ECAM.

Q. Please summarize your concerns with the Staff's position on MAWC's proposed ECAM?

A. Staff's position of not making any recommendation to support or oppose MAWC's ECAM proposal is a concern. While I was a member of Staff for over 20 years it was commonly accepted that one of Staff's primary roles was to make recommendations to the Commission if a utility proposal was in the public interest or was detrimental to the public interest.

Q. Did Mr. Oligschlaeger address the issue of Staff's position on single-issue ratemaking mechanisms in a recent utility rate case?

A. Yes. An ECAM is simply an expense tracker to capture and defer on the books as a regulatory asset expenses incurred outside of a rate case test period. An ECAM, like a tracker, is single-issue ratemaking mechanism. The most significant difference is only in form as a tracker is given rate treatment in the subsequent general rate case while an ECAM (as is the ISRS) results in a rate increase between rate cases.

In his rebuttal testimony in KCPL's 2014 rate case Staff witness Oligschlaeger listed conditions under which Staff would consider a tracker (such as an ECAM) justified. These conditions include when a cost experiences significant fluctuations, new costs for which there is little or no historical experience, costs imposed by Commission rule, and only costs that are material.

Q. Are any of these conditions present for MAWC's ECAM in this rate case?

A. No. MAWC has not represented costs deferred under an ECAM are volatile as they do not have any such expenses. Staff admits the types of costs covered by an ECAM are normal and recurring utility costs suggesting that MAWC's proposed ECAM does not meet the Staff's criteria. The Commission is certainly not imposing any ECAM costs on MAWC and the costs to be deferred under and ECAM are not material as they do not exist.

Q. When did Mr. Oligschlaeger file this testimony in KCPL's 2014 rate case?

A. Mr. Oligschlaeger's policy testimony representing the Staff was filed on May, 7, 2015, less than one year ago. This testimony, unlike his rebuttal testimony in this rate case, made a recommendation to the Commission on KCPL's proposed single-issue ratemaking mechanisms such as an ECAM.

Q. Did Mr. Oligschlaeger in his rebuttal testimony in KCPL's 2014 rate case make a recommendation to the Commission that Staff opposed KCPL's proposed vegetation management tracker?

A. Yes. He did so at page 11 of his rebuttal testimony in that KCPL case, No. ER-2014-0370. His basis for recommending to the Commission to reject the vegetation management tracker was that vegetation management expenses are a normal and ongoing costs just as he describes MAWC's environmental costs.

In this MAWC rate case compared to the KCP&L case, Staff takes an inconsistent position of neutrality towards single-issue ratemaking treatment of normal ongoing costs.

Q. Please state OPC's position on the proposed ECAM.

A. OPC recommends the Commission exercise its authority under Section 386.266.4 RSMo and reject this additional single-issue ratemaking mechanism proposed by MAWC.

OPC generally opposes the implementation of single-issue ratemaking mechanisms because they are based on bad ratemaking policies and result in rates that are not just and reasonable. OPC would support a ratemaking mechanism, such as an expense tracker, that is needed to ensure the financial soundness of the utility. In addition, OPC would support extraordinary ratemaking treatment such as a tracker when one can be shown to be needed to ensure the utility can maintain the provision of safe and adequate service. None of those two circumstances exist in MAWC's ECAM proposal in this case.

Q. If the Commission rejects the evidence put forth by OPC and other parties to this case and approves the creation of an ECAM, does OPC have additional concerns?

A. Yes. This ECAM does not contain a provision that MAWC show its rates are not just and reasonable prior to raising rates through the ECAM. Without showing its utility rates are not just and reasonable, there is a presumption the utility rates currently charged by MAWC are just and reasonable. Therefore, if the Commission approves this ECAM, it is essentially encouraging MAWC to raise rates higher than rates that are just and reasonable.

The Commission participates in many local public hearings and is aware Missouri ratepayers are financially exhausted from paying large and recurring utility rate increases. Ratepayer equity must be considered in the Commission's decision to allow the creation of what used to be, and still is to a great extent, illegal in Missouri – single-issue ratemaking.

Q. **Does MAWC need an ECAM in order for it to provide safe and adequate service and earn a reasonable profit, or return on equity ("ROE")?**

No. This ECAM is detrimental to the public as it provides for unnecessary rate increases. Nowhere in this case is there any evidence MAWC needs a MAWC to provide safe and adequate utility service and earn a reasonable return on equity ("ROE").

Staff witness Oligschlaeger's rebuttal testimony shows MAWC does not need an ECAM. OPC has provided evidence in this rate case that there is no need for an ECAM. Finally, Missouri Industrial Energy Consumers ("MIEC") witness Greg Meyer provides surrebuttal testimony advising the Commission that MAWC does not need and ECAM in this rate case.

Q. **If granted an ECAM, will MAWC's management be less concerned about controlling the level of environmental costs it incurs and charges its Missouri ratepayers?**

Yes. Eliminating the critical cost control incentives imposed on utility management by regulatory lag is one of the reasons why single-issue ratemaking mechanisms such as an ECAM are detrimental to Missouri ratepayers. This fact is recognized by Staff as reflected in Mr. Oligschlaeger's rebuttal testimony in KCPL's 2014 rate case, where he states at page 8 that "….*the existence of regulatory lag does provide utilities with incentive to be as efficient and cost-effective over time as they can. Excessive use of trackers can serve to eliminate or weaken these beneficial incentives*."

Regulatory lag is necessary and essential in setting prices for a monopoly. It is only through regulatory lag that cost reduction incentives are created and provide the most significant, if not the only, incentive for utility management to operate the utility at its lowest reasonable cost between rate cases. Public Counsel knows of no condition or requirement that the Commission can place on MAWC as a condition for the approval of an ECAM that would restore the cost efficiency incentives that will be lost by eliminating regulatory lag cost incentives from the types of costs the Commission will allow in an ECAM.

If the Commission does not impose on utility management explicit conditions that attempt to restore the lost cost-control incentives associated with single-issue ratemaking mechanisms, then the Commission would be imposing a detriment on Missouri utility ratepayers.

Q. In addition to all of the evidence presented in this rate case as to why the Commission should not allow an ECAM for MAWC, is there a final consideration OPC asks the Commission to consider in this issue, and potentially in other issues in this rate case?

A. Yes. In Commission File No. WO-2014-0362, the Commission ordered Staff to review of MAWC's call center operations due to a number of complaints. A reading of the documents filed in that case indicates MAWC was providing substandard customer service. The Staff recommended steps for MAWC to take to improve its call center operations. MAWC agreed to take these steps and the Commission ordered MAWC to follow the Staff's recommendation to improve customer service.

If the Commission would allow non-mandatory, special ratemaking treatment to benefit the utility's shareholders at a time when the utility was not even meeting basic customer service standards, it would service as bad precedent. Instead, the Commission should consider the fact MAWC has not been providing acceptable customer service in its ratemaking decisions in this rate case including its determination of an appropriate ROE for MAWC.

Q. Are there problems with the requirements of the Commission's Rule 4 CSR-50.050, Environmental Cost Adjustment Mechanism?

A. Yes. Paragraph 1, definitions, defines an ECAM qualifying cost as any non-ISRS cost that do not result from negligence or wrongful acts that are:

> a) directly related to imposition of new laws (federal, state or local, including common law, statutes, ordinances and regulations) that require compliance and pertain to:
>
> 1) regulation of health, safety and the environment
> 2) protection of health, safety and the environment
>
> b) directly related to any permit, license, agreement, or order developed or issued that requires compliance in response to any federal, state, or local law, statutes, ordinances, or regulation pertaining to:
>
> 1) regulation of health, safety and the environment
> 2) protection of health, safety and the environment

Q. What specifically does the ECAM law allow?

A. The ECAM law only allows rate adjustments to reflect increases in costs (capital and expense) to comply with any environmental law, environmental regulation or environmental rules at the federal, state or local level.

Q. Does Section 386.266.2 RSMo, which allows for a water company ECAM allow for any cost recovery other than compliance with an environmental law regulation or rule?

A. My reading of the ECAM statute as a public utility professional is that it only allows cost of compliance with an environmental law, regulation, or rule imposed on MAWC by federal, state, or local authorities.

Q. Does Section 386.266.2 RSMo appear to allow for deferral and future rate recovery of costs related to regulation of health and safety or the protection of health and safety?

A. No. There is no reference to costs related to the regulation or protection of health and safety in Section 386.266.2 RSMo.

Q. Does the Commission have the authority to reject or modify MAWC's proposed ECAM?

A. Yes. This authority is granted to the Commission in Section 386.266.4 RSMo with the requirement the Commission provide the opportunity for a full hearing in this general rate case.

Q. Does the Commission have the authority to accept MAWC's proposed ECAM?

A. Yes. This authority is also granted to the Commission in Section 386.266.4 RSMo. However Section 386.266.4 RSMo. places additional conditions on the Commission if it decides to approve the ECAM. The main condition imposed on the Commission is it consider all relevant factors that may affect the cost or overall rates and charges of MAWC. In addition, the Commission must make a finding that any ECAM it approves has the following attributes and meets the following tests:

> 1. Finds that MAWC's ECAM is reasonably designed to provide the utility with sufficient opportunity to earn a fair return on equity;
>
> 2. Includes true-ups that address over and under collections that are to be subject to a carrying cost of MAWC's short-term debt rate;
>
> 3. Require MAWC to file a rate case within four years from the effective date of the Commission's Report and Order in this rate case;
>
> 4. Requires 18-month prudence reviews; and
>
> 5. Expressly authorizes the Commission to lower MAWC's authorized ROE in this case due to its reduced level of business risk that it bears given the additional single-issue ratemaking mechanisms granted in the form of an ECAM. This ROE reduction authorization is also included in the ECAM Rule at paragraph 2C.

Q. Under the Commission's ECAM Rule, what factors will the Commission address when it considers the environmental cost components to include in an ECAM?

A. The Commission will consider a) cost materiality, b) the degree to which utility management can control the incurrence or manage size of the cost, c) what management incentives are created due to the inclusion or exclusion of a particular cost in the ECAM, and d) the extent the cost is related to environmental compliance.

Q. Did the Commission limit itself to only considering these factors when considering a cost to include in an ECAM?

A. No. In its ECAM Rule, the Commission specifically stated at paragraph (2)(D) it did not limit itself to the types of factors that it will consider when determining costs to include in an ECAM.

Q. At paragraph (3)(A) of the ECAM Rule it states "Any party to the general rate proceeding may oppose the discontinuation of an ECAM on the grounds that the water utility is currently experiencing, or in the next four (4) years is likely to experience, declining costs or on other grounds that would result in a detriment to the public interest". Please comment on this ECAM rule provision.

A. A prudent interpretation of this ECAM Rule provision is the Commission recognizes a utility's earnings is a significant factor in an ECAM. This language also indicates the Commission recognizes a utility in an overearnings state is potentially detrimental to the public interest. Lastly, this language indicates the Commission is aware of the importance of protecting ratepayers by ensuring declining costs are recognized in an ECAM.

Q. Are there options for the Commission to consider that would address its concern about overearnings by a utility with an ECAM?

A. Yes. To my knowledge all of the single-issue ratemaking mechanisms created in Missouri (trackers, Fuel Adjustment Clauses ("FAC"), Interim Energy Charges ("IECs), Accounting Authority Orders ("AAOs"), have been designed to protect shareholders earnings and/or shift the risk of cost recovery from the utility to the ratepayer.

Not one single issue ratemaking mechanism was designed to protect the ratepayer's financial interest. Missouri utilities have been successful over the years in preventing the Commission from employing any earnings test for single-issue ratemaking mechanisms. As noted above, the Commission, in its ECAM rule, expressed a concern about potential overearnings under an ECAM. The Commission has available an option that will address the issue of utility overearnings and will allow for the continuation of an ECAM even in periods of overearnings.

Q. How can the Commission reduce the likelihood of public detriment from overearnings while also allowing a continuation of an ECAM during a period of utility overearnings?

A. The Commission can require, in a general rate case as a condition, an "Excess Earnings Refund Provision". This ratepayer protection against overearnings could work as follows.

At the end of each calendar year, the utility will calculate its actual earned per book return on equity for that year. To the extent the utility's actual earned per book return on equity exceeds the ROE ordered by the Commission in a rate case, the company will calculate its excess net income and defer this excess to a regulatory liability account.

This regulatory liability account will then be tracked and amortized to cost of service over future periods in a subsequent general rate case. The number of months in the amortization period will match as closely as possible the period of deferral.

To ensure the integrity of this excess earning provision, the utility will not be allowed to consider any other accounting or ratemaking issue in the calculation of this actual earned ROE. The calculation used will be actual net income divided by beginning stockholders' equity as reflected in the utility's annual audited financial statements.

Q. Is this ratepayer protection mechanism that is available to the Commission in an ECAM very similar to how the Commission has handled AAOs over many years?

A. Yes. There is no conceptual difference. In a typical AAO, utilities deferred an expense as a regulatory asset and amortized this cost to future periods. This ECAM provision defers excess net income as a regulatory liability and flow it back to cost of service in future periods. This option for the Commission is very simple and straightforward and is exactly the same ratemaking treatment the Commission has used for AAOs for many years.

Q. Do you have any particular concerns with how the burden of proof on the prudency of utility costs has been transferred from utility management to the regulatory auditor?

A. Yes. I addressed this issue in my rebuttal testimony in this case. Public Counsel is concerned Missouri utilities are taking advantage of these single-issue ratemaking mechanisms in more ways than just unnecessarily raising utility rates. The utilities are facilitating this transfer of burden of proof away from themselves to ratepayers or ratepayer representatives such as the Public Counsel. Under a prudence review, the utility's costs carry a presumption of prudence, which shifts the burden of proof in that the company is no longer required to prove a cost is reasonable, and instead, ratepayers have the burden to prove a cost is unreasonable

Q. If the Commission approves an ECAM for MAWC in this case, is there a condition that could reduce the potential for a transfer of risk in any prudence review undertaken by the Staff or any party to this rate case?

A. Yes. Public Counsel requests the Commission include the following condition in any ECAM ordered in this rate case:

> Burden of Proof Condition – In any filing involving a rate sought to be increased as a result of MAWC's ECAM, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be on MAWC.

<u>III. TANK PAINTING</u>

Q. At page 3 of his rebuttal testimony MAWC witness Kevin Dunn states that both Staff and OPC recommend that MAWC's Tank Painting Tracker be discontinued. Is he correct?

A. Yes. Mr. Dunn is also correct when he states OPC believes that the expenses incurred to paint MAWC water tanks can easily be normalized.

Q. At page 4 of his rebuttal testimony Mr. Dunn states that "History has proven that only allowing a normalized amount to be recovered in rates has resulted in MAWC failing to recover its costs to paint and inspect tanks." Please comment.

A. Mr. Dunn's statement does not reflect a correct understanding of a basic ratemaking principle. MAWC has recovered each and every dollar of tank painting expense it has ever spent in Missouri. As I explained in detail in my rebuttal testimony, MAWC has, to my knowledge, always reported a positive net income for its Missouri water utility operations. So Mr. Dunn is not factually correct.

Q. What are the negative aspects of continuing MAWC's tank painting tracker?

A. While MAWC has been successful in recovering all of its costs and earning a reasonable ROE since its last rate case, it has also been allowed to transfer the risk of not recovering all of its expenses and earning a reasonable ROE from its shareholders to its customers through the use of its ISRS. An ISRS can be viewed as "no risk rate recovery". This explicit and direct shift of expense recovery risk from the utility to the ratepayers is one of the problems with the adoption and use of single issue ratemaking mechanisms such as trackers, accounting authority order deferrals, and others.

Q. Is it understandable why Mr. Dunn would want to protect its shareholders from the risk of utility cost recovery?

A. Yes. However, MAWC's shareholders are not earning a "risk-free" rate of return on invested capital but a risk-adjusted rate of return. MAWC is being compensated for its business risk. By proposing its ISRS, its ECAM, its RSM and its various trackers, it wants to be paid by ratepayers for having business risk and therefore not actually have any risk. The Commission should not allow MAWC to continue to transfer risk of expense recovery to its shareholders.

Q. How can the Commission not allow this intentional shift in business risk from the utility's shareholders to the utility's ratepayers to occur?

A. It can simply reject outright any single-issue ratemaking mechanisms the Commission is not mandated to allow. This includes MAWC's proposed ECAM, RSM and trackers. It makes absolutely no sense from a ratemaking perspective to allow for single-issue ratemaking mechanisms when a utility is currently earning a reasonable ROE.

Q. You've provided testimony on one aspect of trackers that are detrimental to MAWC's customers, the uncompensated transfer of business risk to ratepayers. Are there others?

A. Yes. It is axiomatic that if a person does not have an incentive to accomplish a certain task, he/she will not put much effort into accomplishing that task. It is likely that a person will put effort into other areas where an incentive, either positive or negative, exists. If the Commission continues to allow MAWC a tank painting tracker, MAWC management has no incentive to minimize the cost of tank paintings such as delaying the maintenance for as long as prudent and aggressively pursuing the least cost option.

Q. If the Commission allows for the continuation of the tank painting tracker, is it allowing MAWC management to act less efficiently?

A. Yes, unless it proposes some conditions that will reinstate the loss of cost minimization incentives.

Q. At page 6 line 19 of his rebuttal testimony Mr. Dunn proposes that the unamortized balance of MAWC's tank painting expenses tracker should be included in rate base. Why would Mr. Dunn propose such ratemaking treatment?

A. The reason Mr. Dunn proposes rate base treatment is so MAWC can earn what is greater than a 10 percent profit on each dollar it spends over the dollar amount of expense in base rates.

In addition to the well-known and well-accepted negative impact on efficient utility services directly caused by trackers, this proposed ratemaking treatment also provides an incentive to overspend on tank painting. Overspending on tank painting will increase rate base and allow MAWC to earn a profit in the neighborhood of 10% expense dollars spent on tank painting.

Utility executives are incentivized through compensation to maximize utility profits sometimes to the detriment of its ratepayers. This is the perfect example of this perverse incentive. MAWC proposes to include in rate base what is a normal and recurring maintenance expense so that it can earn a significant profit on this expense.

Q. What ratemaking treatment does OPC recommend the Commission adopt in this rate case?

A. OPC recommends the Commission adopt the Staff and OPC's position of treating tank painting expense as any other ordinary MAWC maintenance expense and normalize this expense at a level of $1.3 million annually – the same annual level of expense proposed by MAWC witness Dunn at page 6 line 20 of his rebuttal testimony.

Q. Has Staff found evidence where a utility expense tracker likely led to excessive and unreasonable expenses charged to Missouri ratepayers?

A. Yes. In a past KCPL rate case, Staff concluded both the high number of trackers and the specific design of the pension trackers that were currently in place for several years likely contributed to these excessive pension costs for KCPL.

In my rebuttal testimony in KCPL Case No. ER-2012-0174, filed as an employee of the Staff, I provided evidence that KCPL's pension costs were excessive and found KCPL's long use of pension trackers removed any cost cutting or cost control incentives for its pension expenses. The evidence was based on a study commissioned by KCPL showing its pension costs were significantly higher than a peer group of companies, including Missouri electric utilities.

IV. ACCRUAL ACCOUNTING AND RATE CASE MATCHING PRINCIPLE

Q. Do you agree with MAWC witness Ms. Bowen's description of the accrual method accounting in her rebuttal testimony?

A. No. In her rebuttal testimony (pages 12-14), Ms. Bowen expresses a concern that Staff's waste disposal expense adjustment was based on actual expenses and not as defined accrued expenses, which she characterizes as future estimated expenses.

In her opposition to Staff's adjustment, Ms. Bowen indicates water utility rates in this MAWC rate case should not be based on actual expenses but they should be based on what MAWC's Accounting Department thinks the expense might be at some point in the future.

Ms. Bowen's testimony does not recognize the rate case matching principle the Commission applies when stetting rates in Missouri. This Commission normally requires an expense in a general rate case cost of service must be matched with the revenues for that same period and also with the plant and other rate base investments for that period.

Q. Is Ms. Bowen's statement at page 12 line 4 of her rebuttal testimony, that MAWC is an accrual based company, relevant to the setting of utility rates in a rate case?

A. No. All investor-owned utilities that comply with generally accepted accounting principles ("GAAP") are accrual-based companies. The Financial Accounting Standards Board ("FASB") is the designated private sector organization in the U.S. that establishes financial accounting and reporting standards. FASB Concepts Statement No. 6, "Elements of Financial Statements" ("CON 6") provides the authoritative definition of accrual accounting. Paragraph 139 of CON 6 describes accrual accounting as follows:

> Accrual accounting attempts to record the financial effects of an entity of transactions and other events and circumstances that have cash consequences for the entity in the periods in which those transactions, events and circumstances occur rather than only in the periods in which cash is received or paid by the entity.

As one example of how accrual accounting is applied is if MAWC contracted for waste removal services for the month of December 2015 but did not pay cash for the services until February 2016. The accrual accounting requires MAWC to record in its books the expense to acquire those services in December 2015 and not when the cash was paid in 2016. Accrual accounting is important in order to match the expenses in December 2015 with the revenues received in December to properly reflect the earnings for that period. In contrast to accrual accounting, a revenue or expense is recorded when the cash is actually received or paid under the cash basis of accounting.

Q. Does the creation of a utility's cost of service in a rate case require the use of both accrual basis and cash basis of accounting?

A. Yes. For example, rate case adjustments for employee benefits expenses such as pensions and other postretirement benefits expense ("OPEB") employ the use of accrual basis of accounting. However, other expenses adjustments, such as bad debt expense (normally based on actual expense write-offs in the test year) employs the use of cash basis of accounting.

In developing a utility's cost of service, the particular basis of accounting used for an individual expense is not controlling or even important. The overall purpose or rate case adjustments to test year financial data is to determine a cost of service (revenues, expenses and investment) that most closely matches the utility's prudent and reasonable cost structure at a particular point in time.

Q. How does Ms. Bowen's testimony ignore the purpose of accrual accounting as defined by the FASB and the Commission's rate case matching principle?

A. In her testimony, Ms. Bowen does not address accrued expenses that relate to, or are associated with, the Commission's test year for this rate case. Her testimony addresses some unknown future level of expense accruals not actually incurred by MAWC and are neither related to nor relevant to MAWC's test year cost of service in this rate case.

Ms. Bowen's testimony that MAWC is an accrual based company in accordance with GAAP is confusing as her proposed method of accounting is not consistent the Accounting matching principle, nor is it consistent with the definition of accrual accounting promulgated by the FASB in CON 6.

GAAP accrual accounting is designed to record expenses in the period when they are incurred in the act of generating revenue in that period. Ms Bowen is proposing to match current revenues and current rate base with an accrual of estimated future expenses. That is not GAAP and that is not accrual accounting but a distortion of GAAP, a distortion of accrual accounting; a distortion of the Commission's rate case matching principle.

Q. Is the Staff's adjustment to MAWC's test year waste disposal expense appropriate?

A. Yes. In its adjustment, Staff appropriately reflected the amount in cost of service incurred by MAWC in 2014. This amount can be left at the test year level or normalized or annualized depending on certain factors and information related to that expense. Staff appropriately excluded accruals recorded by MAWC's accountants as they do not represent known and measurable expense amounts but merely estimates of future expenses that are not known and measurable.

It is not clear what Ms. Bowen means at page 12 line 9 of her rebuttal testimony when she says "it would be inappropriate to fail to include the accrual amounts that we anticipate incurring in future years and properly accruing for those costs." Under the Commission's rate case "known and measurable standard" for expenses and the Commission's rate case matching principle, potential future expenses are not included in a test year cost of service in a rate case.

V. SERVICE COMPANY LABOR EXPENSE ADJUSTMENT

Q. At page 2 of his rebuttal testimony Mr. Petry criticizes the Staff's approach to calculating annualized service company labor expense. Do you agree with Mr. Petry's criticism?

A. No. Staff used a methodology for annualizing base payroll that it has used for many years. Mr. Petry makes a distinction that Staff's methodology is not appropriate because it adjusts service company payroll costs. However, a significant part of MAWC's expenses are service company expenses. Therefore, it is only logical that a payroll annualization for MAWC employees and AWWC Service Company employees should be calculated using the same methodology. Staff's proposed method of annualizing both MAWC direct employees and AWWC Service Company employees is the method that results in the most accurate measurement of payroll costs to reflect in a utility cost of service.

Q. What service company methodology does Mr. Petry recommend and what is the main problem you find with that method?

A. At page 2 line 29 of his rebuttal testimony, Mr. Petry recommends the Commission include in MAWC's rates whatever the actual level of AWWC Service Company compensation happens to be at the test year true up date. The problem with this short-cut approach is that this amount reflects just the dollar amount recorded in MAWC's books for a certain period – an unadjusted test year amount. Mr. Petry's approach does not make any attempt to reflect compensation expense on a going-forward basis by reflecting end of period wages and other compensation and the end of period employee levels. A methodology such as the one proposed by Mr. Petry will either understate service company payroll (if more employees were hired in the later part of the test year) or will overstate payroll expense (if the number of service company employees are decreasing). This is a simplified short-cut approach that is inferior to the payroll annualization methodology employed by Staff that looks at the payroll cost of each employee and annualizes this cost as close as possible to the dates when new rates will be in effect.

VI. SERVICE COMPANY "REASONABLENESS TEST"

Q. At page 3 line 30 of Mr. Petry's rebuttal testimony he make the statement that all support services charges should be examined for their overall reasonableness. Do you agree with Mr. Petry?

A. Yes, but I doubt that OPC's definition of reasonableness and Mr. Petry's definition of reasonableness are the same. OPC supports what it believes is a commonly-accepted definition of reasonableness when it comes to a utility's cost of service. Reasonable costs are the minimum costs needed to be incurred in order for a utility to provide safe and reliable service. MAWC's support services charges have many charges (such as earnings-based incentive compensation, lobbying, charitable contributions, etc.) that do not meet this definition of reasonable. Therefore, despite the opinion of Mr. Petry, MAWC's service company allocated costs are not reasonable.

I do agree overall reasonableness is one of several requirements of utility costs included in a ratemaking cost of service. Other requirements include whether individual costs are prudent and provide ratepayer benefit and whether the costs are known and measurable. OPC has not performed an overall review of the reasonableness of the level of support services costs charged to MAWC in this rate case. However, OPC has found costs that are not prudent, not reasonable, and do not meet the Commission's known and measurable standard.

Q. Have other Missouri utilities tried to shift the Commission's focus off of the reasonableness and prudence of utility compensation by proposing an "overall reasonableness" test?

A. Yes. For example, Empire District Electric Company witness Kelly Walters made a similar argument in Empire's ER-2014-0352 rate case. This "single issue" argument put forth to try and move the Commission away from its longstanding position against earnings-based incentive compensation should be rejected.

Q. Can you provide one simple example why Mr. Petry's singular "overall reasonableness" test is faulty?

A. Yes. For example, AWWC's total Service Company expenses allocated to MAWC in this rate case could be determined "reasonable" by MAWC on some overall dollar basis. But this amount could still include expenses for lobbying, severance, stock-based compensation, or other costs this Commission had specifically ordered should not be included in a Missouri utility's cost of service. So while an overall cost can be considered reasonable in dollar amount, it is not reasonable, it should be a lower dollar amount by excluding non-utility cost of service expenses.

Also, the basis on which an overall compensation level or expense level is determined reasonable is usually contentious. Reports or analysis that show "reasonableness" are often biased and designed to support one party's position in a rate case. Reports or analyses showing overall reasonableness of a service company cost allocation are usually not auditable, verifiable, or reliable. Unless the report or analysis is auditable, verifiable and reliable, it provides little to no value to the Commission in making a rate case determination.

Q. What are some of the reasons why specific expense items should be adjusted or removed from service company allocations to MAWC even when it has been

determined (but it has not been determined in this rate case) that the overall level of allocated costs is "reasonable"?

A. The primary reason is ratepayers should not be forced to pay though utility rates certain expenses utilities incur that work to the ratepayer's specific detriment. The most obvious example of this type of expense is lobbying. For example, it would not be considered reasonable in any circumstance to charge MAWC's ratepayers for MAWC's lobbying costs to obtain an ISRS and other single-issue ratemaking mechanisms that cause significant ratepayer harm. Clearly, MAWC's lobbying efforts resulted in an ISRS and, while this ISRS is beneficial to its shareholders, it is detrimental to its ratepayers and its ratepayers should not pay for actions to which they suffer a detriment.

Q. **Please provide another example of why all utility costs, including specific service company allocated costs should be closely scrutinized before being included in a utility's cost of service.**

A. Severance costs are an example. One reason why severance costs should not be reflected in a utility's cost of service is the issue of double recovery. Severance payments are usually recovered in rates through regulatory lag and, in essence, are not actual expenses of the utility. For example, an employee whose base salary of $50,000 usually has total compensation expense included in cost of service of about $80,000 ($50,000 times a 1.6 gross up for benefits). Assuming this employee accepted a severance package of 1.5 times base salary, the severance cost of $75,000 would be recovered in rates by the utility in less than one year through regulatory lag.

The revenues associated with the employee's compensation continue to be collected in rates charged to ratepayers long after the employee has left the company. These revenues, directly related to this employee's compensation and benefits, very often are significantly more than necessary to offset the severance payment. Therefore, severance payments are not an actual net cash expense to the utility.

A second reason why there should be no recovery of severance payments in a rate case is that significantly all, if not all, utility employee severance packages include restrictions on the severed employee from seeking compensation from the company regarding the filing of age/ sex discrimination lawsuits. In addition, part of the cost of the severance payment is related to obtaining an agreement not to make any disparaging comments about the utility. This is not the type of expenses that should be recovered from ratepayers and are more appropriately recovered from shareholders of the company. It is the shareholders who bear the burden of Company settlements or penalties that result from such employee lawsuits.

Q. Mr. Petry testifies that service company allocation costs should not be scrutinized or audited any more closely than any other outside service expense incurred by a utility. Is that a reasonable position?

A. No. The transactions between MAWC and its AWWC service company are affiliate transactions. They are not arms-length transactions as are the transactions between MAWC and an unaffiliated vendor.

Affiliate transactions, such as all transactions between MAWC as well as its service company and MAWC and its parent company require a high level of scrutiny and thorough audits or reviews. Affiliate transactions require a high degree of scrutiny to protect Missouri ratepayers from detrimental affiliate transactions such as the transactions between MAWC and its service company.

Q. Are there legal concerns or considerations with Mr. Petry's proposed single-issue standard for including all service company costs in a utility's cost of service?

A. Yes. As a public utility professional, I have been advised that the law on this is very clear. Transactions between affiliates cannot be reviewed through the lens of the presumption of prudence. In *Office of Public Counsel v. Public Serv. Commn*, 409 S.W.3d 371 (Mo.banc

2013; reh. denied; op.mod. Sept. 10, 2013) the Supreme Court of Missouri unanimously ruled ("Atmos Opinion"):

> [W]henever a company conducts transactions among its own affiliates there are inherent issues about the fairness and motivations of such transactions.... One concern is that where one affiliate in a transaction has captive customers, a one-sided deal between affiliates can saddle those customers with additional financial burdens. Another concern is that one affiliate will treat another with favoritism at the expense of other companies or in ways detrimental to the market as a whole.
>
> This greater risk inherent in affiliate transactions arises because agreements between a public utility and its affiliates are not “made at arm's length or on an open market. They are between corporations, one of which is controlled by the other. As such they are subject to suspicion and therefore present dangerous potentialities.” Pac. Tel. & Tel. Co. v. Pub. Utils. Comm'n, 34 Cal.2d 822, 215 P.2d 441, 449 (1950)(Carter, J., dissenting).

Q. Mr. Petry states at page 5 line 1 of his rebuttal testimony that MAWC rebuttal witness Baryenbruch demonstrates that MAWC’s service company costs are equal to or less than the costs MAWC would have to pay for equivalent services. Please comment.

A. Mr. Petry uses, as his support, a report written by or under the supervision of a paid consultant, Mr. Patrick Baryenbruch. This report (“Service Company Report or Report”) is attached as Schedule PLB-1 to Mr. Baryenbruch’s rebuttal testimony.

MAWC filed this Service Company Report in its rebuttal testimony on February 11, 2016. OPC must file surrebuttal testimony on March 4, 2016, which allowed only 15 work days to read this Report, issue discovery on this Report, perform an audit of the data used in reaching the conclusions listed in the Report, and discuss this Report findings with the individuals who performed the analysis on which the Report findings were based.

All of these steps are the minimum-required review steps necessary to formulate an opinion on the quality of this Service Company Report, the appropriateness of the Report’s data selection methods, the validity of the Report's results, and the reasonableness of the conclusions described in the Report.

Q. Did MAWC provide any work papers supporting the findings in this Report?

A. No. OPC did not receive any work papers at or around the time of rebuttal filing as is a customary practice and as agreed to by MAWC in the Joint Proposed Procedural Schedule (EFIS No. 47) and ordered by the Commission in its Order Adopting Procedural Schedule (EFIS No. 50). On February 26, 2016, OPC specifically requested work papers from MAWC.

Q. **What risks does the Commission assume if it gives any weight to this Report?**

A. If it chooses to do so, the Commission is giving weight to a Report that has not been reviewed or audited in any manner and the results listed in the Report could be significantly in error.

Q. Does this Report provide any value to the Commission in this rate case?

A. No.

Q. Could this Report provide value to the Commission in future MAWC rate cases?

A. If this study is updated and it is filed in MAWC's direct filing where parties to the case have the time to audit the study it could provide some value to the Commission. However, this study certainly is not an unbiased or objective study. MAWC paid Mr. Baryenbruch to do the study to support MAWC's rate case proposals. This study, as in all data put forth by a utility supporting a rate increase, should be viewed with the appropriate degree of professional skepticism required in a rate case audit.

Q. Please summarize OPC's concerns with this Service Company Report?

A. MAWC filed this document in rebuttal testimony and not a part of its direct testimony. There is not sufficient time to audit this Report in the period between the date it was filed and the filing of this surrebuttal testimony. If this Report was filed in direct testimony, it would have been appropriate for MAWC to use it as evidence in this case. Since this Report was not filed with its direct filing and there was not sufficient time to audit this report, this report provides no evidential value in this rate case and the Commission should not give any consideration to this Report in its finding on this issue.

VII. SHORT-TERM INCENTIVE COMPENSATION

Q. At page 3 lines 6 through 22 of his rebuttal testimony Mr. Petry describes the difference in the dollar amount of OPC's and Staff's recommendation on incentive compensation expense as compared to MAWC's recommendation. Do you agree with this characterization?

A. Yes. OPC and Staff have basically the same position on incentive compensation expense in this case and both OPC and Staff are supporting the Commission's longstanding opposition to including earnings-based and equity-based incentive compensation in a rate case cost of service.

Q. What is the main difference between Staff and OPC on this issue?

A. Staff's adjustment excludes some dollars associated with what MAWC characterizes as a customer service component of its short-term annual incentive compensation plan ("AIP"). My understanding is Staff reviewed how MAWC developed this component and found serious flaws in how this component is actually measured. OPC did not undertake this audit scope and did not review the prudency and reasonableness of this AIP component. While the OPC has not adjusted this customer service component of MAWC's AIP, it has had discussions with the Staff the issue and agrees with Staff's concerns. The OPC believes MAWC can and should make improvements in the customer service component of its AIP.

Q. How does MAWC compensate its utility employees?

A. MAWC compensates its employees through base salaries, AIP, and long-term incentive compensation ("LTIP").

Q. **Does OPC support the use of properly-designed incentive compensation for utility employees?**

A. Yes, it does. OPC believes a properly-designed incentive compensation plan should be based on factors that will incentivize utility management to improve the provision of safe and reliable service at reasonable rates. Reasonable utility rates are rates based on the lowest possible costs needed to provide safe and reliable utility service.

Q. Consistent with OPC's position on incentive compensation, what are some of the factors that OPC believes should be included in a reasonable and prudent regulated utility incentive compensation program?

A. OPC supports incentive compensation programs that provide incentives to utility employees, management, and executives to provide safe and reliable utility service at reasonable rates. Incentive compensation plan factors that support this include customer and employee safety measures, utility plant reliability metrics, customer service metrics, and cost reduction and expense control measures of the expenses included in a utility cost of service.

Q. What is the Commission's longstanding position on incentive compensation?

A. The Commission generally allows utility employee incentive compensation based on components or criteria that have some reasonable degree of measurability and a finding that the attainment of those criteria benefits utility operations – the ability of the utility to provide safe and adequate service at reasonable rates.

Consistent with this overall philosophy, this Commission has held over many years that earnings and equity-based incentive compensation provides not only zero ratepayer benefit but results in a ratepayer detriment and therefore should not be included in utility rates.

Q. Please provide the basis for your understanding of the Commission's longstanding policy on incentive compensation.

A. In its Report and Order in Case No. GR-96-285, a Missouri Gas Energy ("MGE") case, the Commission explained its policy that compensation not significantly driven by the interests of ratepayers should not be included in a utility's revenue requirement.

> The Commission finds that the costs of MGE's inventive compensation program should not be included in MGE's revenue requirement because the incentive compensation program is driven at least primarily, if not solely, by the goal of shareholder wealth maximization, and it is not significantly driven by the interests of ratepayers.

Approximately eight years later, the Commission reiterated, emphasized, and clarified its position on rate recovery of utility incentive compensation in its Report and Order in Case No. GR-2004-0209.

> The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.
>
> If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the cost of that plan. The portion of the incentive compensation plan relating to the

> company's financial goals will be excluded from the company's cost of service revenue requirement.

In a 2006 electric utility rate case, the Commission again restated its positing on earnings-based incentive compensation. In its Report and Order in Case No. ER-2006-0315, a Empire District Electric Company ("Empire") case, the Commission stated:

> The Commission finds that the Staff reasonably applied objective criteria for the exclusion of certain incentive compensation. The Staff disallowed compensation related to charitable activities and activities related to the provision of services other than retail electric service…We conclude that incentive compensation for meeting earnings goals, charitable activities, activities unrelated to the provision of retail electric service, discretionary awards, and stock options should not be recoverable in rates.

Q. **Did the Commission apply its policy on utility incentive compensation in subsequent utility rate cases?**

A. Yes. The Commission reiterated its position on earnings-based incentive compensation in its Report and Orders in Case Nos. ER-2006-0314 and ER-2007-0291 - both KCPL rate cases.

Despite the fact the Commission has ruled repeatedly on this issue, Missouri utilities keep seeking rate recovery of earnings-based incentive compensation with no new evidence as to why the Commission should reconsider its position.

Q. **Does OPC support rate recovery of 100 percent of MAWC's test year AIP costs that are consistent with the Commission's longstanding policy on rate recovery of incentive compensation?**

A. Yes, it does. OPC supports the level of short-term incentive compensation based on the safety and customer service factors of MAWC's AIP. Consistent with the Commission's longstanding position, which OPC supports, OPC has not included the amounts proposed by MAWC that are based on the net income, or earnings-based factor of its AIP.

Q. Briefly, why does OPC not support incentive compensation components or criteria that are earnings based?

A. The primary reason why OPC does not support the inclusion of the dollars associated with earnings-based incentive compensation in a utility's cost of service is the same as the primary reason stated by the Commission in describing its opposition. OPC believes earnings-based incentives (based on net income, return on equity, and increases in stock price) actually work as intended. These incentives focus utility management on maximizing income in order to maximize their compensation.

As the Commission has noted, the incentives created by compensating employees through an earnings-based incentive lead to utility filing rate increase cases significantly higher than justified and significantly higher than needed to earn a reasonable return on equity. In addition, with utilities that have affiliates, earnings-based incentive compensation incentivize utility management to take actions causing utility operations to subsidize affiliate transactions and nonregulated operations.

Q. Do you believe Missouri regulated utilities subsidize their nonregulated affiliates in an attempt to maximize total company net income?

A. Yes. I know this to be a fact in Missouri with some utilities and believe it is highly likely this problem exists, to some extent, with all Missouri utilities that engage in nonregulated operations and affiliate transactions. While the Commission has affiliate transaction measures in place to mitigate utility affiliate subsidization for electric and natural gas utilities, the Commission has not promulgated any such affiliate-abuse protections for water utilities such as MAWC. OPC is supportive of the promulgation of water utility affiliate transaction rules similar to the Commission's affiliate transaction rules for electric and natural gas utilities.

Q. **Has MAWC engaged in affiliate transactions that result in a detriment to its Missouri ratepayers but result in higher earnings and incentive compensation payments to its executives and management and its parent company executives and management?**

A. Yes. As explained in my direct testimony and in the direct and surrebuttal testimonies of OPC witness Ralph Smith, MAWC failed to take the benefit of certain bonus depreciation tax deductions in the calculation of its Missouri cost of service. The reason MAWC did not take these deductions and lower cost of service in this rate case was to allow its affiliate parent company, AWWC, to use its non-regulated and non-jurisdictional tax deductions as a priority. This action on the part of MAWC management is not only imprudent on its face but also would be a major violation of the affiliate transaction rules the Commission has promulgated for other Missouri utilities.

Q. Do you believe that, in part due to the incentive to maximize net income and incentive compensation, Missouri utilities, including MAWC, have historically sought to overcharge their customers for the services they provide to their regulated utility customers?

A. Yes. I believe the evidence in support of such a finding is significant. It is likely one of the reasons why Missouri utilities continually seek to overcharge their customers in rate cases such as this one is due to the incentives created by earnings-based incentive compensation plans. The higher the rates that can be secured in a rate case the higher the net income of the utility and the higher the compensation of utility management.

Q. Can you provide evidence that MAWC has attempted to significantly overcharge its Missouri regulated utility customers over the past several years?

A. Yes. In the chart below it shows that in MAWC's four previous rate cases, it has sought to overcharge its Missouri regulated utility customers by over $67 million. The increase in rates MAWC said was needed to create just and reasonable rates over this period were $182.3

million. The Commission decided the rate increase needed to create just and reasonable rates over this period were $115 million. The subtraction of what the Commission found was the rate increase needed to provide just and reasonable rates was $67 million less than what MAWC sought to overcharge its customers.

MAWC Rate Case	MAWC Proposed Revenue Requirement	Just and Reasonable Revenue Requirement	MAWC Excess over Just and Reasonable $	MAWC Excess over Just and Reasonable %
WR-2007-0216	$41.4	$28.5	$12.9	31%
WR-2008-0311	$49.5	$34.5	$15.0	30%
WR-2010-0131	$48.5	$28.0	$20.5	42%
WR-2011-0337	$42.9	$24.0	$18.9	44%
Total	$182.3	$115.0	$67.3	37%

Q. Are there other examples of how earnings-based incentive compensation works directly against the interests of ratepayers?

A. Yes. MAWC's ISRS is a single-issue ratemaking device that increases MAWC's net income outside of a rate case. If MAWC management's compensation is tied, in part, to net income (which it is), this compensation incentive will likely cause MAWC management to maximize its ISRS filings and include costs that may not be ISRS related.

With the incentive to maximize net income, MAWC management may rely on the very limited time Staff auditors are allowed to perform an ISRS audit and find the risk that non-ISRS plant costs or questionable ISRS plant costs will be found by Staff to be minimal and an acceptable risk. MAWC management will also rely on the fact that the risk that non-ISRS costs will be found by Staff in a later ISRS prudence cost review is negligible since Staff, to my knowledge, has never looked at ISRS work orders in a general rate case for prudency after its initial less than 60-day review period.

VIII. LONG-TERM INCENTIVE COMPENSATION ("LTIP")

Q. Describe the purpose of AWWC's and MAWC's LTIP.

A. According to AWWC's 2015 Schedule 14A ("Proxy Statement", attached to this testimony) filed with the Securities and Exchange Commission ("SEC"), MAWC's parent company AWWC's executive compensation program is designed to reward its executive officers for delivering results and building long term sustainable value for its stockholders. AWWC states in its Proxy Statement that it believes the program's performance measures "align the interests of our stockholders and executive officers by correlating pay to short- and long-term performance."

AWWC's LTIP is designed to provide incentives for company executives as to help AWWC reach its long-term business objectives by providing an opportunity to earn equity awards tied to long-term goals and continued employment with AWWC. AWWC's LTIP is designed to reward executive officers for delivering results and building long-term sustainable value for its shareholders.

Q. Is MAWC's LTIP compensation paid in cash to MAWC's executives?

A. No. LTIP compensation is paid in stock options, restricted stock units ("RSUs"), and performance stock units ("PSUs"). All compensation is equity based and primarily based on income or other earnings criteria.

Q. **What is Equity-Based Compensation?**

A. The term "equity-based compensation" includes any compensation based on the value of specified stock. Examples of equity-based compensation include Stock Transfers, Stock Options, Stock Warrants, Restricted Stock, Restricted Stock Units, Phantom Stock Plans, Stock Appreciation Rights, and other awards whose value is based on specified stock.

Q. Has MAWC provided any new evidence showing why its equity-based long-term incentive compensation should be included in utility rates, i.e. that it provides a ratepayer benefit?

A. No.

Q. Mr. Petry states at page 4 line 9 of his rebuttal testimony that AWWC's service company employees provides services to AWWC's affiliates at cost and at prices that are more advantageous then could be obtained in the market place. Do you agree with this statement?

A. I don't disagree it would be a possibility that AWWC could provide MAWC with services less costly than if MAWC obtained these services in the open market. However, Mr. Petry does not provide any evidence in his testimony to support this statement. As such, it remains equally likely AWWC's service company charges MAWC above fair market prices for the services it provides than it charges below fair market prices.

Q. Earlier you quoted from the Commission's Report and Order in Case No. GR-2004-0209 where the Commission expressed concern that earning-based incentive compensation creates incentives for utility management to act imprudently. Is this Commission concern backed up by academic research on the issue of incentive compensation?

A. Yes it is. The Commission stated in its Report and Order the financial incentives from an earnings-based incentive compensation plan "*seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.*"

I have read several academic research studies on earnings-based and equity-based incentive compensation to find, consistent with the expressed concerns of the Commission, that this type of compensation incentive causes company management to act in ways to maximize their compensation to the detriment of the company. This action is referred to as “earnings management”. I have attached two articles on incentive compensation incentives to this testimony.

Q. What is earnings management?

The issue of “earnings management” is addressed in the attached article *Maynard Manufacturing An Analysis of GAAP-Based and Operational Earnings Management Techniques*, Strategic Finance, July 2003. Strategic Finance is a monthly publication of the Institute of Management Accountants and this article was written by William Ortega, Ph.D., CMA and Gerry Grant, MPA, CPA, and doctoral student with the School of Business, University of Mississippi at the time of publication.

Q. **Please summarize the findings on earnings-based incentive compensation in the article “*Maynard Manufacturing An Analysis of GAAP-Based and Operational Earnings Management Techniques.*”**

The article describes earnings management is the active manipulation of earnings toward a predetermined target. Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.

The article provides five situations that provide executives incentives to manage earnings. Situation number 4 is “To Maximize Earnings-Based Incentive Compensation Agreements.” The article states several studies have provided evidence earnings are managed in the direction consistent with maximizing executives’ earnings-based incentive compensation.

This article also references a 1985 study performed by Paul M. Healy titled "The Effect of Bonus Schemes on Accounting Decisions". This article was published in Journal of Accounting and Economics, April 1985.

Q. Is Paul Healy a recognized expert in the field of business academic research?

A. Yes. The following credentials for Mr. Healy are listed in the Harvard Business School ("HBS") website:

> Paul Healy is the James R. Williston Professor and Senior Associate Dean for Faculty Development at the Harvard Business School. His research covers a broad range of topics, including financial analysis, Wall Street research, corruption, governance, mergers and acquisitions, and business ethics. He joined the HBS faculty in 1998, after fourteen years on the faculty at the M.I.T. Sloan School of Management, where he received awards for teaching excellence in 1991, 1992, and 1997. He received accounting and finance degrees from Victoria University in New Zealand (1976 and 1977) and a Ph.D. from the University of Rochester (1981). He has published widely in the leading academic and practitioner journals, has received numerous research rewards, and is the co-author of one of the leading financial analysis textbooks. He has taught MBA and executive courses on accounting, financial analysis, corporate boards, and ethical leadership.

Q. What conclusions does Mr. Healy reach in this article based on his research of incentive compensation?

A. Part of Mr. Healy's conclusions were:

> Bonus schemes create incentives for managers to select accounting procedures and accruals to maximize the value of their bonus awards. These schemes appear to be an effective means of influencing managerial accrual and accounting procedure decisions. There is a strong association between accruals and managers' income-reporting incentives under their bonus contracts.

Q. **What is the purpose of your testimony on the academic research of earnings management and equity-based incentive compensation?**

A. My use of academic research is to provide evidence consistent with or supportive of a hypothesis or conclusion. In this case, the academic research supports the conclusion reached previously by the Commission that earnings-based incentive compensation provides incentives for utility management to act only in the interests of its shareholders and against the interests of its ratepayers. It is not evidence MAWC engages in earnings management or that earnings management is a problem with Missouri utilities. It is simply evidence supporting a Commission conclusion that earnings-based incentive compensation has serious problems not only with competitive firms but with regulated monopolies in the setting of utility rates as well.

Q. Can a utility create an overall incentive compensation plan that is consistent with the interests of ratepayers and shareholders and meets Commission criteria?

A. Yes, it can, but it is not likely without a commitment by senior utility management. A utility's incentive compensation plan is either created by its board of directors or it is approved by the board of directors based on management recommendations.

A utility's board of directors has a primary responsibility to the utility's shareholders. Due to the nature of this relationship, unless utility management can convince its board of directors otherwise, I do not see any change to earnings-based criteria being the cornerstone of the utility's incentive compensation plan. As a result, we will continue to have these incentive compensation issues before the Commission in virtually every rate case.

IX. INCOME TAX EXPENSE/NORMALIZATION VIOLATION

Q. Please summarize the issue between OPC and MAWC on income taxes

A. MAWC is engaging in transactions with AWWC resulting in detriments such as unnecessarily higher rates for MAWC's Missouri ratepayers. The transactions involve MAWC not taking available and authorized bonus depreciation tax deductions due to its affiliate relationship with AWWC. Also, as explained in the direct and surrebuttal testimonies of OPC witness

Ralph Smith, MAWC failed to reflect the domestic production activities deduction (DPAD) in the calculation of income tax expense in this rate case. As Mr. Smith explains, the DPAD is a deduction that applies to water utilities and would therefore apply to MAWC on a separate return basis. MAWC has not reflected this due to MAWC's participation in the consolidated federal income tax return with MAWC's New Jersey based parent company, AWWC. Income taxes for MAWC, in the current rate case, are being computed on a separate return basis so the DPAD should be reflected in computing MAWC's federal income tax expense in this case.

Q. What is the DPAD?

A. The American Jobs Creation Act of 2004 authorized DPAD for income attributable to certain manufacturing and domestic production activities conducted in the U.S.. OPC witness Smith filed direct testimony in this case describing MAWC's failure to reflect the DPAD as a cost of service income tax deduction in this rate case. This deduction applies to computing MAWC's federal income tax expense on a separate return (stand-alone) basis but MAWC chose not to reflect this deduction in its cost of service in this rate case. MAWC's authority to reflect this income tax deduction is found in IRS Code Section 199.

Q. What is the basis of Mr. Meyers position that MAWC's rates in this case should not reflect the inclusion of income tax deductions to which MAWC is entitled to take in its cost of service income tax expense calculation?

A. There are two primary methods to reflect income tax expense in a utility's cost of service. The first method, used by all Missouri regulated utilities of which I am aware, is called the "stand alone method" income tax expense calculation. In essence, this method treats the utility as a stand-alone company and calculates its income tax expense in its cost of service solely on regulated utility operations. Calculation of income tax expense on a stand-alone basis does not allow for the reflection of any financial information associated with the utility's affiliates including its affiliated parent company.

The second method, which I do not believe is or has been employed by any Missouri regulated utility, is referred to as the "consolidated method." The consolidated method, which if designed appropriately, may actually be a better method to reflect income tax expense of the utility. The consolidated method reflects the actual income tax liability of the consolidated company (both utility and non-utility operations) and allocates a pro rata share of the actual income tax expense attributable to each individual entity. Under this method, a regulated utility should be compensated for the fact it alone generates most if not all of the taxable income. Without the generation of taxable income, none of the affiliated income tax deductions such as net operating losses, can be used and will expire without providing any value. It is usually only the positive taxable income generated by the regulated utility that gives these affiliated non-regulated tax deductions and net operating losses any value.

Mr. Meyers, in his attempt to maximize net income to AWWC's shareholders, testifies to the Commission that it is appropriate to treat MAWC as a stand-alone tax entity for some income tax deductions. But for other deductions that apply to MAWC under the stand alone method, such as the DPAD, Mr. Meyer is advising the Commission to take a totally inconsistent position and treat these "special" deductions on a consolidated basis. Concerning the DPAD, Mr. Meyers' position is that if the deduction cannot be taken on the American Water Works consolidated federal income tax return, then it should not be reflected on a stand-alone basis for MAWC's calculation of federal income tax expense in the rate case even if MAWC would be entitled to the deduction on a stand-alone basis. In essence, Mr. Meyer is asking the Commission to allow MAWC to continue to subsidize its affiliate transactions with AWWC at the expense of Missouri ratepayers.

Q. At page 3 line 8 of his rebuttal testimony MAWC witness Mr. Meyers makes the unsupported accusation that OPC is proposing to include the DPAD only because MAWC is not reflecting bonus depreciation tax deductions. Does Mr. Meyers provide any support for this accusation?

A. No.

Q. Why can't Mr. Meyers provide support for this accusation?

A. He cannot provide any support for this accusation because the statement he makes is untrue. I don't know if Mr. Meyers knows the statement is false, but if he is going to make an accusation with ethical overtones, he should have some evidence to support it. He does not.

In his direct testimony in this case OPC witness Mr. Smith addressed two separate and distinct income tax issues. The only common features between MAWC's failure to claim available bonus depreciation tax deductions in 2011 and 2013 and its failure to reflect the DPAD in this rate case is the evidence suggesting they both result in ratepayer detriment, both are affiliate abuses, and both result from imprudent utility management behavior.

Q. Is Mr. Meyers testifying to the Commission that OPC is acting in a less than ethical manner in its income tax recommendations to the Commission in this case?

A. Yes. He testifies OPC is reflecting the DPAD in this case only because MAWC failed to take the 2011 and 2013 bonus tax depreciation deductions. He testifies OPC is penalizing MAWC for not taking the bonus tax depreciation deductions by OPC reflecting the DPAD in the calculation of federal income tax expense in MAWC's cost of service.

By making accusations OPC is penalizing MAWC for not taking bonus tax depreciation deductions, he testifies that OPC is deceiving the Commission into ordering MAWC to commit an "indirect" IRS Normalization Rules violation by reflecting the DPAD deduction. These accusations are patently false. As explained above, the DPAD is authorized under §199 of the Internal Revenue Code. The normalization requirements apply to accelerated tax depreciation. The DPAD is not accelerated tax depreciation. There is no normalization violation for reflecting the DPAD in the computation of a water utility's federal income tax expense allowance for ratemaking purposes.

Q. Even though OPC is not proposing to impute the bonus depreciation tax deductions, would it be an income tax normalization violation if OPC imputed the bonus depreciation deductions in this case?

A. No. I don't believe it has to be as long as the AWWC consolidated tax returns were amended to reflect that MAWC claimed the bonus tax depreciation in the years, such as 2013, when it was foregone. If OPC's position was to impute the bonus depreciation tax deductions in this rate case and the Commission adopted this position, MAWC likely has a way to remedy the situation to prevent a Normalization Rules violation.

If AWWC amended its prior federal income tax returns and claimed MAWC's bonus depreciation deductions, there would likely be no normalization violation because the rates set in this case would be consistent with the bonus depreciation deductions actually taken by MAWC and by AWWC on their consolidated federal income tax return. MAWC witness Meyers admits that "the Internal Revenue Code does allow flexibility to opt in and out of bonus depreciation at the legal entity level." (Meyers Rebuttal page 5, lines 7-8.) Bonus tax depreciation could, therefore, have been claimed by MAWC in a tax year such as 2013 when MAWC on a stand-alone basis could have had positive taxable income and this would not require any of the other legal entities that are participating in the AWWC consolidated federal income tax return to also claim bonus tax depreciation in 2013. I am not aware of any reason why MAWC and AWWC cannot take these actions if they chose to do so. It is not uncommon for companies to amend prior-filed federal income tax returns when mistakes have been found or are ordered to do so by a regulatory body.

Q. Can the Commission order MAWC to take what actions are necessary with its affiliate AWWC to amend the prior consolidated federal income tax returns that failed to reflect MAWC's bonus depreciation deductions to reflect these deductions?

A. I am not an attorney and can't speak to the Commission's legal authority to do so. I will say however, that if it is within the Commission's authority, then it would be the most appropriate way of resolving this bonus depreciation issue in this rate case.

Q. At page 4 of his rebuttal testimony Mr. Meyers states that OPC witness Mr. Smith declined to impute bonus depreciation to MAWC because the effect would be to impermissibly pass the benefits that bonus depreciation provides to MAWC's ratepayers without the Company ever receiving the benefits of that accelerated depreciation and thereby violate the IRS regulations. Do you agree with this statement?

A. Partially, yes. I agree OPC did not impute the bonus depreciation deduction due to its potential to violate IRS normalization rules. I also agree taking bonus depreciation deductions benefits ratepayers. I don't agree it would be impermissible for MAWC ratepayers to receive the benefits of bonus depreciation in this rate case if the Commission ordered AWWC to amend its consolidated federal income tax returns and reflect MAWC's bonus depreciation deduction to forego any other nonregulated and affiliate tax deduction, such as a deduction for charitable contributions or other deductions, that AWWC gave a higher priority to when it filed its federal income tax returns and determined which deductions would be claimed or not.

Q. At page 4 of his rebuttal testimony Mr. Meyers states that imputing the DPAD to MAWC as a penalty for its failure to elect bonus depreciation is an indirect normalization violation which is subject to the same sanctions as a direct violation. Do you agree with this statement?

A. Again, partially, yes. I agree with his assertion an indirect normalization violation is subject to the same sanctions as a direct violation. However, Mr. Meyers' statement that OPC is imposing a penalty on MAWC is false. Also, reflecting the DPAD as a deduction in computing a water utility's federal income tax expense for ratemaking purposes in a rate case is not a normalization violation of any type. In fact, as OPC witness Mr. Smith points out and has documented in his Direct Testimony, the DPAD has been reflected for computing federal income tax expense for other AWWC water utility subsidiaries such as California-American Water Company.

If reflecting the DPAD in the calculation of the federal income tax expense allowance for ratemaking purposes on a stand-along basis as has been done for the affiliate, California-American Water Company, was a direct or an indirect normalization violation, Mr. Meyers would presumably have been required to inform the IRS of that violation when it would have occurred in his formal role. Yet there is no evidence that it did so. Moreover, the reason is there is no direct or indirect normalization violation associated with reflecting the DPAD for MAWC on a stand-along basis of water utility federal income taxes.

Q. Mr. Hyneman, were you directly involved in the discussions with Mr. Smith on what tax issues he would put forth in this rate case?

A. Yes. To my knowledge I was involved in each and every discussion with Mr. Smith on the income tax issues he is sponsoring in this rate case.

Q. In all of you discussions on this issue were there ever any discussions of penalizing MAWC for its failure to take the bonus depreciation deductions?

A. Not only were there no discussions of penalizing MAWC, I don't believe that there was even any thought or inclination to use the DPAD as a penalty by me or Mr. Smith.

OPC is not proposing any penalty adjustments in this case. The two issues addressed by OPC witness Smith (DPAD and bonus depreciation) are distinct and different issues. If MAWC actually did take advantage of the bonus depreciation tax deductions in the past, OPC would still be recommending the reflection of the DPAD in MAWC's water utility cost of service in this rate case. If OPC failed to reflect a tax deduction MAWC was entitled to take but chose not to at the detriment of Missouri ratepayers, our office would be imprudent in the performance of its role to represent the interests of the ratepayers of the State of Missouri in utility rate cases.

Q. Should false and baseless accusations made with no supportive evidence at all be a factor when the Commission considers witness' credibility?

A. Yes. I believe it should be.

Q. Please summarize the income tax issues in this case.

A. OPC is asking the Commission to protect the interests of MAWC's Missouri ratepayers by reflecting income tax deductions (DPAD) that apply to MAWC's water utility operations consistent with the determination of MAWC's federal income tax expense in the current case on a stand-alone (separate return) basis.

<u>X. GENERAL RATEMAKING ISSUES</u>

Q. At page 8 line 28 of her rebuttal testimony Ms. Tinsley states that MAWC does not dispute the removal of lobbying related labor expense. Did MAWC make any real attempt to remove lobbying-related labor expenses from its cost of service filing?

A. No. MAWC's filing included many types of charges that should not be included in a utility's cost of service filing. I do not believe MAWC made a serious attempt to protect its Missouri ratepayers from paying in rates costs that this Commission has determined should not be in a utility's cost of service filing.

In my view, OPC hopes and expects MAWC to make a much better filing in its next rate case by providing reliable and verifiable data and not including costs that this Commission does not allow in utility rates without providing new evidence showing why this Commission should change its position, and proposing rate case adjustments that actually comply with the Commission's rate case matching principle.

Q. Do you believe that MAWC completely ignores the Commission's rate case matching principle in its direct filing in this rate case?

A. Yes. For example, at page 10, Ms Tinsley admits MAWC has included in its case a management pay increase that does not take effect until 43 days past the true-up date. Her justification is that it takes place before the operation of law dates of rates. Her argument makes no sense from a ratemaking standpoint.

The Commission may have made an exception to its matching principle and allowed a post-test year expense increase just a day or a few days past the test year. However, to my knowledge, the Commission has never allowed (and should never allow) a management pay increase past the true-up date in a rate case.

Ms. Tinsely is doing nothing more than cherry picking expense increases that may occur at some point in the future to include in this rate case but she is not proposing to match these expense increases with other expense decreases or revenue increases. Her proposal shows no respect for the Commission's relatively strict enforcement of its rate case matching principle and should be rejected on that basis alone.

Q. Does it appear that Ms Tinsley is trying to apply the single-issue ratemaking approach from MAWC's ISRS and its proposed ECAM to this projected management increase?

A. Yes. MAWC's ISRS methodology ignores the matching principle at least to a significant degree. Ms Tinsely appears to be applying the single-issue ratemaking methodology of the ISRS to a general rate case.

Q. **Does Ms Tinsley, like other MAWC witnesses, indicate she does not have any concern for the general principles of ratemaking?**

A. Yes. At page 10 line 19 of her rebuttal testimony she states that if the management pay increase that is scheduled to take place well past the true up date in this rate case, MAWC will not recover nearly $900,000 of expense over the next three years.

That statement is not true and there is no way that statement can be true when one considers how utility ratemaking, including regulatory lag, is developed and applied.

The first issue is when rates are set in a rate case they are considered to be fair and reasonable until changed or until a party makes a filing for a rate change. If MAWC finds subsequent revenue increases, subsequent increases in revenues from its ISRS, or other subsequent expense reductions are not sufficient to offset subsequent pay increases to a point where its ROE is not considered to be reasonable, it can file for a rate case.

The second issue is expenses are not recovered under trackers or some other single issue ratemaking mechanism are not tracked. There is no way to know if MAWC will over-recover its total payroll costs by more than $900,000 in the first year or first few years after rates are set. I would argue that MAWC is equally likely to over-recover (using MAWC's ratemaking paradigm) its March 14, 2016 management pay increase over the next three years than it is under-recover.

Q. **Did MAWC have a management pay increase in 2013 and 2014?**

A. Yes, it did.

Q. **Did MAWC have a rate case in 2013 or 2014?**

A. No, it did not.

Q. **Did MAWC earn a reasonable ROE and recover each and every dollar it incurred to provide utility service in 2014?**

A. Yes it did.

Q. Does the fact that MAWC had pay increases in 2013 and 2014 and did not have rate cases in those years to "recover" those pay increases clearly show that fallacy of Ms. Tinsley's argument?

A. Yes, it does. Not only did MAWC recover each and every dollar of each and every expense it incurred to provide utility service in 2013 and 2014 its ROE in those years were by MAWC's own standards at a reasonable level.

Q. **At page 13 line 7 of her rebuttal testimony Ms Tinsley states that MAWC eliminated all severance costs related to MAWC employees from its proposed cost of service. Did Ms Tinsley, as an AWWC Service Company employee remove service company allocated severance costs from MAWC's cost of service filing?**

A. No, she did not. MAWC's cost of service filing is not consistent on this issue between direct severance costs and Service Company allocated severance costs.

XI. ATRAZINE SETTLEMENT

Q. **At page 13 of her rebuttal testimony Ms. Tinsley discusses the Atrazine settlement issue. Please comment.**

A. At page 13 of her rebuttal testimony, Ms. Tinsley goes to great lengths to attempt to justify why MAWC customers, who paid all costs to prosecute the Atrazine settlement case should not be entitled to the full amount of the compensation associated with the payment of those costs. Ms. Tinsely tries to convince the Commission MAWC's shareholders, who incurred none of the expenses related to the Atrazine case, should receive 50 percent of the dollar settlement.

Q. **What is the OPC's recommendation to the Commission on the Atrazine settlement issue?**

A. As described in both OPC and Staff testimonies, the Atrazine settlement dollars should go to the ratepayers who paid all the dollars spent to prosecute this legal proceeding. Unless MAWC can show that it received a check from its shareholders used specifically to prosecute this Atrazine case, there is no question that the ratepayers funded 100% of the costs. As such, they are entitled to 100% of the refund.

However, if for some reason the Commission rationalizes MAWC's shareholders are somehow entitled to some of the proceeds, then the Commission should also consider the fact MAWC did not provide adequate customer service during the test year as the Commission is well aware from Case No. WO-2014-0362 (see attached). Given this lack of adequate customer service, the Commission should give any benefit of the doubt to customers and find that MAWC's customers are entitled to 100% of the Atrazine proceeds.

Q. **Should the Commission also take into consideration the lack of adequate service by MAWC in its ROE deliberations in this rate case?**

A. Yes, I believe it should. MAWC's customers pay very high utility rates as evidenced by the testimony of the witnesses at MAWC's public hearings. At a minimum, customers are entitled to a high level of customer service. They did not receive sufficient customer service in the test year and they may still not be receiving it. The Commission should consider this fact, less than adequate customer service, when it deliberates what specific ROE is MAWC entitled to in this case.

XII. RATE CASE EXPENSE

Q. At page 17 line 4 of her rebuttal testimony Ms. Tinsley stated that OPC is recommending a normalized level of rate case expense of $167,667. Is that correct?

A. That is correct for OPC's direct filing when a significant amount of rate case expense had yet to be incurred. As noted in OPC's direct testimony, OPC will perform a true-up audit of actual incurred rate case expense and make its final recommendation on rate case expense in its true up direct filing.

Q. At page 18 line 30 of her rebuttal testimony Ms. Tinsley states that rate case expense like every other expense in a rate case is subject to audit and disallowance for imprudence and other grounds. Do you agree with this statement?

A. Yes. OPC will review MAWC's actual incurred rate case expense and make any recommendations for adjustments to this amount based on reasonableness and prudency. However, Ms. Tinsley left out that, like every other expense, rate case expense is subject to an allocation to the parties that benefit from the expense. This Commission has recognized a utility's shareholders benefit from rate cases as much as customers benefit and has reflected that fact in its rulings in previous rate cases.

Q. Could a very reasonable argument be made that MAWC's shareholders should be allocated 100 percent of the rate case expense in this rate case?

A. Yes. All evidence indicates MAWC is currently earning a reasonable ROE and does not need a rate increase. The only reason it had to file this rate case was due to its ISRS requirements. The ISRS is a single-issue ratemaking that benefits only MAWC's shareholders. So, if MAWC's ISRS is the reason it is filing this rate case and the ISRS benefits only MAWC's shareholders, then MAWC's shareholders should be allocated 100 percent of the rate case expense.

Q. At page 19 line 13 through page 20 line 7 of her rebuttal testimony Ms. Tinsley quotes the testimony of Darrin Ives, a KCPL witness in KCPL's last rate case, Case No. ER-2014-0370. Has the Commission reviewed and rejected these arguments made by Mr. Ives?

A. Yes, it did, just six months ago. In its Report and Order in Case No. ER-2014-0370, the Commission did a very good job explaining its basis and rationale for its position on rate recovery of rate case expense. MAWC has presented no reasons why the Commission should change its position on sharing rate case expense in this rate case.

Q. **Based on discussions with Staff and a further review of the Commission's Report and Order in Case No. ER-2014-0370 has the OPC revised its position on rate case expense?**

A. Yes. Based on further study of the Commission's Report and Order in Case No. ER-2014-0370, OPC believes allocating rate case expense based on the ratio of the revenue requirement ordered by the Commission to the revenue requirement proposed by the utility is also an appropriate method of allocating rate case expense. In its true –up direct filing, the OPC will be supporting the Staff's proposed methodology on rate case expense.

Q. **At page 20 line 26 of her rebuttal testimony Ms. Tinsley states that the rate case expense approach adopted by the Commission is a "blanket disallowance". Is she correct?**

A. No. That is not at all the approach the Commission takes with rate case expense. A simple reading of the Commission's Report and Order in Case No. ER-2014-0370 shows the Commission was developing a systematic approach to the allocation of rate case expense.

While some portion of rate case expense may be "disallowed" based on reasonableness and imprudence, expense disallowance is not the substance of the Commission's position on rate case expense. The Commission's position is based on cost allocation principles. Ms Tinsley is confusing the application of cost allocation principles with a "rate case disallowance adjustment" generally applied to expenses such as lobbying and charitable contributions.

XIII. PENSION TRACKERS

Q. At pages 24 through 26 of her rebuttal testimony Ms. Tinsley addresses the issue of pension trackers. Does OPC have the same concerns with pension trackers as it does with many, if not all of the single-issue ratemaking mechanisms that prevent regulatory lag from working as intended?

A. Yes. There is significant evidence the lack of utility management cost control incentives inherent in Kansas City Power & Light's pension expense trackers has worked to the detriment of Missouri ratepayers resulting in unreasonable and excessively high pension costs passed on to Missouri ratepayers. Pensions are a form of compensation. When there is little or no cap on the amount of pension compensation that is paid to utility management, they will maximize the amount of their compensation.

The Commission has expressed concerns about utility management incentives to increase management compensation and this concern is backed up by substantial academic research, some of which is attached to this testimony. Pension trackers work in very much the same way as earnings-based incentive compensation. Utility management will take actions to maximize pension compensation especially when little or no controls are placed on them to not maximize their compensation such as the elimination of regulatory lag and the basic pass-through of any level of pension compensation as is the current state of affairs in Missouri utility regulation with pension expense.

Q. **Does OPC support the continued use of MAWC's pension trackers?**

A. Generally, no. OPC's position on pension trackers is the same as it is for all single-issue ratemaking mechanisms. If a utility experiences a cost that causes it difficult to continue to provide safe and reliable service to its customers at reasonable rates, then the issue of expenses trackers can be used for a limited period of time until that specific cost is addressed.

Pension trackers, with the full support of the Commission's Staff over many years, needs to be addressed. Through stipulation and agreements in utility rate cases, Missouri utilities have been successful in recovering directly in rates not only each and every dollar of pension and pension-related expense it incurs but they have also been allowed to earn a profit on every dollar of pension regulatory assets.

Q. **Have most business entities that had defined benefit pension plans in the past made major changes to its pension plan costs by switching to a less costly and more controllable defined contribution plan as opposed to a much high cost and less controllable defined benefit pension plan?**

A. Yes. Most companies made this change long ago. The utility industry, because of its protection from competition, has been very slow to make changes to its defined benefit pension plan. Missouri utilities have been protected from competition because they have been handed, by the Commission's Staff, authority to pass through virtually all pension costs with little or no scrutiny. If the Commission's Staff has failed in any area, it is in the area of pension expense and its failure to subject Missouri utilities to any degree of competition in the area of pension compensation.

Q. **Have some Missouri utilities recently made changes to their pension plans?**

A. Yes. Some Missouri utilities have made some changes to its pension plans for new employees. It remains to be seen if these changes will result in lower and more reasonable pension costs passed on in utility rates.

<u>XIV. INSURANCE OTHER THAN GROUP</u>

Q. At page 29 of her rebuttal Ms. Tinsley describes how MAWC ratepayers should pay for Kidnap and Ransom insurance for its officers and board of directors. Do you agree?

A. No. Paying annual insurance premiums for an outdated and antiquated policy does not appear to be a prudent type of expense to include in a utility's cost of service.

Q. Are there ways to address this issue other than to charge ratepayers for a cost that has never been incurred over the past 100 years?

A. Yes. If, on the rare chance that an AWWC makes a payment to secure the release of the officer or director, then MAWC can seek recovery in utility rates and recover the cost in rates if the Commission determines the payment of the cost was reasonable and prudent and appropriately charged to MAWC ratepayers.

Q. Beginning at page 30 of her rebuttal testimony Ms. Tinsely addresses the issue of an insurance "retrospective adjustment". Does OPC support the inclusion of a "retrospective adjustment" in this rate case?

A. OPC has had discussions with Staff and reviewed MAWC's responses to Staff Data Request Nos. 364, 364.1, and 364.2. Staff Data Request 364.3 was due on March 1, 2016 but as of March 3, 2016, has not been received. OPC is concerned that the 3-year average proposed by MAWC is too short and would not result in a normalized expense. OPC recommends expanding this period to a 10-year period to better capture the significant fluctuations in this expense.

Q. Does this conclude your testimony?

A. Yes it does.

AWK PRE+14A 5/15/2015

Section 1: PRE 14A (PRE 14A)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934

Filed by the Registrant ☒

Filed by a Party other than the Registrant ☐

Check the appropriate box:

☒ Preliminary Proxy Statement

☐ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e) (2))**

☐ Definitive Proxy Statement

☐ Definitive Additional Materials

☐ Soliciting Material Pursuant to §240.14a-12

AMERICAN WATER WORKS COMPANY, INC.

(Name of Registrant as Specified in its Charter)

(Name of Person(s) Filing Proxy Statement if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

☒ No fee required.

☐ Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

☐ Fee paid previously with preliminary materials.

☐ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

AMERICAN WATER

PRELIMINARY PROXY STATEMENT
SUBJECT TO COMPLETION DATED MARCH 17, 2015

AMERICAN WATER WORKS COMPANY, INC.

[March 27], 2015

Dear American Water Stockholder:

I am pleased to invite you to attend American Water's 2015 Annual Meeting of Stockholders on Friday, May 15, 2015. The meeting will be held at 10:00 a.m., Eastern Daylight Time, at The Mansion, 3000 Main Street, Voorhees, New Jersey 08043. For your convenience, we are providing a live webcast (audio only) of the meeting at www.amwater.com. Instructions on accessing the webcast are explained in detail on page 2.

The materials accompanying this letter include a formal notice of the meeting and the proxy statement. The proxy statement provides information on, among other things, American Water's corporate governance, the Company's executive compensation program, and the matters to be voted on at the meeting. We believe that matters addressed in the proxy statement reflect American Water's commitment to strong governance processes, including independent and active board oversight, accountability to stockholders, transparent disclosure and compliance with regulatory responsibilities.

The American Water board of directors' commitment to sound corporate governance is illustrated by a number of practices adopted in recent years:

- Our Chairman of the Board is an independent director;
- We have instituted a majority vote standard for election of directors;
- We have a policy mandating independence for the Compensation Committee's compensation consultant;
- We have an annual advisory vote to approve our executive compensation; and
- Stockholders have direct and confidential access to the board of directors through our email address: *contacttheboard@amwater.com*

We believe that these steps, and other effective governance practices described in this proxy statement, as well as American Water's largely performance-based executive compensation program, exhibit our proactive approach to governance. We encourage you to learn more about our governance practices by reading the proxy statement and visiting the Investor Relations page on our website at www.amwater.com.

It is important that your shares be represented and voted at the Annual Meeting regardless of the size of your holdings. Whether or not you plan to attend the Annual Meeting, we encourage you to vote your shares in advance of the Annual Meeting by using one of the methods described in the accompanying proxy materials.

We will set aside time at the meeting for discussion of each item of business, and American Water's management will report on the Company's performance during the last fiscal year and respond to questions from stockholders. If you will need special assistance at the meeting because of a disability, please contact Michael A. Sgro, Senior Vice President, General Counsel and Secretary, American Water Works Company, Inc., 1025 Laurel Oak Road, Voorhees, New Jersey 08043, or Investor Relations via email at *aw.investorrelations@amwater.com* or by telephone at (877) 310-7174.

Thank you for your support and continued interest in American Water.

Sincerely,

G. MacKenzie

George MacKenzie
Chairman of the Board

PRELIMINARY PROXY STATEMENT
SUBJECT TO COMPLETION DATED MARCH 17, 2015

American Water Works Company, Inc.

1025 Laurel Oak Road
Voorhees, New Jersey 08043

NOTICE OF 2015 ANNUAL MEETING OF STOCKHOLDERS TO BE HELD ON MAY 15, 2015

The Annual Meeting of Stockholders of American Water Works Company, Inc. (the "Company") will be held at The Mansion, 3000 Main Street, Voorhees, New Jersey 08043, on Friday, May 15, 2015, at 10:00 a.m., Eastern Daylight Time to consider and take action on the following:

1. election to the board of directors of the nine (9) nominees named in the accompanying proxy statement for terms expiring at the 2016 Annual Meeting of Stockholders or until their successors are duly elected and qualified;
2. ratification of the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2015;
3. an advisory vote to approve the compensation of our named executive officers;
4. re-approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan to allow certain equity grants under the plan to continue to be deductible under Section 162(m) of the Internal Revenue Code;
5. approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. Annual Incentive Plan to allow certain incentive awards under the plan to be deductible under Section 162(m) of the Internal Revenue Code;
6. adoption of an amendment to our bylaws establishing the courts located within the State of Delaware as the exclusive forum for the adjudication of certain legal actions; and
7. such other business, if any, as may properly be brought before the meeting or any adjournment or postponement of the meeting.

The Company's board of directors has no knowledge of any other business to be transacted at the 2015 Annual Meeting. Only holders of record of our outstanding common stock as of the close of business on March 17, 2015, are entitled to notice of and to vote at the 2015 Annual Meeting.

By Order of the Board of Directors

Michael A. Sgro
Senior Vice President, General Counsel and Secretary

[March 27, 2015]

Your vote is very important to us. Whether or not you plan to attend the Annual Meeting, we encourage you to read this proxy statement and submit your proxy or voting instructions as soon as possible. It is important that your shares of common stock be represented on the important issues presented at the meeting and we encourage you to vote in the method that best suits you. If you are unable to join us in Voorhees on May 15, 2015, you will have the ability to participate and cast your vote electronically on the Internet during the meeting at www.virtualshareholdermeeting.com/awk2015. Investors will also be able to hear a live audio-only webcast of the meeting by visiting our Investor Relations website at www.amwater.com. For specific instructions on how to vote your shares, please refer to the instructions on the Notice of Internet Availability of Proxy Materials you received in the mail (or, if you received printed proxy materials, on the enclosed proxy card), and the section entitled "Questions and Answers about the Annual Meeting and Voting" beginning on page 1 of this proxy statement.

IMPORTANT NOTICE REGARDING THE AVAILABILITY OF PROXY MATERIALS FOR THE ANNUAL MEETING TO BE HELD ON MAY 15, 2015: The proxy statement and 2014 Annual Report (which includes our annual report on Form 10-K for the year ended December 31, 2014) are available at the Investor Relations section of the Company's web site at *www.amwater.com.*

AMERICAN WATER WORKS COMPANY, INC
PROXY STATEMENT

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PRELIMINARY PROXY STATEMENT
SUBJECT TO COMPLETION DATED MARCH 17, 2015

AMERICAN WATER WORKS COMPANY, INC.
1025 Laurel Oak Road
Voorhees, New Jersey 08043

PROXY STATEMENT

QUESTIONS AND ANSWERS ABOUT THE ANNUAL MEETING AND VOTING

Our board of directors is soliciting your proxy to vote at our 2015 Annual Meeting of Stockholders and at any reconvened or rescheduled meeting following any adjournment or postponement of the Annual Meeting). This proxy statement contains important information for you to consider when deciding how to vote on the matters brought before the Annual Meeting. Please read it carefully.

In accordance with rules of the U.S. Securities and Exchange Commission, which we refer to as the "SEC," most of our stockholders are receiving a Notice of Internet Availability of Proxy Materials, which we refer to as the "Notice," rather than a printed copy of our proxy materials. Our proxy materials consist of this proxy statement, a proxy card and our annual report to stockholders, which includes our Form 10-K for the year ended December 31, 2014, and a letter from our President and CEO. We are making these materials available to our stockholders beginning on or about [March 27], 2015. In this regard, we intend to mail our definitive proxy statement to our stockholders on or about March 27, 2015. More information is provided in the following set of questions and answers, including information on how to receive by mail, free of charge, paper copies of the proxy materials.

When and where will the Annual Meeting be held?

The date, time and place of our 2015 Annual Meeting of Stockholders are set forth below:

DATE: Friday, May 15, 2015

TIME: 10:00 a.m. (Eastern Daylight Time)

PLACE: The Mansion
3000 Main Street
Voorhees, New Jersey 08043

What is the purpose of the Annual Meeting?

At the Annual Meeting, stockholders will consider and take action upon the matters outlined in the Notice of Meeting:

- Proposal 1 - election to the board of directors of the nine (9) nominees named in the proxy statement for terms expiring at the 2016 Annual Meeting of Stockholders or until their successors are duly elected and qualified;
- Proposal 2 - ratification of the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2015;
- Proposal 3 - an advisory vote to approve the compensation of our named executive officers;
- Proposal 4 - re-approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan to allow certain equity grants under the plan to continue to be deductible under Section 162(m) of the Internal Revenue Code;
- Proposal 5 - approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. Annual Incentive Plan to allow certain incentive awards under the plan to be deductible under Section 162(m) of the Internal Revenue Code;
- Proposal 6 - adoption of an amendment to our bylaws to provide that the courts located within the State of Delaware will serve as the exclusive forum for the adjudication of certain legal actions; and
- such other business, if any, as may properly be brought before the meeting or any adjournment or postponement of the meeting.

American Water's management will also report on the Company's performance during the last fiscal year and respond to questions from stockholders.

Who is entitled to vote at the Annual Meeting?

Stockholders of record who owned American Water common stock at the close of business on March 17, 2015, the record date, are entitled to vote. As of the record date, there were 179,907,031 shares of American Water common stock outstanding.

What is required to attend the Annual Meeting?

You will need an admission card and appropriate photo identification to enter the Annual Meeting. To obtain an admission card, which will be mailed to you prior to the meeting, please follow the advance registration instructions on the back inside cover of this proxy statement. If your shares are not registered in your own name, you must provide, at the entrance to the Annual Meeting, evidence of your stock ownership as of March 17, 2015. You can obtain this evidence from your bank or brokerage firm, typically in the form of your most recent monthly statement. We reserve the right to deny admittance to anyone who cannot adequately show proof of share ownership as of the record date. No cameras, recording equipment, large bags, briefcases or packages will be permitted into the 2015 Annual Meeting.

To attend the Annual Meeting on the Internet, visit www.virtualshareholdermeeting.com/awk2015. To enter the meeting and vote, you must use your 12-digit Control Number printed on your proxy card. Stockholders of record will be able to vote their shares electronically. Questions submitted online, but not answered during the meeting, will be addressed within the next business day following the meeting.

If you have a disability, we can provide reasonable assistance to help you participate in the meeting. If you plan to attend the meeting and require assistance, please contact Michael A. Sgro, Senior Vice President, General Counsel and Secretary, American Water Works Company, Inc., 1025 Laurel Oak Road, Voorhees, New Jersey, 08043, or Investor Relations by email at *aw.investorrelations@amwater.com* or by telephone at (877) 310-7174, at least one week prior to our meeting.

Will there be a public webcast of the Annual Meeting?

Yes. The Annual Meeting will be webcast, in audio-only format, live to the public via the Internet on Friday, May 15, 2015, beginning at 10:00 a.m., Eastern Daylight Time. Accessing the webcast will enable you to hear the speakers on a live basis.

The webcast may be accessed on our website at www.amwater.com. Click on "Investors Relations" at the top of the page, and follow the Annual Meeting webcast link under Upcoming Events. Minimum requirements to listen to this broadcast online are: Windows Media Player software, downloadable at *www.microsoft.com/windows/windowsmedia/download/default.asp,* and at least a 28K connection to the Internet.

To listen to the live webcast, please go to the website at least 30 minutes early to download and install any necessary software. If you plan to listen online, we suggest that you test your computer's access to Windows Media Player by visiting the above URL one week prior to the meeting date.

If you are unable to listen online during the meeting, the event will be archived on the Company's website at the same website address through June 15, 2015.

What are the board of directors' recommendations regarding the matters to be acted on at the Annual Meeting?

The board of directors recommends a vote:

- ***FOR Proposal 1 -*** the election of nine (9) director nominees named in this proxy statement for terms expiring at the 2016 Annual Meeting or until their successors are duly elected and qualified;
- ***FOR Proposal 2 -*** the ratification of the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2015;
- ***FOR Proposal 3 -*** the approval, on an advisory basis, of the compensation of our named executive officers;
- ***FOR Proposal 4 -*** the re-approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan to allow certain equity grants under the plan to continue to be deductible under Section 162(m) of the Internal Revenue Code;

- ***FOR Proposal 5 -*** the approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. Annual Incentive Plan to allow certain incentive awards under the plan to be deductible under Section 162(m) of the Internal Revenue Code; and
- ***FOR Proposal 6 –*** the adoption of an amendment to our bylaws to provide that the courts located within the State of Delaware will serve as the exclusive forum for the adjudication of certain legal actions.

What is e-proxy, and why is American Water using it?

E-proxy is the informal name for a process permitted by SEC rules. Under this process, a company can make its proxy materials available to some or all of its stockholders over the Internet, instead of mailing paper copies of the proxy materials to every stockholder. We are using e-proxy to distribute proxy materials to some of our stockholders because it will reduce our printing and mailing costs and reduce the consumption of paper and other resources.

How do I access the proxy materials on the Internet?

A Notice has been mailed to some of our stockholders. The Notice has instructions on how to access our proxy materials on the Internet.

I received the Notice, but I prefer to read my proxy materials on paper—can I get paper copies?

Yes. The Notice has instructions on how to request paper copies by telephone, e-mail or on the Internet. We will send, free of charge, printed materials by first class mail within three business days of receiving your request, either directly or through your bank or broker. If you so indicate in your request, you also will receive the materials in paper form with respect to future stockholder meetings.

I previously consented to the electronic delivery of proxy materials—will I continue to receive them via e-mail?

Yes. If you have already elected to receive proxy materials electronically, you will continue to receive them that way.

How many votes do I have?

Each outstanding share of American Water common stock is entitled to one vote. The number of shares you own is reflected on your proxy card.

Is there a difference between holding shares "of record" and holding shares in "street name"?

Yes. If your shares are registered directly in your name, you are considered to be the stockholder "of record" with respect to those shares, and either the Notice or paper copies of the proxy materials are being sent directly to you by American Water. If your shares are held in the name of a bank or broker, then you are considered to hold those shares in "street name." In that case, the Notice is being sent to you or paper copies of the proxy materials are being forwarded to you by or on behalf of your bank or broker.

How many votes must be present to hold the Annual Meeting?

A quorum of shares outstanding is necessary to hold a valid meeting. The presence at the meeting, in person or by proxy, of the holders of record of a majority of the shares entitled to vote constitutes a quorum.

How can I vote my shares?

If you are a holder of record, you may vote in person at the Annual Meeting or you may designate another person—your proxy—to vote your stock. The written document used to designate someone as your proxy also is called a proxy or proxy card. We urge you to vote your shares by proxy even if you plan to attend the Annual Meeting. You can change your vote at the meeting. If you are a stockholder of record, you can vote by proxy over the Internet or by telephone, or by submitting your proxy by mail.

If your shares are held in "street name," then you may give voting instructions in the manner provided by your bank or broker. Please note that New York Stock Exchange rules prohibit your broker from voting on proposals 1, 3, 4, 5 and 6, unless you provide voting instructions. Therefore, if you do not provide voting instructions to your bank or broker, your shares may be voted only on the proposal to ratify the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm.

If I want to vote my shares in person at the Annual Meeting, what must I do?

If you attend the Annual Meeting, hold your shares directly in your own name, and wish to vote in person rather than by proxy, we will give you a ballot when you arrive. However, if you hold your shares in street name, you must obtain a proxy from your broker or bank assigning to you the right to vote your shares. You must submit your proxy with your ballot to vote your shares in person.

If I want to vote my shares electronically during the Annual Meeting, what must I do?

If you attend the Annual Meeting online, you will need to provide your 12-Digit Control Number, located on your proxy card, which identifies you as a stockholder of record. Stockholders voting via the Internet will need to follow the instructions at www.proxyvote.com or www.virtualshareholdermeeting.com/awk2015 in order to vote. Votes submitted in person or via the Internet by a stockholder will revoke any previous votes submitted by proxy.

What are my choices when voting?

You may specify whether your shares should be voted for or against, or whether you abstain from voting with respect to each of the director nominees specified in this proxy statement for election as directors. You also may specify whether your shares should be voted for or against, or whether you abstain from voting with respect to each of the other proposals. If you sign and return a proxy card, one of the individuals named on the proxy card will vote your shares as you have directed.

What if I do not specify how I want my shares voted?

If you are a stockholder of record and return a signed proxy card, or if you give your proxy by telephone or over the Internet, but do not provide voting instructions, one of the individuals named on your proxy card will vote your shares in accordance with the board's recommendations described above. Please see the discussion below under "What vote is required to elect directors?" and "What vote is required to approve the other proposals?" for further information on the voting of shares.

How can I revoke my proxy or substitute a new proxy or change my vote?

If you are a record holder, you can revoke your proxy as follows:

For a proxy submitted by internet or telephone

- Submitting in a timely manner a later-dated proxy in person at the meeting or through the Internet or by telephone; or
- Voting in person at the Annual Meeting.

For a proxy submitted by mail

- Subsequently executing and mailing another proxy card bearing a later date; or
- Giving written notice of revocation to American Water's Secretary at 1025 Laurel Oak Road, Voorhees, NJ 08043 that is received by the Secretary prior to the Annual Meeting;
- Voting in person at the Annual Meeting; or
- Casting your vote at the Virtual Stockholder Meeting during the live meeting before the polls are closed. See "What is required to attend the Annual Meeting?" for information on voting at the Virtual Stockholder Meeting.

If your shares are held in street name, contact your bank or broker.

What vote is required to elect directors?

Directors will be elected by the vote of the majority of votes cast. For this purpose, a majority of the votes cast means that the number of shares voted for a director must exceed the number of shares voted against the director.

What vote is required to approve the other proposals?

Approval of the other proposals requires the affirmative vote of a majority of the votes cast at the meeting. Abstentions are counted as votes "against" a proposal, and broker non-votes are not counted as votes for or against the proposals. A "broker non-vote" occurs when a broker holding shares for the account of a beneficial owner is not permitted to vote on a matter because the broker has not received voting instructions from the beneficial owner. Under New York Stock Exchange rules, brokers are not permitted to vote on proposals 1, 3, 4, 5 and 6; brokers may vote on these matters only if you provide voting instructions.

Who counts the votes?

A representative from Broadridge Financial Solutions, Inc., an investor communications service, will serve as our inspector of election. In that capacity, Broadridge will tabulate the votes and certify the results.

How do I obtain the voting results?

Preliminary voting results will be announced at the Annual Meeting, and a webcast of our meeting will be archived on the Events and Presentation page which can be accessed through our Investor Relations page at www.amwater.com through June 15, 2015. Preliminary or, if then available, final voting results will be published in a Current Report on Form 8-K that we will file with the SEC within four business days after the meeting ends. If only preliminary voting results are available within four business days following the meeting date, we will file an amendment to the Form 8-K to provide final voting results within four business days following the receipt of those results. A copy of the Form 8-K and any amendment that we file will be available on the SEC Filings page of our web site after it is filed with the SEC, or can be obtained by calling Investor Relations at (877) 310-7174 and requesting a copy. To access the SEC Filings page, click on the Financial Reports link on our Investor Relations page and then click on the link that says "SEC filings."

Can American Water deliver only one set of Annual Meeting materials to multiple stockholders who share the same address?

Yes. The SEC's rules regarding the delivery to stockholders of Notices, proxy statements and annual reports permit us or an intermediary such as a broker to deliver a single copy of these documents to an address shared by two or more of our stockholders. This method of delivery is called "householding," and can significantly reduce printing and mailing costs. It also reduces the volume of mail you receive. This year, you may receive only one Notice, or if applicable, one proxy statement and Annual Report to Stockholders, addressed to multiple stockholders sharing a single address, unless you provide instructions to the contrary. If you would like to receive more than one copy of the Notice, or if applicable, the proxy statement and our Annual Report to Stockholders, or if you receive multiple copies of some or all of these materials and would prefer to receive a single copy, you should submit a request to your broker if your shares are held in a brokerage account or to Michael A. Sgro, Senior Vice President, General Counsel and Secretary, American Water Works Company, Inc., 1025 Laurel Oak Road, Voorhees, New Jersey, 08043, telephone: (856) 346-8200, if the shares are registered in your name. We will send promptly additional copies of the relevant materials following our receipt of a written or oral request for additional copies. The same phone number and address may be used to notify us that you wish to receive a separate Notice, or if applicable, annual report or proxy statement in the future, or to request delivery of a single copy of the Notice, or if applicable, annual report or proxy statement if you are receiving multiple copies.

Who will pay the costs for proxy solicitation?

The entire cost of soliciting proxies, including the costs of preparing, assembling, printing and mailing this proxy statement, the proxy card and any additional soliciting material furnished to stockholders, will be borne by us. We will pay the costs of the solicitation of proxies. We will also pay the fees of brokerage firms and other nominees of beneficial owners associated with their provision of the Notice, forwarding of proxy materials to beneficial owners and obtaining beneficial owners' voting instructions.

In addition to soliciting by e-proxy and by mail, our directors, officers and employees also may solicit by telephone, electronically (including through the Internet) or in person. We will pay for the cost of these solicitations, but these individuals will receive no additional compensation for their solicitations.

(Proposal 1)

ELECTION OF DIRECTORS

Our board currently consists of nine (9) directors. All of our current directors have been nominated for election this year to hold office until the 2016 Annual Meeting of Stockholders or until their successors are duly elected and qualified. The board of directors believes that these nominees will be able to serve as directors if elected. If a nominee is not able to serve, proxies will be voted for another person nominated by the board of directors, unless the board of directors reduces the number of directors.

Our bylaws require that in order to be elected in an uncontested election, a director nominee must receive a majority of the votes cast (for this purpose, a majority of the votes cast means that the number of shares voted "for" a director nominee must exceed the number of votes cast "against" that nominee). All of our director nominees are currently serving on the board of directors. If a nominee who is currently serving as a director is not re-elected, Delaware law provides that the director would continue to serve on the board of directors until a successor is duly elected. Under our bylaws and corporate governance guidelines, each incumbent director nominee submits, prior to an annual meeting of stockholders, a contingent resignation that the board of directors may accept if the nominated incumbent director does not receive the vote of at least the majority of the votes cast at the annual meeting of stockholders. In that situation, our nominating/corporate governance committee would make a recommendation to the board of directors on whether to accept or reject the resignation, or whether to take other action. The board of directors would act on the resignation, taking into account the nominating/corporate governance committee's recommendation, and publicly disclose its decision and the rationale behind it within 90 days from the date that the election results were certified. The nominated incumbent director who did not receive a majority of votes cast at the annual meeting of stockholders will not participate in the nominating/corporate governance committee's recommendation or in the board's decision. If a non-incumbent nominee fails to receive a majority of votes cast, the board may, in accordance with our bylaws, fill the resulting vacancy or decrease the size of the board.

Nominees for Election as Directors

Martha Clark Goss, 65, Director since 2003

Ms. Clark Goss has been a member of our board of directors since October 2003, and she served as Chair of the audit committee from December 2005 to May 2014. She currently serves on the finance and audit committees. Ms. Clark Goss has served on the board of trustees of the Neuberger Berman Mutual Funds since 2007, where she served as vice chair of the audit committee from 2010 until 2014 and the chair of the governance and nominating committee since 2014. Ms. Clark Goss served as Chief Operating Officer and Chief Financial Officer of Amwell Holdings/Hopewell Holdings LLC, a holding company and investment vehicle for investments in healthcare related companies, from 2003 until 2014. From March 2008 until October 2009 she served on the board of Parsons Brinckerhoff, Inc., where she also served as chair of the finance committee and served on the audit and governance and nominating committees. From July 2006 to March 2009, she served as the non-executive Chair of Channel Reinsurance Ltd. From February 2005 until May 2007 she served on the board of Claire's Stores Inc. where she served as chair of the compensation committee and as a member of the audit and governance and nominating committees. From July 2005 until May 2010 she served as a director of Ocwen Financial, where she served on the audit and governance and nominating committees. Previously, Ms. Clark Goss served as Chief Financial Officer of The Capital Markets Company from 1999 until 2001, the Chief Financial Officer of Booz-Allen & Hamilton from 1995 to 1999 and in various senior executive positions at Prudential Insurance Company from 1981 until 1995, including President of Prudential Power Funding Associates, the investment arm of Prudential responsible for its portfolio of assets in electric and gas utilities and alternative energy projects, and Treasurer of Prudential. She began her career at The Chase Manhattan Bank. Ms. Clark Goss received a Bachelor of Arts degree from Brown University and an MBA degree from The Harvard Business School. She served as a Trustee and Treasurer of Brown University from 1987 to 1998 and remains a Trustee Emerita, and she is currently a member of the Board of the Museum for American Finance. She is a member and Past President, director and audit committee chair of the Financial Women's Association of New York and is a member of The Committee of 200, a women's professional organization.

Ms. Clark Goss' extensive financial, investment, and governance experience provides valuable insights to both our audit committee and our board. In addition, her experience as President of an investment subsidiary of Prudential, responsible for substantial investments in electric and gas public utilities and alternative energy projects, enables her to share with the board her considerable knowledge regarding public utilities.

Julie A. Dobson, 58, Director since 2009

Ms. Dobson has been a member of our board of directors since June 2009 and the chair of our audit committee since 2014. She is also a member of our nominating/corporate governance committee. She most recently served as Chief Operating Officer and one of the founding principals of TeleCorp PCS, a wireless/mobile phone company serving more than a million customers when sold to AT&T Wireless in 2002. Prior to her tenure at TeleCorp PCS, Ms. Dobson served in a variety of leadership positions during an almost 20 year career with what has become Verizon Communications, Inc., including President of the New York Region of Bell Atlantic Mobile, vice president of Bell Atlantic Enterprises Corporation, and President and Chief Executive Officer of Bell Atlantic Business Systems International. Ms. Dobson currently serves on the board of directors of Safeguard Scientifics, Inc., where she chairs the compensation committee and serves on the nominating and governance committee, and the board of directors of RadioShack Corporation, where she chairs the management development and compensation committee. Ms. Dobson also served on the board of directors of PNM Resources, Inc. from September 2002 to May 2014, where she served most recently as lead independent director. In addition, until January 2010, Ms. Dobson served on the board of directors of LCC International, Inc., where she was non-executive Chairman of the Board and served on the audit, finance, compensation and nominating and governance committees at various times during her tenure. Ms. Dobson earned her Bachelor of Science degree from the College of William and Mary and an MBA from the University of Pittsburgh.

Ms. Dobson's executive experience with both regulated and unregulated subsidiaries of a major telecommunications company provides her with a substantive understanding of a variety of issues confronting our business, which includes both regulated and unregulated operations. Specifically, her experience includes management over several initiatives to expand deregulated lines of business, which enables her to assess similar expansion efforts relating to our market-based businesses. Her involvement in strategic planning and mergers and acquisitions at Bell Atlantic also enables her to provide insights with respect to our acquisition strategy.

Paul J. Evanson, 73, Director since 2013

Mr. Evanson has been a member of our board of directors since March 2013 and serves on our compensation and finance committees. Mr. Evanson served as Chairman, Chief Executive Officer and President of Allegheny Energy, Inc., a company engaged in the operation of three electric public utility companies and in merchant power generation operations, from 2003 until the company's merger with FirstEnergy Corp. in February 2011. Following the merger, he served as Executive Vice Chair of FirstEnergy until his retirement in May 2011. Mr. Evanson previously served as President of Florida Power & Light Company, and president of Lynch Corporation. He also held leadership positions with Moore McCormack Resources and Arthur Anderson & Co. He served as Chairman of the Board of the Florida Reliability Coordinating Council, a non-profit company whose purpose is to ensure and enhance the reliability and adequacy of bulk electricity in Florida. In addition, he served on the board of directors of Edison Electric Institute, an association of shareholder-owned electric companies, and North American Electricity Reliability Council, a group that was formed in 1968 by electric companies to promote the reliability and adequacy of power supplies. Mr. Evanson received a Bachelor of Business Administration degree from St. John's University, a Juris Doctor degree from Columbia Law School, and Master of Laws degree from New York University School of Law. He also received a Doctor of Commercial Science degree (honorary) from St. John's University, where he sits on the board of trustees. Mr. Evanson also sits on the board of trustees of the Westmoreland Museum of American Art.

Mr. Evanson's extensive executive experience in the electric industry, including his leadership of a company with both significant regulated and unregulated operations, enables him to provide important insights regarding various aspects of our business, which includes both regulated and unregulated operations. In addition, his success in addressing difficult financial conditions upon assuming leadership at Allegheny Energy underscores his ability to provide valuable perspectives with respect to strategic planning, finance and risk management matters.

Richard R. Grigg, 66, Director since 2008

Mr. Grigg has been a member of our board of directors since August 2008. Mr. Grigg is chair of our finance committee and also serves on our nominating/corporate governance committee. Mr. Grigg most recently served as Executive Vice President of FirstEnergy Corp. and President of FirstEnergy Utilities Group, a diversified energy company headquartered in Akron, Ohio, until his retirement in April 2010. The business unit he led included FirstEnergy's Energy Delivery Group, which includes seven electric utility operating companies in Ohio, Pennsylvania and New Jersey, along with Customer Service and Federal Energy Regulatory Commission Compliance. He first joined FirstEnergy in 2004 as Executive Vice President and Chief Operating Officer. Prior to joining FirstEnergy, Mr. Grigg had a 34-year career at Wisconsin Energy Corporation, a public holding company, which we refer to as WEC, retiring as President and Chief Executive Officer of its subsidiary, WE Generation. He served in a variety of management positions at other WEC subsidiaries, including Wisconsin Electric Power Company and Wisconsin Gas Company, where he was President and Chief Operating Officer. Mr.Grigg also served as a director of WEC from 1995 to 2003. Mr. Grigg is currently on the Board of Trustees of the Akron Children's Hospital and he also serves on the board of directors of Tangent Energy Solutions, Inc., which provides commercial and industrial customers with technology solutions in the energy market. Mr. Grigg is a former member of the board of directors of the Northeast Ohio Council on Higher Education, where he served as an associate member of The President's Council, Cleveland, Ohio. Mr. Grigg was President and served on the board of the Association of Edison Illuminating Companies and is a member of the American Society of Mechanical Engineers. Mr. Grigg held professional engineer licenses in Ohio and Wisconsin.

Mr. Grigg's long career as a public utility executive, including experience as a senior executive at two large public utilities, and his engineering and technical expertise, enables him to provide valuable insights to the board on regulated utility financial structures and regulatory considerations in several states, including Pennsylvania and New Jersey, where we have significant regulated operations.

Julia L. Johnson, 52, Director since 2008

Ms. Johnson has been a member of our board of directors since August 2008 and is the chair of our nominating/corporate governance committee. She also serves on our compensation committee. Ms. Johnson is president of NetCommunications, LLC, a strategy consulting firm specializing in the communications, energy, and information technology public policy arenas. Ms. Johnson served on the Florida Public Service Commission from January 1992 until November 1999, serving as chairwoman from January 1997 to January 1999. Ms. Johnson has served on the board of directors of FirstEnergy Corp. since 2011, and the board of directors of Allegheny Energy, Inc. from 2003 until its merger with FirstEnergy Corp. In addition, Ms. Johnson also serves on the board of directors of MasTec, Inc., a provider of telecommunications and energy infrastructure construction, and Northwestern Corporation, a provider of electricity and natural gas.

Ms. Johnson's service on a state public service commission with regulatory oversight over Florida's electric, telecommunications and water and wastewater industries, coupled with her current leadership of a firm specializing in regulatory analysis and legal strategy, enables her to provide a valuable perspective on regulatory and public policy matters affecting our operations.

Karl F. Kurz, 53, Director since 2015

Mr. Kurz joined our board in February 2015 and is a member of the nominating/corporate governance and finance committees. Mr. Kurz is currently a private investor in the energy industry. From September 2009 to September 2012, Mr. Kurz served as managing director, co-head of energy, and a member of the investment committee for CCMP Capital Advisors LLC, a leading global private equity firm. Prior to joining CCMP, Mr. Kurz spent nine years with Anadarko Petroleum Corporation, lastly serving as Chief Operating Officer responsible for overseeing the company's global exploration, production, marketing, midstream and technology businesses. Prior to joining Anadarko, Mr. Kurz was general manager of midstream and marketing for Vastar Resources, Inc. where he managed the company's marketing of oil, natural gas liquids, gas and gas processing. Prior to joining Vastar in 1995, Mr. Kurz held various management positions at ARCO Oil and Gas Company in reservoir engineering, production operations, and financial trading. Mr. Kurz holds a B.S. in Petroleum Engineering from Texas A&M University, graduating magna cum laude. He is also a graduate of Harvard Business School's Advanced Management Program. Mr. Kurz also serves as a director of Semgroup Corporation (a public energy midstream company) since 2009 and of WPX Energy (a public independent oil and gas company) since January 2014. Mr. Kurz also serves as the Chairman of Siluria Technologies Inc. (a private energy technology company) where he has been director since 2013.

Mr. Kurz’s long history of working in the oil and gas industry is invaluable as we continue our strategic growth in shale and pursue the potential opportunities in the national water-energy nexus discussion, smart water grid development, and water supply solutions. His experience in finance and capital markets brings additional insights for our company and board.

George MacKenzie, 66, Director since 2003

Mr. MacKenzie has been a member of our board of directors since August 2003 and Chairman of our board since May 2006. In addition to his role with American Water, Mr. MacKenzie has served on the board of directors of Safeguard Scientifics, Inc. since February 2003, where he is a member of the audit committee and nominating and corporate governance committee, and of Tractor Supply Co. since May 2007, where he also is a member of the audit committee and compensation committee. He previously served on the board of directors of C&D Technologies, Inc. from March 1999 until December 2010, Central Vermont Public Service Corp. from May 2001 to May 2006 and traffic.com from December 2005 to March 2007. He also serves on the board of directors of Weston Solutions, Inc., an environmental services company, and the Board of Trustees of the Medical Center of Delaware. Mr. MacKenzie previously served as Vice Chairman of the Board and Chief Financial Officer of Hercules Incorporated, a global manufacturer of chemical specialties, where he was employed from 1979 to 2001. During his 22-year career with Hercules, he served in a variety of senior management roles including President of the Chemical Specialty Division. From September 2001 to June 2002, Mr. MacKenzie was Executive Vice President and Chief Financial Officer of P.H. Glatfelter Company, a specialty paper manufacturer.

Mr. MacKenzie’s extensive service on public company boards of directors enables him to provide valuable insights into our corporate governance. Moreover, his lengthy experience in operational and financial management enables him to provide useful insights on executive management considerations. His financial executive experience, coupled with his public accounting background, gives him an intimate knowledge of financial matters.

William J. Marrazzo, 65, Director since 2003

Mr. Marrazzo has been a member of our board of directors since October 2003. Mr. Marrazzo is the chair of our compensation committee and also serves on our audit committee. He has been the Chief Executive Officer and President of WHYY, Inc., a public television and radio company, since 1997. He served as Water Commissioner for the Philadelphia Water Department from 1971 to 1988 and Managing Director for the City of Philadelphia from 1983 to 1984. From 1988 to 1997, Mr. Marrazzo served as Chief Executive Officer of Roy F. Weston, Inc., an environmental and redevelopment firm that was a public company during his tenure. Mr. Marrazzo has been a member of the board of directors of Amerigas Partners, L.P. since April 2000, and currently serves as its chair of the audit committee and is a member of its compensation committee.

Mr. Marrazzo's distinguished public service career, including his responsibilities as Water Commissioner for the Philadelphia Water Department, one of the nation's largest, which serves the Greater Philadelphia region by providing integrated water, wastewater and stormwater services, coupled with his executive experience at an environmental firm, enables him to assist the board in addressing water system, environmental and sustainability issues, as well as regulatory and public policy matters. Mr. Marrazzo's experience as an executive of a public television and radio company enables him to assist the board in assessing our marketing and communications strategies. Moreover, his executive experience in both the public and private sector enables him to contribute meaningfully to board consideration of a variety of operational and financial matters.

Susan N. Story, 55, Director since 2014

Ms. Story has been our Chief Executive Officer since May 2014 and previously was our Senior Vice President and Chief Financial Officer since April 2013. Previously, she was employed for over 30 years by Southern Company, which owns and operates electric utilities in four states, and also is engaged in electric wholesale generation and telecommunications, including both wireless and wireline, fiber optic communications. Ms. Story was an executive officer of Southern Company from 2003 until she joined the Company. In addition, from January 2011 until she joined the Company, she served as the President and Chief Executive Officer of Southern Company Services, which provides shared services for all of Southern Company's subsidiaries, including information technology and cyber security efforts, human resources, procurement and supply chain management, marketing services, customer research and system transportation functions. From 2003 to December 2010, she was the President and Chief Executive Officer of Gulf Power Company, an electric utility serving the northwestern portion of Florida. Ms. Story is an independent board member of Raymond James Financial, Inc., a financial services firm, and serves on the boards of the Bipartisan Policy Center in Washington, DC and the Moffitt Cancer Center in Tampa, FL.

Ms. Story's intimate knowledge regarding our operations, by virtue of her service as our Senior Vice President and Chief Financial Officer, enables her to provide valuable insights regarding our operations, as well as finance, administration and personnel matters. In addition, her long career at Southern Company, including her leadership role at Gulf Power Company, enables her to provide important insights on regulated utility operations, and her leadership experience at Southern Company Services enables her to provide meaningful insights on a variety of key areas pertaining to our operations, including information technology and human resources.

CORPORATE GOVERNANCE

Corporate Governance Guidelines and Other Corporate Governance Documents

Our corporate governance guidelines, including guidelines relating to director qualification standards, director responsibilities, the committees of the board, director access to management, employees and independent advisors, director compensation and other matters relating to our corporate governance, are available on the Corporate Governance page of our website, which can be accessed by clicking on the Investor Relations link on our homepage, www.amwater.com. Also available on the Corporate Governance page are other corporate governance documents, including our Code of Ethics and the charters of the compensation committee, audit committee, finance committee and nominating/corporate governance committee.

You may also request a copy of these documents in printed form at no cost by writing to Michael A. Sgro, Senior Vice President, General Counsel and Secretary, American Water Works Company, Inc., 1025 Laurel Oak Road, Voorhees, New Jersey 08043, or by telephoning us at (856) 346-8200.

Our website is not part of this proxy statement; references to our website address in this proxy statement are intended to be inactive textual references only.

Determination of Independence of Directors

The board of directors is, among other things, responsible for determining whether each of the directors is "independent" within the meaning of New York Stock Exchange, which we refer to as the "NYSE," listing standards. In addition, the board of directors has adopted the following categorical standards to assist it in making independence determinations. Under these standards a director is not independent if:

- the director is, or has been within the last three years, an employee of American Water, or an immediate family member of the director is, or has been within the last three years, an executive officer of American Water (employment as an interim CEO or other officer will not disqualify a director from being considered independent following that employment);
- the director or an immediate family member of the director is a current partner of a firm that is our internal or external auditor; the director is a current employee of the firm; an immediate family member of the director is a current employee of the firm and personally works on our audit; or the director or an immediate family member of the director is a former partner or employee of such a firm and personally worked on our audit within the last three years;
- the director or an immediate family member of the director is, or has been within the last three years, employed as an executive officer of another company where any of our present executive officers at the same time serves or served on that company's compensation committee;
- the director or an immediate family member of the director received, during any 12 month period within the last three years, more than $120,000 in direct compensation from us, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service). (Compensation received by a director for former service as an interim CEO or other executive officer need not be considered in determining independence under this test. Compensation received by an immediate family member for service as an employee of us (other than as an executive officer) need not be considered in determining independence under this standard);
- the director is a current employee or holder of more than 10 percent of the equity of another company, or an immediate family member of the director is a current executive officer or holder of more than 10 percent of the equity of another company, that has made payments to, or received payments from, us in any of the last three fiscal years of the other company, that exceeds the greater of $1 million or two percent of such other company's consolidated gross revenues; or
- the director is a current executive officer of a charitable organization to which we have made charitable contributions in any of the charitable organization's last three fiscal years that exceed the greater of $1 million or two percent of that charitable organization's consolidated gross revenues.

For purposes of the categorical standards set forth above, (a) a person's immediate family includes a person's spouse, parents, children, siblings, mother- and father-in-law, sons- and daughters-in-law, and brothers- and sisters-in-law and anyone (other than domestic employees) who shares such person's home, and (b) the term "executive officer" has the same meaning as specified for the term "officer" in regulations under Section 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

The Company's board of directors has affirmatively determined that each of Martha Clark Goss, Julie A. Dobson, Paul J. Evanson, Richard R. Grigg, Julia L. Johnson, Karl F. Kurz, George MacKenzie and William J. Marrazzo is independent.

Executive Sessions of Independent Directors

The board meets at regularly scheduled executive sessions without members of management present. Mr. MacKenzie, our board chairman, presides over these sessions.

Board Leadership Structure

Our corporate governance guidelines currently provide that the chairman of the board is to be an independent director. We believe that the oversight function of the board of directors is enhanced when an independent director, serving as chairman, is in a position to set the agenda for, and preside over, meetings of our board. We also believe that our leadership structure enhances the active participation of our independent directors.

Board Role in Risk Oversight

The board administers its risk oversight function principally through our finance committee and also through our audit committee and compensation committee. The finance committee oversees our enterprise risk management process. To gain an understanding of the magnitude of risks and to consider approval of risk management policies, the finance committee receives quarterly reports from management regarding our major financial and operational risk exposures and management's activities to monitor and mitigate these exposures. In addition, our audit committee routinely discusses our policies with respect to risk assessment and risk management. To assist the audit committee in addressing these matters, the finance committee reports to the audit committee at least annually regarding finance committee activities relating to enterprise risk management. In this regard, the chairman of the finance committee meets annually with management and the audit committee. The compensation committee also considers risk in the context of our incentive compensation programs and practices.

The board regularly receives reports with regard to the board committee risk assessments described above.

Board Role in Succession Planning

The board of directors believes that one of its primary responsibilities is planning for the succession of our CEO and other members of executive management.

Our corporate governance guidelines contemplate a collaborative effort between the board and CEO in connection with succession planning for our CEO and other executive officers. Specifically, the corporate governance guidelines provide that the CEO annually submits a succession plan for the CEO and other executive officers to the board for its review. The board retains full responsibility for CEO selection. The succession plan covers identification and assessment of internal candidates, development plans for internal candidates and, as appropriate, identification of external candidates.

The goal of our succession planning process is to identify executive talent at the Company and provide for continuity of effective leadership that can fulfill the long-term requirements of our business. Our corporate governance guidelines also call for the CEO to submit to the board annually an emergency succession plan if an unforeseen event prevents the CEO from continuing to serve.

Although the corporate governance guidelines contemplate an annual review and assessment process, consideration of management succession planning occurs throughout the year and involves regular interaction between and among the board, the CEO and management.

Code of Ethics

We have a Code of Ethics applicable to our directors, officers and employees. Among other things, the Code of Ethics is designed to deter wrongdoing and to promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; to promote full, fair, accurate, timely and understandable disclosures in periodic reports we are required to file; and to promote compliance with applicable governmental laws, rules and regulations. The Code of Ethics provides for the prompt internal reporting of violations of the Code to an appropriate person identified in the Code and contains provisions regarding accountability for adherence to the Code. The Code of Ethics is available at the web site address listed above, or can be requested, free of charge, by writing to the Office of the Secretary, American Water Works Company, Inc., 1025 Laurel Oak Road, Voorhees, New Jersey 08043. We intend to satisfy the disclosure requirements regarding any amendment to, or waiver from, a provision of the Code of Ethics by making disclosures concerning such matters available on the Investor Relations page of our website.

Assessment of Board and Committee Performance

The board conducts annual assessments regarding the performance of the board of directors and board committees.

Stockholder Communications to the Board

Stockholders may communicate directly with the board of directors or individual members of the board of directors including those wishing to express concerns relating to accounting, internal controls, audit matters, fraud or unethical behavior, by submitting written correspondence to American Water Works Company, Inc. Board of Directors, 1025 Laurel Oak Road, Voorhees, New Jersey 08043 or via email: *contacttheboard@amwater.com.* The Corporate Secretary reviews and provides summaries and/or copies of the communications to the Board and relevant committees. All communications are treated confidentially.

Our "whistleblower" policy prohibits American Water or any of its employees from retaliating or taking any adverse action against anyone for raising a concern in good faith. If an interested party nonetheless prefers to raise his or her concern to the board in a confidential or anonymous manner, the concern may be directed to our confidential ethics hotline at (877) 207-4888. Such matters raised on the hotline are investigated by the Ethics and Compliance Department and reviewed by the chair of the audit committee.

Board and Board Committee Meetings

During 2014, our board of directors held eleven meetings. In addition, there were five audit committee meetings, ten compensation committee meetings, nine nominating/corporate governance committee meetings and four finance committee meetings. Some of these meetings were conducted by telephone conference. All of the incumbent directors attended at least 75 percent of the total number of meetings of the board and board committees of which the director was a member during 2014. Although we do not have a formal policy regarding board member attendance at the annual meeting, we do encourage their attendance, and all of the directors attended last year's annual meeting.

Committees of the Board of Directors

Our board of directors conducts its business through four standing committees: the audit committee, the compensation committee, the finance committee and the nominating/corporate governance committee. In addition, from time to time, special committees may be established under the direction of our board of directors. All of the current committees of the board are comprised of directors who have been determined by our board of directors to be independent under currently applicable listing standards of the NYSE, and in the case of members of the audit and compensation committees, to have satisfied additional independence requirements applicable to audit and compensation committee members. Each of the board's four standing committees operates in accordance with the terms of a written charter, and each committee has the authority to retain outside advisors, including legal counsel or other experts, as it deems appropriate in its sole discretion and to approve the fees and expenses associated with such advisors. These committee charters are available on our website at http://ir.amwater.com under "Corporate Governance > Governance Documents" and are also available in print upon request.

The table below provides membership information for each board committee:

Director	Audit	Compensation	Nominating/ Corporate Governance	Finance
George MacKenzie**♦	♦	♦	♦	♦
Martha Clark Goss*	P			P
Julie A. Dobson*	Chair		P	
Paul J. Evanson**		P		P
Richard R. Grigg			P	Chair
Julia L. Johnson		P	Chair	
Karl F. Kurz			P	P
William J. Marrazzo*	P	Chair		

* Audit Committee Financial Expert
** Financial Expert
¿ Ex-Officio Member

Audit Committee

Our audit committee consists of Mses. Dobson (Chair), Clark Goss and Mr. Marrazzo. Our board of directors has determined that each member of the audit committee is an "audit committee financial expert," within the meaning of SEC regulations. The audit committee operates under a written charter, which is available at the website address provided above. The audit committee has responsibility for, among other things:

- appointing the independent registered public accounting firm to audit the consolidated financial statements of American Water and its subsidiaries;
- reviewing and discussing with management and the independent auditors the results of the audit of the consolidated financial statements;
- reviewing any significant deficiency or material weakness in the design or operation of internal accounting controls identified by the independent auditors and overseeing any remediation plans;
- reviewing all alternative accounting treatments of financial information within generally accepted accounting principles that have been discussed with management;
- reviewing and discussing SEC filings with management and, to the extent that such filings contain financial information, with the independent auditors;
- discussing earnings press releases, as well as financial information and earnings guidance, if any, provided to analysts and ratings agencies;
- at least annually, discussing with the chair of the finance committee and management, our policies with respect to risk assessment and risk management, our major financial risk exposures and the steps management has taken to monitor and control these exposures;
- overseeing management's ethics and compliance program and reviewing reports from our chief ethics and compliance officer;
- overseeing the internal audit function and reviewing the reports of any internal auditor with respect to any financial safeguarding problem that has not resulted in corrective action or otherwise been resolved to the internal auditors' satisfaction; and
- reviewing with the General Counsel any legal matter that could have a significant impact on our financial statements.

Compensation Committee

Our compensation committee consists of Messrs. Marrazzo (Chair) and Evanson and Ms. Johnson. The compensation committee operates under a written charter, which is available at the website address provided above. The compensation committee has responsibility for, among other things:

- establishing and reviewing our overall compensation philosophy;
- reviewing and recommending to the board of directors the corporate goals and objectives relevant to the CEO's compensation, the CEO's performance in light of the goals and objectives approved by the board of directors and the compensation for our CEO, including annual base salary and annual and long-term performance-based compensation opportunities;
- approving, after receiving the CEO's recommendations and consulting with the CEO, the annual base salary and annual and long-term performance-based opportunities for our other executive officers, and the actual awards of performance-based compensation for our other executive officers;
- annually reviewing other benefit plans and perquisites;
- annually reviewing and recommending to the board of directors the form and amount of director and chairman compensation;
- reviewing and making recommendations to our board of directors, or approving, all awards of stock or stock options pursuant to our equity-based plans; and
- at least annually, reviewing and making recommendations to the board of directors regarding the compensation related risk assessment of our compensation policies and practices.

In addition, the compensation committee annually reviews our short- and long-term incentive plans to determine the appropriate mix of fixed and at-risk components.

The compensation committee adopted a policy under which it will use only compensation consultants that are independent of American Water. A compensation consultant is deemed independent under the policy if the compensation consultant:

- is retained by the compensation committee, and reports solely to the compensation committee in connection with the compensation committee's discharge of its duties and responsibilities; and
- does not provide any other services or products to American Water or its management.

The compensation committee performs an annual assessment of its compensation consultant's independence.

The compensation committee has retained Hay Group as its independent compensation consultant, referred to below as "Hay Group", to assist the compensation committee with respect to executive and director compensation and, to a lesser extent, enterprise compensation matters in general. Hay Group did not provide any other services to us or our management.

Nominating/Corporate Governance Committee

Our nominating/corporate governance committee consists of Mses. Johnson (Chair) and Dobson and Messrs. Grigg and Kurz. The nominating/corporate governance committee operates under a written charter, which is available at the website address provided above. The nominating/corporate governance committee has responsibility for, among other things:

- establishing criteria for the selection of new directors to serve on our board of directors;
- identifying qualified candidates to serve on our board of directors and recommending their election to our board of directors;
- making recommendations to our board of directors as to whether members of our board of directors should stand for re-election;
- developing and recommending to our board of directors our corporate governance guidelines, assessing those guidelines annually and making recommendations to our board of directors in light of such assessments as may be appropriate; and
- reviewing the composition of each committee of the board of directors and recommending appropriate changes to the committees.

We believe that the backgrounds and qualifications of our directors, considered as a group, should provide a significant composite mix of experience, knowledge and abilities that will enable the board of directors to fulfill its responsibilities. Therefore, the nominating/corporate governance committee considers diversity in identifying nominees for directors. In this regard, the nominating committee views diversity in a broad sense, including on the basis of business experience, public service experience, gender and ethnicity. In addition, our corporate governance guidelines provide that members of the board must be persons of good character and thus must possess all of the following personal characteristics:

- Integrity: Directors must demonstrate high ethical standards and integrity in their personal and professional dealings.
- Accountability: Directors must be willing to be accountable for their decisions as directors.
- Judgment: Directors must possess the ability to provide wise and thoughtful counsel on a broad range of issues.
- Responsibility: Directors must interact with each other in a manner which encourages responsible, open, challenging and informed discussion.
- High Performance Standards: Directors must have a history of achievement which reflects high standards for themselves and others.
- Commitment and Enthusiasm: Directors must be committed to, and enthusiastic about, their performance for American Water as directors, both in absolute terms and relative to their peers.
- Courage: Directors must possess the courage to express views openly, even in the face of opposition.

Our corporate governance guidelines also state that the board of directors should strive to have members with knowledge, experience and skills in the following core competencies: accounting and finance, business judgment, management, crisis response, industry knowledge, utility regulation, leadership and strategy/vision. In this regard, in evaluating a candidate's experience and skills, the nominating/corporate governance committee will consider qualities such as an understanding of the water industry, utilities, marketing, finance, customer service, utility and environmental regulation and public policy issues. The nominating/corporate governance committee does not assign specific weights to particular criteria and no particular criterion is necessarily applicable to all prospective nominees.

In addition, the board is committed to being comprised of directors that add tangible value to our company with a diversity of ideas, approaches and experiences and the interpersonal capacity to foster effective communication within, and operation of, the board and with management. Annually, the nominating/corporate governance committee reviews the profile, engagement and performance of each director to determine whether he or she should be renominated for board service. The nominating/corporate governance committee also considers whether, in light of our strategy or trends in our market environment, new skill sets or experience would benefit our company and our stockholders. The board believes in balancing the value that longevity of director service can bring to our company with the value of new ideas and insights that can come through new members.

The process followed by the nominating/corporate governance committee to identify and evaluate candidates includes requests to members of the board of directors and others for recommendations, meetings from time to time to evaluate biographical information and background material relating to potential candidates, and interviews of selected candidates by members of the nominating/corporate governance committee and other members of the board of directors. The nominating/corporate governance committee may engage a third party to assist in the search for director candidates or to assist in gathering information regarding a director candidate's background and experience. If the nominating/corporate governance committee engages a third party, the nominating/corporate governance committee approves the fee that American Water pays for these services.

The nominating/corporate governance committee also will consider qualified director candidate recommendations by stockholders. A stockholder's recommendation should be sent to: Office of the Secretary, American Water Works Company, Inc., 1025 Laurel Oak Road, Voorhees, NJ 08043. The recommendation must include the following information:

- the name, age, business address and residence address of the candidate;
- a resume describing the candidate's qualifications;
- other information about the candidate that would be required to be included in a proxy statement under the rules of the SEC;
- a description of all arrangements or understandings relating to the nomination between or among the stockholder, the candidate and any other person or persons;
- the signed consent of the candidate to serve as a director if elected;
- the name and address of the stockholder who is submitting the recommendation; and
- evidence of the number of shares of American Water's common stock that the recommending stockholder owns and the length of time the shares have been owned.

The nominating/corporate governance committee may seek additional information regarding the candidate. The committee will consider all potential candidates in the same manner regardless of the source of the recommendation.

Finance Committee

Our finance committee consists of Messrs. Grigg (Chair), Evanson and Kurz and Ms. Clark Goss. The finance committee operates under a written charter, which is available at the website address provided above. The finance committee is responsible for, among other things, monitoring, reviewing and evaluating:

- our financial forecasts, financial condition and our anticipated financing requirements;
- our capital structure and proposed short-and long-term changes in our capital structure, including changes resulting from new issuances, purchases or redemptions of debt and equity securities;
- our capital expenditure plan and strategies;
- our dividend payment policy and any proposed changes;

- the investment performance of the assets held under our employee benefits plans, and the investment guidelines of the Retirement and Benefits Plan Committee;
- our plans and strategies relating to the divestiture or disposition of assets;
- our cash management plans and strategies; and
- our growth opportunities, including acquisitions and business development proposals.

In addition, the finance committee oversees our enterprise risk management process and our insurance risk management policies and programs and approves our debt issuances within limits authorized by the board in our business plan.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

Messrs. Marrazzo and Evanson and Mses. Dobson and Johnson served as members of the Compensation Committee during fiscal year 2014. None of these individuals was an officer or employee of us or any of our subsidiaries during fiscal year 2014 or any prior fiscal year. None of these individuals had any relationship with us or any of our subsidiaries during 2014 pursuant to which disclosure would be required under applicable rules of the SEC pertaining to the disclosure of transactions with related persons. None of our executive officers served on the board of directors or compensation committee of any other entity that has or had one or more executive officers who served as a member of our board of directors or compensation committee during fiscal year 2014.

DIRECTOR COMPENSATION

In 2014, our non-employee directors received compensation for their services as described below:

Annual Retainer Fees (payable in quarterly installments):		
• Chairman of the Board	$	130,000
• Chairs of the Audit Committee and the Compensation Committee	$	95,000
• Chairs of the Nominating/Corporate Governance Committee and the Finance Committee	$	85,000
• Other non-employee directors	$	75,000

Meeting Fees:

- No separate fee for attendance at board of directors' or committee meetings; however, members of the special demand review committee (Messrs. MacKenzie, Evanson and Ms. Dobson) received a $15,000 special payment for serving on that committee.

The non-employee directors are reimbursed for expenses incurred in attending board and committee meetings.

In addition, each non-employee director and the Chairman of the Board receives annual equity compensation of $85,000 and $140,000, respectively in stock units. The actual number of stock units granted is based on the closing price of our common stock on the date of grant, as reported on the NYSE Composite Tape. The stock units vest on the date of grant and the shares underlying the stock units typically are distributed to the directors 15 months after the date of grant.

We have a stock retention policy for directors under which each director is required to hold shares equaling five times the director's annual cash retainer by the fifth anniversary of the commencement of service as a director.

The Company has a Nonqualified Deferred Compensation Plan for Non-Employee Directors under which directors may defer up to 100 percent of their annual retainer on a tax-deferred basis. Directors may elect to receive their deferrals upon (i) separation from service or (ii) a specified distribution date, if earlier, a change in control, and may elect to receive their deferrals in the form of a lump sum or annual installments paid over a period of between two and 10 years. Amounts will be paid earlier upon the death of a director. Directors are immediately vested in their contributions to the plan. Accounts of directors are credited with returns in accordance with the deemed investment options elected by the director.

The following table provides information regarding compensation for our non-employee directors. The table does not include amounts paid for reimbursement of travel expenses related to attending board and board committee meetings, and does not include compensation paid to Susan N. Story, our President and Chief Executive Officer or Jeffry E. Sterba, our former President and Chief Executive Officer. It also does not include compensation paid to Karl F. Kurz, as Mr. Kurz did not serve as a director during 2014. See “Executive Compensation” for information relating to Ms. Story’s and Mr. Sterba’s compensation.

2014 Director Compensation

Name	Fees Earned or Paid in Cash ($)		Stock Unit Awards ($)(3)	Total ($)
Stephen P. Adik*	$ 26,786		$ —	$ 26,786
Julie A. Dobson	$ 102,912	(1)	$ 101,068	$ 203,980
Paul J. Evanson	$ 90,000	(1)	$ 101,068	$ 191,068
Martha Clark Goss	$ 82,088		$ 101,068	$ 183,156
Richard R. Grigg	$ 85,000		$ 101,068	$ 186,068
Julia L. Johnson	$ 85,000	(2)	$ 101,068	$ 186,068
George MacKenzie	$ 145,000	(1)	$ 166,450	$ 311,450
William J. Marrazzo	$ 95,000	(2)	$ 101,068	$ 196,068

* Mr. Adik did not stand for re-election as a director in May 2014 and received no stock award in 2014.

(1) Includes $15,000 special payment for service on the Demand Review Committee.

(2) Ms. Johnson and Mr. Marrazzo elected to defer all of this amount under our Nonqualified Deferred Compensation Plan for Non-Employee Directors.

(3) The amounts shown in this column reflect the grant date fair value of the stock units granted to the directors as part of their annual retainer. The grant date fair value was computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, “Compensation-Stock Compensation”, which we refer to as “FASB ASC Topic 718”. See Note 8-Stockholders’ Equity in the notes to American Water’s audited consolidated financial statements included in American Water’s Annual Report on Form 10-K for the year ended December 31, 2014 for the assumptions used in determining grant date fair value.

The following table shows the aggregate number of stock options and stock units held by each non-employee director as of December 31, 2014:

Name	Stock Options (#)	Stock Units (#)
Ms. Dobson	—	1,837
Mr. Evanson	—	1,837
Ms. Goss	—	1,837
Mr. Grigg	—	1,837
Ms. Johnson	—	1,837
Mr. MacKenzie	—	3,026
Mr. Marrazzo	—	1,837

We did not grant stock options to non-employee directors in 2014 and none of the non-employee directors held any stock options as of December 31, 2014.

SECURITY OWNERSHIP OF MANAGEMENT

The following table shows the shares of our common stock beneficially owned, as of March 17, 2015, by our directors and executive officers. Except as noted, all such persons possess sole voting and dispositive powers with respect to the shares listed. Under applicable SEC rules, the definition of beneficial ownership for purposes of this table includes shares over which a person has sole or shared voting or investment power, and stock options that are vested and exercisable or that will become vested and/or exercisable within 60 days of March 17, 2015. An asterisk in the column listing the percentage of shares outstanding indicates that the person owns less than 1% of the common stock outstanding.

Name	Number of Shares (1)	Exercisable Options (2)	Total	% of Shares Outstanding (3)	Other Stock-Based Items (4)	Total Stock-Based Ownership
Directors						
Martha Clark Goss	18,724	—	18,724	*	1,837	20,561
Julie A. Dobson	11,367	—	11,367	*	4,218	15,585
Paul J. Evanson	13,835	—	13,835	*	1,837	15,672
Richard R. Grigg	14,907	—	14,907	*	1,837	16,744
Julia L. Johnson	14,805	—	14,805	*	6,661	21,466
Karl F. Kurz	—	—	-	*	364	364
George MacKenzie	22,490	—	22,490	*	3,026	25,516
William J. Marrazzo	12,675	—	12,675	*	5,251	17,926
Named Executive Officers				*		
Susan N. Story	32,099	33,940	66,039	*	—	66,039
Jeffry E. Sterba	-	495,000	495,000	*	—	495,000
Linda G. Sullivan	1,119	7,260	8,379	*	—	8,379
Walter J. Lynch	65,543	180,803	246,346	*	—	246,346
Kellye L. Walker	27,850	—	27,850	*	—	27,850
Loyd A. Warnock	292	4,091	4,383	*	—	4,383
All Directors and Named Executive Officers	235,706	721,094	956,800		25,031	981,831
All Directors and Executive Officers as a Group (25 Persons)	360,938	437,748	798,686	*	25,031	823,717

(1) Represents the number of outstanding shares beneficially owned.

(2) Represents shares which may be acquired through the exercise of stock options within 60 days of March 17, 2015.

(3) Based on 179,907,031 shares outstanding on March 17, 2015.

(4) Includes a notional interest in shares of our common stock held in the form of stock units or deferred stock units. While the notional interest in shares of our common stock may not be voted or transferred, the shares subject to the notional interest have been included in the table above as they represent an economic interest in our common stock that is subject to the same market risk as ownership of actual shares of our common stock.

SECURITY OWNERSHIP OF CERTAIN STOCKHOLDERS

The table below indicates the persons or entities known to us to be the beneficial holders of more than 5% of our common stock, as of March 17, 2015.

Name and Address of Beneficial Owner	Number of Shares Beneficially Owned	% of Shares Outstanding
BlackRock, Inc. (1) 55 East 52nd Street New York, NY 10022	18,055,325	10.04%
The Vanguard Group (2) 100 Vanguard Boulevard Malvern, PA 19355	11,396,129	6.33%

(1) BlackRock, Inc. ("BlackRock") is the beneficial owner of the 18,055,325 shares listed in the table. BlackRock Inc. is a holding company of subsidiaries that hold the shares, including BlackRock Japan Co. Ltd, BlackRock Advisors (UK) Limited, BlackRock Institutional Trust Company N.A., BlackRock Fund Advisors, BlackRock Asset Management Canada Limited, BlackRock Advisors LLC, BlackRock Capital Management, BlackRock Financial Management, Inc., BlackRock Investment Management, LLC, BlackRock Investment Management (Australia), Limited, BlackRock (Luxembourg) S.A., BlackRock (Netherlands) B.V., BlackRock Asset Management North Asia Limited, BlackRock Asset Management Ireland Limited, BlackRock Investment Management (UK) Limited, BlackRock International Limited, BlackRock Fund Management Ireland Limited, BlackRock Fund Managers Ltd, and BlackRock Life Limited. BlackRock Inc. holds sole voting power with respect to 16,196,150 shares and sole dispositive power with respect to all of the shares listed in the table. The information in this footnote is derived from an amendment to Schedule 13G, filed by BlackRock with the SEC on January 9, 2015. The information is as of December 31, 2014, and the number of shares beneficially owned by BlackRock may have changed subsequently.

(2) The Vanguard Group ("Vanguard"), an investment management company, is the beneficial owner of the 11,396,129 shares of the Company's common stock listed in the table. Vanguard holds sole power to vote or direct to vote 190,361 shares, sole power to dispose of or to direct the disposition of 11,236,432 shares, and shared power to dispose or to direct disposition of 159,697 shares. The information in this footnote is derived from an amendment to Schedule 13G, filed by Vanguard with the SEC on February 11, 2015. The information is as of December 31, 2014, and the number of shares beneficially owned by Vanguard may have changed subsequently.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company's directors and executive officers and persons who own more than 10% of our common stock to file with the SEC an initial report of beneficial ownership and subsequent reports of changes in beneficial ownership resulting from transactions in our common stock, generally within two business days of a reportable transaction. As a practical matter, we seek to assist our directors and executives by monitoring transactions and completing and filing these reports on their behalf. To our knowledge, based on our review of these reports, we believe that the applicable Section 16(a) reporting requirements were complied with for all transactions that occurred during the fiscal year ended December 31, 2014, except that, due to administrative error, one Form 4 filing was made late on behalf of each of Messrs. John Bigelow, Mark Chesla, Walter Lynch, William Rogers, Nick Rowe, Mark Smith, Jeffry E. Sterba, Mark Strauss and William Varley and Mses. Sharon Cameron, Maureen Duffy, Kathy Pape, Susan N. Story and Kellye Walker, reporting shares withheld to cover taxes that occurred on January 1, 2014, and an additional Form 4 filing was made late on behalf of Ms. Walker, reporting an open market sale of shares that occurred on November 13, 2014.

COMPENSATION DISCUSSION AND ANALYSIS

In this Compensation Discussion and Analysis, we address our compensation philosophy and programs, the decisions of our compensation committee with respect to these programs and the reasons for those decisions, principally with respect to our named executive officers or "NEOs," who are:

- Susan N. Story, President and Chief Executive Officer
- Jeffry E. Sterba, our former President and Chief Executive Officer. In accordance with a succession plan approved by our Board of Directors, Mr. Sterba was succeeded by Ms. Story on May 9, 2014.
- Linda G. Sullivan, Senior Vice President and Chief Financial Officer
- Walter J. Lynch, President and Chief Operating Officer, Regulated Operations
- Kellye L. Walker, our former Senior Vice President, General Counsel and Secretary

- Loyd A. Warnock, Senior Vice President of External Affairs, Communications and Public Policy

EXECUTIVE SUMMARY

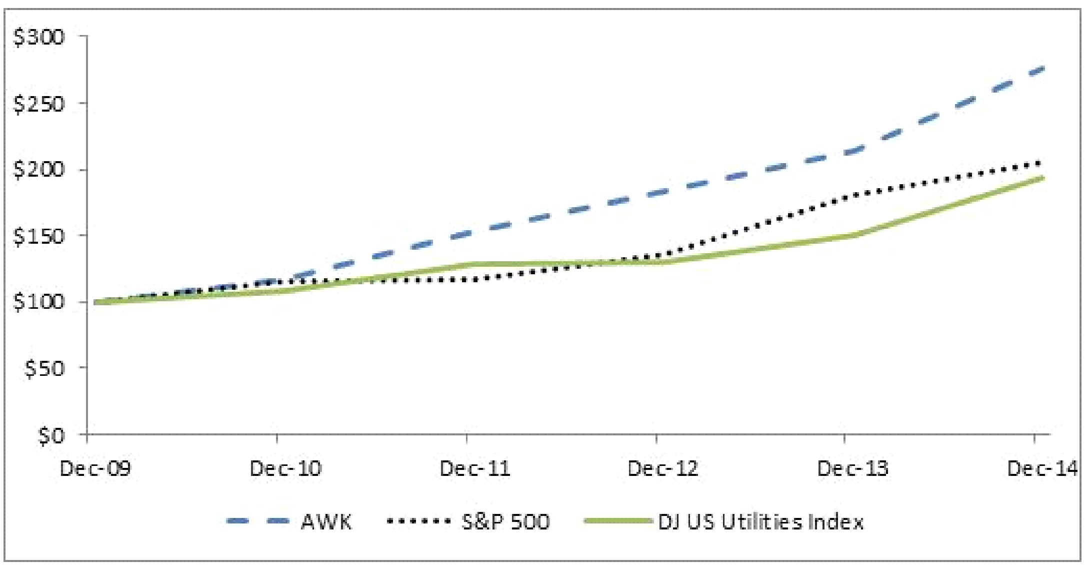
Operating Performance

Our 2014 performance demonstrates continued execution of our strategic goals. By focusing on delivering outstanding customer service, effectively managing costs, investing capital where needed, maintaining strong regulatory relationships and growing strategically, we continue to create value for our stockholders. Operating highlights for 2014 include the following:

- Total stockholder return (market price plus dividends) increased 29.4 percent over 2013 compared to an increase of 28.1 percent for the Dow Jones U.S. Utilities Total Return Index.
- Adjusted net income from continuing operations, excluding the charge related to the Freedom Industries chemical spill in West Virginia, increased by ten percent over 2013 (A non-GAAP measure. See the reconciliation table in Appendix A).
- Our Regulated Businesses showed continued improvement in their O&M efficiency ratio. (A non-GAAP measure. See the reconciliation table in Appendix A). For the 12 months ended December 31, 2014, the O&M efficiency ratio was 36.7 percent, compared to 38.5 percent for the same 12-month period in 2013.
- Our Regulated Businesses completed 12 regulated acquisitions in 2014, representing 4,500 additional new customers, and we have 12 pending acquisitions representing about 21,000 additional new customers.
- In our market-based businesses, our Military Services group won two competitively bid contracts with the U.S. Department of Defense, and our Homeowner Services group expanded into eight new states and received a notice of intent to be awarded an exclusive service line protection agreement with the city of Orlando.

Return to Stockholders

We have returned significant value to stockholders over the past five years. The following chart shows how a $100 investment in our common stock on December 31, 2009 would have grown to $276.32 on December 31, 2014, assuming dividend reinvestment. As shown in the chart, this return compares favorably to the return that would have been obtained through the same investment in the Standard & Poor's 500 Index and the Dow Jones U.S. Utilities Total Return Index, assuming dividend reinvestment, during the same period:

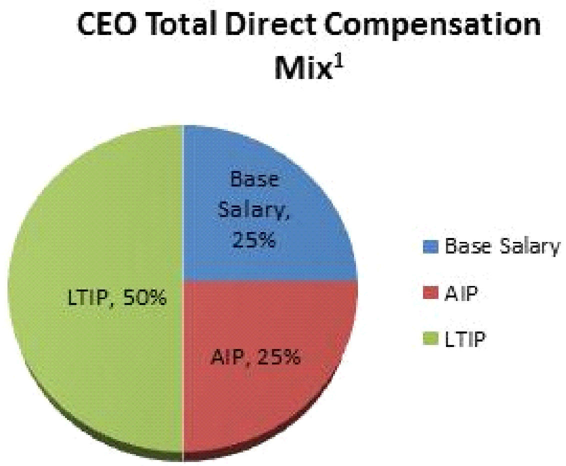


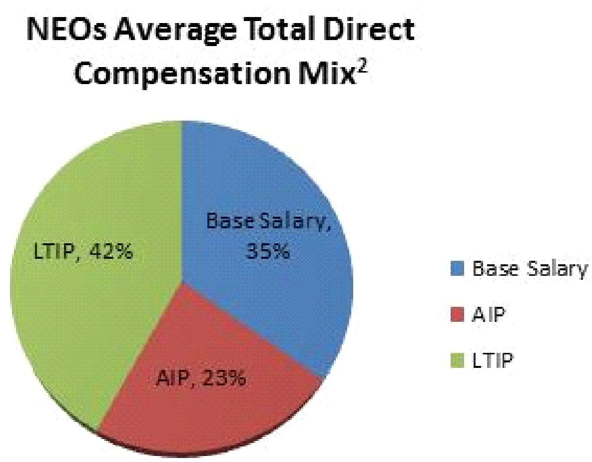
	12/31/09	12/31/10	12/30/11	12/31/12	12/31/13	12/31/14
American Water	$100.00	$117.25	$152.47	$183.88	$213.52	$276.32
S&P 500	$100.00	$115.06	$117.49	$136.30	$180.44	$205.14
DJ U.S. Utilities Index	$100.00	$107.80	$128.44	$130.70	$150.57	$192.86

Compensation Philosophy

Our executive compensation program is designed to reward our named executive officers for delivering results and building long term sustainable value for our stockholders. We believe our program's performance measures align the interests of our stockholders and the NEOs by correlating pay to our short- and long-term performance.

Our focus on pay for performance is demonstrated by the way we have structured our three key elements of compensation designed to implement our compensation objectives: Base Salaries, Annual Incentive Plan (AIP) and Long Term Incentive Plan (LTIP). Particularly for our NEOs, the allocation among these elements of compensation is designed to provide a significant level of variability and compensation risk tied to performance. The following graphic represents the percentage of total compensation for each of these elements (assuming annual and long-term incentive awards are paid at target levels) for our CEO and the average percentage of total compensation for each of these elements for the other NEOs as a group in 2014:





[1]Reflects Susan N. Story who became our CEO on May 9, 2014

[2]Excludes Susan N. Story and Jeffry E. Sterba

In addition, we provide employee retirement and health and welfare benefit plans, as well as an executive severance policy. We designed the plans and policy to provide competitive supplemental benefits, as described below under "Ongoing and Post-Employment Arrangements and Benefit Plans."

Set forth below is summary information regarding payments made in 2014 with respect to our three key elements of compensation.

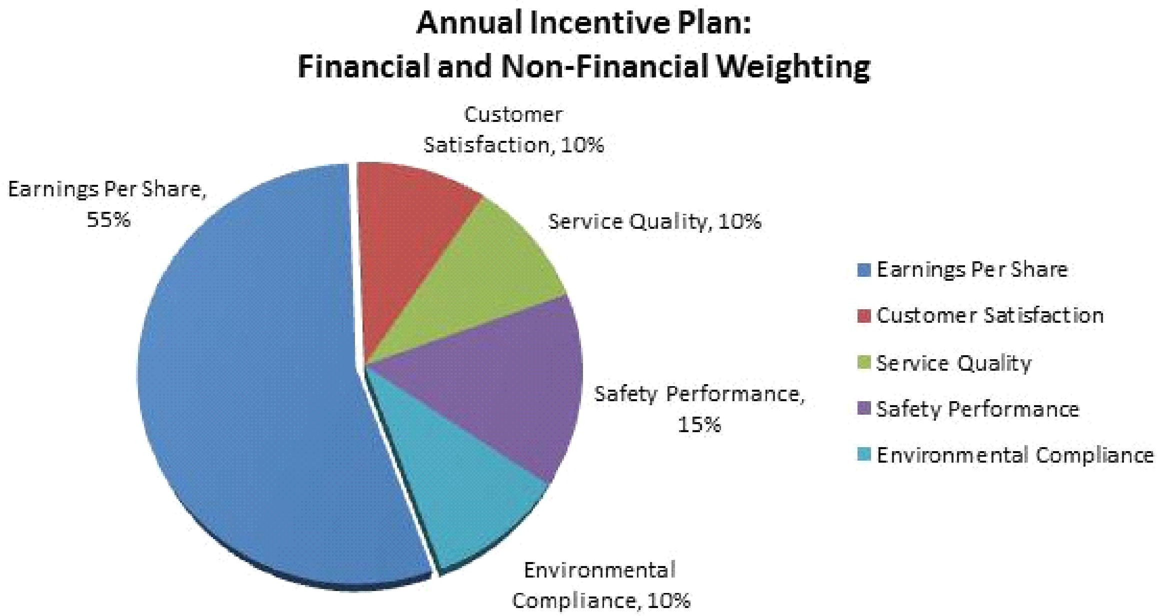
Base Salaries

For 2014, salary adjustments for our continuing NEOs (other than Ms. Story, who received an incremental increase in salary upon assuming responsibilities as President and Chief Executive Officer) ranged from no increase to an increase of approximately 3 percent. The salaries of newly-employed NEOs were based on the terms of the employment agreements we negotiated with each of them. For further information see "2014 Compensation-Base Salaries."

Annual Incentive Plan

For our NEOs, we believe our AIP again provided appropriate incentive opportunities. Subject to certain adjustments described below, AIP awards are based upon the product of each NEO's respective target award times the "Corporate Multiplier," which is computed based upon five performance measures and can be reduced depending on the overall performance of the company. For business unit heads, such as Mr. Lynch, achievement with respect to business unit performance measures is also taken into account.

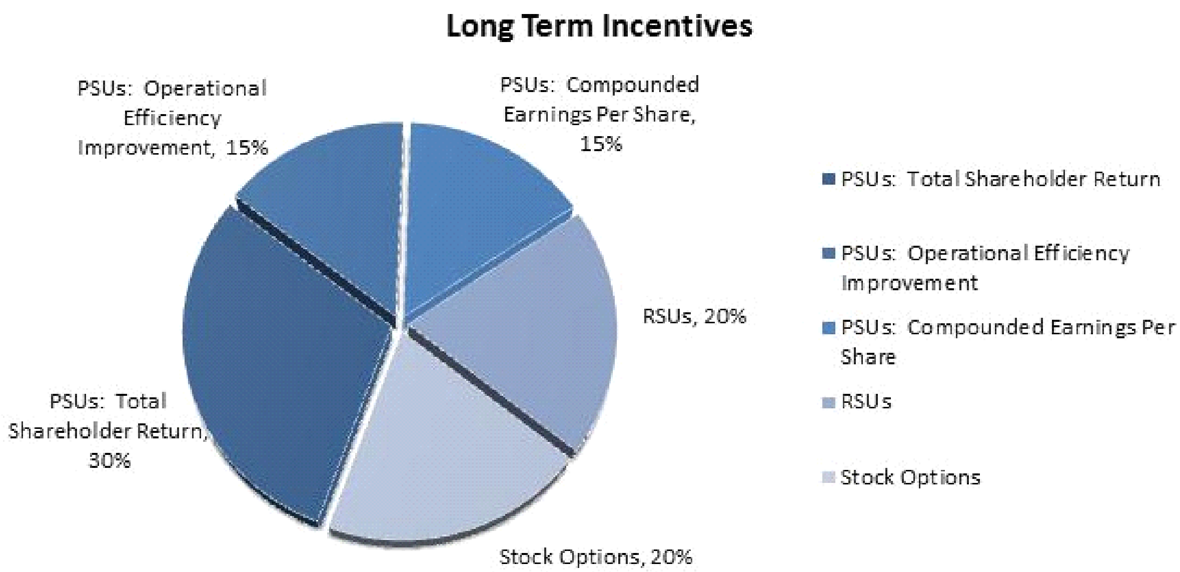
The following graphic indicates the percentage of the Corporate Multiplier represented by each component performance measure:



We believe that the measures used in computing the amount of the Corporate Multiplier collectively provide a strong indication of our overall performance and, therefore, effectively tie pay to performance. In 2014, the Corporate Multiplier -- which is calculated based on business segment performance against the goals -- equaled 104.3 percent. The actual payout was lower than the Corporate Multiplier as our CEO used discretion to reduce the AIP pool to reflect the impact of parent company expenses, and each NEO's award was reduced accordingly and is consistent with the AIP pool for the non-NEO participants. Mr. Lynch's award was also reduced in a consistent manner below the Corporate Multiplier which represents half of his payout calculation, even though the performance of the regulated businesses was somewhat above the overall corporate performance, as reflected by the Corporate Multiplier. For further information, see "2014 Compensation—Annual Incentive Plan," below.

Long Term Incentives

The LTIP is designed to incentivize eligible participants to help us achieve our long-term business objectives by providing an opportunity to earn equity awards that are tied to our long-term goals and continued employment with the Company. Our LTIP for 2014 included stock options, restricted stock units or “RSUs,” and performance stock units, or “PSUs.” As described in more detail below, the extent to which shares of our common stock are issued with respect to the PSUs is based on our achievement, over a three-year period, relative to three performance measures:



As in the past, we based the target value of LTIP awards on a percentage of the NEO's salary. The compensation committee applied 20 percent of an NEO’s LTIP target award to stock options, 20 percent to RSUs and 60 percent to PSUs. With regard to newly hired NEOs, we provided additional LTIP grants, designed to replace a portion of the benefits the NEOs forfeited as a result of terminating employment with their respective former employers. For further information, see “2014 Compensation—Long Term Incentive Plan,” below.

In 2012, we granted PSUs to our executives and other employees for which the performance period ended in 2014. The PSUs were subject to the same performance measures as the PSUs granted under the LTIP in 2014. Based on our performance with respect to these measures, a number of shares equal to 166.86 percent of the PSUs granted with respect to all measures were performance vested. For further information, see "2014 Compensation – Performance Vesting of PSUs Granted in 2012," below.

Stockholder Advisory Vote

At our 2014 annual meeting, the stockholders approved, on a non-binding basis, the compensation paid to our NEOs, as disclosed under the compensation disclosure rules of the SEC, including the compensation discussion and analysis, the compensation tables and any related materials disclosed in the proxy statement for the 2014 annual meeting. The stockholder vote in favor of NEO compensation totaled approximately 96.6 percent of the votes cast (including abstentions). We considered the results of the advisory vote and determined that, in light of the strong favorable vote of our stockholders, no specific action need be taken in response to the vote. At the 2015 Annual Meeting of Stockholders, we will again hold an advisory vote on the compensation of our NEOs. In making its decisions regarding executive compensation, the compensation committee will consider the results of the advisory vote, as well as feedback from stockholders throughout the course of the year.

Summary of Executive Compensation Practices

Set forth below are compensation practices that we have implemented because we believe they are consistent with our stockholder interests and practices we have not implemented because we do not believe they are consistent with those interests.

What We Do

P Provide for a considerable portion of executive pay to be "at risk" and based on our actual performance;

P Utilize performance-based stock units with vesting requirements;

P Require our executives to retain a meaningful portion of our common stock derived from equity grants;

P Provide limited perquisites, principally executive physicals, which serve a reasonable business purpose;

P Use a representative and relevant peer group;

P Maintain a clawback policy;

P Use an independent compensation consultant retained by the compensation committee; and

P Provide reasonable severance arrangements.

What We Don't Do

X Provide separate change of control agreements;

X Provide tax gross-ups;

X Reprice underwater stock options; and

X Permit hedging or pledging of our common stock by Named Executive Officers or directors.

COMPENSATION DETERMINATIONS AND PAY COMPETITIVENESS IN 2014

For 2014, the compensation committee reviewed and approved all compensation paid to our executive officers including Mr. Sterba and Ms. Story. Upon Ms. Story's appointment as President and Chief Executive Officer, the independent members of the board of directors, after consideration of the recommendation of the compensation committee, approved her compensation. Mr. Sterba and Ms. Story did not participate in the compensation committee's decision-making regarding his or her own compensation and were excused from those portions of the committee and board meetings during which his or her compensation was discussed and determined.

The compensation committee considered Mr. Sterba's and, following her appointment as President and Chief Executive Officer, Ms. Story's assessment of the performance of the other executive officers, as well as Ms. Story's compensation recommendations regarding each executive officer's AIP award. The compensation committee, with Ms. Story's participation, discussed the 2014 performance of each executive officer, and then approved Ms. Story's recommendations for them in February 2015.

In making executive compensation determinations for 2014, we referenced data provided by Hay Group to gauge the comparability of our executive compensation to the compensation of executives of other companies with generally corresponding responsibilities. Hay Group has served as an independent consultant to the compensation committee since 2011, and assists the compensation committee in its review of compensation for executive officers. Aside from also providing, with the approval of the compensation committee, compensatory information to us relevant to specified non-executive officer functions, Hay Group does not perform any other services for us.

The compensation consultant provided data to the compensation committee focused on compensation paid by a peer group of 16 companies that had revenues in the range of approximately 47 to 256 percent of our revenues. We believe there is a strong likelihood that an executive officer's skills will be transferable among these companies, so we would expect to compete with these companies for executive officer talent. We updated our comparator group in 2014 to set 2015 compensation and added two more companies – Ameren Corp. and Avista Corp. The comparator group used to set 2014 compensation was unchanged from the previous year. The group was as follows:

- AGL Resources, Inc.
- Alliant Energy Corp.
- Atmos Energy Corp.
- Great Plains Energy, Inc.
- Northeast Utilities
- NV Energy, Inc.
- Piedmont Natural Gas Company, Inc.
- Pinnacle West Capital Corp.
- PNM Resources, Inc.
- SCANA Corp.
- TECO Energy, Inc.
- UNS Energy Corp.
- Vectren Corp.
- Weststar Energy, Inc.
- WGL Holdings, Inc.
- Wisconsin Energy Corp.

While the compensation committee reviewed and discussed the data with Hay Group for purposes of benchmarking, it was only a part of the information considered by the compensation committee in its determinations regarding our NEOs' compensation. For instance, Hay Group also provided data based on a Towers Watson survey reflecting a blend of energy utility and general industry data, as well as the Hay Group 2014 General Industry Executive Compensation Report. The compensation committee also considered information provided by Hay Group regarding other U.S. publicly traded water utilities, although the comparability of these companies is limited due to the significantly larger size of American Water's operations. The compensation committee referenced all of this data to obtain an understanding of general industry, utility industry and peer group compensation practices.

2014 COMPENSATION

Compensation Philosophy and Objectives

Our executive compensation program is designed to reward our named executive officers for delivering results and building long term sustainable value for our stockholders. We believe our program's performance measures align the interests of our stockholders and the NEOs by correlating pay to our short- and long-term performance.

Our compensation objectives remained largely unchanged in 2014, although we eliminated our focus on our business transformation goal because the project was essentially implemented by 2014. Accordingly, we focused on the following objectives in making compensation decisions in 2014:

- Promote our success in achieving both superior financial performance and outstanding non-financial performance relating to workplace safety, environmental compliance, customer service quality and customer satisfaction.
- Compensate our executive officers at competitive levels that reflect their responsibilities and contributions, with a focus on pay for performance and the compensation environment in our comparator companies and the utilities industry generally.
- Condition a significant portion of an executive officer's total compensation on a combination of short and long-term performance, with a proportionately greater emphasis on long-term, performance-based compensation than on annual incentive compensation.
- Align executive officer and stockholder interests as an incentive to increase stockholder value by requiring consistent, meaningful equity ownership.

Succession Plan for the President and Chief Executive Officer

Under a succession plan approved by our Board of Directors, Mr. Sterba was succeeded by Ms. Story as President and Chief Executive Officer following our 2014 Annual Meeting. In connection with the succession plan, we entered into an agreement with Mr. Sterba amending his March 2012 employment agreement. Among other things, the amended agreement provided for Mr. Sterba to serve as an advisor to Ms. Story through January 1, 2015. He continued to participate in the LTIP for 2014 with his target awards based on his salary prior to the conclusion of his tenure as our President and Chief Executive Officer; his 2014 AIP was based upon the actual salary paid to him in 2014. In addition, Mr. Sterba's equity awards vested on January 1, 2015 (in the case of his PSUs, subject to Company performance over the three year performance period). See "Annual Incentive Plan" and "Long Term Incentive Plan," below for additional information.

In accordance with the succession plan, Ms. Story became our President and Chief Executive Officer on May 9, 2014. Previously, she served as our Senior Vice President and Chief Financial Officer. In connection with this promotion, we increased Ms. Story's base salary to $700,000, increased her target award under the AIP as a percentage of salary to 100 percent and her target award under the LTIP to 200 percent. In connection with the increase in her LTIP target award, we also provided incremental grants under the LTIP, prorated to reflect the portion of the year she was serving as our President and Chief Executive Officer. These grants are described below under "2014 Compensation – Long Term Incentive Plan." The Board increased Ms. Story’s base salary from $700,000 to $800,000 for the 2015 Performance Period, effective March 16, 2015. The Board also increased Ms. Story’s LTIP target award from 200 percent to 225 percent for the 2016 LTIP grant. Ms. Story’s AIP as a percentage of salary will remain at 100 percent for the 2015 Performance Period.

Employment Agreement with Linda G. Sullivan

In 2014, the compensation of Linda G. Sullivan, our Senior Vice President and Chief Financial Officer, was largely based on the terms of the employment agreement we negotiated with her in connection with the commencement of her employment in April 2014. In addition to standard components of her compensation described below, we provided an additional equity award under our 2014 LTIP of $500,000; 70 percent of which was allocated to PSUs and 30 percent to RSUs. In addition, we granted AIP and LTIP awards to Ms. Sullivan for the full 2014 year, without proration. See "2014 Compensation – Long-Term Incentive Plan" for additional Information regarding her LTIP awards. We made these accommodations in light of the benefits provided by her former employer that she forfeited by accepting employment with us.

Employment Agreement with Loyd Warnock

In 2014, the compensation of Loyd Warnock, our Senior Vice President of External Affairs, Communications and Public Policy, was largely based on the terms of an employment agreement we negotiated with him in connection with the commencement of his employment in April 2014. In addition to the standard components of his compensation described below, we paid a $220,000 cash sign-on bonus to Mr. Warnock and he received a sign on equity grant of $220,000 all of which was allocated to RSUs. In addition, we granted AIP and LTIP awards to Mr. Warnock for the full 2014 year, without proration. We made these accommodations in light of the benefits provided by his former employer that he forfeited by accepting employment with us.

Base Salaries

For 2014, salary determinations for our NEOs were as follows:

- Ms. Story's base salary continued to be $535,000, until it was increased to $700,000 upon her assumption of duties as our President and Chief Executive Officer. The Board increased Ms. Story’s base salary from $700,000 to $800,000, effective March 16, 2015.
- Mr. Sterba's annual base salary was adjusted from $787,500 to $20,000 per month for the remaining seven months of 2014, as he was relinquishing his role as President and Chief Executive Officer to Advisor in accordance with the succession plan approved by the Board of Directors.
- Mr. Lynch's and Ms. Walker's salaries were increased by 2.94 percent and 1.28 percent, respectively.
- Ms. Sullivan's and Mr. Warnock's salaries were set at $460,000 and $360,000, respectively, in accordance with the terms of their respective employment agreements.

Annual Incentive Plan

The AIP is designed to incentivize eligible participants to help us achieve our annual business objectives by providing an opportunity to earn cash award payouts that are tied primarily to corporate performance. The measures chosen for 2014 reflected our primary objectives for financial performance, safety, environmental stewardship, customer satisfaction and service quality. We maintained earnings per share as our principal performance measure (55 percent weighting) because we continue to believe this measure has a meaningful effect on stockholder value. We eliminated business transformation implementation as a performance measure because implementation of our enterprise asset management and customer information systems and analysis regarding the implementation process was essentially completed in 2013. In lieu of the 25 percent weighting previously allocated to business transformation process, we increased our safety performance weighting to 15 percent from 5 percent and increased the weighting of each of our other three non-financial performance measures by 5 percent which increased each measure to 10 percent. The determination of awards under the AIP with respect to the NEOs was made as follows:

- The 2014 target award opportunity for each NEO is equal to a percentage of each NEO's base salary, based on the individual’s position with American Water. The following table indicates the percentage of salary used to determine the target AIP award for each NEO. Continuing NEOs, other than Ms. Story, maintained the same target award as a percentage of salary as in 2013. Ms. Story's target award percentage was increased from 75 percent to 100 percent upon her assumption of duties as our President and Chief Executive Officer. Ms. Sullivan's and Mr. Warnock's target award percentages were fixed in accordance with the terms of their respective employment agreements. All other NEO target awards as a percentage of salary were unchanged from 2013.

Name	Percentage of Salary	Target Award	
Susan N. Story	75/100%	$ 594,414	(1)
Jeffry E. Sterba	100%	$ 468,125	
Linda Sullivan	75%	$ 345,000	
Walter J. Lynch	75%	$ 393,750	
Kellye L. Walker	55%	$ 217,250	
Loyd A. Warnock	50%	$ 180,000	

(1) Ms. Story's target award as a percentage of salary initially was 75% and was applied to her $535,000 annual salary. Upon her appointment as our President and Chief Executive Officer, Ms. Story's annual salary was increased to $700,000 and her target award as a percentage of salary was increased to 100%. Her target award was prorated based on the portion of the year she served as our President and Chief Executive Officer.

The actual payout may be lower or higher than the target award opportunity depending, in the case of the NEOs, on corporate and, in rare instances, individual performance against specific goals. Cash awards under the AIP are distributed to participants in March following the performance year.

- The Board evaluated Ms. Story’s 2014 performance based generally upon corporate performance and achievements compared to the targets contained in the Corporate Multiplier. These expectations focused on advancements in the Company’s strategic goals, including safety performance, environmental compliance, service quality and customer satisfaction. The Board without assigning a specific score for each or all of the strategic goals, assessed Ms. Story’s performance as “Highly Effective” and awarded her an AIP payment of $587,243, which was 98.8% as described below under the Corporate Multiplier Table.
- As noted earlier, in 2014 the Corporate Multiplier -- which is calculated based on business segment performance against the goals -- equaled 104.3%. The actual payout was lower than the Corporate Multiplier, as our CEO used discretion to reduce the AIP pool to reflect the impact of parent company expenses, and each NEO's award was reduced accordingly and consistent with the AIP pool for the non-NEO participants. Mr. Lynch’s award was also reduced in a consistent manner below the Corporate Multiplier, which represents half of his payout calculation.
- For 2014, the Corporate Multiplier represented the sum of five percentage amounts, each determined based upon our level of achievement against company-wide performance measures that are objective. Of the five performance measures, one was a financial measure (55 percent of the target Corporate Multiplier) and four were non-financial measures (45 percent of the target Corporate Multiplier). The Corporate Multiplier could have ranged from 0 percent to 150 percent of the target Corporate Multiplier (which is 100 percent), depending on how well we performed against the financial and non-financial measures. For 2014, the Corporate Multiplier was 104.3 percent, subject to the adjustments discussed above. The actual percentage included in the Corporate Multiplier with respect to each performance measure is set forth in the Corporate Multiplier Table below under the caption, “Determination of the Corporate Multiplier.” In the case of Mr. Lynch, one-half of his award is based on the Corporate Multiplier, while the other half is based on the 105.6 percent level of achievement of our regulated operations against five specified performance metrics.

- While the NEOs are subject to individual performance goals as well as the corporate goals comprising the Corporate Multiplier, the 2014 AIP awards reflect an NEO's target award times the adjusted Corporate Multiplier of 98.8% (and against regulated operations goals in the case of Mr. Lynch), without adjustment for individual performance. The compensation committee has adhered to this convention based on the recommendation of Ms. Story that NEOs should assume principal responsibility for, and their awards generally should be based upon, performance of the entire corporation, except with respect to those NEOs who lead a profit center, such as Mr. Lynch, in which case performance of the relevant business units also will be reflected.

Determination of the Corporate Multiplier

The following table provides information regarding the performance measures used to determine the Corporate Multiplier:

Performance Measure	Percentage Amount at Target Included in the Corporate Multiplier	How we calculate the measure	Why we use this measure
Earnings Per Share	55%	EPS means basic earnings per share, adjusted to eliminate the impact of a $0.04 per share charge related to the impact of the Freedom Industries chemical spill in West Virginia; we do not believe management should be penalized for this event, over which it had no control.	EPS is a key metric affecting our stock price. In addition, increasing EPS enhances our capacity to raise the financing necessary to make prudent capital improvements in our water and wastewater systems as well as provides greater total return to our stockholders.
Safety Performance	15%	Determined by reference to the total Occupational Safety and Health Administration Recordable Incident Rate or "ORIR" for American Water. ORIR is a measure of injuries and illnesses requiring treatment beyond first aid for every 200,000 hours worked.	We want to continue our momentum toward becoming an industry leader with respect to the safety and well-being of our workforce. The benefits of improved safety are tangible, from the standpoint of the welfare of our employees as well as increased efficiency due to fewer lost workdays.
Environmental Compliance	10%	Based on the number of notices of violation (NOVs) for which we are responsible in accordance with our reporting practices for environmental non-compliance. An NOV is a written formal notification from a governmental agency, local health department or other regulatory agency that a system exceeded an acceptable limit, failed to perform required monitoring, failed to record the required documentation or failed to meet another Federal, state, or local requirement. All drinking water maximum contaminant limit (MCL) and monitoring and reporting (MR) NOVs are counted for purposes of calculating this measure. NOVs for our wastewater systems that are directly within our control, such as deficiencies in monitoring, are counted for purposes of calculating this measure. The NOVs for our market-based operations, where we operate but do not own the water or wastewater systems, are considered our responsibility and are counted for purposes of calculating this measure unless it can be shown that (1) the NOV was outside the scope of the contract and (2) we formally notified the owner of the system in writing of the need for changes or improvements in order to maintain compliance, but the owner did not approve the changes or improvements.	We are committed to protecting the environment and to maintaining our consistent history of materially complying with, and in many cases surpassing, minimum standards required by applicable laws and regulations. The NOV target was established based upon our goals to outperform the U.S. EPA published industry averages and to lead the water industry in environmental compliance.
Service Quality	10%	Based on our Service Quality Survey, which is conducted throughout the year for customers whose request for service resulted in completion of a service order by our field service representatives, and contains the following question: "Overall, how satisfied were you with the outcome of your service contact?" The question contains a five category response scale, ranging from Extremely Satisfied to Very Dissatisfied. Responses in the top two categories are indicative of overall service quality satisfaction levels.	Service Quality is key to our ability to maintain customer and brand loyalty.
Customer Satisfaction	10%	Based on an annual survey, which is conducted throughout the year for customers having had recent contact with one of our customer service or field service representatives, and that contains the following question (modified to identify the applicable American Water subsidiary): "Overall, how satisfied have you been with American Water in general during the past twelve months?" The question has a five category response scale, ranging from Extremely Satisfied to Very Dissatisfied. Responses in the top three categories are indicative of overall customer satisfaction levels.	Customer Satisfaction is key to our ability to maintain customer and brand loyalty. In addition, the quality of our service and issues raised by customers is a principal focus of state public utility commissions in evaluating a rate case.

The percentage added to the Corporate Multiplier with respect to each measure was dependent on actual performance with regard to each measure. The following table includes (i) the minimum performance threshold requirement for the measure, (ii) the performance required for achievement of the target and (iii) the performance required to achieve the maximum contribution to the Corporate Multiplier for that measure. The table also indicates the percentage that would be included in the Corporate Multiplier for threshold, target and maximum performance. If the minimum performance threshold requirement for a performance measure was not met, no additional percentage would be added to the Corporate Multiplier. No AIP awards would have been made if EPS had been below 90 percent of the target EPS.

Performance Measure	Threshold Performance (and percentage to be added to Corporate Multiplier)	Target Performance (and percentage to be added to Corporate Multiplier)	Maximum Performance (and percentage to be added to Corporate Multiplier)
EPS	$2.27 (13.75%)	$2.42 (55.0%)	$2.49 (82.5%)
Safety Performance	3.15 ORIR (7.5%)	2.75 ORIR (15.0%)	2.55 ORIR (22.5%)
Environmental Compliance	17 NOVs (5.0%)	13 NOVs (10.0%)	7 NOVs (15%)
Service Quality	80% of Surveyed Customers (5.0%)	85% of Surveyed Customers (10.0%)	90% of Surveyed Customers (15.0%)
Customer Satisfaction	85% of Surveyed Customers (5.0%)	90% of Surveyed Customers (10.0%)	95% of Surveyed Customers (15.0%)

Corporate Multiplier Table

Based upon our performance with regard to the financial and non-financial performance measures, the board approved the Corporate Multiplier of 104.3 percent. The Corporate Multiplier of 104.3% was adjusted to 98.8% for our NEOs other than Mr. Lynch due to the following adjustments: (a) certain parent company costs; (b) allocation of $150,000 to create an Executive Leadership Team discretionary award pool for members of the executive leadership team to award high performers on their team, if appropriate; and (c) payment of certain executive severance benefits as required by their agreement. Mr. Lynch's award was 99.5% as discussed below subject to the above adjustments.

The Corporate Multiplier was determined as follows:

Performance Measure	Percentage Amount at Target for Inclusion in the Corporate Multiplier	Target	Actual Performance	Percentage Amount Included in Calculation of Corporate Multiplier Based on Actual Performance
EPS (1)	55%	$2.42	$2.43	110%
Safety Performance	15%	2.75 ORIR	3.03	65%
Environmental Compliance	10%	13 NOVs	9	137.5%
Service Quality	10%	85% IP Surveyed Customers	85.9%	109%
Customer Satisfaction	10%	90% of Surveyed Customers	89.3%	93%
			TOTAL	104.3%

(1) As adjusted to eliminate the impact of $.04 per share from the Freedom Industries chemical spill in West Virginia.

Determination of Individual AIP Awards for NEOs

The actual awards paid to each NEO, other than Ms. Story, were recommended by Ms. Story and, after review, approved by the compensation committee, based on the application of the adjusted Corporate Multiplier. Ms. Story advised the compensation committee that there were no factors of a magnitude that would cause her to recommend an adjustment for any of the other NEOs based on his or her individual performance. Therefore, Ms. Story recommended that each of the NEOs receive an award equal to the Corporate Multiplier times the executive's target award. The compensation committee accepted Ms. Story's recommendation.

Mr. Lynch's award was structured so that 50 percent was based on achievement with respect to the adjusted Corporate Multiplier and 50 percent was based on performance of the regulated operations with respect to five specified performance measures: net income, safety, NOVs, customer satisfaction and service quality. The performance of regulated operations resulted in achievement equal to 105.6 percent of target performance. After applying the same adjustment as was applied to the Corporate Multiplier, as described in footnote 2 to the Corporate Multiplier Table above, Mr. Lynch's award was adjusted to 99.5 percent.

We have set forth the awards paid to our NEOs under the Non-Equity Incentive Plan Compensation column of the 2014 Summary Compensation Table.

Long Term Incentive Plan

Our LTIP for 2014 included stock option grants, PSUs and RSUs. As described in more detail below, the PSUs are awarded contingently, and the extent to which they are earned and the underlying shares of our common stock are distributed will be based on our achievement, over a three-year period, with respect to three performance measures.

We based the target value of LTIP awards on a percentage of the NEOs salary. The percent of salary on which the LTIP targets are based, and the total dollar values of the respective target LTIP awards for the NEOs, were as follows:

Name	LTIP Target Award as Percentage of Salary	Value of LTIP Target Award	
Susan N. Story	150/200%	$ 1,190,875	(1)
Jeffry E. Sterba	250%	$ 1,968,750	
Linda G. Sullivan	125%	$ 575,000	(2)
Walter J. Lynch	150%	$ 765,000	
Kellye L. Walker	110%	$ 429,000	
Loyd A. Warnock	90%	$ 324,000	(3)

(1) Ms. Story's LTIP Target Award as a percentage of salary initially was 150% and was applied to her $535,000 annual salary. Upon her appointment as President and Chief Executive Officer, Ms. Story's annual salary was increased to $700,000, and her LTIP Target Award as a percentage of salary was increased to 200%. Accordingly, Ms. Story was provided incremental stock option, PSU and RSU grants to reflect the increases in her salary and LTIP award as a percentage of salary, prorated for the portion of 2014 during which she served as our President and Chief Executive Officer. The Board increased Ms. Story's 2016 LTIP target award from 200% to 225%.

(2) In addition to the amount shown in the table, and under the terms of Ms. Sullivan's employment agreement, we agreed to provide an additional $500,000 in equity, of which 30% was allocated to RSUs and 70% was allocated to PSUs. The additional amount was designed to replace a portion of benefits Ms. Sullivan forfeited as a result of terminating employment with her former employer.

(3) In addition to the amount shown in the table, and under the terms of Mr. Warnock's employment agreement, we agreed to provide an additional $220,000, all of which was allocated to RSUs. The additional amount was designed to replace a portion of the benefits Mr. Warnock forfeited as a result of terminating employment with his former employer.

Except as noted in the footnotes to the table above, the compensation committee applied 20 percent of an NEOs LTIP target award to stock options, 20 percent to RSUs and 60 percent to PSUs. We divided long-term compensation in this manner because we believe it provides an appropriate balance between two related but discrete goals. RSUs and stock options are designed to align the executive officer's interests with stockholder interests, since the value of RSUs and the intrinsic value of stock options is a function of our stock price. We introduced RSUs in 2013 to reflect trends in compensation, which indicate companies' increasing use of RSUs to encourage continued employment and declining use of stock options. As explained in more detail below, the PSUs are designed to encourage long-term performance both from the standpoint of favorable stock performance in relation to the other companies in the Dow Jones U.S. Utilities Total Return Index (which we refer to below as the "Comparator Group"), and from the standpoint of specific company-wide performance measures. We chose to provide the largest percentage weighting for PSUs because we believe the greater emphasis should be on out-performing similarly situated companies and on the satisfaction of long-term operational goals.

In determining the number of shares underlying stock option grants, we used the $5.36 ($5.19 in the case of an incremental stock option granted to Ms. Story in connection with her assumption of duties as our President and Chief Executive Officer and $5.28 in the case of Ms. Sullivan and Mr. Warnock) grant date fair value per underlying share of the options, calculated in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, which we refer to below as ASC 718. In accordance with ASC 718, the grant date fair value of stock options is calculated using the closing market price of the underlying common stock and assumptions related to specified items, determined as of the grant date. Ms. Story's incremental stock option was granted on May 9, 2014, and Ms. Sullivan's and Mr. Warnock's stock options were granted on April 28, 2014, resulting in grant date fair values that differed from the grant date fair values of the stock options granted to the other NEOs (stock options were granted to the other NEOs on February 20, 2014). Mr. Sterba's stock options vested on January 1, 2015 rather than over a three year period, as is the case for the options granted to the other NEOs, which resulted in a lower grant date fair value per underlying share of $2.72 for Mr. Sterba's stock options. Based on the applicable grant date fair value, the number of shares underlying stock options was calculated as follows:

Name	LTIP Target Award Allocated to Stock Options	Number of Shares Underlying Stock Options
Susan N. Story	$ 238,175 (1)	44,910
Jeffry E. Sterba	$ 393,750	144,761
Linda G. Sullivan	$ 115,000	21,780
Walter J. Lynch	$ 153,000	28,545
Kellye L. Walker	$ 85,800	16,007
Loyd A. Warnock	$ 64,800	12,273

(1) Includes an incremental target award allocation provided to Ms. Story upon her appointment as President and Chief Executive Officer. See "Promotion of Susan N. Story," above.

In determining the number of RSUs, we used the $44.06 ($46.45 in the case of Ms. Sullivan and Mr. Warnock, and $46.26 in the case of Ms. Story's incremental grant) grant date fair value of an RSU, calculated in accordance with ASC 718. Based on the applicable grant date fair value, the number of RSUs was calculated as follows:

Name	LTIP Target Award Allocated to RSUs	Number of RSUs
Susan N. Story	$ 238,175 (1)	5,322
Jeffry E. Sterba	$ 393,750	8,937
Linda G. Sullivan	$ 265,000 (2)	5,705 (2)
Walter J. Lynch	$ 153,000	3,473
Kellye L. Walker	$ 85,800	1,947
Loyd A. Warnock	$ 284,800 (2)	6,131 (2)

(1) Includes an incremental target award allocation provided to Ms. Story upon her appointment as President and Chief Executive Officer. See "Promotion of Susan Story," above.

(2) Includes additional allocations for RSUs under the terms of Ms. Sullivan's and Mr. Warnock's respective employment agreements. See "Employment Agreement with Linda G Sullivan" and "Employment Agreement with Loyd A. Warnock," above.

We based the number of shares underlying the PSUs granted to each of our NEOs on the LTIP Target Award allocated to PSUs, which, for each NEO, is shown in the table below:

Name	LTIP Target Award Allocated to PSUs	
Susan N. Story	$ 714,550	(1)
Jeffry E. Sterba	$ 1,181,250	
Linda G. Sullivan	$ 695,000	(2)
Walter J. Lynch	$ 459,000	
Kellye L. Walker	$ 257,400	
Loyd A. Warnock	$ 194,400	

(1) Includes incremental target award allocation provided to Ms. Story upon her appointment as President and Chief Executive Officer. See "Promotion of Susan N. Story," above.

(2) Includes an additional allocation for PSUs under the terms of Ms. Sullivan's employment agreement. See "Employment Agreement with Linda Sullivan," above.

We allocated the LTIP target award for PSUs among the three separate measures shown on the following tables, which are discussed below:

Performance Measure	Weighting at Target
Total Stockholder Return	50%
Operational Efficiency Improvement	25%
Compounded EPS Growth	25%
Total	100%

The actual percentages of total PSUs granted to the NEOs with respect to the three performance measures differed from the percentage allocation of the target award. The grant date fair value of a PSU related to the total stockholder return performance measure was somewhat higher ($46.83, $50.93 for Ms. Story's incremental grant and $47.62 for Ms. Sullivan's and Mr. Warnock's grants) than the grant date fair value of a PSU related to the other two performance measures ($44.06, $46.26 for Ms. Story's incremental grant and $46.45 for Ms. Sullivan's and Mr. Warnock's grants). Therefore, the percentage of PSUs granted with respect to each performance measure was within the following ranges; variations were almost entirely based on differences in grant dates:

Performance Measure	Range of Percentage of PSUs Granted
Total Stockholder Return	47.6% - 49.4%
Operational Efficiency Improvement	25.3% - 26.2%
Compounded EPS Growth	25.3% - 26.2%

The total number of PSUs granted to each of the NEOs is shown in the following table:

Name	Number of PSUs Granted
Susan N. Story	15,412
Jeffry E. Sterba	26,017
Linda G. Sullivan	14,778
Walter J. Lynch	10,110
Kellye L. Walker	5,669
Loyd A. Warnock	4,134

The following table provides information regarding the three performance measures related to the PSUs:

Performance Measure	**How we calculate the measure**	**Why we use this measure**
Total Stockholder Return	Based on American Water's total stockholder return, which we refer to as "TSR," compared to the total stockholder return performance of the companies in the Comparator Group, in each case subject to a dividend adjustment factor, during the three-year performance period from January 1, 2014 through December 31, 2016. We will compare (i) the percentage increase in the average daily closing stock price for our common stock for the 20 trading days before the end of the performance period over the average daily closing stock price of our common stock for the 20 days before the beginning of the performance period to (ii) the percentage increase over the same periods in the average closing price of each of the companies in the Comparator Group. For purposes of the comparison, we assume reinvestment of dividends during the performance period.	To encourage performance that not only increases stockholder value, but increases it to an extent that compares favorably relative to the Comparator Group.
Operational Efficiency Improvement	Based on the ratio of total operation and maintenance (O&M) expense to total operating revenues for our regulated operations; the ratio is reduced as operational efficiency improves. The calculation of this measure will be based on the average of the ratio for each of 2014, 2015 and 2016.	We want to focus management on improving our overall cost structure and improving our return on equity.
Compounded EPS Growth	Based on the growth of our EPS, as reported in our audited financial statements, adjusted to exclude all items of gain, loss or expense for the fiscal year determined to be extraordinary or unusual in nature or infrequent in occurrence related to the disposal of a segment of a business or related to a change in accounting principle, compounded annually over the three year period from January 1, 2014 through December 31, 2016, over the adjusted EPS of $2.20 for the year ended December 31, 2013. In addition to adjustments made to EPS as determined for purposes of the AIP, Adjusted EPS for the year ended December 31, 2013 excludes after tax loss on debt in connection with a cash tender offer on 6.085% Senior Notes due 2017.	For the same reasons as set forth with respect to EPS under the AIP description above, although we also are using the measure in connection with the LTIP to encourage a long-term focus on earnings growth.

The following tables show the actual number of PSUs to be earned, as a percentage of the target PSU award (equivalent to the number of PSUs granted) based upon our performance with regard to each of the three measures. (In actual practice, we grant two types of PSUs; one type relates to the TSR measure, while the other type relates to the other two measures, which are equally weighted. We describe the target awards with respect to each measure separately to enhance an understanding of the effect that performance with respect to each measure can have on vesting):

Total Stockholder Return

American Water TSR Ranking*	**Percent of Target Award PSUs Earned***
75% or more (maximum)	85.1%
50% (target)	48.6%
25% (threshold)	12.2%
Less than 25%	0%

* If the TSR ranking is between 25 percent and 50 percent, or between 50 percent and 75 percent, the percentage of target award PSUs earned will be adjusted proportionately.

Operational Efficiency Improvement

Ratio of Regulated Operations O&M Expense to Total Operating Revenues*	Percent of Target Award PSUs Earned*
34.0% or less (maximum)	44.9%
36.0% (target)	25.7%
38.0% (threshold)	6.4%
More than 38.0%	0%

* If the ratio of regulated operations' O&M expense to total operating revenues is between 38.0 percent and 36.0 percent or 36.0 percent and 34.0 percent, the percentage of target award PSUs earned will be adjusted proportionately.

Compounded EPS Growth

Compounded EPS Growth*	Percent of Target Award PSUs Earned*
10.0% (maximum)	44.9%
7.0% (target)	25.7%
5.0% (threshold)	6.4%
Less than 5.0%	0%

* If compounded EPS growth is between 5.0 percent and 7.0 percent or 7.0 percent and 10.0 percent, the percentage of target award PSUs earned will be adjusted proportionately.

Vesting of Options and PSUs

The options granted to our NEOs in 2014 terminate on December 31, 2020 (if not previously exercised or forfeited), and, with the exception of Mr. Sterba's options, vest in equal increments on January 1, 2015, 2016 and 2017. Mr. Sterba's options vested on January 1, 2015. Similarly, an NEO’s right to PSUs ultimately earned at the end of the performance period and to RSUs (other than PSUs earned and RSUs granted to Mr. Sterba and incremental RSUs granted to Mr. Warnock) vests in equal increments on January 1, 2015, 2016 and 2017. Mr. Sterba's rights to PSUs ultimately earned and to RSUs vested on January 1, 2015. The vesting provisions with regard to Mr. Sterba's awards are in accordance with the terms of his March 26, 2012 employment letter agreement. See "Executive Compensation - Employment Agreements – Jeffry E. Sterba" for further information. Mr. Warnock's 4,736 incremental RSUs vest on January 1, 2017. We believe that the vesting terms provide our continuing executive officers a meaningful incentive for continued employment.

Performance Vesting of PSUs Granted in 2012

In 2012, we granted PSUs to our executives and other employees for which the performance period ended in 2014. The number of PSUs earned was based on our performance with respect to three separate measures shown on the following table and discussed below:

Performance Measure	Weighting at Target
Total Stockholder Return	44.8%
Operational Efficiency Improvement	27.6%
Compounded EPS Growth	27.6%
Total	100.0%

We awarded two types of PSUs in 2012; one type related to the TSR measure, while the other type related to the other two measures, which were equally weighted. The payouts with respect to the two types of PSUs are addressed below.

Total Stockholder Return. This measure is based on the comparative American Water TSR, relative to the total stockholder return performance of the companies in the Dow Jones U.S. Utilities Total Return Index during the applicable performance period. The comparative TSR was computed in the same manner as the comparative TSR is computed with respect to the PSUs granted in 2014, except that the performance period for the PSUs granted in 2012 extended from January 1, 2012 through December 31, 2014.

Our TSR during the performance period was greater than 90 percent of the other companies in the Dow Jones U.S. Utilities Total Return Index Comparator Group. As a result, a number of shares equal to 175 percent of the PSUs granted with respect to this measure were issuable based upon performance vesting, as indicated in the following table:

Name	Number of PSUs Granted	Number of PSUs Performance Vested
Jeffry E. Sterba	13,318	23,308
Walter J. Lynch	5,080	8,891
Kellye L. Walker	2,949	5,161

Operational Efficiency Improvement. This measure was calculated in the same manner as described above for PSUs granted in 2014, but was calculated with respect to each of 2012, 2013 and 2014.

The average of the ratio of total operation and maintenance expense to total operating revenues for our regulated operations in 2012, 2013 and 2014 was 39.99 percent, which resulted in a performance percentage with respect to this measure of 145.5 percent of target.

Compounded EPS Growth. This measure was based on the growth of our EPS, as reported in our audited financial statements, adjusted to exclude the net impact of any impairment, compounded annually over the three year period from January 1, 2012 through December 31, 2014, over the adjusted EPS of $1.78 for the year ended December 31, 2011.

Our Compounded EPS Growth during the performance period was 10.9 percent, which resulted in a performance percentage equal to 175 percent of target.

After averaging the performance percentage with respect to the operational efficiency improvement measure and the compounded EPS growth measure, a number of shares equal to 160.25 percent of the PSUs granted with respect to the two measures were issuable based on performance vesting, as indicated in the following table:

Name	Number of PSUs Granted	Number of PSUs Performance Vested
Jeffry E. Sterba	16,455	26,369
Walter J. Lynch	6,247	10,010
Kellye L. Walker	3,627	5,812

The performance vested PSUs were paid out in shares of our stock upon certification by the compensation committee on January 16, 2015.

Perquisites

We provide limited perquisites to our executive officers, principally consisting of executive physicals. Because the efforts of our leadership team are important to our success, we believe it is important to provide an executive physical benefit. In keeping with our wellness culture, we believe providing periodic physicals for executives can help our executives detect medical conditions before they become serious.

STOCK OPTION GRANT PRACTICES

Our compensation committee makes annual stock option grants to employees, including executive officers, in February of each year. Grants are made at other times in connection with new hires and promotions. The exercise price per share for options is at least equal to the last reported sale price of our common stock on the date of grant. Moreover, we will not reprice any options without seeking stockholder approval. We believe that our stock option grant practices are appropriate and effectively address any concerns regarding “timing” of grants in anticipation of material events.

EXECUTIVE STOCK OWNERSHIP AND RETENTION REQUIREMENTS

To further emphasize the importance of linking executive and stockholder interests, the company has added stock ownership guidelines to our retention requirements that require NEOs to own American Water stock in an amount ranging from three to six times their annual base salary. The CEO is required to hold American Water stock equal to six times her base salary until her termination; all other NEOs are required to hold equity instruments three times his or her base salary until their termination. NEOs have five years from the date of their appointment as an executive officer to comply in good faith with these requirements. The compensation committee recently approved a stock retention holding requirement of 50% of the net value realized on each equity award until the executive attains the above retention requirements. Absent a hardship and except with respect to grandfathered shares obtained prior to appointment, NEOs are restricted from divesting any securities if they have not complied in good faith with the ownership guidelines or with the retention requirements.

HEDGING POLICY

We have a policy that prohibits trading in our derivatives by employees and directors. Specifically, the policy prohibits employees and directors from trading in options (other than options issued under a company plan), futures on our securities or any other security that derives its price from the price or other attributes of our securities.

ONGOING AND POST-EMPLOYMENT ARRANGEMENTS AND BENEFIT PLANS

We have several plans and arrangements that enable our NEOs to accrue retirement benefits as they continue to work for us, provide severance benefits upon certain types of termination of employment, or provide other forms of deferred compensation. Most of these plans and agreements have been adopted within the past few years, although some plans, particularly our defined benefit plans that are no longer available to new employees, were adopted some time ago. Not all plans apply to each NEO, as indicated in the discussion below.

Savings Plan for Employees of American Water Works, Inc. and Designated Subsidiaries—the "Savings Plan"

This is a tax qualified defined contribution plan available to employees of American Water, including our NEOs, and certain subsidiaries. Each of our currently employed NEOs participates in the Savings Plan . Under the Savings Plan, an employee may contribute, subject to Internal Revenue Code limitations, 50 percent of his or her base salary up to a maximum contribution of $17,500**,** plus, for eligible participants, **$**5,500 for catch-up contributions. For any NEO participant hired before January 1, 2006 who continues to be employed by us (Mr. Lynch is the only NEO in this category), the matching contribution formula is: 50 percent of a participant's base salary contributions for the year, up to a maximum of 5 percent of the participant's base salary. For NEO participants hired after January 1, 2006, the matching contribution formula is: (a) 100 percent for every dollar contributed up to the first 3 percent of the participant's base salary, and (b) 50 percent on the next 2 percent of the participant's base salary. In addition, for NEO participants hired after January 1, 2006, we make additional annual contributions equal to the sum of 5.25 percent of the participant's base salary, subject to Internal Revenue Code limitations. We provide more generous contributions to participants hired after January 1, 2006 because they are ineligible to participate in the defined benefit pension plans described below.

Amounts credited to an employee's account may be invested among a number of funds, and the value of a participant's account will be increased or decreased to reflect the performance of selected investments.

American Water Works Company, Inc. Pension Plan—the "AWWPP"; American Water Works Company, Inc. Executive Retirement Plan—the "ERP"

The AWWPP is a tax-qualified defined benefit pension plan available to eligible employees who commenced employment with us prior to January 1, 2006. The AWWPP provides an annual retirement benefit based on an employee's earnings and years of service. For executives hired prior to July 1, 2001, a grandfathered benefit is provided. Mr. Lynch participates in the AWWPP.

The ERP is a nonqualified defined benefit pension plan that provides pension benefits under the same formula as the AWWPP, but without the pay and benefit limitations that are applicable to the AWWPP under the Internal Revenue Code. Mr. Lynch participates in the ERP. We closed the AWWPP and the ERP to new employees on December 31, 2005 and replaced those plans with defined contribution plans. This action was taken for a number of reasons, including to enable us to predict fixed costs for retirement benefits on an ongoing basis. In contrast, we are subject to variable costs in connection with our defined benefit plans based on the performance of the plans' investment portfolios.

See "Executive Compensation—2014 Pension Benefits" for further information regarding the AWWPP and the ERP.

Nonqualified Savings and Deferred Compensation Plan for Employees of American Water Works Company, Inc. and its Designated Subsidiaries—the "Deferred Compensation Plan"

This plan is a nonqualified deferred compensation plan that enables participants to defer salary and annual incentive plan awards and provides benefits to executive officers and other highly paid employees in excess of the maximum benefits that may be provided under the Savings Plan as a result of limits imposed by the Internal Revenue Code. We refer to compensation in excess of those limits as "excess compensation." All of the currently employed NEOs participate in the Deferred Compensation Plan.

Generally, under the Deferred Compensation Plan, an executive may elect to defer up to 20 percent of salary and up to 100 percent of the award paid under the AIP. We provide matching contributions that differ depending on whether the executive was hired by us on or after January 1, 2006. For currently-serving NEOs hired after January 1, 2006 (Ms. Story, Ms. Sullivan and Mr. Warnock), we provide the matching contribution we would have made for the executive under the Savings Plan with respect to the executive's excess compensation if the excess compensation had been taken into account under the Savings Plan. In addition, we make a defined contribution for the account of each of these executives generally equal to 5.25 percent of the sum of base salary that constitutes excess compensation and the award payable under the AIP for the relevant plan year. For Mr. Lynch, who was hired prior to January 1, 2006, our matching contribution is equal to 50 percent of salary deferrals up to a maximum of five percent of base salary; our contributions are more limited for Mr. Lynch due to his eligibility under our defined benefit pension plan. Each participant may allocate amounts credited to his or her account among several notional investments, and the value of the account will be increased or decreased to reflect deemed returns under the selected notional investments. The participant may elect to receive payment of deferred amounts in a lump sum or in annual installments, on or beginning at separation from service or a specified distribution date. See "Executive Compensation—2014 Nonqualified Deferred Compensation" for additional information.

Executive Severance Policy

Under our executive severance policy, adopted in 2008, we provide severance benefits to our NEOs. Our policy is designed to provide a clear statement of the rights of our executive officers if they are involuntarily terminated without cause. Among other things, the policy calls for 18 months for our CEO and for 12 months of salary continuation for the other NEOs, and a pro rata AIP award for the year in which the termination date occurs to the extent such payment is provided for under the terms of the applicable AIP. See "Executive Compensation—Potential Payments on Termination or Change in Control" for further information.

American Water Works Company, Inc. Nonqualified Employee Stock Purchase Plan—the "ESPP"

Under the ESPP, eligible employees, including our NEOs, are provided an opportunity to purchase our common stock at a discount of ten percent from the lower of the prevailing market price on the first day and last day of each three-month purchase period. Purchases generally are limited to $25,000 per year. We believe that, in addition to the benefit employees realize from the discount, our stockholders will benefit because the ESPP helps to more closely align the interests of our employees and our stockholders.

Change in Control Provisions in Equity Plans

Most of our compensation plans and policies do not contain change in control provisions affecting compensation of our NEOs. However, our equity awards generally vest upon a change in control of American Water. In addition, certain of our contributions to the Deferred Compensation Plan will vest upon a change in control. See "Executive Compensation—Potential Payments on Termination or Change in Control" for further information.

Recovery of Incentive Compensation

In 2010, we instituted a policy governing the recovery of incentive compensation in the event of a material restatement of our financial results under specified circumstances. As a result of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which imposes an executive compensation "clawback" requirement on public companies, and the related NYSE listing standards expected to be adopted, we anticipate that we will amend the policy to comply with these executive compensation recovery requirements.

TAX CONSIDERATIONS

Section 162(m) of the Internal Revenue Code limits to $1 million the deductibility for federal income tax purposes of annual compensation paid by a publicly held corporation to its chief executive officer and other NEOs, unless certain conditions are met. At the 2015 Annual Meeting, we are proposing stockholder reapproval of the performance measures under our 2007 Omnibus Equity Compensation Plan and approval of a new plan to govern our annual incentive plan to enable performance-based awards to satisfy the deductibility requirements of Section 162(m). See Proposals 4 and 5 below.

COMPENSATION COMMITTEE REPORT

The compensation committee has reviewed and discussed the foregoing Compensation Discussion and Analysis with management. Based on this review and discussion, the compensation committee has recommended to the full board of directors that the Compensation Discussion and Analysis be included in this proxy statement.

Respectfully submitted,

William J. Marrazzo (Chair)
Julie A. Dobson
Paul J. Evanson
Julia L. Johnson

Ms. Dobson served on the compensation committee until May 9, 2014 and did not participate in the compensation committee's subsequent determinations.

The information contained in the foregoing report shall not be deemed to be "soliciting material" or "filed" or incorporated by reference into any of our previous or future filings with the SEC, or subject to the liabilities of Section 18 of the Exchange Act, except to the extent specifically incorporated by reference into a document filed under the Securities Act of 1933, as amended (the "Securities Act") or the Exchange Act.

Risk Considerations Related to Compensation Policies and Practices

The board and compensation committee have each assessed potential risks related to our compensation policies and practices and have concluded that they are not reasonably likely to have a material adverse effect on American Water. In considering risks related to our compensation policies and practices, the board and compensation committee noted that less than 30 percent of our employees participate in any form of variable compensation and 62 percent of the participating employees have a target award that is not greater than 15 percent of base pay. Therefore, the analysis focused on our executive compensation, because a significant portion of compensation for our senior managers is performance-based. The board and compensation committee considered the following mitigating factors with respect to executive compensation:

- Factors mitigating risks relating to short-term incentives—Short-term incentives, available through the AIP, comprised only a limited portion of total compensation (in the case of Ms. Story, her 2014 AIP target award was approximately 25 percent of direct compensation); company-wide and individual targets were dispersed among a variety of financial and non-financial goals; maximum awards are capped at 200 percent of target; and the compensation committee has broad discretion in determining the amount of AIP awards.
- Factors mitigating risks related to long-term incentives—The three year vesting and performance periods applicable to our long-term incentive compensation require a long-term executive focus; annual grants of long-term awards result in overlapping vesting and performance periods, which reduces risks that executives will focus only on one performance or vesting period; executives are discouraged from seeking short-term increases in stock prices in connection with stock option exercises because stock options comprise only a portion of our equity compensation and the rest of our equity compensation is based on long-term performance; and our equity compensation is subject to our Stock Retention Program, described above under "Executive Stock Retention Requirements" and our newly instituted stock ownership guidelines for executives described earlier.

EXECUTIVE COMPENSATION

2014 Summary Compensation Table

The following table sets forth information regarding the compensation of our Chief Executive Officer, our former Chief Executive Officer, our Chief Financial Officer and each of the persons who were the three other most highly paid executive officers in 2014.

Name and Principal Position	Year	Salary (3)	Bonus	Stock Awards (4)	Option Awards (5)	Non-Equity Incentive Plan Compensation (6)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (7)	All Other Compensation (8)	Total
Susan N. Story	2014	$637,174	-	$ 952,736	$238,174	$ 587,243	-	$ 150,520	$2,565,847
President and Chief Executive Officer (Former Senior Vice President and Chief Financial Officer (1))	2013	$390,959	-	$2,189,650	$160,497	$ 420,911	-	$ 137,942	$3,299,959
Jeffry E. Sterba	2014	$488,321	-	$1,575,008	$393,750	$ 488,254	-	$ 231,829	$3,177,162
Former President and Chief	2013	$778,854	-	$1,500,032	$374,998	$ 826,088	-	$ 216,167	$3,696,139
Executive Officer	2012	$732,695	-	$1,124,988	$750,002	$ 970,500	-	$ 209,530	$3,787,715
Linda Sullivan	2014	$300,764	-	$ 959,973	$114,998	$ 340,871	-	$ 94,878	$1,811,484
Senior Vice President and Chief Financial Officer (2)									
Walter J. Lynch	2014	$521,531	-	$ 612,043	$153,001	$ 391,834	$ 451,509	$ 84,542	$2,214,460
President and Chief Operating	2013	$506,534	-	$ 593,983	$148,497	$ 405,806	$ 77,835	$ 94,562	$1,827,217
Officer of Regulated Operations	2012	$493,846	-	$ 426,305	$284,201	$ 448,371	$ 369,850	$ 46,437	$2,069,010
Kellye L. Walker	2014	$393,840	-	$ 343,173	$ 85,798	$ 226,592	-	$ 90,557	$1,139,960
Former Senior Vice President,	2013	$388,267	-	$ 336,625	$ 84,152	$ 225,011	-	$ 100,868	$1,134,923
General Counsel and	2012	$380,765		$ 247,493	$165,001	$ 272,225	-	$ 62,005	$1,127,489
Secretary			-						
Loyd Warnock	2014	$235,389	$440,000	$ 479,197	$ 64,801	$ 177,845	-	$ 22,495	$1,419,727
Senior Vice President External Affairs, Communications and Public Policy (2)									

(1) Ms. Story served as our Senior Vice President and Chief Financial Officer from April 1, 2013 until she became our Chief Executive Officer on May 9, 2014.

(2) Ms. Sullivan received an additional equity award under our 2014 LTIP of $500,000 in her employment agreement. Mr. Warnock received a $220,000 sign on cash bonus and $220,000 in Restricted Stock Units which vest on January 1, 2017.

(3) The following officers deferred a portion of their salary under our Nonqualified Savings and Deferred Compensation Plan as follows: Ms. Story $123,020, Mr. Sterba $137,321, Mr. Lynch $77,088 and Ms. Walker $30,493.

(4) The amounts shown in this column reflect the grant date fair value of the performance stock units ("PSUs") and, beginning in 2014, the aggregate grant date fair value of PSUs and restricted stock units ("RSUs") granted to the named executive officers:

The grant date fair value of PSUs and RSUs granted in 2014 are as follows:

	PSUs	RSUs
Susan N. Story	$ 714,554	$ 238,182
Jeffrey E. Sterba	$ 1,181,244	$ 393,764
Linda Sullivan	$ 694,976	$ 264,997
Walter J. Lynch	$ 459,023	$ 153,020
Kellye L. Walker	$ 257,388	$ 85,785
Loyd Warnock	$ 194,412	$ 284,785

With respect to the PSUs, the amounts disclosed in the table above represent the grant date fair value based upon the target outcome of the performance conditions, determined at the grant date in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718 "Compensation-Stock Compensation," which we refer to as "FASB ASC Topic 718." The following table shows the value of the PSU awards at the grant date, assuming the highest level of performance was achieved:

Name	Year	Grant Date Fair Value
Susan N. Story	2014	$ 1,250,470
	2013	$ 842,671
Jeffry E. Sterba	2014	$ 2,067,177
	2013	$ 1,968,785
	2012	$ 1,968,729
Linda Sullivan	2014	$ 1,216,208
Walter J. Lynch	2014	$ 803,290
	2013	$ 779,613
	2012	$ 746,034
Kellye L. Walker	2014	$ 450,429
	2013	$ 441,837
	2012	$ 433,113
Loyd Warnock	2014	$ 340,221

See Note 8: Stockholders' Equity in the notes to the consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014 for the assumptions that were made in determining grant date fair values of the PSU and RSU awards.

(5) The amounts shown in this column reflect the grant date fair value of stock options granted to the named executive officers, determined in accordance with FASB ASC Topic 718. See Note 8: Stockholders' Equity in the notes to the consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014 for the assumptions that were made in determining grant date fair values of the stock options.

(6) The amounts shown in this column for 2014 constitute the payments for the 2014 AIP, which was paid in March, 2015. The amounts shown in this column for 2013 represent the payment for the 2013 AIP, which was paid in March, 2014. The amounts shown in this column for 2012 represent the payment for the 2012 AIP, which was paid in March, 2013.

(7) The amounts shown in this column reflect the aggregate changes in the actuarial present values of the named executive officer's accumulated benefits under our qualified and nonqualified defined benefit pension plans from the pension plan measurement date used for our audited financial statements, to the pension plan measurement date used for our audited financial statements. For further information on the pension plans, see "2014 Pension Benefits," below. In addition, because there were no above-market earnings on the named executive officers' deferred compensation, no amounts of deferred compensation are required to be shown in this column, pursuant to rules of the SEC.

(8) The following table shows the components of the amounts listed in the 2014 "All Other Compensation" column for each named executive officer:

Name	401 (k) Company Match	401 (k) Defined Contribution Company Match Account (a)	Company Contributions to Deferred Contribution Plan (b)	Executive Perquisite Executive Physical	Dividend Equivalents (c)	Company Paid Life Insurance	Relocation	Total All Other Comp
Susan N. Story	$ 10,400	$ 13,650	$ 89,209	$ —	$ 36,839	$ 422	$ —	$150,520
Jeffry E. Sterba	$ 10,400	$ 13,650	$ 66,283	$ 3,700	$ 137,374	$ 422	$ —	$231,829
Linda Sullivan	$ 7,077	$ 13,650	$ 17,896	$ —	$ —	$ 246	$ 56,009	$ 94,878
Walter J. Lynch	$ 6,336	$ —	$ 6,538	$ —	$ 71,246	$ 422	$ —	$ 84,542
Kellye L. Walker	$ 10,400	$ 13,650	$ 21,444	$ 3,292	$ 41,349	$ 422	$ —	$ 90,557
Loyd Warnock	$ 554	$ 12,358	$ 9,337	$ —	$ —	$ 246	$ —	$ 22,495

(a) The Defined Contribution Match Account is an account in our 401(k) plan to which American Water contributes 5.25% of each eligible employee's total cash compensation (which includes base pay and annual incentive plan payouts), subject to Internal

Revenue Code limits on compensation that may be taken into account. Only employees hired on or after January 1, 2006 are eligible for this contribution.

(b) The amounts in this column represent matching contributions that the Company has made to the named executive officers' accounts in our Nonqualified Savings and Deferred Compensation Plan. For further information on this plan, see "2014 Nonqualified Deferred Compensation" below.

(c) Dividend equivalents are paid in cash, with respect to PSUs and RSUs, at such time, if ever, as the PSUs or RSUs are converted to American Water common stock. PSU and RSU dividend equivalents were paid out in 2014.

Employment Agreements

We have employment agreements with Mses. Story and Sullivan and Mr. Warnock, the terms of which, including terms relating to retirement or other termination of employment, are summarized in the Compensation Discussion and Analysis above.

2014 Grants of Plan-Based Awards

The following table provides certain information regarding plan-based awards granted to our named executive officers during the fiscal year ended December 31, 2014:

Name	Grant Date	Estimated Possible Payouts Under Non-Equity Incentive Plan Awards (1)		Estimated Future Payouts Under Equity Incentive Plan Awards (2)			All Other Stock Awards: Number of Shares of Stock or Units (3)	All Other Option Awards: Number of Securities Underlying Options (4)	Exercise or Base Price of Option Awards ($)(4)	Grant Date Fair Value of Stock and Option Awards ($)(5)
		Target	Maximum	Threshold	Target	Maximum				
Susan N. Story										
Annual Incentive Plan		$594,414	$1,200,834							
Options	2/20/2014							29,944	$ 44.06	$ 160,500
PSU	2/20/2014			1,285	5,141	8,997				$ 240,753
PSU	2/20/2014			1,366	5,464	9,562				$ 240,744
RSU	2/20/2014						3,643			$ 160,511
Options	5/9/2014							14,966	$ 46.26	$ 77,674
PSU	5/9/2014			572	2,288	4,004				$ 116,528
PSU	5/9/2014			630	2,519	4,408				$ 116,529
RSU	5/9/2014						1,679			$ 77,671
Jeffry E. Sterba										
Annual Incentive Plan		$468,125	$ 936,250							
Options	2/20/2014							144,761	$ 44.06	$ 393,750
PSU	2/20/2014			3,153	12,612	22,071				$ 590,620
PSU	2/20/2014			3,351	13,405	23,459				$ 590,624
RSU	2/20/2014						8,937			$ 393,764
Linda Sullivan										
Annual Incentive Plan		$345,000	$ 690,000							
Options	4/28/2014							21,780	$ 46.45	$ 114,998
PSU	4/28/2014			1,824	7,297	12,770				$ 347,483
PSU	4/28/2014			1,870	7,481	13,092				$ 347,492
RSU	4/28/2014						5,705			$ 264,997
Walter J. Lynch										
Annual Incentive Plan		$393,750	$ 787,500							
Options	2/20/2014							28,545	$ 44.06	$ 153,001
PSU	2/20/2014			1,225	4,901	8,577				$ 229,514
PSU	2/20/2014			1,302	5,209	9,116				$ 229,509
RSU	2/20/2014						3,473			$ 153,020
Kellye L. Walker										
Annual Incentive Plan		$217,250	$ 434,500							
Options	2/20/2014							16,007	$ 44.06	$ 85,798
PSU	2/20/2014			687	2,748	4,809				$ 128,689
PSU	2/20/2014			730	2,921	5,112				$ 128,699
RSU	2/20/2014						1,947			$ 85,785
Loyd Warnock										
Annual Incentive Plan		$180,000	$ 360,000							
Options	4/28/2014							12,273	$ 46.45	$ 64,801
PSU	4/28/2014			510	2,041	3,572				$ 97,192
PSU	4/28/2014			523	2,093	3,663				$ 97,220
RSU	4/28/2014						6,131			$ 284,785

(1) These columns present target and maximum annual incentive plan payout opportunities. The actual payments that were made under the annual incentive plan for 2014 performance are shown in the 2014 Summary Compensation Table. There is no specified minimum award for participants in the annual incentive plan and therefore we did not include a column in the table for the threshold amount of such award. For further information on the annual incentive plan, see “Compensation Discussion and Analysis—2014 Compensation—Annual Incentive Compensation.”

(2) These columns present threshold, target and maximum payout opportunities with respect to our performance stock units. For further information on the Long Term Incentive Plan, under which the performance stock units were granted, see "Compensation Discussion and Analysis—2014 Compensation—Long Term Incentive Compensation."

(3) This column reflects grants of restricted stock units. For further information on the Long Term Incentive Plan, under which the restricted stock units were granted, see "Compensation Discussion and Analysis – 2014 Compensation – Long Term Incentive Compensation."

(4) These columns reflect grants of stock options and their respective exercise prices. For further information on the Long Term Incentive Plan, under which the stock options were granted, see "Compensation Discussion and Analysis—2014 Compensation—Long Term Incentive Compensation."

(5) This column represents the grant date fair values of the performance stock units, restricted stock units and stock options, determined in accordance with FASB ASC Topic 718. See footnotes (4) and (5) to the 2014 Summary Compensation Table for additional information.

2014 Outstanding Equity Awards at Fiscal Year-End

The following table provides information regarding equity awards held by our named executive officers at December 31, 2014.

		Option Awards				Stock Awards (PSUs only)			
Name	**Grant Date**	**Number of Securities Underlying Unexercised Options: Exercisable**	**Number of Securities Underlying Unexercised Options: Unexercisable (1)**	**Option Exercise Price**	**Option Expiration Date**	**Number of Shares or Units of Stock That Have Not Vested (2)**	**Market Value of Shares or Units of Stock That Have Not Vested (3)**	**Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (4)**	**Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (3)**
Susan N. Story									
	4/1/2013	9,485	18,972	$ 41.27	12/31/2019	15,093	$ 804,457	11,868	$ 632,564
	2/20/2014		29,944	$ 44.06	12/31/2020	3,643	$ 194,172	10,605	$ 565,247
	5/9/2014		14,966	$ 46.26	12/31/2020	1,679	$ 89,491	4,807	$ 256,213
Jeffry E. Sterba									
	2/23/2012	58,919	29,461	$ 34.12	12/31/2018			21,522	$1,147,123
	4/02/2012	22,801	11,401	$ 34.35	12/31/2018			8,251	$ 439,778
	2/21/2013	34,786	34,787	$ 39.45	12/31/2019	4,753	$ 253,335	28,304	$1,508,603
	2/20/2014		144,761	$ 44.06	12/31/2020	8,937	$ 476,342	26,017	$1,386,706
Linda Sullivan									
	4/28/2014		21,780	$ 46.45	12/31/2020	5,705	$ 304,077	14,778	$ 787,667
Walter J. Lynch									
	2/23/2012	31,009	15,505	$ 34.12	12/31/2018			11,327	$ 603,729
	2/21/2013	8,389	16,780	$ 39.45	12/31/2019	2,510	$ 133,783	11,208	$ 597,386
	2/20/2014		28,545	$ 44.06	12/31/2020	3,473	$ 185,111	10,110	$ 538,863
Kellye L. Walker									
	2/23/2012	5,903	9,002	$ 34.12	12/31/2018			6,576	$ 350,501
	2/21/2013	4,754	9,509	$ 39.45	12/31/2019	1,422	$ 75,793	6,352	$ 338,562
	2/20/2014		16,007	$ 44.06	12/31/2020	1,947	$ 103,775	5,669	$ 302,158
Loyd Warnock									
	4/28/2014		12,273	$ 46.45	12/31/2020	6,131	$ 326,782	4,134	$ 220,342

(1) The options granted in 2012, 2013 and 2014 (other than the options granted to Mr. Sterba on February 21, 2013 and February 20, 2014) vest in equal increments on January 1 of each of the three years next following the year in which the options were granted. The options granted to Mr. Sterba on February 21, 2013 vest in equal increments on January 1, 2014 and January 1, 2015. The options granted to Mr. Sterba on February 20, 2014 vest on January 1, 2015.

(2) This column reflects restricted stock units granted as described under "Compensation Discussion and Analysis—2014 Compensation—Long Term Incentive Plan," that are not subject to performance conditions and will time-vest in equal increments on January 1, 2015, 2016 and 2017, subject to continued employment through such date, except as noted in the following sentence. The restricted stock units held by Mr. Sterba will time vest in equal installments on January 1, 2014 and 2015, and 37,500 restricted stock units held by Ms. Story will time vest in equal installments on April 1, 2014, October 1, 2014 and April 1, 2015.

(3) The market value of the restricted stock units and performance-based stock units is based on the $53.30 closing price of our common stock on December 31, 2014, as reported by the NYSE.

(4) This column reflects performance stock units granted as described under "Compensation Discussion and Analysis—2014 Compensation—Long Term Incentive Plan," that are subject to performance conditions and, to the extent performance conditions have been satisfied, time-vest in equal increments on January 1, 2015, 2016 and 2017, subject to continued employment through such date. The number of shares disclosed in this column represents the amount that performance vests if target performance is achieved.

2014 Option Exercises and Stock Vested

The following table provides information regarding the exercise of stock options and vesting of restricted stock units held by our named executive officers at December 31, 2014.

	Option Awards		Stock Awards	
Name	**Number of Shares Acquired on Exercise**	**Value Realized On Exercise(1)**	**Number of Shares Acquired on Vesting**	**Valued Realized on Vesting(2)**
Susan N. Story	—	—	26,296	$ 1,220,519
Jeffry E. Sterba	25,000	$ 730,674	49,967	$ 2,107,084
Linda Sullivan	—	$ —	—	$ —
Walter J. Lynch	45,414	$ 1,147,772	25,048	$ 1,056,149
Kellye L. Walker	30,701	$ 562,110	14,525	$ 612,445
Loyd Warnock	—	$ —	—	$ —

(1) Based on the difference between the market value of the underlying common stock at exercise and the exercise price of the options.

(2) Based on the closing share price on the date the applicable share units vested.

2014 Pension Benefits

American Water Works Company, Inc. Pension Plan

The American Water Works Company, Inc. Pension Plan, which we refer to as the "AWWPP," is a qualified pension plan that provides for a pension benefit equal to 1.6% of final average pay multiplied by years of service. Final average pay is defined for purposes of the plan as the average sum of base pay plus annual incentive payout for the highest 60 months out of the final 120 months of employment. For executives hired prior to July 1, 2001, a grandfathered benefit is provided. Normal retirement is defined as age 65, and early retirement eligibility is satisfied when an employee's age is at least 55 and the employee has attained a service requirement that varies based on whether the employee is in a grandfathered group and, if so, the location of such group. Benefits vest in the AWWPP upon completion of five years of service. Our named executive officer who participates in the plan is vested in his pension benefit. The normal form of payment is a single life annuity for single participants and a 50% joint and survivor annuity for married participants. The 50% joint and survivor annuity benefit amount is determined to be actuarially equivalent to the single life annuity amount. There is a reduction in benefits for early retirement for participants other than those who retire at age 62 or older with specified service levels, such as 20 years of service for someone who is age 62.

American Water Works Company, Inc. Executive Retirement Plan

The American Water Works Company, Inc. Executive Retirement Plan, which we refer to as the ERP, is a nonqualified defined benefit pension plan that provides benefits under the same formula as the AWWPP, but without the pay and benefit payment limitations that are applicable to the AWWPP under the Internal Revenue Code and including deferred compensation in calculating the final average pay. The ERP also provides a minimum benefit in accordance with provisions of former executive retirement plans that American Water sponsored, the American Water Works Company, Inc. Supplemental Executive Retirement Plan and Supplemental Retirement Plan, which we refer to as the SERP and SRP, respectively. Mr. Lynch who participates in this nonqualified pension plan is entitled to the greater of the benefits determined pursuant to the restoration formula under the ERP and the benefits determined pursuant to his prior nonqualified plan formulas. Mr. Lynch participates in the restoration provisions of the ERP and is vested in this nonqualified pension benefit. Upon retirement, nonqualified plan benefits are payable as lump sums unless the participant has elected an alternate form of payment pursuant to the regulations under Section 409A of the Internal Revenue Code. Mr. Lynch will receive his benefits as a lump sum. Upon voluntary termination of employment prior to eligibility for early or normal retirement, nonqualified benefits are payable as deferred (to age 65) annuities or lump sum equivalents of such deferred annuities. All nonqualified plan lump sums are calculated as the present value of deferred or immediate single life annuities.

Name	Plan Name	Number of Years Accredited Service	Present value of Accumulated Benefit(3)	Payments During Last Fiscal Year
Susan N. Story	N/A(1)	N/A	N/A	N/A
Jeffry E. Sterba	N/A(1)	N/A	N/A	N/A
Linda Sullivan	N/A(1)	N/A	N/A	N/A
Walter J. Lynch(2)	AWW Inc. Executive Retirement Plan	10.04	$ 1,027,076	N/A
	AWW Co. Pension Plan	10.04	$ 401,241	N/A
Kellye L. Walker	N/A(1)	N/A	N/A	N/A
Loyd Warnock	N/A(1)	N/A	N/A	N/A

(1) Since Ms. Story, Mr. Sterba, Ms. Sullivan, Ms. Walker and Mr. Warnock were hired after 2005, they do not participate in our defined benefit plans.

(2) At the time Mr. Lynch's age plus credited service exceed 70, he also becomes eligible for a subsidized early retirement benefit payable as an annuity under the provisions of the plans.

(3) Amounts shown reflect the present value of Mr. Lynch's accumulated benefit as of December 31, 2014. All amounts for the pension plans were determined using the same interest and mortality assumptions as those used for financial reporting purposes. The following assumptions were used to calculate pension values at the following measurement dates: (for purposes of the column titled "Change in Pension Value and Nonqualified Deferred Compensation Earnings" in the "2014 Summary Compensation Table"): In 2013, for discounting annuity payments a discount rate of 5.12% and mortality table of RP2000, sex distinct with no collar adjustments and for calculating lump sums, an interest rate of 5.12% and the RP2000 static unisex table prescribed by Internal Revenue Code 417 (e) for 2013. In 2014, for discounting annuity payments a discount rate of 4.24% and mortality table of RP2014 projected using Scale BB2-D generational and for calculating lump sums, an interest rate of 4.24% and the RP2000 static unisex table prescribed by Internal Revenue Code 417 (e) for 2014.

For further information on American Water’s defined benefit pension plans, see “Potential Payments on Termination or Change in Control,” below.

2014 Nonqualified Deferred Compensation

All the named executive officers participate in the Nonqualified Savings and Deferred Compensation Plan for Employees of American Water Works Company, Inc. and its Designated Subsidiaries. For the named executive officers, the deferred compensation plan permits the deferral of up to 20% of base salary and up to 100% of bonus each year on a tax-favored basis. It also provides for annual matching contributions determined by the following formula for named executive officers hired on or after January 1, 2006 (Mses. Story and Sullivan and Mr. Warnock): (a) the sum of (i) 100% of a participant’s voluntary deferrals for the year, up to a maximum of 3% of the sum of the participant’s base salary and bonus and (ii) 50% of a participant’s voluntary deferrals for the year, up to a maximum of the next 2% of the sum of the participant’s base salary and bonus, less (b) the maximum amount of matching contributions that the participant is eligible to receive under the 401(k) plan for the year. For named executive officers hired before January 1, 2006 (Mr. Lynch is the only NEO in this category), the matching contribution formula is: (a) 50% of a participant’s base salary deferrals for the year, up to a maximum of 5% of the participant’s base salary, less (b) the maximum amount of matching contributions that the participant is eligible to receive under the 401(k) plan for the year. In addition, we make additional annual contributions for named executive officers hired on or after January 1, 2006, equal to the sum of (a) 5.25% of the participant’s base salary in excess of the dollar limitation in effect under Section 401(a)(17) of the Internal Revenue Code with respect to the year and (b) 5.25% of the participant’s bonus. Participants’ deferred compensation accounts are credited with returns in accordance with the deemed investment options elected by the participant. Participants are immediately vested in all contributions to the plan, except for the 5.25% annual contributions, which vest at the earliest of (i) completion of five years of service, (ii) attainment of age 65, (iii) death, or (iv) a change in control. Under the terms of the December 12, 2013 amendment to Mr. Sterba’s employment letter agreement, effective January 1, 2015 or as soon thereafter as administratively possible, we will fully vest the 5.25 percent annual contributions credited to Mr. Sterba’s account for each of the 2011-2014 plan years. Participants may elect to receive their account balances at any of the following times: (i) separation from service or (ii) a specified distribution date, if earlier, a change in control, and may elect any of the following forms for distribution of their accounts: (i) lump sum or (ii) annual installments paid over a period of between two and 10 years. None of the named executive officers had any withdrawals from the plan in 2014. Mr, Lynch had a distribution in 2014.

Name	Executive Contributions in Last Fiscal Year (1)	Registrant Contributions in Last Fiscal Year (2)	Aggregate Earnings in Last Fiscal Year	Aggregate Withdrawals/ Distributions in Last Fiscal Year	Aggregate Balance at Last Fiscal Year (3)
Susan N. Story	$ 710,263	89,209	$ 4,575	_	$ 826,144
Jeffry E. Sterba	$ 217,990	$ 66,283	$ 26,174	$ —	$ 1,035,767
Linda Sullivan	$ —	$ 17,896	$ —	$ —	$ 17,896
Walter J. Lynch	$ —	$ —	$ 29,295	$ (64,800)	$ 593,944
Kellye L. Walker	$ 31,002	$ 21,444	$ 7,941		$ 220,082
Loyd Warnock	$ —	$ 9,377		$ —	$ 9,377

(1) The following amounts in this column are also reported as compensation to the named executive officers in the 2014 Summary Compensation Table in the columns indicated:

Named Executive Officer	Salary	Non Equity Incentive Plan Compensation
Susan N. Story	$ 123,020	$ 587,243
Jeffry E. Sterba	$ 95,926	$ 122,064
Linda Sullivan	$ —	$ —
Walter J. Lynch	$ 36,507	$ 39,183
Loyd Warnock	$ —	$ —
Kellye L. Walker	$ 19,692	$ 11,330

(2) The amounts in this column are also reported as compensation to the named executive officers in the 2014 Summary Compensation Table in the “All Other Compensation” column.

(3) The following amounts were reported in the Summary Compensation Table in previous years as compensation to the listed named executive officers: Ms. Story $22,098; Mr. Sterba $725,321; Mr. Lynch $547,220; Ms. Walker $159,676.

Potential Payments on Termination or Change in Control

This section describes the potential payments that would have been made to the named executive officers upon various types of terminations of employment or a change in control of American Water on December 31, 2014.

Executive Severance Policy. Our executive severance policy provides severance benefits to executives whose employment is involuntarily terminated by American Water for reasons other than cause. The determination of whether an executive's employment is terminated for cause will be made at the sole discretion of the board of directors of American Water. Under the policy, our CEO will receive 18 months and other NEOs will receive 12 months of their base salary, in the form of base salary continuation. As noted below under "Severance Terms in Jeffry E. Sterba's Employment Letter Agreement and Amendment to Employment Letter Agreement," Mr. Sterba's employment letter provides that, notwithstanding the terms of the executive severance policy, he would be entitled to 18 months of base salary. Eligible executives are entitled to continued health, dental and vision coverage based on their years of service, in the amount of eight weeks of coverage for less than five years of service, 12 weeks of coverage for at least five years but less than 10 years of service and 16 weeks of coverage for 10 or more years of service. They are also entitled to life insurance coverage and continued participation in the employee assistance plan for the number of months of their severance benefits, as well as 12 months of outplacement services. In order to receive severance benefits under the executive severance policy, an executive must sign a release and waiver of any claims against American Water and agree to certain restrictive covenants. Severance benefits payable under the severance policy will be offset and reduced by any other severance benefits payable under any employment agreement or otherwise.

Severance Terms in Jeffry E. Sterba's Employment Letter Agreement and Amendment to the Employment Letter Agreement Mr. Sterba's employment letter agreement with us, dated March 26, 2012, provides that, in the event we terminate Mr. Sterba's employment without "cause" (as defined in the agreement) or he terminates employment with us for "good reason" (as defined in the agreement),

- Mr. Sterba will be entitled to receive 18 months base salary, payable in installments, and will continue to receive health, dental and vision coverage in accordance with our executive severance policy.
- The option term of options to purchase 25,000 shares previously granted to Mr. Sterba in August 2010 will be extended to the earlier of two years from his termination or the end of the seven year term of the options.
- All outstanding PSUs and options granted to him in 2012, 2013 and 2014 will fully time-vest (and the option term will be extended to the earlier of two years from his termination or the end of the stated term of such options). Time-vesting also will be accelerated in the event of his death or disability. (Each PSU grant will remain subject to performance-vesting criteria based upon our performance during the applicable three year performance period.)

To the extent the terms of the LTIP and related grants provide more favorable vesting provisions than those set forth above, the terms of the LTIP and related grants will control.

"Good reason" is defined as meaning any of the following events occurring without Mr. Sterba's consent: Mr. Sterba ceases to be our Chief Executive Officer other than in connection with the appointment by the board of directors during 2014 or thereafter of a new Chief Executive Officer; Mr. Sterba ceases to be a member of the board of directors; any material breach by us of any of the terms and conditions of the 2013 Employment Agreement; Mr. Sterba is required to relocate his office to a location more than 50 miles from its current location in Voorhees, New Jersey; Mr. Sterba's duties as Chief Executive Officer are diminished or altered in any way to his material detriment other than in connection with the appointment during 2014 or thereafter of a new Chief Executive Officer; or Mr. Sterba's compensation or benefits are diminished or altered in any way to his material detriment.

We amended Mr. Sterba's employment letter agreement on December 12, 2013. Under the amendment Mr. Sterba agreed that he will not be entitled to any payments under the executive severance policy upon termination of his employment on January 1, 2015. In addition, effective January 1, 2015 and as soon thereafter as administratively practicable, we will fully vest employer defined contributions credited to Mr. Sterba's account under the Nonqualified Savings and Deferred Compensation Plan for each of the 2011-2014 plan years. For further information on the amendment, see "Executive Compensation—Employment Agreements—Jeffry E. Sterba," above.

Severance Agreement with Kellye Walker

On January 6, 2015 we entered into a severance agreement and general release with Ms. Walker. The severance agreement provided for a severance payment and payment for her provision of consulting services over the six month period following termination of her employment, and specified the calculation of her entitlements under the AIP (Ms. Walker's payout under the AIP is described under "2014 Compensation – Annual Incentive Plan").

Deferred Compensation Plans. Our deferred compensation plan for employees is described above under "2014 Nonqualified Deferred Compensation." This Section describes the payments that would be made under that plan upon various types of termination. Since employees are immediately vested in all contributions to the plan other than our annual 5.25 percent contributions, they would receive their full account balances, less the portion of their balances attributable to such 5.25 percent contributions, upon any termination of employment other than for cause. Because participants other than Mr. Sterba do not vest in our 5.25 percent contributions until completion of five years of service, attainment of age 65, change in control or death, participants whose employment terminates before any such events would not receive amounts attributable to such contributions, and participants whose employment terminates after any such events would receive such amounts. Mr. Sterba will vest in our 5.25 percent annual contributions for each of the 2011-2014 plan years on January 1, 2015 or as soon thereafter as administratively possible. Upon a termination for cause, all employer contributions to the deferred compensation plan would be forfeited by the participants but participants would still be entitled to their elective deferrals. Payments of vested amounts will be made at the time and in the form elected by the participant, except that a lump-sum distribution of vested amounts will be paid upon death. Amounts shown in the table are the values each named executive officer would have been entitled to given a termination on December 31, 2014.

Defined Benefit Plans. Our retirement plans are described above under "2014 Pension Benefits." This section describes the payments that would be made under the retirement plans upon various types of termination of employment.

Voluntary termination—Despite being ineligible for retirement, Mr. Lynch would have been entitled to benefits from the AWWPP and the ERP, upon voluntary termination at December 31, 2014. Mr. Lynch's annual AWWPP benefit, payable as a 50 percent joint and survivor annuity beginning at age 65, is $32,519. Mr. Lynch will receive his ERP benefit as a lump sum.

Involuntary termination without cause—Under the AWWPP and the nonqualified plan benefits payable upon a termination of employment without cause are in the same amount, have the same timing and are in the same form as those payable upon a voluntary termination for Mr. Lynch.

Involuntary termination without cause following a change in control—Upon an involuntary termination of employment without cause resulting from a change in control, AWWPP and nonqualified plan benefits are in the same amount, have the same timing and are in the same form as those payable upon a voluntary termination for Mr. Lynch.

Termination for cause—In the case of termination for cause, benefits payable from the AWWPP and from the nonqualified plan are in the same amount, have the same timing and are in the same form as those payable upon a voluntary termination for Mr. Lynch.

Disability —Benefits payable upon a termination of employment as a result of a disability are determined under the AWWPP and the nonqualified plan in the same manner as benefits payable upon early retirement, except that disability benefits are payable immediately and without reduction for early commencement. AWWPP benefits are payable as annuities; nonqualified plan disability benefits are payable as lump sums unless the participant has elected an alternate form of payment. Mr. Lynch, who has completed the required 10 years of service, qualifies for disability benefits.

Death —If Mr. Lynch had died on December 31, 2014, his surviving spouse or named beneficiary would have received benefits under the AWWPP and the ERP calculated as if he had survived to age 55 and elected a 100 percent joint and survivor annuity. The benefit under the AWWPP would have been payable to him as an annuity beginning at his 55th birthday based on the age 55 early retirement factor, the age 55 100 percent joint and survivor factor (where the survivor's age is what it would be on his 55th birthday) and using service as of the date of death. The benefit under the ERP would have been paid to Mr. Lynch as the immediate lump-sum equivalent of an annuity determined in the same manner as under the AWWPP.

For purposes of reporting these benefits in the termination tables, we assumed that Mr. Lynch was married and his spouse was the same age as Mr. Lynch.

Omnibus Equity Compensation Plan Awards. Vesting of our stock option, performance share unit and restricted stock unit awards under our 2007 Omnibus Equity Compensation Plan will be accelerated as follows:

- All stock options will vest in full upon a holder's death or disability, or upon a change in control.
- Upon a change in control, the performance share units will vest with respect to the tranches of performance share unit awards that have time-vested, based upon the assumption that target performance is achieved. Upon death or disability, the performance share units will performance-vest with respect to the tranches of performance share unit awards that already have time-vested, based upon actual performance as determined at the end of the performance period.
- All unvested restricted stock units for NEOs will be immediately forfeited upon a change in control or death or disability.

As described above under "Severance Terms in Jeffrey E. Sterba's Employment Letter Agreement and Amendment to Employment Letter Agreement," Mr. Sterba's employment letter agreement provides that options and PSUs we grant to him in 2012, 2013 and 2014 will fully time-vest upon our termination of his employment without cause or termination by Mr. Sterba for good reason. All the named executive officers' options time-vest upon death or disability, and time-vest on a prorated basis upon retirement (based on the portion of the vesting period completed prior to retirement).

Quantifications of Potential Payments on Termination or Change in Control

The following table quantifies the potential payments and benefits to which the named executive officers would have been entitled if one of several different termination of employment or change in control events occurred on December 31, 2014. The amounts shown in the table do not include certain payments and benefits to the extent they are provided on a non-discriminatory basis to non-union employees generally upon a termination of employment, including accrued salary and vacation pay, 401(k) plan benefits, continued health and welfare coverage following an involuntary termination of employment and coverage under the Consolidated Omnibus Budget Reconciliation Act (COBRA). All employees are also entitled to life insurance benefits of up to 1.5 times base salary, up to a maximum amount of $200,000, if death occurs while actively employed.

With regard to all options and restricted stock units subject to time-based vesting at December 31, 2014, the assumed values of the awards are shown in the table in the applicable columns. With regard to performance stock units that remain subject to performance-based vesting following the acceleration of service-based vesting, we have assumed that shares will be issued in respect of the performance stock units based on target performance, and that dividend equivalents will continue to accrue through the duration of the applicable performance period. The value of each stock option as to which vesting is accelerated is assumed to be equal to the product of the number of shares underlying the option multiplied by the difference between the exercise price per share and $53.30, the closing price of our common stock as reported on the NYSE Composite Tape on December 31, 2014. For restricted stock units and performance stock units, the value shown in the table is based on the number of restricted stock units or performance stock units multiplied by the $53.30 closing price on December 31, 2014. In addition, the value of accumulated dividends (and, for awards that remain subject to performance conditions through the end of the performance period, expected dividends for the remainder of the performance period) was included.

Name	Benefit	Voluntary Termination	Early Normal Retirement	Involuntary Termination without Cause	Voluntary Termination for Good Reason	Involuntary Termination for Cause	Involuntary Termination without Cause Following a Change in Control	Disability	Death	Change in Control (1)
Susan N. Story	Cash Severance	$ —	$ —	$ 1,750,000	$ —	$ —	$ 1,750,000	$ —	$ —	$ —
	Outplacement Services	$ —	$ —	$ 15,000	$ —	$ —	$ —	$ —	$ —	$ —
	Deferred Compensation Benefits	$ 152,230	$ 152,230	$ 152,230	$ 152,230	$ —	$ 184,581	$ 152,230	$ 184,581	$ 184,581
	Nonqualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Qualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Life Insurance and Employee Assistance Program	$ —	$ —	$ 662	$ —	$ —	$ 662	$ —	$ —	$ —
	Options	$ —	$ —	$ —	$ —	$ —	$ 610,276	$ 610,276	$ 610,276	$ 610,276
	Performance Stock Units	$ —	$ —	$ —	$ —	$ —	$ 2,268,950	$ 224,028	$ 224,028	$ 2,268,950
	Total	$ 152,230	$ 152,230	$ 1,917,892	$ 152,230	$ —	$ 4,814,469	$ 986,534	$ 1,018,885	$ 3,063,807

Name	Benefit	Voluntary Termination	Early Normal Retirement	Involuntary Termination without Cause	Voluntary Termination for Good Reason	Involuntary Termination for Cause	Involuntary Termination without Cause Following a Change in Control	Disability	Death	Change in Control (1)
Jeffry E. Sterba	Cash Severance	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Outplacement Services	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Deferred Compensation Benefits	$ 600,753	$600,753	$ 600,753	$ 600,753	$ —	$ 868,540	$ 600,753	$ 868,540	$ 868,540
	Nonqualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Qualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Life Insurance and Employee Assistance Program	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Options	$ —	$ —	$2,600,503	$2,600,503	$ —	$2,600,503	$2,600,503	$2,600,503	$2,600,503
	Performance Stock Units	$ —	$ —	$5,554,298	$5,554,298	$ —	$5,419,009	$5,554,298	$5,554,298	$5,419,009
	Total	$600,753	$600,753	$8,755,554	$8,755,554	$ -	$8,888,052	$8,755,554	$9,023,341	$8,888,052

Name	Benefit	Voluntary Termination	Early Normal Retirement	Involuntary Termination without Cause	Voluntary Termination for Good Reason	Involuntary Termination for Cause	Involuntary Termination without Cause Following a Change in Control	Disability	Death	Change in Control (1)
Linda Sullivan	Cash Severance	$ —	$ —	$ 805,000	$ —	$ —	$ 805,000	$ —	$ —	$ —
	Outplacement Services	$ —	$ —	$ 12,000	$ —	$ —	$ —	$ —	$ —	$ —
	Deferred Compensation Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Nonqualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Qualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Life Insurance and Employee Assistance Program	$ —	$ —	$ 441	$ —	$ —	$ 441	$ —	$ —	$ —
	Options	$ —	$ —	$ —	$ —	$ —	$ 149,193	$ 149,193	$ 149,193	$ 149,193
	Performance Stock Units	$ —	$ —	$ —	$ —	$ —	$ 1,110,794	$ —	$ —	$ 1,110,794
	Total	$ —	0$ —	$ 817,441	$ —	$ —	$ 2,065,428	$ 149,193	$ 149,193	$ 1,259,987

Name	Benefit	Voluntary Termination	Early Normal Retirement	Involuntary Termination without Cause	Voluntary Termination for Good Reason	Involuntary Termination for Cause	Involuntary Termination without Cause Following a Change in Control	Disability	Death	Change in Control (1)
Walter J. Lynch	Cash Severance	$ —	$ —	$ 918,750	$ —	$ —	$ 918,750	$ —	$ —	$ —
	Outplacement Services	$ —	$ —	$ 12,000	$ —	$ —	$ —	$ —	$ —	$ —
	Deferred Compensation Benefits	$ 554,761	$ 554,761	$ 554,761	$ 554,761	$ —	$ 554,761	$ 554,761	$ 554,761	$ 554,761
	Nonqualified Pension Benefits	$ 798,456	ineligible	$ 798,456	$ 798,456	$ 798,456	$ 798,456	$ 1,791,524	$ 639,217	$ 798,456
	Qualified Pension Benefits	$ 306,053	ineligible	$ 306,053	$ 306,053	$ 306,053	$ 306,053	$ 675,197	$ 251,992	$ 306,053
	Life Insurance and Employee Assistance Program	$ —	$ —	$ 441	$ —	$ —	$ 441	$ —	$ —	$ —
	Options	$ —	$ —	$ —	$ —	$ —	$ 793,545	$ 793,545	$ 793,545	$ 793,545
	Performance Stock Units	$ —	$ —	$ —	$ —	$ —	$ 2,140,355	$ 638,654	$ 638,654	$ 2,140,355
	Total	$ 1,659,270	$ 554,761	$ 2,590,461	$ 1,659,270	$ 1,104,509	$ 5,512,361	$ 4,453,681	$ 2,878,169	$ 4,593,170

Name	Benefit	Voluntary Termination	Early Normal Retirement	Involuntary Termination without Cause	Voluntary Termination for Good Reason	Involuntary Termination for Cause	Involuntary Termination without Cause Following a Change in Control	Disability	Death	Change in Control (1)
Kellye L. Walker	Cash Severance	$ —	$ —	$ —	$ —	$ —	$	$ —	$ —	$ —
	Outplacement Services	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Deferred Compensation Benefits	$ 137,112	$137,112	$ 137,112	$ 137,112	$ —	$ 199,689	$137,112	$ 199,689	$ 199,689
	Nonqualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Qualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Life Insurance and Employee Assistance Program	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Options	$ —	$ —	$ —	$ —	$ —	$ 452,263	$452,263	$ 452,263	$ 452,263
	Performance Stock Units	$ —	$ —	$ —	$ —	$ —	$1,217,379	$367,845	$ 367,845	$1,217,379
	Total	$ 137,112	$137,112	$ 137,112	$ 137,112	$ —	$1,869,331	$957,220	$1,019,797	$1,869,331

Name	Benefit	Voluntary Termination	Early Normal Retirement	Involuntary Termination without Cause	Voluntary Termination for Good Reason	Involuntary Termination for Cause	Involuntary Termination without Cause Following a Change in Control	Disability	Death	Change in Control (1)
Loyd Warnock	Cash Severance	$ —	$ —	$ 540,000	$ —	$ —	$ 540,000	$ —	$ —	$ —
	Outplacement Services	$ —	$ —	$ 12,000	$ —	$ —	$ —	$ —	$ —	$ —
	Deferred Compensation Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Nonqualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Qualified Pension Benefits	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
	Life Insurance and Employee Assistance Program	$ —	$ —	$ 441	$ —	$ —	$ 441	$ —	$ —	$ —
	Options	$ —	$ —	$ —	$ —	$ —	$ 84,070	$ 84,070	$ 84,070	$ 84,070
	Performance Stock Units	$ —	$ —	$ —	$ —	$ —	$ 556,671	$ —	$ —	$ 556,671
	Total	$ —	$ —	$ 552,441	$ —	$ —	$ 1,181,182	$ 84,070	$ 84,070	$ 640,741

(1) Pension and deferred compensation amounts shown in this column assume a termination of employment (other than an involuntary termination for cause) following a change in control. Performance stock unit amounts shown in this column are payable upon a change in control, without a termination of employment.

RELATED PERSON TRANSACTION PROCEDURES

We have adopted a written procedure for approving and ratifying related person transactions. The procedure covers transactions or series of transactions between directors, director nominees, employees and stockholders who own more than 5 percent of any class of voting securities, or immediate family members of any such persons, and American Water where any of the classes of persons described above has a direct or indirect material interest.

Permission for a related person transaction may only be granted in writing in advance by the following:

- the audit committee of the board of directors in the case of transactions involving officers, directors, nominees or other employees in specified senior grade levels;
- the ethics committee (comprised of members of management) in the case of all other employees; or
- in any case, the board of directors, acting through its disinterested members only.

Transactions involving compensation of executive officers are reviewed and, if appropriate, approved by the compensation committee of the board of directors (or a group of our independent directors performing a similar function) as specified in the charter of the compensation committee.

Before any related person transaction is permitted, the following factors are to be considered:

- the related person's interest in the transaction;
- the dollar value of the amount involved in the transaction;
- the dollar value of the related person's interest in the transaction without regard to the amount of any profit or loss;
- whether the transaction is to be undertaken in the ordinary course of business of American Water;
- whether the transaction with the related person is proposed to be entered into on terms more favorable to American Water than terms that could have been reached with an unrelated third party;
- the purpose of, and the potential benefits to American Water of, the transaction; and
- any other information regarding the transaction or the related person that are material in light of the circumstances of the particular transaction.

Approval of a related person transaction will be granted only if it is determined that, under all of the circumstances, the transaction is in the best interests of American Water and only so long as those interests outweigh any negative effects that may arise from permitting it to occur.

AUDIT COMMITTEE REPORT

The Audit Committee assists the board in its oversight of the integrity of American Water's financial statements, compliance with legal and regulatory requirements and the performance of the internal audit function. Management is responsible for American Water's internal controls, financial reporting process and compliance with legal and regulatory requirements. PricewaterhouseCoopers LLP, American Water's independent registered public accounting firm, is responsible for performing an independent audit of American Water's consolidated financial statements and for issuing a report on these financial statements and on the effectiveness of American Water's internal control over financial reporting.

In this context, the Audit Committee hereby reports as follows:

1. The Audit Committee has reviewed and discussed with management and PricewaterhouseCoopers LLP the audited financial statements for the fiscal year ended December 31, 2014.
2. The Audit Committee has reviewed and discussed with management and PricewaterhouseCoopers LLP our system of internal control over financial reporting
3. The Audit Committee has discussed with PricewaterhouseCoopers LLP the matters required to be discussed by Public Company Accounting Oversight Board Auditing Standard No. 16**,** "Communications with Audit Committees."

4. The Audit Committee has received the written disclosures and the letter from PricewaterhouseCoopers LLP required by applicable requirements of the Public Company Accounting Oversight Board regarding PricewaterhouseCoopers LLP's conversations with the Audit Committee concerning independence, and has discussed with PricewaterhouseCoopers LLP that firm's independence.

Based on the review and discussion referred to above, the Audit Committee recommended to the board of directors that the audited financial statements be included in American Water's Annual Report on Form 10-K for the fiscal year ended December 31, 2014, for filing with the SEC.

Respectfully submitted,

Julie A. Dobson (Chair)
Martha Clark Goss
William J. Marrazzo

The information contained in the foregoing report shall not be deemed to be "soliciting material" or "filed" or incorporated by reference into any of our previous or future filings with the SEC, or subject to the liabilities of Section 18 of the Exchange Act, except to the extent specifically incorporated by reference into a document filed under the Securities Act or the Exchange Act.

FEES PAID TO INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The following table presents fees paid to PricewaterhouseCoopers LLP for professional services rendered with respect to 2014 and 2013.

	Fiscal Year 2014	Fiscal Year 2013
Audit Fees(1)	$ 2,393,000	$ 3,051,000
Audit-Related Fees		
Tax Fees(2)	250,000	450,597
All Other Fees(3)	5,564	5,564
Total	$ 2,648,564	$ 3,507,161

(1) Represents fees for professional services provided in connection with the audit of the Company's annual consolidated financial statements, reviews of the Company's interim financial statements included on our quarterly reports on Form 10-Q, audits of the Company's subsidiaries and services in connection with comfort letters, consents and procedures related to documents filed with the SEC.

(2) Represents fees for professional services in connection with the review of the Company's federal and state tax returns and tax advice related to tax compliance, tax planning and tax refund claims.

(3) Represents fees for software licensing fees for disclosure checklists and accounting research tools.

Approval of audit and permitted non-audit services. The audit committee has the responsibility to approve in advance all audit and permitted non-audit services performed by its independent registered public accounting firm. As allowed by applicable law, the audit committee has delegated to its Chair the authority to grant pre-approval of audit and permitted non-audit services provided by its independent registered public accounting firm and associated fees up to a maximum of $20,000 per service provided and $50,000 in the aggregate per annum. The Chair of the audit committee reports any pre-approval of these services to the full audit committee at its next regularly scheduled meeting following the pre-approval.

(Proposal 2)

RATIFICATION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The audit committee is directly responsible for the appointment, compensation, retention, evaluation and oversight of the Company's independent registered public accounting firm. As part of this responsibility, the audit committee annually evaluates the independent registered public accounting firm's qualifications, performance and independence and assesses whether to continue to retain the firm or select a different firm.

The audit committee has appointed the firm of PricewaterhouseCoopers LLP to serve as the independent registered public accounting firm for American Water during the fiscal year ending December 31, 2015, and is recommending that the stockholders ratify this appointment. PricewaterhouseCoopers LLP has served as our auditors since 1948. The audit committee and its Chair are also involved in and approve the selection of the lead audit partner, who is limited to no more than five consecutive years in that role before the position must be rotated in accordance with SEC rules. The audit committee and the Board believe that the continued retention of PricewaterhouseCoopers LLP as the Company's independent auditor is in the best interests of the Company and its stockholders. Although stockholder ratification is not required by our organizational documents, or applicable law, the board of directors believes that it is a sound corporate governance practice to seek stockholder ratification of the appointment of PricewaterhouseCoopers LLP.

In the event the stockholders fail to ratify the appointment, the audit committee will reconsider its selection. Even if the selection is ratified, the audit committee, in its discretion, may direct the appointment of a different independent registered public accounting firm at any time during the year if the audit committee believes that such a change would be in the best interests of our company and our stockholders.

A representative of PricewaterhouseCoopers LLP is expected to be present at the Annual Meeting and will have the opportunity to make a statement if he or she desires to do so. The representative also will be available to respond to appropriate questions from stockholders at the Annual Meeting.

Recommendation of the Board of Directors

The board of directors unanimously recommends a vote **FOR** the ratification of PricewaterhouseCoopers LLP to serve as our independent registered public accounting firm for 2015.

(Proposal 3)

ADVISORY VOTE TO APPROVE THE COMPENSATION OF OUR NAMED EXECUTIVE OFFICERS

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, or the "Dodd-Frank Act," enables our stockholders to vote to approve, on an advisory (non-binding) basis, the compensation of our named executive officers as disclosed in this proxy statement in accordance with the SEC's rules. Specifically, these rules address the information we must provide in the compensation discussion and analysis, compensation tables and related disclosures included in this proxy statement. In accordance with the advisory vote of our stockholders at our 2011 Annual Meeting of Stockholders, we are providing to our stockholders the opportunity to vote annually to approve, on an advisory basis, the compensation of our named executive officers.

As described more fully under "Compensation Discussion and Analysis," our executive compensation philosophy and programs are designed to create a positive correlation of pay to performance, consistent with sound governance principles. We believe that our compensation philosophy and programs contribute to our overall objective of being a trusted steward of the environment, meeting or exceeding our customers' expectations regarding water and wastewater service and value, and promoting the safety and well-being of our workforce, while simultaneously being the trusted stewards of our investors' capital by creating stockholder value.

Accordingly, the board recommends that our stockholders vote in favor of the following resolution:

> RESOLVED, that the stockholders of American Water Works Company, Inc. approve, on an advisory basis, the compensation paid to our named executive officers, as disclosed pursuant to the compensation disclosure rules of the U.S. Securities and Exchange Commission, including the compensation discussion and analysis, the compensation tables and any related materials disclosed in the proxy statement for the 2015 annual meeting of stockholders.

While the vote is not binding on us, our compensation committee values the opinions expressed by our stockholders and will carefully consider the outcome of the vote when making future compensation decisions for our named executive officers.

Recommendation of the Board of Directors

The board of directors unanimously recommends a vote **FOR** the approval of the compensation of our named executive officers.

(Proposal 4)

RE-APPROVAL OF THE MATERIAL TERMS OF THE PERFORMANCE GOALS SET FORTH IN THE AMERICAN WATER WORKS COMPANY, INC. 2007 OMNIBUS EQUITY COMPENSATION PLAN TO ALLOW CERTAIN EQUITY GRANTS UNDER THE PLAN TO CONTINUE TO BE DEDUCTIBLE UNDER SECTION 162(m) OF THE CODE

We are re-submitting the American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan (the "Equity Plan") for stockholder approval so that our compensation committee may continue to award stock units, stock awards, dividend equivalents and other stock-based awards under the Equity Plan that qualify for the performance-based compensation exemption from the $1 million deduction limitation under Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"). The Equity Plan, including the material terms of the performance goals, was last approved by our stockholders at our 2009 Annual Meeting of Stockholders. Section 162(m) of the Code generally requires re-approval of the material terms of the performance goals under an incentive program, such as the Equity Plan, every five years in order for a company to continue to have the ability to grant awards under it that qualify as performance-based compensation under Section 162(m) of the Code if the committee has the authority to change targets under the performance goals. The five-year re-approval requirement generally does not apply to grants of stock options and stock appreciation rights. The material terms for which approval is being sought include the performance criteria used to determine whether such awards intended as qualified performance-based compensation under Section 162(m) of the Code will be paid, the eligibility requirements for such awards, and the maximum amount that may be paid to any participant under the Equity Plan.

The Equity Plan provides for the award of stock options, stock units, stock awards, stock appreciation rights, dividend equivalents and other stock-based awards to our eligible employees and those of our subsidiaries, as well as to the non-employee members of our board of directors. Our board of directors believes that the Equity Plan furthers our compensation structure and strategy. Section 162(m) of the Code generally allows a publicly held corporation's tax deduction for compensation in excess of $1 million paid in any year to its chief executive officer and certain other executive officers, if, among other things, the material terms of the performance goals to which the performance-based compensation relates has been approved by the corporation's stockholders. Our board of directors believes that our interests, as well as the interests of our stockholders, will be advanced if we continue to have the ability to grant stock units, stock awards, dividend equivalents and other stock-based awards under the Equity Plan that qualify for the exemption from the $1 million deduction limitation under Section 162(m) of the Code.

As our stockholders last approved the material terms of the performance goals under the Equity Plan at our 2009 Annual Meeting, after our 2014 Annual Meeting no grants of stock units, stock awards, dividend equivalents and other stock-based awards may be made under the Equity Plan as performance-based compensation under Section 162(m) of the Code until stockholders re-approve the material terms of the performance goals, unless the grants are conditioned upon stockholder approval. If our stockholders re-approve the material terms of the performance goals under the Equity Plan, we may continue to make grants of stock units, stock awards, dividend equivalents and other stock-based awards that are intended to qualify as performance-based compensation under Section 162(m) of the Code.

As a result, if the material terms of performance goals are re-approved by stockholders at the Annual Meeting, the grants approved by our compensation committee and conditional on the re-approval of the material terms of the performance goals by the stockholders at the Annual Meeting that are discussed below, as well as grants made by the compensation committee after the Annual Meeting may qualify as performance-based compensation under Section 162(m) of the Code. If our stockholders do not re-approve the material terms of the performance goals under the Equity Plan, the conditional grants discussed below will be cancelled and our compensation committee may not grant stock units, stock awards, dividend equivalents and other stock-based awards that are intended to qualify as performance-based compensation under Section 162(m) of the Code under the Equity Plan.

No changes have been made to the Equity Plan since the 2009 Annual Meeting of Stockholders and our stockholders are not being asked to approve an increase in the number of shares authorized for issuance under the Equity Plan nor any other changes to the Equity Plan.

The material terms of the Equity Plan are summarized below. This summary of the Equity Plan is not intended to be a complete description of the Equity Plan and is qualified in its entirety by the actual text of the Equity Plan to which reference is made, which is attached as Appendix B to this proxy statement.

Material Features of the Equity Plan

General. The Equity Plan provides that grants may be in any of the following forms: (i) incentive stock options, (ii) nonqualified stock options (incentive stock options and nonqualified stock options collectively are referred to as “options”), (iii) stock appreciation rights (“SARs”), (iv) stock units (which include dividend equivalents), (v) stock awards and (vi) other stock-based awards.

Subject to adjustment in certain circumstances, the aggregate number of shares of common stock that may be issued or transferred under the Equity Plan is 15,500,000 shares. The shares of our common stock that are issued or transferred under the Equity Plan may be authorized but unissued shares of our common stock or reacquired shares of our common stock, including shares of our common stock purchased by us on the open market for purposes of the Equity Plan.

The maximum aggregate number of shares of our common stock that may be granted pursuant to all grants to any individual under the Equity Plan during any calendar year is 500,000 shares, subject to adjustment as described below. This individual share limit applies regardless of whether grants are to be paid in shares or cash.

No individual may accrue dividend equivalents during any calendar year in excess of $750,000.

If and to the extent options or SARs granted under the Equity Plan terminate, expire or are cancelled, forfeited, exchanged or surrendered without being exercised, and to the extent any stock awards, stock units or other stock-based awards are forfeited or terminated, or otherwise not paid in full, the shares reserved for such grants will again become available for purposes of the Equity Plan. However, shares of our common stock surrendered in payment of the exercise price of an option and shares withheld or surrendered for payment of taxes, will not be available for re-issuance under the Equity Plan. Additionally, if SARs are granted, the full number of shares subject to the SAR are considered issued under the Equity Plan, without regard to the number of shares of our common stock that are issued upon exercise of the SARs and without regard to any cash settlement of the SARs. To the extent that any grants of stock units under the Equity Plan are designated to be paid in cash, and not in shares of Common Stock, such grants do not count against the share limits under the Equity Plan.

As of March 17, 2015, there were 8,380,190 shares (not including shares issuable upon vesting or exercise of existing grants) of common stock available for issuance under the Equity Plan.

Administration. The Equity Plan is administered and interpreted by our compensation committee with respect to grants to employees, and with respect to grants to our non-employee directors, the Equity Plan is administered and interpreted by our board of directors. For purposes of this discussion, we refer to the compensation committee, or the board of directors, as applicable, as the “Committee.” The Committee has the sole authority to (i) determine the individuals to whom grants will be made under the Equity Plan, (ii) determine the type, size and terms and conditions of the grants, (iii) determine the time when grants will be made and the duration of any applicable exercise or restriction period, including the criteria for exercisability and the acceleration of exercisability, (iv) amend the terms and conditions of any previously issued grant, subject to the limitations described below, and (v) deal with any other matters arising under the Equity Plan. The determinations of the Committee are conclusive and binding. Ministerial functions may be performance by an administrative committee comprised of our employees, who are appointed by the Committee.

Eligibility for Participation. All of our employees (including officers) and those of our subsidiaries are eligible for grants under the Equity Plan. Our non-employee directors are also eligible to receive grants under the Equity Plan. As of March 17, 2015, approximately 6,500 employees and 8 non-employee directors were eligible to receive grants under the Equity Plan.

Types of Awards.

<u>Stock Options</u>

The Committee may grant options intended to qualify as “incentive stock options” within the meaning of Section 422 of the Code (“ISOs”) or “nonqualified stock options” that are not intended to so qualify (“NQSOs”) or any combination of ISOs and NQSOs. Anyone eligible to participate in the Equity Plan may receive a grant of NQSOs. Only our employees and those of our subsidiaries may receive a grant of ISOs.

The Committee fixes the exercise price per share for options on the date of grant. The exercise price of any NQSO or ISO granted under the Equity Plan will be equal to, or greater than, the fair market value of the underlying shares of our common stock on the date of grant. The current measure of fair market value on a particular date is the last reported sale price of our common stock on the New York Stock Exchange on the relevant date (or, if there were no trades on such date, the latest preceding date upon which a sale was reported). However, if an ISO is granted to an employee who holds more than 10% of the total combined voting power of all classes of our outstanding stock, the exercise price per share of an ISO granted to such person must be at least 110% of the fair market value of a share of our common stock on the date of grant.

The Committee determines the term of each option, which will not exceed ten years from the date of grant; however, if an ISO is granted to an employee who holds more than 10% of the combined voting power of all classes of our outstanding stock, the term of the ISO may not exceed five years from the date of grant.

The period for when any option may first become exercisable will be determined by the Committee at the time of grant and the Committee may grant options that are subject to achievement of performance goals or other conditions. The Committee may accelerate the exercisability of any or all outstanding options at any time for any reason. To the extent that the aggregate fair market value of shares of our common stock, determined on the date of grant, with respect to which ISOs become exercisable for the first time by an employee during any calendar year exceeds $100,000, such ISOs will be treated as NQSOs.

The Equity Plan provides that, unless otherwise provided in the grant agreement, an option may only be exercised while the grantee is employed by, or providing service to, us or one of our subsidiaries. The Committee will specify in the grant agreement the circumstances, if any, and time periods, if any, a grantee may exercise an option after termination of employment or service.

A grantee may exercise an option by delivering notice of exercise to us. The grantee will pay the exercise price and any withholding taxes for the option: (i) in cash, (ii) with the approval of the Committee, by delivering shares of our common stock already owned by the grantee, or by attestation of ownership of shares, in either case having a fair market value on the date of exercise equal to the exercise price, (iii) by payment through a broker in accordance with procedures permitted by Regulation T of the Federal Reserve Board, or (iv) by such other method as the Committee may approve, to the extent permitted by applicable law.

SARs

The Committee may grant SARs in connection with, or independently of, any option granted under the Equity Plan. Upon exercise of a SAR, the grantee will receive an amount equal to the excess of the fair market value of our common stock on the date of exercise over the base amount for the SAR. The Committee may grant SARs to anyone eligible to participate in the Equity Plan.

The Committee will determine the terms and conditions of the SAR, including the base amount, the number of shares subject to the SAR, the term of the SAR, and the period over which the SAR becomes exercisable, at the time of grant. The base amount of each SAR will not be less than the fair market value of our common stock on the date of grant of the SAR and the term of a SAR will not exceed ten years from the date of grant. The Committee may grant SARs that are subject to the achievement of performance goals or other conditions. The Committee may accelerate the exercisability of SARs at any time for any reason. The Committee will determine in the grant agreement the circumstances and the periods a grantee may retain a SAR after termination of employment or service. Upon exercise of a SAR, payment will be made in cash, shares of our common stock or a combination of the two.

Stock Units

The Committee may grant stock units, which provide the grantee with the right to receive shares of our common stock or an amount based on the value of a share of our common stock at a future date. The Committee may grant stock units to anyone eligible to participate in the Equity Plan.

The Committee determines the number of stock units that will be granted, whether stock units will become payable if specified performance goals or other conditions are met, and the other terms and conditions applicable to the stock units. The grant agreement will specify the maximum number of shares of our common stock that can be issued under the stock units. Stock units may be paid at the end of a specified period or deferred to a date authorized by the Committee. If a stock unit becomes distributable it will be paid to the grantee in cash, in shares of our common stock, or in a combination of cash and shares of Common Stock, as determined by the Committee. The Committee will determine in the grant agreement under what circumstances a grantee may retain a stock unit after termination of employment or service, and the circumstances under which stock units are forfeited.

The Committee may grant dividend equivalents in connection with stock units, under such terms and conditions as the Committee deems appropriate. Dividend equivalents may be paid currently or deferred and may be paid in cash or shares of our common stock or in a combination of the two. Dividend equivalents may be accrued as a cash obligation or may be converted to additional stock units for the grantee, and deferred dividend equivalents may accrue interest, all as determined by the Committee. The Committee may determine that dividend equivalents are payable based on the achievement of specific performance goals.

Stock Awards

The Committee may grant shares of our common stock under a stock award to anyone eligible to participate in the Equity Plan for consideration or no consideration, and subject to such restrictions, if any, as determined by the Committee. If restrictions are imposed on stock awards, the Committee will determine whether they will lapse over a period of time or according to such other criteria as the Committee deems appropriate, including restrictions based upon the achievement of specific performance goals. The Committee determines the number of shares of our common stock subject to the grant of stock awards and the other terms and conditions of the grant. The Committee will determine in the grant agreement under what circumstances a grantee may retain a stock award after termination of employment or service and the circumstances under which a stock award will be forfeited.

The Committee will determine to what extent, and under what conditions, grantees will have the right to vote shares of our common stock subject to a stock award and receive dividends or other distributions paid on such shares during the restriction period. The Committee may determine that a grantee's entitlement to dividends with respect to stock awards will be withheld while the stock awards are subject to restrictions and that the dividends will be payable only upon the lapse of the restrictions on the stock awards, or on such other terms as the Committee determines appropriate.

Other Stock-Based Awards

The Committee may grant other stock-based awards that are awards (other than options, SARs, stock units, and stock awards) that are based on or measured by our common stock to anyone eligible to participate in the Equity Plan. Other stock-based awards may be granted subject to the achievement of performance goals or other conditions and may be payable in shares of our common stock or cash, or a combination of the two, as determined by the Committee.

Qualified-Performance Compensation. Under the Equity Plan, the Committee may structure stock units, stock awards, dividend equivalents or other stock-based awards as "qualified performance-based compensation," thereby preserving the deductibility of the compensation expense relating to these awards under Section 162(m) of the Code.

The Equity Plan provides that when stock units, stock awards, dividend equivalents or other stock-based awards intended to constitute "qualified performance-based compensation" are granted, the Committee will establish in writing (i) the objective performance goals that must be met, (ii) the period during which the performance will be measured, (iii) the maximum amounts that may be paid if the performance goals are met, and (iv) any other conditions that the Committee deems appropriate and consistent with the requirements of Section 162(m) of the Code. The performance goals may relate to one or more business units or our performance and that of our subsidiaries as a whole, or any combination of the foregoing. The performance goals need not be uniform among grantees. The Committee will use objectively determinable performance goals based on one or more of the following criteria: our stock price, earnings per share, price-earnings multiples, net earnings, operating earnings, revenue, number of days sales outstanding in accounts receivable, productivity, margin, EBITDA (earnings before interest, taxes, depreciation and amortization), net capital employed, return on assets, stockholder return, return on equity, return on capital employed, net income to shares of our common stock, growth in assets, unit volume, sales, cash flow, market share, relative performance to a comparison group designated by the Committee, or strategic business criteria consisting of one or more objectives based on meeting specified revenue goals, market penetration goals, customer growth, geographic business expansion goals, cost targets or goals relating to acquisitions or divestitures.

The Committee will establish the performance goals in writing either before the beginning of the performance period or during a period ending no later than the earlier of (i) 90 days after the beginning of the performance period or (ii) the date on which 25% of the performance period has been completed, or such other date as may be required or permitted under applicable regulations under Section 162(m) of the Code. The performance goals will satisfy the requirements for "qualified-performance based compensation," including the requirement that the achievement of the goals be substantially uncertain at the time they are established and that the goals be established in such a way that a third party with knowledge of the relevant facts could determine whether and to what extent the performance goals have been met. The Committee will not have the discretion to increase the amount of compensation that is payable upon achievement of the designated performance goals, but the Committee may reduce the amount of compensation that is payable upon achievement of the designated performance goals.

The Committee will certify and announce the results for each performance period specified in the grant agreement after the performance period ends. If and to the extent that the Committee does not certify that the performance goals have been met, the grants of stock units, stock awards, dividend equivalents or other stock-based awards intended as "qualified-performance based compensation" for the performance period will be forfeited or will not be made, as applicable.

If our stockholders do not re-approve the material terms of the performance goals under the Equity Plan, stock units, stock awards, dividend equivalents or other stock-based awards may not be granted under the Equity Plan as "qualified performance-based compensation" under Section 162(m) of the Code.

Deferrals. The Committee may permit or require grantees to defer receipt of the payment of cash or the delivery of shares of our common stock that otherwise would be due to the grantee in connection with a grant under the Equity Plan. The Committee will establish the rules and procedures applicable to any such deferrals, consistent with the applicable requirements of Section 409A of the Code.

Adjustment Provisions. If there is any change in the number or kind of shares of our common stock outstanding by reason of (i) a stock dividend, spinoff, recapitalization, stock split, or combination or exchange of shares, (ii) by reason of a merger, reorganization or consolidation, (iii) by reason of a reclassification or change in par value, or (iv) by reason of any other extraordinary or unusual event affecting the outstanding shares of our common stock as a class without our receipt of consideration, or if the value of outstanding shares of our common stock are substantially reduced as a result of a spinoff or our payment of an extraordinary dividend or distribution, the maximum number of shares of our common stock available for issuance under the Equity Plan, the maximum number of shares of our common stock for which any individual may receive grants in any year, the kind and number of shares covered by outstanding grants, the kind and number of shares issued or to be issued under the Equity Plan, and the price per share or the applicable market value of such grants will be equitably adjusted by the Committee, in such manner as the Committee deems appropriate, to reflect any increase or decrease in the number of, or change in the kind or value of, the issued shares of our common stock to preclude, to the extent practicable, the enlargement or dilution of the rights and benefits under the Equity Plan and such outstanding grants; provided, that any fractional shares resulting from such adjustment will be eliminated. In addition, in the event of a change of control, the provisions applicable to a change of control, described below, will apply.

Change of Control. If a change of control occurs, the Committee may take any one or more of the following actions with respect to outstanding grants, without the consent of the grantee: (i) provide that outstanding options and SARs will be fully exercisable, and restrictions on outstanding stock awards and stock units will lapse, as of the date of the change of control or at such other time as the Committee determines, (ii) provide that grantees surrender their outstanding options and SARs in exchange for one or more payments by us, in cash or shares of common stock as determined by the Committee, in an amount equal to the amount, if any, by which the then fair market value of the shares of common stock subject to the grantee's unexercised options and SARs exceeds the exercise price, and on such terms as the Committee determines, (iii) after giving grantees an opportunity to exercise their outstanding options and SARs, terminate any and all unexercised options and SARs at such time as the Committee deems appropriate, (iv) with respect to grantees holding stock units and other stock-based awards, determine that such grantees will receive one or more payments in settlement of such stock units and other stock- based awards, in such amount and form and on such terms as may be determined by the Committee, or (v) determine that all outstanding options and SARs that are not exercised will be assumed by, or replaced with comparable options or rights in the surviving corporation (or a parent or subsidiary of the surviving corporation), and other outstanding grants that remain in effect after the change of control will be converted to similar grants of the surviving corporation (or a parent or subsidiary of the surviving corporation). Such acceleration, surrender, termination, settlement or conversion will take place as of the date of the change of control or such other date as the Committee may specify. The Committee may provide in a grant agreement that a sale or other transaction involving one of our subsidiaries or other business units will be considered a change of control for purposes of a grant, or the Committee may establish other provisions that will be applicable in the event of a specified transaction.

For purposes of the Equity Plan, a change of control will generally be deemed to have occurred if one of the following events occurs:

- any person becomes a beneficial owner, directly or indirectly, of our securities representing more than 50% of the voting power of our then outstanding securities; provided that a change of control will not be deemed to have occurred as a result of (A) a transaction in which we become a subsidiary of another corporation and in which our stockholders, immediately prior the transaction, will beneficially own, immediately after the transaction, shares entitling such stockholders to more than 50% of all votes to which all stockholders of the parent corporation would be entitled in the election of directors, (B) the initial public offering of shares of our common stock; or (C) any subsequent offering of shares of our common stock;
- the consummation of (A) a merger or consolidation of us with another corporation where our stockholders, immediately prior to the merger or consolidation, will not beneficially own, immediately after the merger or consolidation, shares entitling such stockholders to more than 50% of all votes to which all stockholders of the surviving corporation would be entitled in the election of directors, (B) a sale or other disposition of all or substantially all of our assets; or (C) a liquidation or dissolution of us; or
- directors are elected such that a majority of the members of our board of directors have been members for less than one year, unless the election or nomination for election of each new director who was not a director at the beginning of such one-year period was approved by a vote of at least two-thirds of the directors then still in office who were directors at the beginning of such period.

The Committee may provide for a different definition of a change of control in a grant agreement if such grant is subject to the requirements of Section 409A of the Code and the grant will become payable on a change of control.

Transferability of Grants. Generally, only the grantee may exercise rights under a grant during the grantee's lifetime. A grantee may not transfer those rights except by will or the laws of descent and distributions. The Committee may provide, in a grant agreement, that a grantee may transfer nonqualified stock options to his or her family members, or one or more trusts or other entities for the benefit of or owned by family members, consistent with applicable securities laws, according to such terms as the Committee may determine.

Foreign Grantees. If any individual who receives a grant under the Equity Plan is subject to taxation in countries other than the United States, the Committee may make grants to such individuals on such terms and conditions as the Committee deems appropriate to comply with the laws of the applicable countries, and the Committee may create such procedures, addenda and subplans and make such modifications as may be necessary or advisable to comply with such laws.

No Repricing of Options/SARs. The Equity Plan includes a restriction providing that, except in connection with a corporate transaction (including, without limitation, any stock dividend, stock split, extraordinary cash dividend, recapitalization, reorganization, merger, consolidation, split-up, spin-off, combination or exchange of shares), the terms of outstanding grants may not be amended to reduce the exercise price of outstanding options or SARs or cancel outstanding options or SARs in exchange for cash, other awards or options or SARs with an exercise price that is less than the exercise price of the original options and SARs without stockholder approval.

Amendment and Termination of the Equity Plan. Our board of directors may amend or terminate the Equity Plan at any time, subject to stockholder approval if such approval is required in order to comply with the Code, applicable laws or applicable stock exchange requirements. No grants may be issued under the Equity Plan after April 21, 2018.

Grants Under the Equity Plan. As of March 17, 2015, options to purchase an aggregate of 5,208,115 shares of our common stock (net of cancellations) had been granted under the Equity Plan, of which 2,138,402 were outstanding and stock units representing an aggregate of 1,881,490 shares of our common stock (net of cancellations) had been granted under the Equity Plan, of which 427,576 remain subject to restrictions and conversion to shares of common stock. The following table sets forth the grants made to the current named executive officers and certain groups (identified on the table) on February 17, 2015.

Name and Position	Stock Options	Restricted Stock Units	Performance Share Units	
Susan N. Story, President and Chief Executive Officer	45,089	5,308	14,843	(2)
Linda G. Sullivan, Senior Vice President and Chief Financial Officer	18,519	2,180	6,096	
Walter J. Lynch, President, Regulated Operations and Chief Operating Officer	25,362	2,986	8,349	(2)
Michael A. Sgro, Senior Vice President, General Counsel and Secretary	10,870	1,280	3,578	(2)
Loyd Warnock, Senior Vice President, External Affairs, Communications and Public Policy	10,435	1,228	3,435	(2)
Executive Group (1)	177,418	20,886	58,406	
Non-Executive Director Group	-	364	-	(3)
Non-Executive Officer Employee Group	123,643	14,561	40,700	
Total	301,061	35,811	99,106	

(1) Includes current named executive officers above.

(2) Above table includes the conditional Performance Share Units which are also included in the below chart.

(3) Karl F. Kurz was appointed to the Board of Directors on February 18, 2015.

The last sales price of our common stock on March 17, 2015, was $_______ per share.

Grants Conditioned on Stockholder Re-Approval of the Material Terms of the Performance Goals under the Equity Plan. The table below reflects grants approved by the Committee on February 17, 2015 under the Equity Plan that are conditional upon our stockholders re-approving the material terms of the performance goals under the Equity Plan. If the stockholders do not re-approve the material terms of the performance goals under the Equity Plan, such conditional grants will not become effective.

Name and Position	Performance Stock Units	
Susan N. Story, President and Chief Executive Officer	14,843	(1)
Walter J. Lynch, President and Chief Operating Officer	8,349	(2)
Michael A. Sgro, Senior Vice President, General Counsel and Secretary	3,578	(3)
Loyd Warnock, Senior Vice President External Affairs, Communications and Public Policy	3,435	(4)

(1) This grant consists of: 6,881 Performance Stock Units based on Total Stockholder Return and 7,962 Performance Stock Units based on Internal Metrics.

(2) This grant consists of: 3,870 Performance Stock Units based on Total Stockholder Return and 4,479 Performance Stock Units based on Internal Metrics.

(3) This grant consists of: 1,659 Performance Stock Units based on Total Stockholder Return and 1,919 Performance Stock Units based on Internal Metrics.

(4) This grant consists of: 1,592 Performance Stock Units based on Total Stockholder Return and 1,843 Performance Stock Units based on Internal Metrics.

Federal Income Tax Consequences. The federal income tax consequences of grants under the Equity Plan will depend on the type of grant. The following description provides only a general description of the application of federal income tax laws to grants under the Equity Plan. This discussion is intended for the information of stockholders considering how to vote at the Annual Meeting and not as tax guidance to grantees in the Equity Plan, as the consequences may vary depending on the types of grants made, the identity of the recipients, and the method of payment or settlement. The summary does not address the effects of other federal taxes (including possible “golden parachute” excise taxes) or taxes imposed under state, local, or foreign tax laws.

From the grantee’s standpoint, as a general rule, ordinary income will be recognized at the time of delivery of shares of common stock (equal to the fair market value of the shares received, less the amount paid, if any, for such shares) or payment of cash under the Equity Plan. Future appreciation on shares of common stock held after the ordinary income recognition event will be taxable at capital gains rates when the shares of common stock are sold. The tax rate applicable to capital gain will depend upon how long the grantee holds the shares. We, as a general rule, will be entitled to a tax deduction that corresponds in time and amount to the ordinary income recognized by the grantee, and we will not be entitled to any tax deduction in respect of capital gain income recognized by the grantee.

Exceptions to these general rules may arise under the following circumstances:

- If shares of our common stock, when delivered, are subject to a substantial risk of forfeiture by reason of any employment, service, or performance related condition, ordinary income taxation and our tax deduction will be delayed until the risk of forfeiture lapses, unless the grantee makes a special election to accelerate taxation under Section 83(b) of the Code.
- If an employee exercises an option that qualifies as an ISO, no ordinary income will be recognized, and we will not be entitled to any tax deduction, if shares of our common stock acquired upon exercise of the ISO are held until the later of (i) one year from the date of exercise and (ii) two years from the date of grant. However, if the employee disposes of the shares acquired upon exercise of the ISO before satisfying both holding period requirements, the employee will recognize ordinary income to the extent of the difference between the fair market value of the share on the date of exercise (or the amount realized on the disposition, if less) and the exercise price, and we will be entitled to a tax deduction in that amount. The gain, if any, in excess of the amount recognized as ordinary income will be long-term or short-term capital gain, depending upon the length of time the employee held the shares before the disposition.
- A grant may be subject to a 20% penalty tax, in addition to ordinary income tax, at the time the grant becomes vested, plus interest, if the grant constitutes “deferred compensation” under Section 409A of the Code and the requirements of Section 409A of the Code are not satisfied.

As discussed above, Section 162(m) of the Code generally disallows a publicly held corporation’s tax deduction for compensation paid to its chief executive officer and certain other executive officers in excess of $1 million in any year. Qualified performance-based compensation is excluded from the $1 million deductibility limit and therefore remains fully deductible by the corporation that pays it. We intend that options and SARs granted under the Equity Plan will be qualified performance-based compensation. If stockholder re-approval of the material terms of the performance goals under the Equity Plan is obtained, stock units, dividend equivalents, stock awards and other stock-based awards granted under the Equity Plan may be designated as qualified performance-based compensation if the Committee conditions such grants on the achievement of specific performance goals in accordance with the requirements of Section 162(m) of the Code.

We have the right to require the recipient of any grant under the Equity Plan to pay to us an amount necessary for us to satisfy our federal, state, or local tax withholding obligations with respect to grants. We may withhold from other amounts payable to such individual an amount necessary to satisfy these obligations. If the Committee permits, a grantee may satisfy our withholding obligation by having shares acquired pursuant to the grant withheld, provided that the number of shares withheld does not exceed the individual's minimum applicable withholding tax rate for federal (including FICA), state, and local tax liabilities.

Recommendation of the Board of Directors

The board of directors unanimously recommends a vote **FOR** re-approval of the material terms of the performance goals set forth in the Equity Plan to allow certain equity grants under the Equity Plan to continue to be deductible under Section 162(m) of the Code.

EQUITY COMPENSATION PLAN INFORMATION

The following table sets out the number of shares of common stock to be issued upon exercise of outstanding options, warrants and rights, the weighted-average exercise price of outstanding options, warrants and rights, and the number of securities available for future issuance under equity compensation plans as of December 31, 2014.

	[a]	[b]	[c]
Plan category	**Number of securities to be issued upon exercise of outstanding options, warrants and rights**	**Weighted-average exercise price of outstanding options, warrants and rights**	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column [a])**
Equity compensation plans approved by security holders	1,910,072	$33.47	8,868,862
Equity compensation plans not approved by security holders	-	-	1,240,069 (1)
Total	1,910,072	$33.47	10,108,931

(1) Represents the balance of shares issuable under the American Water Works Company Inc. and its Designated Subsidiaries Nonqualified Employee Stock Purchase Plan under which a total of 2,000,000 shares are issuable.

(Proposal 5)

APPROVAL OF THE MATERIAL TERMS OF THE PERFORMANCE GOALS SET FORTH IN THE AMERICAN WATER WORKS COMPANY, INC. ANNUAL INCENTIVE PLAN TO ALLOW CERTAIN INCENTIVE AWARDS UNDER THE PLAN TO BE DEDUCTIBLE UNDER SECTION 162(M) OF THE INTERNAL REVENUE CODE

On March 4, 2015, our board of directors adopted the American Water Works Company, Inc. Annual Incentive Plan (the "Incentive Plan"). The board of directors has directed that the Incentive Plan be submitted for stockholder approval so that the compensation committee may grant awards under the Incentive Plan that are intended to qualify for the performance-based compensation exemption from the $1 million deduction limit under Section 162(m) of the Code. Section 162(m) of the Code requires approval of the material terms of the performance goals under an incentive program, such as the Incentive Plan, by the stockholders in order for a company to have the ability to grant awards under the program that qualify as performance-based compensation under Section 162(m) of the Code. The material terms for which approval is being sought include the performance criteria used to determine whether such awards intended as qualified-performance based compensation under Section 162(m) of the Code will be paid, the eligibility requirements for such awards, and the maximum amount that may be paid to any participant under the Incentive Plan.

The Incentive Plan generally provides for the award of cash payments to eligible employees based on their achievement of certain preset performance objectives over our fiscal year. The board of directors believes that the Incentive Plan furthers our compensation structure and strategy and encourages results-oriented actions on the part of our eligible employees. Our full-time exempt employees and those of our subsidiaries are eligible to participate in the Incentive Plan.

Section 162(m) of the Code permits us to deduct "qualified performance-based compensation" in excess of $1 million in any taxable year to our President and Chief Executive Officer and certain of our other executive officers, if, among other things, the material terms of the performance-based compensation have been approved by our stockholders. The board of directors believes that our interests, as well as the interests of our stockholders, will be advanced if we can have the ability to structure incentive awards under the Incentive Plan that qualify for the exemption from the $1 million deduction limitation under Section 162(m) of the Code. If our stockholders approve this proposal, we will have the ability to provide performance-based incentive payments to our officers under the Incentive Plan that are intended to meet the requirements of Section 162(m) of the Code, including the awards approved by our compensation committee and conditional on the approval of this proposal by the stockholders that are discussed below.

If our stockholders do not approve this proposal, the Incentive Plan will continue; however, the compensation committee will not be able to grant awards under the Incentive Plan that qualify for the qualified performance-based exemption under Section 162(m) of the Code and the conditional awards discussed below will be cancelled.

The material terms of the Incentive Plan are summarized below. This summary of the Incentive Plan is not intended to be a complete description of the Incentive Plan and is qualified in its entirety by the actual text of the Incentive Plan, which is attached as Appendix C to this proxy statement.

Material Features of the Incentive Plan

Types of Awards. The Incentive Plan provides that incentive awards may be granted that qualify as qualified performance-based compensation under Section 162(m) of the Code. In addition to such awards, awards may be granted under the Incentive Plan that do not qualify as qualified performance-based; however, in no event may any award be granted under the Incentive Plan in substitution or replacement of an award intended to qualify as qualified performance-based compensation under Section 162(m) of the Code. If our stockholders do not approve this proposal, we will not be able to issue incentive awards under the Incentive Plan that qualify for exemption from the $1 million deduction limitation under Section 162(m) of the Code. All incentive awards payable under the Incentive Plan are paid in cash.

Administration. The Incentive Plan is administered and interpreted by our compensation committee. With respect to incentive compensation that is intended to be performance-based compensation for purposes of Section 162(m) of the Code, the compensation committee will consist of two or more persons appointed by the board of directors, all of whom shall be "outside directors" as defined under Section 162(m) of the Code and related Treasury Regulations. With respect to incentive compensation that is not intended to be performance-based compensation, the compensation committee may delegate its responsibilities for administering the Incentive Plan to an award committee or an executive officer as it deems appropriate, but it may not delegate its responsibilities under the Incentive Plan relating to executive officers or its authority to amend or terminate the Incentive Plan. For purposes of this discussion, we refer to the compensation committee, or its delegate, as the "Committee."

The Committee has the full authority to establish rules and regulations relating to the Incentive Plan, to determine each participant's minimum, target and maximum award percentage, to approve all awards, to decide the facts in any case arising under the Incentive Plan and to make all other determinations, including factual determinations, and to take all other actions necessary or appropriate for the proper administration of the Incentive Plan, including the delegation of authority or power, where appropriate; provided, however, that the Committee will not be able to authorize to increase the amount of the award payable to a participant that would otherwise be payable pursuant to the terms of the Incentive Plan to the extent that the award is designated as "qualified performance-based compensation." All determinations of the Committee will be final and binding on all persons.

Eligibility and Participation. Participation in the Incentive Plan will be limited to our full-time exempt employees (including officers) and those of our subsidiaries who are selected for participation in the Incentive Plan by the Committee. Incentive Plan participation excludes any individual (i) who we employ in a casual or temporary capacity (e.g., those hired for a specific job of limited duration), (ii) who we characterize as "part-time," (iii) who is classified as a "non-exempt" employee eligible for overtime compensation under the Fair Labor Standards Act of 1938, (iv) whose terms of employment are governed by a collective bargaining agreement that does not provide for participation in the Incentive Plan, (v) who is characterized as a "leased employee" within the meaning of Section 414 of the Code, or (vi) who we classify as a "contractor" or "consultant."

The Committee will determine the employees who will be participants in the Incentive Plan for the performance period. In general, an employee must be actively employed on the date the incentive payment is paid in order to be eligible to receive an incentive payment for that period. Newly hired employees or employees promoted or transferred to an eligible/higher class will be eligible to receive a prorated award for the performance period, provided that their date of hire (or promotion/transfer) occurs on or before September 30, or such other date as determined by the Committee.

On March 4, 2015, there were approximately 1,850 employees eligible to participate in the Incentive Plan for the 2015 performance period.

Performance Period. Unless the Committee determines otherwise, the performance period for which the performance goals will be measured will be our fiscal year.

Establishment of Plan Components. With respect to awards designated as "qualified performance-based compensation," the Committee will establish in writing no later than 90 days after the commencement of period of service to which the performance goal relates (i) the performance goals, (ii) designate the participants, (iii) the relative weightings of such business criteria and (iv) the minimum, target and maximum payment amounts (determined as a percentage of base salary), but in no event will these be established after 25% of the period of service has elapsed. With respect to awards that are not designated as "qualified performance-based compensation" the Committee may establish the foregoing at such time or times as the Committee determines in its sole discretion. To the extent an incentive payment is designated as qualified performance-based compensation under Section 162(m) of the Code, no such incentive payment will be made as an alternative to any other award that is not designated as qualified performance-based compensation and such incentive payment will be separate and apart from all other awards made.

Section 162(m) of the Code requires us to establish a maximum annual incentive payment that can be paid to any individual under the Incentive Plan. As a result, the Incentive Plan provides that the maximum amount that can be paid for an incentive payment under the Incentive Plan that is payable to any participant for any fiscal year is $3,000,000.

Performance Goals. For any incentive payment under the Incentive Plan designated to qualify as qualified performance-based compensation under Section 162(m) of the Code, the performance goals will be based on pre-established, objective business criteria and will be set forth in writing by the Committee within the period required under Section 162(m) of the Code. The relevant business criteria will be one or more of the following: (A) diluted earnings per share, (B) environmental compliance, (C) safety performance, (D) service quality, (E) customer satisfaction, (F) stock price, (G) earnings per share, (H) price-earnings multiples, (I) net earnings, (J) operating earnings, (K) revenue, (L) number of days sales outstanding in accounts receivable, (M) productivity, (N) margin, (O) EBITDA (earnings before interest, taxes, depreciation and amortization), (P) net capital employed, (Q) return on assets, (R) stockholder return, (S) return on equity, (T) return on capital employed, (U) net income to shares of our stock, (V) growth in assets, (W) unit volume, (X) sales, (Y) cash flow, (Z) market share, (AA) relative performance to a comparison group designated by the Committee, and/or (BB) strategic business criteria consisting of one or more objectives based on meeting specified revenue goals, market penetration goals, customer growth, geographic business expansion goals, cost targets or goals relating to acquisitions or divestitures. Any criteria used may be measured, as applicable, (I) in absolute terms, (II) in relative terms (including but not limited to, the passage of time and/or against other companies or financial metrics), (III) on a per share and/or share per capita basis, (IV) against our and our subsidiaries' performance as a whole or against our performance or the performance of one or more particular subsidiary, entity, segment, operating unit or our products, or any combination thereof, and /or (V) on a pre-tax or after tax basis. For awards under the Incentive Plan not designated as qualified performance-based compensation, the performance goals may be based on one or more of the objective criteria set forth above and/or may take into account any other factors deemed appropriate by the Committee in its sole discretion. Performance goals need not be uniform as among participants.

To the extent permitted by Section 162(m) of the Code, if applicable, in setting the performance goals, the Committee may at such time also provide that the achievement of the performance goals will be determined without regard to the negative or positive effect of certain events, including for one or more of the following items: asset write-downs; litigation or claim judgments or settlements; changes in accounting principles; changes in tax law or other laws affecting reported results; changes in commodity prices; severance, contract termination, and other costs related to exiting, modifying or reducing any business activities; costs of, and gains and losses from, the acquisition, disposition, or abandonment of businesses or assets; gains and losses from the early extinguishment of debt; gains and losses in connection with the termination or withdrawal from a pension plan; stock compensation costs and other non-cash expenses; any extraordinary non-recurring items as described in applicable Accounting Principles Board opinions or Financial Accounting Standards Board statements or in management's discussion and analysis of financial condition and results of operation appearing in our annual report to stockholders for the applicable year; or any other specified non-operating items as determined by the Committee in setting performance goals.

The Committee may at any time prior to the final determination of the awards change the target percentage of any participant or assign a different award percentage to a participant to reflect any change in the participant's responsibility level of position during the performance period; provided, however, that no such changes may be made with respect to any incentive payment designated as qualified performance-based compensation for purposes of Section 162(m) of the Code under the Incentive Plan.

Actual Incentive Awards. Generally, a participant earns an incentive payment for a performance period based on the level of achievement of the performance goals established by the Committee. With respect to incentive compensation designated as qualified performance-based compensation for purposes of Section 162(m) of the Code, the Committee will have the discretion to reduce the incentive payment that would otherwise be payable to one or more participants on the basis of the certified level of attained performance. In the event of such reduction, the Committee may not increase the incentive payment of another participant that is designated as qualified performance-based compensation. Incentive payments which are not designated as qualified performance-based compensation under Section 162(m) of the Code may be increased or decreased at the discretion of the Committee.

Determination and Payment of Incentive Compensation. The Committee will certify and announce the awards that will be made to each participant as soon as practicable following the final determination of the financial results for the relevant performance period. Payment of awards will be made, in a single lump sum cash payment as soon as practicable following the Committee certification, which payment will not be later than March 15 of the year following the year in which the performance period ends.

Limitations on the Payment of Incentives. Unless the Committee determines otherwise, no participant will have any right to receive payment of an award under the Incentive Plan for a performance period unless the participant remains employed by us or one of our subsidiaries through the date that the award is paid.

Term of Incentive Plan. The Incentive Plan will continue until terminated by our board of directors or the Committee, but no incentive payment intended to be performance-based compensation under Section 162(m) of the Code will be paid under the Incentive Plan unless this proposal is approved by the stockholders at the Annual Meeting.

Amendment and Termination. Our board of directors or the Committee may at any time amend (in whole or in part), suspend or terminate the Incentive Plan; provided, however, that the board of directors or the Committee may not amend or modify the Incentive Plan without stockholder approval if such approval is required by Section 162(m) of the Code.

New Incentive Plan Benefits

The amounts payable under the Incentive Plan for 2015 cannot be determined until after the 2015 fiscal year is completed and achievement of the various performance goals is determined. Accordingly, the benefits or amounts of incentive payments, if any, are not yet determinable. The table below, however, sets forth the threshold, target, and maximum payment amounts that are potentially payable under the Incentive Plan to our current named executive officers if the stockholders approve the Incentive Plan as set forth in this proposal for the purposes of Section 162(m) of the Code at the Annual Meeting and certain pre-established performance goals are achieved for fiscal year 2015. In addition, the table below lists the aggregate amounts that are potentially payable for the 2015 fiscal year at the threshold, target and maximum levels under the Incentive Plan for all of our executive officers (including our current named executive officers) and non-executive officer employee group, which payments are also conditioned on stockholder approval of the material terms of the performance goals under the Incentive Plan for the purposes of Section 162(m) of the Code at the Annual Meeting. If the stockholders do not approve the Incentive Plan, the amounts for the persons or groups of persons noted below will not be payable.

Name	Threshold ($)	Target ($)	Maximum ($)
Susan N. Story, President and Chief Executive Officer	$ 290,000	$ 800,000	$ 1,600,000
Linda G. Sullivan, Senior Vice President and Chief Financial Officer	$ 128,814	$ 355,350	$ 710,700
Walter J. Lynch, President, Regulated Operations and Chief Operating Officer	$ 147,016	$ 405,562	$ 811,124
Michael A. Sgro, Senior Vice President, General Counsel and Secretary	$ 67,969	$ 187,500	$ 375,000
Loyd Warnock, Senior Vice President, External Affairs, Communications and Public Policy	$ 67,077	$ 185,040	$ 370,080
Executive Group(1)	$ 1,271,749	$ 3,508,274	$ 7,016,548
Non Executive Officer Employee Group	$ 9,339,279	$ 25,723,209	$ 51,446,418
Total	$ 10,611,028	$ 29,231,483	$ 58,462,966

(1) Includes the current named executive officers above.

Federal Income Tax Consequences

The following description of the federal income tax consequences of incentive payments under the Incentive Plan is a general summary. State, local and other taxes may also be imposed in connection with incentive payments. This discussion is intended for the information of stockholders considering how to vote at the Annual Meeting and not as tax guidance to individuals who participate in the Incentive Plan.

Tax Treatment of Incentives. Under present federal income tax laws, participants will recognize taxable income equal to the incentive payment that they receive under the Incentive Plan. Such taxable income will be recognized in the year the incentive payment is made to them.

Tax Deductibility under Section 162(m) of the Code. Section 162(m) of the Code disallows a tax deduction to publicly-held corporations for compensation paid to certain of their executive officers to the extent that such compensation exceeds $1 million per covered officer in any fiscal year, but contains an exception for “qualified performance-based compensation.” The Incentive Plan has been drafted and is intended to be administered in a manner that would enable incentive payments paid to our named executive officers to satisfy the requirements for “qualified performance-based compensation.”

To the extent incentive payments under the Incentive Plan satisfy the requirements for qualified performance-based compensation under Section 162(m) or are otherwise deductible as compensation, we will be entitled to a corresponding tax deduction in the year the incentive payment is paid.

Tax Withholding. We will deduct from all incentive payments, any federal, state or local taxes required by law to be withheld with respect thereto.

Recommendation of the Board of Directors

The board of directors unanimously recommends a vote **FOR** approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. Annual Incentive Plan to allow certain incentive awards under the plan to be deductible under Section 162 (m) of the Internal Revenue Code.

(Proposal 6)

ADOPTION OF AN AMENDMENT TO THE BYLAWS OF AMERICAN WATER WORKS COMPANY, INC. TO PROVIDE THAT THE COURTS LOCATED WITHIN THE STATE OF DELAWARE WILL SERVE AS THE EXCLUSIVE FORUM FOR THE ADJUDICATION OF CERTAIN LEGAL DISPUTES

We are asking stockholders to approve an amendment (the "Amendment") to the Company's Amended and Restated Bylaws (the "Bylaws") that, if adopted, would result in the courts located within the State of Delaware serving as the exclusive forum for the adjudication of certain legal actions involving the Company. Specifically, if this proposal is approved by stockholders, the Bylaws will be amended to add a new Article XIII thereto, with the text of such Article as follows:

EXCLUSIVE FORUM FOR ADJUDICATION OF DISPUTES

Unless the Corporation consents in writing to the selection of an alternative forum, the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director or officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim against the Corporation or any director or officer or other employee of the Corporation arising pursuant to any provision of the DGCL or the Corporation's Restated Certificate of Incorporation or Bylaws (in each case, as they may be amended from time to time), or (iv) any action asserting a claim against the Corporation or any director or officer or other employee of the Corporation governed by the internal affairs doctrine, shall be a state court located within the State of Delaware (or, if no state court located within the State of Delaware has jurisdiction, the federal district court for the District of Delaware), in all cases to the fullest extent permitted by law and subject to said court having personal jurisdiction over the indispensable parties named as defendants therein.

The Bylaws, as proposed to be amended and marked to show the proposed changes, are attached as Appendix D to this proxy statement. If approved by stockholders, the Amendment will be immediately effective.

The Company, which is incorporated in Delaware, is the most geographically diversified, as well as the largest publicly-traded, United States water and wastewater utility company, as measured by both operating revenue and population served. The Company provides drinking water, wastewater and other water-related services in over 40 states and two Canadian provinces. From time to time the Company has been, and expects that it may continue to be, the subject of various lawsuits arising out of its business and operations.

The Amendment is intended to assist the Company in avoiding multiple lawsuits in multiple jurisdictions on matters relating to the corporate law of Delaware, our state of incorporation. The Company believes that the Amendment would reduce the risk that the Company could become subject to duplicative litigation in multiple forums, as well as the risk that the outcome of cases in multiple forums could be inconsistent, even though each forum purports to follow Delaware law. Any of these could expose the Company to increased expenses or losses.

The Amendment would only regulate the forum where our stockholders may file claims relating to the specified intra-corporate disputes. The Amendment does not restrict the ability of our stockholders to bring such claims, nor the remedies available if such claims are ultimately successful; rather it attempts to prevent the Company from being forced to waste corporate assets defending against duplicative suits.

Although the board of directors believes that the designation of the Delaware Court of Chancery as the exclusive forum for intra-corporate disputes serves the best interests of the Company and our stockholders as a whole, the board of directors also believes that we should retain the ability to consent to an alternative forum on a case-by-case basis. Specifically, where the board of directors determines that the Company's interests and those of our stockholders are best served by permitting a dispute to proceed in a forum other than the Delaware Court of Chancery, the Amendment permits the corporation to consent to the selection of such alternative forum.

The board of directors believes that our stockholders will benefit from having intra-corporate disputes litigated in the Delaware Court of Chancery. Although some plaintiffs might prefer to litigate such matters in a forum outside of Delaware because they perceive another court as more convenient or more favorable to their claims (among other reasons), the board of directors believes that the substantial benefits to us and our stockholders as a whole from designating the Delaware Court of Chancery as the exclusive forum for intra-corporate disputes outweigh these concerns. The Delaware Court of Chancery is widely regarded as the preeminent court for the determination of disputes involving a corporation's internal affairs in terms of precedent, experience and focus. The Court's considerable expertise has led to the development of a substantial and influential body of case law interpreting Delaware's corporate law. This provides us and our stockholders with more predictability regarding the outcome of intra-corporate disputes. In addition, the Delaware Court of Chancery has developed streamlined procedures and processes that help provide decisions for litigating parties on a relatively expedited basis. This accelerated schedule can limit the time, cost, and uncertainty of litigation for all parties. Furthermore, there is a significant risk that allowing stockholders to bring such highly sophisticated matters in forums with little familiarity or experience in corporate governance leaves stockholders at risk that foreign jurisdictions may misapply Delaware law.

Without a bylaw or similar provision such as that contemplated by the Amendment, the Company remains exposed to the possibility of plaintiffs using the Company's geographically diverse operational base to bring claims against the Company in multiple jurisdictions or choosing a forum state for litigation that may not apply Delaware law to the Company's internal affairs in the same manner as the Delaware courts would be expected to do so.

The Company is aware, notwithstanding the adoption of an exclusive jurisdiction provision, that the enforceability of similar choice of forum provisions in other companies' governing document has been challenged in various legal proceedings, and it is possible that, in connection with any such proceedings, including any legal proceedings that may be brought to challenge the Amendment if it is approved, judicial decisions or other rulings or changes in law could declare or otherwise render exclusive forum clauses like the one contained in the Amendment to be inapplicable or unenforceable.

After considering the foregoing, the Board believes the Amendment is in the best interests of the Company and its stockholders and recommends that our stockholders approve the Amendment.

Vote Required for Approval

Stockholder approval is not required for the board of directors to amend our Bylaws; however, the board of directors believes that stockholder support of the Amendment is important and is a matter of good corporate governance practice. Approval of the Amendment requires the affirmative "**FOR**" vote of a majority of shares present in person or represented by proxy and entitled to vote on the proposal.

Recommendation of the Board of Directors

The board of directors unanimously recommends a vote **FOR** approval of the amendment to our bylaws establishing the courts located within the State of Delaware as the exclusive forum for the adjudication of certain legal disputes.

STOCKHOLDER PROPOSALS

Any stockholder who, in accordance with SEC Rule 14a-8, wishes to present a proposal for inclusion in the proxy materials to be distributed in connection with the 2016 Annual Meeting of Stockholders must submit the proposal to the Office of the Secretary, American Water Works Company, Inc., 1025 Laurel Oak Road, Voorhees, NJ 08043. Stockholder proposals for inclusion in our proxy statement for the 2016 Annual Meeting of Stockholders must be received on or before November 28, 2015 and must comply in all other respects with applicable SEC rules.

Any stockholder who wishes to propose any business to be considered by the stockholders at the 2016 Annual Meeting of Stockholders (other than a proposal for inclusion in the proxy statement pursuant to SEC Rule 14a-8), or who wants to nominate a person for election to the board of directors at that meeting, must provide timely and proper notice to the Office of the Secretary of American Water in writing, including the specified information described in our Bylaws concerning the proposed business or nominee. The requirements for such notice are set forth in our Bylaws, a copy of which can be obtained upon request directed to the Office of the Secretary at the address set forth above. The notice must be delivered to or mailed to the address set forth in the preceding paragraph and received at American Water's principal executive offices no later than February 15, 2016. However, if the 2016 Annual Meeting of Stockholders is to be held more than 30 days before or 60 days after the anniversary of this year's annual meeting, notice must be received not later than 90 days prior to the date of the 2016 Annual Meeting of Stockholders, or, if later, by the tenth day following the Company's public announcement of the date of the 2016 Annual Meeting of Stockholders.

In order for stockholder proposals that are submitted outside of SEC Rule 14a-8 and are intended to be considered by the stockholders at the 2016 Annual Meeting of Stockholders to be considered "timely" for purposes of SEC Rule 14a-4(c) under the Exchange Act, the proposal must be received by the Office of the Secretary of American Water no later than February 15, 2016. If a stockholder fails to provide such timely notice of a proposal to be presented at the 2016 Annual Meeting, the proxies designated by the Board will have discretionary authority to vote on any such proposal.

OTHER MATTERS

At the time this proxy statement went to press, we do not know of any matters to be acted upon at the Annual Meeting other than those discussed in this Proxy Statement. If any other items or matters are properly presented before the Annual Meeting, the proxy holders will vote on such matters in their discretion. A proxy granted by a stockholder will give discretionary authority to the proxy holders to vote on any matters introduced pursuant to these procedures, subject to applicable SEC rules.

Appendix A

Reconciliation of income from continuing operations to adjusted income from continuing operations (A Non-GAAP, unaudited measure)

	Year Ended December 31, 2014 (In thousands except per share data) Income	Diluted Earnings Per Share
Income from continuing operations	$ 429,841	$ 2.39
Add: After-tax impact of West Virginia Freedom Industries chemical spill	7,007	0.04
Adjusted income from continuing operations	$ 436,848	$ 2.43

Reconciliation of (i) total operation and maintenance expenses to adjusted regulated operation and maintenance expense and (ii) total operating revenues to adjusted regulated operating revenues; the adjusted amounts are used in the calculation of Regulated Operations and Maintenance Efficiency Ratio (adjusted regulated operation and maintenance expense divided by adjusted regulated operating revenues, expressed as a percentage) (A Non-GAAP, unaudited measure)

	Years Ended December 31, (In thousands) 2014	2013
Total Operation and Maintenance Expense	$ 1,349,864	$ 1,289,081
Less:		
Operation and maintenance expense – Market-Based Operations	289,395	240,610
Operation and maintenance expense – Other	(51,038)	(56,973)
Total Regulated Operation and Maintenance Expense	1,111,507	1,105,444
Less:		
Regulated purchase water expense	121,301	111,119
Allocation of internal operation & maintenance expense	38,985	34,635
Impact of West Virginia Industries chemical spill	10,438	—
Estimated impact of weather (mid-point of range)	(1,762)	(1,687)
Adjusted Regulated Operation and Maintenance Expense (a)	$ 942,545	$ 961,377
Total Operating Revenues	$ 3,011,328	$ 2,878,936
Less:		
Operating Revenues – Market-Based Operations	354,679	302,541
Operating Revenues – Other	(17,680)	(17,523)
Total Regulated operating revenues	2,674,329	2,593,918
Less:		
Regulated purchase water expense *	121,301	111,119
Plus:		
Impact of West Virginia Freedom Industries chemical spill	1,012	—
Estimated impact of weather (mid-point of range)	16,785	15,625
Adjusted Regulated Operating Revenues (b)	$ 2,570,825	$ 2,498,424
Regulated Operations and Maintenance Efficiency Ratio (a)/(b)	36.7%	38.5%

* Calculation assumes purchased water revenues approximate purchased water expenses.

Appendix B

American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan

(As amended and restated, effective as of May 8, 2009)

1. *Purpose*

The purpose of the American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan, as amended and restated, effective as of May 8, 2009, (the "Plan") is to provide (i) designated employees of American Water Works Company, Inc. (the "Company") and its subsidiaries and (ii) non-employee members of the board of directors of the Company with the opportunity to receive grants of stock options, stock units, stock awards, stock appreciation rights and other stock-based awards. The Company believes that the Plan will encourage the participants to contribute materially to the growth of the Company, thereby benefiting the Company's stockholders, and will align the economic interests of the participants with those of the stockholders.

2. *Definitions*

Whenever used in this Plan, the following terms will have the respective meanings set forth below:

(a) *"Board"* means the Company's Board of Directors.

(b) *"Change of Control"* shall be deemed to have occurred if:

(i) Any "person" (as such term is used in sections 13(d) and 14(d) of the Exchange Act) becomes a "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the Company representing more than 50% of the voting power of the then outstanding securities of the Company; provided that a Change of Control shall not be deemed to occur as a result of (A) a transaction in which the Company becomes a subsidiary of another corporation and in which the stockholders of the Company, immediately prior to the transaction, will beneficially own, immediately after the transaction, shares entitling such stockholders to more than 50% of all votes to which all stockholders of the parent corporation would be entitled in the election of directors, (B) the initial public offering of the Company Stock, or (C) any subsequent offering of shares of the Company Stock;

(ii) The consummation of (A) a merger or consolidation of the Company with another corporation where the stockholders of the Company, immediately prior to the merger or consolidation, will not beneficially own, immediately after the merger or consolidation, shares entitling such stockholders to more than 50% of all votes to which all stockholders of the surviving corporation would be entitled in the election of directors, (B) a sale or other disposition of all or substantially all of the assets of the Company, or (C) a liquidation or dissolution of the Company; or

(iii) After the Original Effective Date, directors are elected such that a majority of the members of the Board shall have been members of the Board for less than one year, unless the election or nomination for election of each new director who was not a director at the beginning of such one-year period was approved by a vote of at least two-thirds of the directors then still in office who were directors at the beginning of such period.

Notwithstanding the foregoing, the Committee may provide for a different definition of a "Change of Control" in a Grant Agreement if such Grant is subject to the requirements of section 409A of the Code and the Grant will become payable on a Change of Control.

(c) *"Code"* means the Internal Revenue Code of 1986, as amended.

(d) *"Committee"* means (i) with respect to Grants to Employees, the Compensation Committee of the Board or another committee appointed by the Board to administer the Plan, (ii) with respect to Grants made to Non-Employee Directors, the Board, and (iii) with respect to Grants that are intended to be "qualified performance-based compensation" under section 162(m) of the Code, a committee that consists of two or more persons appointed by the Board, all of whom shall be "outside directors" as defined under section 162(m) of the Code and related Treasury regulations.

(e) *"Company"* means American Water Works Company, Inc. and any successor corporation.

(f) *"Company Stock"* means the common stock of the Company, par value $0.01 per share.

(g) *"Dividend Equivalent"* means an amount calculated with respect to a Stock Unit, which is determined by multiplying the number of shares of Company Stock subject to the Stock Unit by the per-share cash dividend, or the per-share fair market value (as determined by the Committee) of any dividend in consideration other than cash, paid by the Company on its Company Stock. If interest is credited on accumulated dividend equivalents, the term "Dividend Equivalent" shall include the accrued interest.

(h) *"Effective Date"* of the Plan shall mean May 8, 2009, the effective date of this amendment and restatement of the Plan. The "*Original Effective Date*" is the day immediately preceding the date of the Underwriting Agreement was executed and the Company Stock was priced for the initial public offering of such Company Stock.

(i) *"Employee"* means an employee of the Employer (including an officer or director who is also an employee), but excluding any person who is classified by the Employer as a "contractor" or "consultant," no matter how characterized by the Internal Revenue Service, other governmental agency or a court. Any change of characterization of an individual by the Internal Revenue Service or any court or government agency shall have no effect upon the classification of an individual as an Employee for purposes of this Plan, unless the Committee determines otherwise.

(j) *"Employer"* means the Company and its subsidiaries.

(k) *"Exchange Act"* means the Securities Exchange Act of 1934, as amended.

(l) *"Exercise Price"* means the per share price at which shares of Company Stock may be purchased under an Option, as designated by the Committee.

(m) *"Fair Market Value"* of Company Stock means, unless the Committee determines otherwise with respect to a particular Grant, (i) if the principal trading market for the Company Stock is a national securities exchange, the last reported sale price of Company Stock on the relevant date or (if there were no trades on that date) the latest preceding date upon which a sale was reported, (ii) if the Company Stock is not principally traded on such exchange, the mean between the last reported "bid" and "asked" prices of Company Stock on the relevant date, as reported on the OTC Bulletin Board, or (iii) if the Company Stock is not publicly traded or, if publicly traded, is not so reported, the Fair Market Value per share shall be as determined by the Committee.

(n) *"Grant"* means an Option, Stock Unit, Stock Award, SAR or Other Stock-Based Award granted under the Plan.

(o) *"Grant Agreement"* means the written instrument that sets forth the terms and conditions of a Grant, including all amendments thereto.

(p) *"Incentive Stock Option"* means an Option that is intended to meet the requirements of an incentive stock option under section 422 of the Code.

(q) *"Non-Employee Director"* means a member of the Board who is not an Employee.

(r) *"Nonqualified Stock Option"* means an Option that is not intended to be taxed as an incentive stock option under section 422 of the Code.

(s) "*1933 Act*" means the Securities Act of 1933, as amended.

(t) *"Option"* means an option to purchase shares of Company Stock, as described in Section 7.

(u) *"Other Stock-Based Award"* means a grant that is based on, measured by or payable in Company Stock (other than an Option, Stock Unit, Stock Award or SAR), as described in Section 11.

(v) *"Participant"* means an Employee or Non-Employee Director designated by the Committee to participate in the Plan.

(w) *"Plan"* means this American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan, as may be amended from time to time.

(x) *"SAR"* means a stock appreciation right as described in Section 10.

(y) *"Stock Award"* means an award of Company Stock as described in Section 9.

(z) *"Stock Unit"* means an award of a phantom unit representing a share of Company Stock, as described in Section 8.

(aa) *"Underwriting Agreement"* means the agreement between the Company and the underwriter or underwriters managing the initial public offering of the Company Stock.

3. *Administration*

(a) *Committee*. The Plan shall be administered and interpreted by the Committee. Ministerial functions may be performed by an administrative committee comprised of Company employees appointed by the Committee.

(b) *Committee Authority*. The Committee shall have the sole authority to (i) determine the Participants to whom Grants shall be made under the Plan, (ii) determine the type, size and terms and conditions of the Grants to be made to each such Participant, (iii) determine the time when the Grants will be made and the duration of any applicable exercise or restriction period, including the criteria for exercisability and the acceleration of exercisability, (iv) amend the terms and conditions of any previously issued Grant, subject to the provisions of Section 18 below, and (v) deal with any other matters arising under the Plan.

(c) *Committee Determinations*. The Committee shall have full power and express discretionary authority to administer and interpret the Plan, to make factual determinations and to adopt or amend such rules, regulations, agreements and instruments for implementing the Plan and for the conduct of its business as it deems necessary or advisable, in its sole discretion. The Committee's interpretations of the Plan and all determinations made by the Committee pursuant to the powers vested in it hereunder shall be conclusive and binding on all persons having any interest in the Plan or in any awards granted hereunder. All powers of the Committee shall be executed in its sole discretion, in the best interest of the Company, not as a fiduciary, and in keeping with the objectives of the Plan and need not be uniform as to similarly situated Participants.

4. *Grants*

(a) Grants under the Plan may consist of Options as described in Section 7, Stock Units as described in Section 8, Stock Awards as described in Section 9, SARs as described in Section 10 and Other Stock-Based Awards as described in Section 11. All Grants shall be subject to such terms and conditions as the Committee deems appropriate and as are specified in writing by the Committee to the Participant in the Grant Agreement.

(b) All Grants shall be made conditional upon the Participant's acknowledgement, in writing or by acceptance of the Grant, that all decisions and determinations of the Committee shall be final and binding on the Participant, his or her beneficiaries and any other person having or claiming an interest under such Grant. Grants under a particular Section of the Plan need not be uniform as among the Participants.

5. *Shares Subject to the Plan*

(a) *Shares Authorized*. Subject to adjustment as described in subsection (d) below, the total aggregate number of shares of Company Stock that may be issued or transferred under the Plan is 6,000,000 shares and, effective May 8, 2009, the aggregate number of shares of Company Stock that may be issued or transferred under the Plan shall be increased by 9,500,000 shares so that the total number of shares of Company Stock authorized for issuance or transfer under the Plan shall be 15,500,000 shares.

(b) *Source of Shares; Share Counting*. Shares issued under the Plan may be authorized but unissued shares of Company Stock or reacquired shares of Company Stock, including shares purchased by the Company on the open market for purposes of the Plan. If and to the extent Options or SARs granted under the Plan terminate, expire, or are canceled, forfeited, exchanged or surrendered without having been exercised, and if and to the extent that any Stock Awards, Stock Units, or Other Stock-Based Awards are forfeited or terminated, or otherwise are not paid in full, the shares reserved for such Grants shall again be available for purposes of the Plan. Shares of Stock surrendered in payment of the Exercise Price of an Option, and shares withheld or surrendered for payment of taxes, shall not be available for re-issuance under the Plan. If SARs are granted, the full number of shares subject to the SARs shall be considered issued under the Plan, without regard to the number of shares issued upon exercise of the SARs and without regard to any cash settlement of the SARs. To the extent that a Grant of Stock Units is designated in the Grant Agreement to be paid in cash, and not in shares of Company Stock, such Grants shall not count against the share limits in subsection (a).

(c) *Individual Limits*. All Grants under the Plan shall be expressed in shares of Company Stock. The maximum aggregate number of shares of Company Stock with respect to which all Grants may be made under the Plan to any individual during any calendar year shall be 500,000 shares, subject to adjustment as described in subsection (d) below. The individual limits of this subsection (c) shall apply without regard to whether the Grants are to be paid in Company Stock or cash. All cash payments (other than with respect to Dividend Equivalents) shall equal the Fair Market Value of the shares of Company Stock to which the cash payments relate. A Participant may not accrue Dividend Equivalents during any calendar year in excess of $750,000.

(d) *Adjustments*. If there is any change in the number or kind of shares of Company Stock outstanding (i) by reason of a stock dividend, spinoff, recapitalization, stock split, or combination or exchange of shares, (ii) by reason of a merger, reorganization or consolidation, (iii) by reason of a reclassification or change in par value, or (iv) by reason of any other extraordinary or unusual event affecting the outstanding Company Stock as a class without the Company's receipt of consideration, or if the value of outstanding shares of Company Stock is substantially reduced as a result of a spinoff or the Company's payment of an extraordinary dividend or distribution, the maximum number of shares of Company Stock available for issuance under the Plan, the maximum number of shares of Company Stock for which any individual may receive Grants in any year, the kind and number of shares covered by outstanding Grants, the kind and number of shares issued and to be issued under the Plan, and the price per share or the applicable market value of such Grants shall be equitably adjusted by the Committee, in such manner as the Committee deems appropriate, to reflect any increase or decrease in the number of, or change in the kind or value of, the issued shares of Company Stock to preclude, to the extent practicable, the enlargement or dilution of rights and benefits under the Plan and such outstanding Grants; provided, however, that any fractional shares resulting from such adjustment shall be eliminated. In addition, in the event of a Change of Control of the Company, the provisions of Section 16 of the Plan shall apply. Any adjustments to outstanding Grants shall be consistent with section 409A or 422 of the Code, to the extent applicable. Any adjustments determined by the Committee shall be final, binding and conclusive.

6. *Eligibility for Participation*

(a) *Eligible Persons*. All Employees and Non-Employee Directors shall be eligible to participate in the Plan.

(b) *Selection of Participants*. The Committee shall select the Employees and Non-Employee Directors to receive Grants and shall determine the number of shares of Company Stock subject to each Grant.

7. *Options*

(a) *General Requirements*. The Committee may grant Options to an Employee or Non-Employee Director upon such terms and conditions as the Committee deems appropriate under this Section 7. The Committee shall determine the number of shares of Company Stock that will be subject to each Grant of Options to Employees and Non-Employee Directors.

(b) *Type of Option, Price and Term*.

(i) The Committee may grant Incentive Stock Options or Nonqualified Stock Options or any combination of the two, all in accordance with the terms and conditions set forth herein. Incentive Stock Options may be granted only to Employees of the Company or its parents or subsidiaries, as defined in section 424 of the Code. Nonqualified Stock Options may be granted to Employees or Non-Employee Directors.

(ii) The Exercise Price of Company Stock subject to an Option shall be determined by the Committee and shall be equal to or greater than the Fair Market Value of a share of Company Stock on the date the Option is granted. However, an Incentive Stock Option may not be granted to an Employee who, at the time of grant, owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Company or any parent or subsidiary, as defined in section 424 of the Code, unless the Exercise Price per share is not less than 110% of the Fair Market Value of the Company Stock on the date of grant.

(iii) The Committee shall determine the term of each Option, which shall not exceed ten years from the date of grant. However, an Incentive Stock Option that is granted to an Employee who, at the time of grant, owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Company or any parent or subsidiary, as defined in section 424 of the Code, may not have a term that exceeds five years from the date of grant.

(c) *Exercisability of Options*.

(i) Options shall become exercisable in accordance with such terms and conditions as may be determined by the Committee and specified in the Grant Agreement. The Committee may grant Options that are subject to achievement of performance goals or other conditions. The Committee may accelerate the exercisability of any or all outstanding Options at any time for any reason.

(ii) The Committee may provide in a Grant Agreement that the Participant may elect to exercise part or all of an Option before it otherwise has become exercisable. Any shares so purchased shall be restricted shares and shall be subject to a repurchase right in favor of the Company during a specified restriction period, with the repurchase price equal to the lesser of (A) the Exercise Price or (B) the Fair Market Value of such shares at the time of repurchase, or such other restrictions as the Committee deems appropriate.

(iii) Options granted to persons who are non-exempt employees under the Fair Labor Standards Act of 1938, as amended, may not be exercisable for at least six months after the date of grant (except that such Options may become exercisable, as determined by the Committee, upon the Participant's death, disability or retirement, or upon a Change of Control or other circumstances permitted by applicable regulations).

(d) *Termination of Employment or Service*. Except as provided in the Grant Agreement, an Option may only be exercised while the Participant is employed as an Employee or providing service as a Non-Employee Director. The Committee shall determine in the Grant Agreement under what circumstances and during what time periods a Participant may exercise an Option after termination of employment or service.

(e) *Exercise of Options*. A Participant may exercise an Option that has become exercisable, in whole or in part, by delivering a notice of exercise to the Company. The Participant shall pay the Exercise Price for the Option (i) in cash, (ii) if permitted by the Committee, by delivering shares of Company Stock owned by the Participant and having a Fair Market Value on the date of exercise equal to the Exercise Price or by attestation to ownership of shares of Company Stock having an aggregate Fair Market Value on the date of exercise equal to the Exercise Price, (iii) by payment through a broker in accordance with procedures permitted by Regulation T of the Federal Reserve Board, or (iv) by such other method as the Committee may approve, to the extent permitted by applicable law. Shares of Company Stock used to exercise an Option shall have been held by the Participant for the requisite period of time to avoid adverse accounting consequences to the Company with respect to the Option. Payment for the shares pursuant to the Option, and any required withholding taxes, must be received by the time specified by the Committee depending on the type of payment being made, but in all cases prior to the issuance of the Company Stock.

(f) *Limits on Incentive Stock Options*. Each Incentive Stock Option shall provide that, if the aggregate Fair Market Value of the stock on the date of the grant with respect to which Incentive Stock Options are exercisable for the first time by a Participant during any calendar year, under the Plan or any other stock option plan of the Company or a parent or subsidiary, as defined in section 424 of the Code, exceeds $100,000, then the Option, as to the excess, shall be treated as a Nonqualified Stock Option. An Incentive Stock Option shall not be granted to any person who is not an Employee of the Company or a parent or subsidiary, as defined in section 424 of the Code.

8. *Stock Units*

(a) *General Requirements*. The Committee may grant Stock Units to an Employee or Non-Employee Director, upon such terms and conditions as the Committee deems appropriate under this Section 8. Each Stock Unit shall represent the right of the Participant to receive a share of Company Stock or an amount based on the value of a share of Company Stock. All Stock Units shall be credited to bookkeeping accounts on the Company's records for purposes of the Plan.

(b) *Terms of Stock Units*. The Committee may grant Stock Units that are payable on terms and conditions determined by the Committee, which may include payment based on achievement of performance goals. Stock Units may be paid at the end of a specified vesting or performance period, or payment may be deferred to a date authorized by the Committee. The Committee shall determine the number of Stock Units to be granted and the requirements applicable to such Stock Units.

(c) *Payment With Respect to Stock Units*. Payment with respect to Stock Units shall be made in cash, in Company Stock, or in a combination of the two, as determined by the Committee. The Grant Agreement shall specify the maximum number of shares that can be issued under the Stock Units.

(d) *Requirement of Employment or Service*. The Committee shall determine in the Grant Agreement under what circumstances a Participant may retain Stock Units after termination of the Participant's employment or service, and the circumstances under which Stock Units may be forfeited.

(e) *Dividend Equivalents*. The Committee may grant Dividend Equivalents in connection with Stock Units, under such terms and conditions as the Committee deems appropriate. Dividend Equivalents may be paid to Participants currently or may be deferred. All Dividend Equivalents that are not paid currently shall be credited to bookkeeping accounts on the Company's records for purposes of the Plan. Dividend Equivalents may be accrued as a cash obligation, or may be converted to additional Stock Units for the Participant, and deferred Dividend Equivalents may accrue interest, all as determined by the Committee. The Committee may provide that Dividend Equivalents shall be payable based on the achievement of specific performance goals. Dividend Equivalents may be payable in cash or shares of Company Stock or in a combination of the two, as determined by the Committee.

9. *Stock Awards*

(a) *General Requirements*. The Committee may issue shares of Company Stock to an Employee or Non-Employee Director under a Stock Award, upon such terms and conditions as the Committee deems appropriate under this Section 9. Shares of Company Stock issued pursuant to Stock Awards may be issued for cash consideration or for no cash consideration, and subject to restrictions or no restrictions, as determined by the Committee. The Committee may establish conditions under which restrictions on Stock Awards shall lapse over a period of time or according to such other criteria as the Committee deems appropriate, including restrictions based upon the achievement of specific performance goals. The Committee shall determine the number of shares of Company Stock to be issued pursuant to a Stock Award.

(b) *Requirement of Employment or Service*. The Committee shall determine in the Grant Agreement under what circumstances a Participant may retain Stock Awards after termination of the Participant's employment or service, and the circumstances under which Stock Awards may be forfeited.

(c) *Restrictions on Transfer*. While Stock Awards are subject to restrictions, a Participant may not sell, assign, transfer, pledge or otherwise dispose of the shares of a Stock Award except upon death as described in Section 15(a). If certificates are issued, each certificate for a share of a Stock Award shall contain a legend giving appropriate notice of the restrictions in the Grant. The Participant shall be entitled to have the legend removed when all restrictions on such shares have lapsed. The Company may retain possession of any certificates for Stock Awards until all restrictions on such shares have lapsed.

(d) *Right to Vote and to Receive Dividends*. The Committee shall determine to what extent, and under what conditions, the Participant shall have the right to vote shares of Stock Awards and to receive any dividends or other distributions paid on such shares during the restriction period. The Committee may determine that dividends on Stock Awards shall be withheld while the Stock Awards are subject to restrictions and that the dividends shall be payable only upon the lapse of the restrictions on the Stock Awards, or on such other terms as the Committee determines. Dividends that are not paid currently shall be credited to bookkeeping accounts on the Company's records for purposes of the Plan. Accumulated dividends may accrue interest, as determined by the Committee, and shall be paid in cash, shares of Company Stock, or in such other form as dividends are paid on Company Stock, as determined by the Committee.

10. *Stock Appreciation Rights*

(a) *General Requirements*. The Committee may grant SARs to an Employee or Non-Employee Director separately or in tandem with an Option. The Committee shall establish the number of shares, the terms and the base amount of the SAR at the time the SAR is granted. The base amount of each SAR shall be not less than the Fair Market Value of a share of Company Stock as of the date of grant of the SAR. The Committee shall determine the term of each SAR, which shall not exceed ten years from the date of grant.

(b) *Tandem SARs*. The Committee may grant tandem SARs either at the time the Option is granted or at any time thereafter while the Option remains outstanding; provided, however, that, in the case of an Incentive Stock Option, SARs may be granted only at the date of the grant of the Incentive Stock Option. In the case of tandem SARs, the number of SARs granted to a Participant that shall be exercisable during a specified period shall not exceed the number of shares of Company Stock that the Participant may purchase upon the exercise of the related Option during such period. Upon the exercise of an Option, the SARs relating to the Company Stock covered by such Option shall terminate. Upon the exercise of SARs, the related Option shall terminate to the extent of an equal number of shares of Company Stock.

(c) *Exercisability*. A SAR shall become exercisable in accordance with such terms and conditions as may be specified. The Committee may grant SARs that are subject to achievement of performance goals or other conditions. The Committee may accelerate the exercisability of any or all outstanding SARs at any time for any reason. The Committee shall determine in the Grant Agreement under what circumstances and during what periods a Participant may exercise a SAR after termination of employment or service. A tandem SAR shall be exercisable only while the Option to which it is related is exercisable.

(d) *Grants to Non-Exempt Employees*. SARs granted to persons who are non-exempt employees under the Fair Labor Standards Act of 1938, as amended, may not be exercisable for at least six months after the date of grant (except that such SARs may become exercisable, as determined by the Committee, upon the Participant's death, Disability or retirement, or upon a Change of Control or other circumstances permitted by applicable regulations).

(e) *Exercise of SARs*. When a Participant exercises SARs, the Participant shall receive in settlement of such SARs an amount equal to the value of the stock appreciation for the number of SARs exercised. The stock appreciation for a SAR is the amount by which the Fair Market Value of the underlying Company Stock on the date of exercise of the SAR exceeds the base amount of the SAR as specified in the Grant Agreement.

(f) *Form of Payment*. The Committee shall determine whether the stock appreciation for a SAR shall be paid in the form of shares of Company Stock, cash or a combination of the two. For purposes of calculating the number of shares of Company Stock to be received, shares of Company Stock shall be valued at their Fair Market Value on the date of exercise of the SAR. If shares of Company Stock are to be received upon exercise of a SAR, cash shall be delivered in lieu of any fractional share.

11. *Other Stock-Based Awards*

The Committee may grant other awards not specified in Sections 7, 8, 9 or 10 above that are based on or measured by Company Stock to Employees and Non-Employee Directors, on such terms and conditions as the Committee deems appropriate. Other Stock-Based Awards may be granted subject to achievement of performance goals or other conditions and may be payable in Company Stock or cash, or in a combination of the two, as determined by the Committee in the Grant Agreement.

12. *Qualified Performance-Based Compensation*

(a) *Designation as Qualified Performance-Based Compensation*. The Committee may determine that Stock Units, Stock Awards, Dividend Equivalents or Other Stock-Based Awards granted to an Employee shall be considered "qualified performance-based compensation" under section 162(m) of the Code, in which case the provisions of this Section 12 shall apply.

(b) *Performance Goals*. When Grants are made under this Section 12, the Committee shall establish in writing (i) the objective performance goals that must be met, (ii) the period during which performance will be measured, (iii) the maximum amounts that may be paid if the performance goals are met, and (iv) any other conditions that the Committee deems appropriate and consistent with the requirements of section 162(m) of the Code for "qualified performance-based compensation." The performance goals shall satisfy the requirements for "qualified performance-based compensation," including the requirement that the achievement of the goals be substantially uncertain at the time they are established and that the performance goals be established in such a way that a third party with knowledge of the relevant facts could determine whether and to what extent the performance goals have been met. The Committee shall not have discretion to increase the amount of compensation that is payable, but may reduce the amount of compensation that is payable, pursuant to Grants identified by the Committee as "qualified performance-based compensation."

(c) *Criteria Used for Objective Performance Goals*. The Committee shall use objectively determinable performance goals based on one or more of the following criteria: stock price, earnings per share, price-earnings multiples, net earnings, operating earnings, revenue, number of days sales outstanding in accounts receivable, productivity, margin, EBITDA (earnings before interest, taxes, depreciation and amortization), net capital employed, return on assets, stockholder return, return on equity, return on capital employed, net income to shares of Company Stock, growth in assets, unit volume, sales, cash flow, market share, relative performance to a comparison group designated by the Committee, or strategic business criteria consisting of one or more objectives based on meeting specified revenue goals, market penetration goals, customer growth, geographic business expansion goals, cost targets or goals relating to acquisitions or divestitures. The performance goals may relate to one or more business units or the performance of the Company and its subsidiaries as a whole, or any combination of the foregoing. Performance goals need not be uniform as among Participants.

(d) *Timing of Establishment of Goals*. The Committee shall establish the performance goals in writing either before the beginning of the performance period or during a period ending no later than the earlier of (i) 90 days after the beginning of the performance period or (ii) the date on which 25% of the performance period has been completed, or such other date as may be required or permitted under applicable regulations under section 162(m) of the Code.

(e) *Certification of Results*. The Committee shall certify the performance results for the performance period specified in the Grant Agreement after the performance period ends. The Committee shall determine the amount, if any, to be paid pursuant to each Grant based on the achievement of the performance goals and the satisfaction of all other terms of the Grant Agreement.

(f) *Death, Disability or Other Circumstances*. The Committee may provide in the Grant Agreement that Grants under this Section 12 shall be payable, in whole or in part, in the event of the Participant's death or disability, a Change of Control or under other circumstances consistent with the Treasury regulations and rulings under section 162(m) of the Code.

13. *Deferrals*

The Committee may permit or require a Participant to defer receipt of the payment of cash or the delivery of shares that would otherwise be due to the Participant in connection with any Grant. The Committee shall establish rules and procedures for any such deferrals, consistent with applicable requirements of section 409A of the Code.

14. *Withholding of Taxes*

(a) *Required Withholding*. All Grants under the Plan shall be subject to applicable federal (including FICA), state and local tax withholding requirements. The Company may require that the Participant or other person receiving or exercising Grants pay to the Company the amount of any federal, state or local taxes that the Company is required to withhold with respect to such Grants, or the Company may deduct from other wages paid by the Company the amount of any withholding taxes due with respect to such Grants.

(b) *Election to Withhold Shares*. If the Committee so permits, shares of Company Stock may be withheld to satisfy the Company's tax withholding obligation with respect to Grants paid in Company Stock, at the time such Grants become taxable, up to an amount that does not exceed the minimum applicable withholding tax rate for federal (including FICA), state and local tax liabilities.

15. *Transferability of Grants*

(a) *Restrictions on Transfer*. Except as described in subsection (b) below, only the Participant may exercise rights under a Grant during the Participant's lifetime, and a Participant may not transfer those rights except by will or by the laws of descent and distribution. When a Participant dies, the personal representative or other person entitled to succeed to the rights of the Participant may exercise such rights. Any such successor must furnish proof satisfactory to the Company of his or her right to receive the Grant under the Participant's will or under the applicable laws of descent and distribution.

(b) *Transfer of Nonqualified Stock Options to or for Family Members*. Notwithstanding the foregoing, the Committee may provide, in a Grant Agreement, that a Participant may transfer Nonqualified Stock Options to family members, or one or more trusts or other entities for the benefit of or owned by family members, consistent with applicable securities laws, according to such terms as the Committee may determine; provided that the Participant receives no consideration for the transfer of a Nonqualified Stock Option and the transferred Nonqualified Stock Option shall continue to be subject to the same terms and conditions as were applicable to the Nonqualified Stock Option immediately before the transfer.

16. ***Consequences of a Change of Control***

In the event of a Change of Control, the Committee may take any one or more of the following actions with respect to any or all outstanding Grants, without the consent of any Participant: (i) the Committee may determine that outstanding Options and SARs shall be fully exercisable, and restrictions on outstanding Stock Awards and Stock Units shall lapse, as of the date of the Change of Control or at such other time as the Committee determines, (ii) the Committee may require that Participants surrender their outstanding Options and SARs in exchange for one or more payments by the Company, in cash or Company Stock as determined by the Committee, in an amount equal to the amount, if any, by which the then Fair Market Value of the shares of Company Stock subject to the Participant's unexercised Options and SARs exceeds the Exercise Price, and on such terms as the Committee determines, (iii) after giving Participants an opportunity to exercise their outstanding Options and SARs, the Committee may terminate any or all unexercised Options and SARs at such time as the Committee deems appropriate, (iv) with respect to Participants holding Stock Units and Other Stock-Based Awards, the Committee may determine that such Participants shall receive one or more payments in settlement of such Stock Units and Other Stock-Based Awards, in such amount and form and on such terms as may be determined by the Committee, or (v) determine that all outstanding Options and SARs that are not exercised shall be assumed by, or replaced with comparable options or rights by the surviving corporation (or a parent or subsidiary of the surviving corporation), and other outstanding Grants that remain in effect after the Change of Control shall be converted to similar grants of the surviving corporation (or a parent or subsidiary of the surviving corporation). Such acceleration, surrender, termination, settlement or conversion shall take place as of the date of the Change of Control or such other date as the Committee may specify. The Committee may provide in a Grant Agreement that a sale or other transaction involving a subsidiary or other business unit of the Company shall be considered a Change of Control for purposes of a Grant, or the Committee may establish other provisions that shall be applicable in the event of a specified transaction.

17. ***Requirements for Issuance of Shares***

No Company Stock shall be issued in connection with any Grant hereunder unless and until all legal requirements applicable to the issuance of such Company Stock have been complied with to the satisfaction of the Committee. The Committee shall have the right to condition any Grant made to any Participant hereunder on such Participant's undertaking in writing to comply with such restrictions on his or her subsequent disposition of such shares of Company Stock as the Committee shall deem necessary or advisable, and certificates representing such shares may be legended to reflect any such restrictions. Certificates representing shares of Company Stock issued under the Plan will be subject to such stop-transfer orders and other restrictions as may be required by applicable laws, regulations and interpretations, including any requirement that a legend be placed thereon. No Participant shall have any right as a stockholder with respect to Company Stock covered by a Grant until shares have been issued to the Participant.

18. ***Amendment and Termination of the Plan***

(a) *Amendment*. The Board may amend or terminate the Plan at any time; provided, however, that the Board shall not amend the Plan without approval of the stockholders of the Company if such approval is required in order to comply with the Code or applicable laws, or to comply with applicable stock exchange requirements. No amendment or termination of this Plan shall, without the consent of the Participant, materially impair any rights or obligations under any Grant previously made to the Participant under the Plan, unless such right has been reserved in the Plan or the Grant Agreement, or except as provided in Section 19(b) below. Notwithstanding anything in the Plan to the contrary, the Board may amend the Plan in such manner as it deems appropriate in the event of a change in applicable law or regulations.

(b) *No Repricing Without Stockholder Approval*. Except in connection with a corporate transaction involving the Company (including, without limitation, any stock dividend, stock split, extraordinary cash dividend, recapitalization, reorganization, merger, consolidation, split-up, spin-off, combination or exchange of shares), the terms of outstanding awards may not be amended to reduce the exercise price of outstanding Options or SARs or cancel outstanding Options or SARs in exchange for cash, other awards or Options or SARs with an exercise price that is less than the exercise price of the original Options or SARs without stockholder approval.

(c) *Stockholder Approval for "Qualified Performance-Based Compensation*." If Grants are made under Section 12 above, the Plan must be reapproved by the Company's stockholders no later than the first stockholders meeting that occurs in the fifth year following the year in which the stockholders previously approved the provisions of Section 12, if additional Grants are to be made under Section 12 and if required by section 162 (m) of the Code or the regulations thereunder.

(d) *Termination of Plan*. The Plan shall terminate on the day immediately preceding the tenth anniversary of its Original Effective Date, unless the Plan is terminated earlier by the Board or is extended by the Board with the approval of the stockholders. The termination of the Plan shall not impair the power and authority of the Committee with respect to an outstanding Grant.

19. ***Miscellaneous***

(a) *Effective Date*. The amendment and restatement of the Plan shall be effective as of the Effective Date.

(b) *Grants in Connection with Corporate Transactions and Otherwise*. Nothing contained in this Plan shall be construed to (i) limit the right of the Committee to make Grants under this Plan in connection with the acquisition, by purchase, lease, merger, consolidation or otherwise, of the business or assets of any corporation, firm or association, including Grants to employees thereof who become Employees, or for other proper corporate purposes, or (ii) limit the right of the Company to grant stock options or make other stock-based awards outside of this Plan. Without limiting the foregoing, the Committee may make a Grant to an employee of another corporation who becomes an Employee by reason of a corporate merger, consolidation, acquisition of stock or property, reorganization or liquidation involving the Company in substitution for a grant made by such corporation. The terms and conditions of the Grants may vary from the terms and conditions required by the Plan and from those of the substituted stock incentives, as determined by the Committee.

(c) *Compliance with Law*. The Plan, the exercise of Options and the obligations of the Company to issue or transfer shares of Company Stock under Grants shall be subject to all applicable laws and to approvals by any governmental or regulatory agency as may be required. With respect to persons subject to section 16 of the Exchange Act, it is the intent of the Company that the Plan and all transactions under the Plan comply with all applicable provisions of Rule 16b-3 or its successors under the Exchange Act. In addition, it is the intent of the Company that Incentive Stock Options comply with the applicable provisions of section 422 of the Code, that Grants of "qualified performance-based compensation" comply with the applicable provisions of section 162(m) of the Code and that, to the extent applicable, Grants comply with the requirements of section 409A of the Code or an exception from such requirements. To the extent that any legal requirement of section 16 of the Exchange Act or section 422, 162(m) or 409A of the Code as set forth in the Plan ceases to be required under section 16 of the Exchange Act or section 422, 162(m) or 409A of the Code, that Plan provision shall cease to apply. The Committee may revoke any Grant if it is contrary to law or modify a Grant to bring it into compliance with any valid and mandatory government regulation. The Committee may also adopt rules regarding the withholding of taxes on payments to Participants. The Committee may, in its sole discretion, agree to limit its authority under this Section.

(d) *Enforceability*. The Plan shall be binding upon and enforceable against the Company and its successors and assigns.

(e) *Funding of the Plan; Limitation on Rights*. This Plan shall be unfunded. The Company shall not be required to establish any special or separate fund or to make any other segregation of assets to assure the payment of any Grants under this Plan. Nothing contained in the Plan and no action taken pursuant hereto shall create or be construed to create a fiduciary relationship between the Company and any Participant or any other person. No Participant or any other person shall under any circumstances acquire any property interest in any specific assets of the Company. To the extent that any person acquires a right to receive payment from the Company hereunder, such right shall be no greater than the right of any unsecured general creditor of the Company.

(f) *Rights of Participants*. Nothing in this Plan shall entitle any Employee, Non-Employee Director or other person to any claim or right to receive a Grant under this Plan. Neither this Plan nor any action taken hereunder shall be construed as giving any individual any rights to be retained by or in the employment or service of the Employer.

(g) *No Fractional Shares*. No fractional shares of Company Stock shall be issued or delivered pursuant to the Plan or any Grant. The Committee shall determine whether cash, other awards or other property shall be issued or paid in lieu of such fractional shares or whether such fractional shares or any rights thereto shall be forfeited or otherwise eliminated.

(h) *Employees Subject to Taxation Outside the United States*. With respect to Participants who are subject to taxation in countries other than the United States, the Committee may make Grants on such terms and conditions as the Committee deems appropriate to comply with the laws of the applicable countries, and the Committee may create such procedures, addenda and subplans and make such modifications as may be necessary or advisable to comply with such laws.

(i) *Governing Law*. The validity, construction, interpretation and effect of the Plan and Grant Agreements issued under the Plan shall be governed and construed by and determined in accordance with the laws of the State of Delaware, without giving effect to the conflict of laws provisions thereof.

Appendix C

American Water Works Company, Inc. Annual Incentive Plan

1. Purpose

The purpose of the Plan is to give eligible full-time exempt employees an annual opportunity to earn a cash incentive award that recognizes and rewards their contributions to the Company's success. To this end, the Plan provides a means of annually rewarding Participants based on the performance of the Company, as a whole or through a subsidiary, and, where appropriate, on a Participant's personal performance. The Plan also provides the Committee with the ability to make incentive awards designated as "qualified performance-based compensation" under Code section 162(m). All capitalized terms are as defined in Section 2. The Board adopted this Plan on March 4, 2015, effective as of January 1, 2015.

2. Definitions

(a) *"Award"* shall mean the amount of the incentive award (if any) that is earned by a Participant under the Plan for any Performance Period.

(b) "*Award Percentages*" shall mean the applicable minimum, target and maximum percentage of annual base salary that a Participant would be eligible to earn as an Award based on the level of achievement of the Performance Goals for the Performance Period, which Award Percentages shall be set by the Committee at the time the Performance Goals for the Performance Period are set; provided, that, if a Participant (other than any time prior to the final determination of the awards change the target percentage of any participant or assign a different target percentage to a participant to reflect any change in the participant's responsibility level of position during the performance period; provided, however, that no such changes may be made with respect to any incentive payment designated as qualified performance-based compensation Participants eligible to receive an Award designated as "qualified performance-based compensation") held more than one position during the Performance Period, then the Committee may designate different Award Percentages with respect to each position and the Award will be pro-rated to reflect the period during which such Participant had each Award Percentage (based on the number of days during the Performance Period the Participant held each position).

(c) *"Board"* shall mean the Company's Board of Directors as constituted from time to time.

(d) *"Code"* shall mean the Internal Revenue Code of 1986, as amended or any successor statute thereto and the regulations promulgated thereunder.

(e) *"Committee"* shall mean the Compensation Committee of the Board. With respect to the administration of Awards designated as "qualified performance-based compensation," the Committee shall consist of two or more persons appointed by the Board, all of whom shall be "outside directors" as defined under Code section 162(m). With respect to Awards not designated as "qualified performance-based compensation," the Committee may delegate its responsibilities for administering the Plan to an award committee or an Executive Officer as it deems appropriate; provided that it may not delegate its responsibilities under the Plan relating to Executive Officers or its authority to amend or terminate the Plan.

(f) *"Company"* shall mean American Water Works Company, Inc. or any successor corporation.

(g) *"Employee"* shall mean an employee of the Employer (including officers), but excluding any individual (i) employed in a casual or temporary capacity (i.e., those hired for a specific job of limited duration), (ii) characterized as "part-time" by the Employer, (iii) classified as a "non-exempt" employee eligible for overtime compensation under the Fair Labor Standards Act of 1938, (iv) whose terms of employment are governed by a collective bargaining agreement that does not provide for participation in this Plan, (v) characterized as a "leased employee" within the meaning of Code section 414, or (vi) classified by the Employer as a "contractor" or "consultant," no matter how characterized by the Internal Revenue Service, other governmental agency or a court. Any change of characterization or classification of an individual by any court, government agency (including, but not limited to, the Internal Revenue Service or U.S. Department of Labor), or arbitrator shall have no effect upon the characterization or classification of an individual as an Employee for purposes of this Plan, unless the Committee determines otherwise.

(h) *"Employer"* shall mean the Company and each of its subsidiaries.

(i) *"Executive Officer"* shall mean the executive officers of the Company as defined in the Securities Exchange Act of 1934, as amended, and as determined by the Committee in its sole discretion.

(j) *"Participant"* for any Performance Period, shall mean an Employee designated by the Committee to participate in the Plan. Only those Employees who are designated as Participants for a Performance Period shall be eligible to participate in the Plan for such Performance Period.

(k) *"Performance Goals"* for any Performance Period, shall mean: (i) For Awards designated as "qualified performance-based compensation" pursuant to Section 5, the performance goals of the Company, as specified by the Committee, based on one or more of the following objective criteria: (A) diluted earnings per share, (B) environmental compliance, (C) safety performance, (D) service quality, (E) customer satisfaction, (F) stock price, (G) earnings per share, (H) price-earnings multiples, (I) net earnings, (J) operating earnings, (K) revenue, (L) number of days sales outstanding in accounts receivable, (M) productivity, (N) margin, (O) EBITDA (earnings before interest, taxes, depreciation and amortization), (P) net capital employed, (Q) return on assets, (R) stockholder return, (S) return on equity, (T) return on capital employed, (U) net income to shares of Company stock, (V) growth in assets, (W) unit volume, (X) sales, (Y) cash flow, (Z) market share, (AA) relative performance to a comparison group designated by the Committee, and/or (BB) strategic business criteria consisting of one or more objectives based on meeting specified revenue goals, market penetration goals, customer growth, geographic business expansion goals, cost targets or goals relating to acquisitions or divestitures. Any criteria used may be measured, as applicable, (I) in absolute terms, (II) in relative terms (including but not limited to, the passage of time and/or against other companies or financial metrics), (III) on a per share and/or share per capita basis, (IV) against the performance of the Company and its subsidiaries as a whole or against the Company or one or more particular subsidiary, entity, segment, operating unit or product of the Company, or any combination thereof, and /or (V) on a pre-tax or after-tax basis, or (ii) For Awards not designated as "qualified performance-based compensation" pursuant to Section 5, the performance goals may be based on one or more of the objective criteria set forth in clause (i) above and/or may take into account any other factors deemed appropriate by the Committee in its sole discretion.

(l) *"Performance Period"* shall mean the fiscal year of the Company or any other period designated by the Committee with respect to which an Award may be earned.

(m) *"Plan"* shall mean this American Water Works Company, Inc. Annual Incentive Plan, as from time to time amended and in effect.

3. Eligibility

Subject to the limitations contained in this Section 3, all Employees of the Employer are eligible to participate in the Plan. The Committee shall designate which Employees shall participate in the Plan for each Performance Period and only those Employees designated by the Committee to participate in the Plan for the Performance Period shall be eligible to participate for such Performance Period. To be eligible to receive an Award with respect to any Performance Period, an Employee must be actively employed by the Employer on the day on which the Award payout for a Performance Period is made (except as provided in Section 8). Newly hired Employees or Employees promoted/transferred to an eligible/higher class shall be eligible to receive a prorated Award for a Performance Period, provided that their date of hire (or promotion/transfer) occurs on or before September 30, or such other date as the Committee may specify.

4. Administration

The administration of the Plan shall be consistent with the purpose and the terms of the Plan. The Plan shall be administered by the Committee. The Committee shall have full authority to establish the rules and regulations relating to the Plan, to interpret the Plan and those rules and regulations, to select Participants in the Plan, to determine each Participant's Award Percentages, to approve all of the Awards, to decide the facts in any case arising under the Plan and to make all other determinations, including factual determinations, and to take all other actions necessary or appropriate for the proper administration of the Plan, including the delegation of such authority or power, where appropriate; provided, however, that the Committee shall not be authorized to increase the amount of the Award payable to a Participant that would otherwise be payable pursuant to the terms of the Plan to the extent the Award is designated as "qualified performance-based compensation" under Code section 162(m). All powers of the Committee shall be executed in its sole discretion, in the best interest of the Company, not as a fiduciary, and in keeping with the objectives of the Plan and need not be uniform as to similarly situated individuals.

All Awards shall be made conditional upon the Participant's acknowledgement, in writing or by acceptance of the Award, that all decisions and determination of the Committee shall be final and binding on the Participant, his or her beneficiaries and any other person having or claiming an interest under such Award. Awards need not be uniform as among Participants. The Committee's administration of the Plan, including all such rules and regulations, interpretations, selections, determinations, approvals, decisions, delegations, amendments, terminations and other actions, shall be final and binding on the Employer and all employees of the Employer, including the Participants and their respective beneficiaries.

5. Determination of Awards

(a) *Setting Award Percentages and Performance Goals.*
(i) To the extent Awards are designated as "qualified performance-based compensation" under Code section 162(m), Performance Goals and Award Percentages must be pre-established by the Committee. Performance Goals and Award

Percentages are considered pre-established if established in writing not later than 90 days after the commencement of the period of service to which the Performance Goals relates. In no event will a Performance Goal and Award Percentage be considered pre-established if it is established after 25% of the period of service (as scheduled in good faith at the time the Performance Goal is established) has elapsed. To the extent Awards are not designated as "qualified performance-based compensation," the Committee may establish Performance Goals and Award Percentages for Participants at such time or times as the Committee determines in its sole discretion. Subject to the requirements of this Section 5(a)(i), the Performance Goals and Award Percentages established by the Committee may be (but need not be) different for each Performance Period and different Performance Goals and Award Percentages may be applicable to different Participants.

(ii) The Committee shall determine and shall reflect in its minutes: (A) the Employees who shall be Participants during the Performance Period, (B) the Performance Goal or Goals for the Performance Period (and how they are weighted, if applicable) and (C) each Participant's Award Percentages. The Company shall notify each Participant of the Participant's Award Percentages and the applicable Performance Goals for the Performance Period.

(iii) To the extent permitted by Code section 162(m), if applicable, in setting the Performance Goals within the period prescribed in Section 5 (a)(i), the Committee may at such time also provide that the achievement of the Performance Goals will be determined without regard to the negative or positive effect of certain events, including for one or more of the following items: asset write-downs; litigation or claim judgments or settlements; changes in accounting principles; changes in tax law or other laws affecting reported results; changes in commodity prices; severance, contract termination, and other costs related to exiting, modifying or reducing any business activities; costs of, and gains and losses from, the acquisition, disposition, or abandonment of businesses or assets; gains and losses from the early extinguishment of debt; gains and losses in connection with the termination or withdrawal from a pension plan; stock compensation costs and other non-cash expenses; any extraordinary non-recurring items as described in applicable Accounting Principles Board opinions or Financial Accounting Standards Board statements or in management's discussion and analysis of financial condition and results of operation appearing in the Company's annual report to stockholders for the applicable year; or any other specified non-operating items as determined by the Committee in setting Performance Goals.

(b) *Earning An Award.* Generally, a Participant earns an Award for a Performance Period based on the level of achievement of the Performance Goals established by the Committee for that Performance Period. A Participant will receive no Award if the level of achievement of all Performance Goals is below the minimum required to earn an Award for the applicable Performance Period, as specified by the Committee at the time the Performance Goals are established. No Participant may earn an Award that is greater than the maximum Award amount set forth in Section 5(c). Notwithstanding anything to the contrary in the Plan, in determining the actual Award that is payable to a Participant, (i) with respect to Awards designated as "qualified performance-based compensation" under Code section 162(m), the Committee, in its sole discretion, may reduce the Award payable to an amount below the amount that would otherwise be payable based on the level of achievement of the Performance Goals and (ii) with respect to Awards not designated as "qualified performance-based compensation" under Code section 162(m), the Committee, in its sole discretion, may reduce or increase the Award payable below or above the amount that would otherwise be payable based on the level of achievement of the Performance Goals

(c) Maximum Award Amount. The maximum Award payable to any Participant for any fiscal year shall not exceed $3,000,000.

(d) Special Rules for Awards Designated As Qualified Performance-Based Compensation. To the extent Awards are designated as "qualified performance-based compensation," the Awards shall be based on Performance Goals for each Performance Period that shall satisfy the requirements for "qualified performance-based compensation" under Code section 162(m), including the requirement that the achievement of the Performance Goals be substantially uncertain at the time they are established and that the Performance Goals be objective and established in such a way that a third party with knowledge of the relevant facts could determine whether and to what extent the Performance Goals have been met. To the extent that Awards designated as "qualified performance-based compensation" under Code section 162(m) are made, no such Award may be made as an alternative to any other award that is not designated as "qualified performance-based compensation" but instead must be separate and apart from all other awards made. To the extent an Award is designated as "qualified performance-based compensation," the Committee is authorized to reduce the Award payable to the applicable Participant for any Performance Period based upon its assessment of personal performance or other factors, but not to increase the Award beyond the amount that is payable as a result of the level of achievement of the Performance Goals for such Performance Period, as certified by the Committee. Any reduction of an Award payable to a Participant with respect to an Award designated as "qualified performance-based compensation" shall not result in an increase in the Award payable to any other Participant with respect to an Award designated as "qualified performance-based compensation."

6. Changes to the Award Percentages

The Committee may at any time prior to the final determination of Awards change the Award Percentages of any Participant or assign different Award Percentages to a Participant to reflect any change in the Participant's responsibility level or position during the course of the Performance Period; provided, however, that no such changes may be made with respect to Awards that are designated as "qualified performance-based compensation" under Code section 162(m).

7. Payment of Awards

The Committee shall certify and announce the actual Awards that will be paid to each Participant as soon as practicable following the final determination of the Company's financial results for the relevant Performance Period. Subject to the provisions of Section 8, payment of the actual Awards certified by the Committee shall normally be made, in a single lump sum cash payment as soon as practicable following the Committee certification, but in any event, such Award shall be paid on or after January 1 of the year following the year in which the Performance Period ends, but no later than March 15 of the year following the year in which the Performance Period ends.

8. Limitations on Rights to Payment of Awards

(a) *Employment.* Unless the Committee determines otherwise, no Participant shall have any right to receive payment of an Award under the Plan for a Performance Period unless the Participant remains in the employ of the Employer through the date that Award is paid.

(b) Accelerated Payment. In no event will payment be made to a Participant with respect to an Award designated as "qualified performance-based compensation" or, unless the Committee determines otherwise, to any other Participant with respect to any other Award, prior to the end of the Performance Period to which it relates.

9. Amendment, Suspension or Termination of the Plan

The Plan shall continue until terminated by the Board or the Committee. The Board or the Committee may at any time amend (in whole or in part), suspend or terminate this Plan; provided, however, that the Board or the Committee shall not amend or modify the Plan without stockholder approval if such approval is required by Code section 162(m). No such amendment which adversely affects any Participant's rights to or interest in an Award earned prior to the date of the amendment shall be effective unless the Participant shall have agreed thereto. If Awards are intended as "qualified performance-based compensation" under Code section 162(m), the Plan must be reapproved by the Company's stockholders no later than the first stockholders' meeting that occurs in the fifth year following the year in which the stockholders previously approved the material terms of the performance goals under the Plan, if Awards after such stockholders' meeting are to be made as "qualified performance-based compensation" under Code section 162(m) and if required by Code section 162(m).

10. Miscellaneous Provisions

(a) *No Employment Right.* This Plan is not a contract between the Employer and the Employees or the Participants. Neither the establishment of this Plan, nor any action taken hereunder, shall be construed as giving any Employee or any Participant any right to be retained in the employ of the Employer. The Company is under no obligation to continue the Plan. Nothing contained in the Plan shall limit or affect in any manner or degree the normal and usual powers of management, exercised by the officers and the Board or committees thereof, to change the duties or the character of employment of any employee of the Employer or to remove the individual from the employment of the Employer at any time, all of which rights and powers are expressly reserved.

(b) *Code Section 409A.* The Plan is intended to comply with the short-term deferral rule set forth in the regulations under Code section 409A in order to avoid application of Code section 409A to the Plan. If, and to the extent that, any payment under this Plan is deemed to be deferred compensation subject to the requirements of Code section 409A, this Plan shall be administered so that such payments are made in accordance with the requirements of Code section 409A. If an Award is subject to Code section 409A, (i) payments shall only be made in a manner and upon an event permitted under Code section 409A, (ii) payments to be made upon a termination of employment shall only be made upon a "separation from service" under Code section 409A, and (iii) in no event shall a Participant, directly or indirectly, designate the calendar year in which a payment is made except in accordance with Code section 409A. Any Award under the Plan that is subject to Code section 409A and that is to be paid to a key employee (as defined below) upon separation from service shall be administered so that any payment with respect to such Award shall be postponed for six months following the date of the Participant's separation from service, if required by Code section 409A. If a payment is delayed pursuant to Code section 409A, the payment shall be paid within 30 days after the end of the six-month period. If the Participant dies during such six-month period, any postponed amounts shall be paid within 90 days of the Participant's death. The determination of key employees, including the number and identity of persons considered key employees and the identification date, shall be made by the Committee or its delegate each year in accordance with Code section 416(i) and the "specified employee" requirements of Code section 409A. Notwithstanding anything to the contrary in this Plan, each Participant shall be solely responsible for the tax consequences of Awards under this Plan, and in no event shall the Company nor any other Employer have any responsibility or liability if any Award does not meet the applicable requirements of Code section 409A. Although the Company intends to administer the Plan to prevent taxation under Code section 409A, the Company does not represent nor warrant that the Plan or any Award complies with any provision of federal, state, local or other tax law.

(c) *No Assignment.* A Participant's right and interest under the Plan may not be assigned or transferred and any attempted assignment or transfer shall be null and void and shall extinguish, in the Company's sole discretion, the Employer's obligation under the Plan to pay Awards with respect to the Participant.

(d) *Unfunded Plan.* The Plan shall be unfunded. The Company shall not be required to establish any special or separate fund, or to make any other segregation of assets, to assure payment of Awards.

(e) *Company Policies*. As a condition of participation in the Plan, each Participant agrees to be subject to any compensation, clawback and recoupment policies that may be applicable to the Participant as an Employee of the Employer, as in effect from time to time and as approved by the Board or a duly authorized committee thereof, whether or not approved before or after the effective date of the Plan.

(f) *Stockholder Approval.* Notwithstanding any provision of the Plan to the contrary, Awards designated as "qualified performance-based compensation," if made prior to stockholder approval of the material terms of the performance goals under the Plan at the Company's 2015 annual stockholders' meeting, will be made contingent upon, and subject to, stockholder approval of the material terms of the performance goals under the Plan at the Company's 2015 annual stockholders' meeting.

(g) *Withholding Taxes.* The Employer shall have the right to deduct from actual Awards paid any taxes or other amounts required by law to be withheld.

(h) *Compliance with 162(m).* It is the intent of the Company that the Plan and Awards under the Plan designated as "qualified performance-based compensation" comply with the applicable provisions of Code section 162(m). To the extent that any legal requirement of Code section 162(m) as set forth in the Plan ceases to be required under Code section 162(m), that Plan provision shall cease to apply. Further, with respect to Awards intended to qualify as "qualified performance-based compensation, terms used in the Plan shall be interpreted in a manner consistent with Code section 162(m) and regulations thereunder (including Treasury Regulation section 1.162-27).

Governing Law. The validity, construction, interpretation and effect of the Plan shall exclusively be governed by and determined in accordance with the law of the State of Delaware.

Appendix D

Proposed Amended and Restated Bylaws of American Water Works Company, Inc.

ARTICLE I

Offices

SECTION 1. Registered Office. The registered office of American Water Works Company, Inc. (the "Corporation") in the State of Delaware shall be located in the City of Wilmington.

SECTION 2. Other Offices. The Corporation may also have offices in such places, within or without the State of Delaware, as the Board of Directors of the Corporation (the "Board") may from time to time determine or the business of the Corporation may require.

ARTICLE II

Meetings of Stockholders

SECTION 1. Annual Meetings. The annual meeting of the stockholders for the election of directors and for such other business as may properly come before the meeting shall be held at such place (within or without the State of Delaware), date and hour as shall be designated by the Board or as shall be designated in the notice or waiver of notice thereof.

SECTION 2. Special Meetings. Special meetings of the stockholders may be held only upon call by the Board or the Chairman of the Board or President or a stockholder or stockholders holding at least 15% of the shares of stock of the Corporation issued and outstanding and entitled to be voted at the meeting, at such place and at such time and date as may be fixed by the body or person or persons giving such call, and as may be stated in the notice setting forth such call. Only business within the purpose or purposes described in the notice or waiver of notice required by these Bylaws may be conducted at a special meeting of the stockholders.

SECTION 3. Notice of Meetings. Each stockholder of record of each class of stock of the Corporation then outstanding and entitled to vote at any meeting of stockholders shall be given written notice of such meeting, which notice shall state the place, date and hour of the meeting, and, in the case of a special meeting, the purpose or purposes for which the meeting is called. Each stockholder receiving such a notice shall be entitled to attend such meeting. Except as otherwise expressly required by law, notice of each meeting of stockholders shall be given not less than ten nor more than sixty days before the date of such meeting to each stockholder entitled to vote at such meeting.

Attendance of a stockholder at a meeting shall constitute a waiver of notice of such meeting, except when the stockholder attends for the express purpose of objecting at the beginning of the meeting to the transaction of any business because the meeting is not lawfully called or convened

SECTION 4. Quorum. At each meeting of the stockholders, except as otherwise expressly required by law or the Corporation's Restated Certificate of Incorporation, stockholders holding a majority of the shares of stock of the Corporation issued and outstanding and entitled to be voted at the meeting shall be present in person or by proxy to constitute a quorum for the transaction of business. In the absence of a quorum at any such meeting or any adjournment or adjournments thereof, a majority in voting interest of those present in person or by proxy and entitled to vote thereat, or any officer entitled to preside at, or to act as secretary of, such meeting may adjourn such meeting until stockholders holding the amount of stock requisite for a quorum are present in person or by proxy. At any such adjourned meeting at which a quorum may be present, any business may be transacted which might have been transacted at the meeting as originally called.

SECTION 5. Organization. Meetings of stockholders shall be presided over by the Chairman of the Board, or in his or her absence by the President, or such other person as the Board may determine. The Secretary shall act as secretary of the meeting, and in his or her absence such other person as the person presiding over the meeting may appoint.

SECTION 6. Voting. When a quorum is present, the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders, unless the question is one upon which by express provisions of an applicable law, the rules and regulations of any stock exchange or quotation system applicable to the Corporation, these Bylaws or the Corporation's Restated Certificate of Incorporation, a different vote is required, in which case such express provision shall govern and control the decision of such question.

SECTION 7. Notice of Stockholder Business and Nominations. (a) Annual Meetings of Stockholders.

(i) Nominations of persons for election to the Board and the proposal of business to be considered by the stockholders may be made at an annual meeting of stockholders (A) by or at the direction of the Chairman of the Board or the Board generally, (B) pursuant to the Corporation's notice of meeting (or any supplement thereto) or (C) by any stockholder of the Corporation who is entitled to vote at the meeting and who complies with the notice procedures set forth in clauses (ii) and (iii) of this paragraph and who was a stockholder of record at the time such notice is delivered to the Secretary.

(ii) For nominations or other business to be properly brought before an annual meeting by a stockholder, pursuant to clause (C) of paragraph (a)(i) of this Section 7 (or before a special meeting of stockholders pursuant to paragraph (b) of this Section 7), the stockholder must have given timely notice thereof in writing to the Secretary and any such proposed business other than the nominations of persons for election to the Board must constitute a proper matter for stockholder action. To be timely, a stockholder's notice shall be delivered to the Secretary at the principal executive offices of the Corporation not less than ninety days prior to the first anniversary of the date of the preceding year's annual meeting; provided, however, that if the Corporation did not hold an annual meeting the preceding year or if the date of the annual meeting is changed by more than thirty days from the date of the preceding year's annual meeting, to be timely, notice by the stockholder must be delivered not later than the ninetieth day prior to the date of the annual meeting (or, if later, the tenth day following the day on which public announcement is first made of the date of the annual meeting and of the nominees proposed by the Board to be elected at such meeting). In no event shall the adjournment of an annual meeting commence a new time period for the giving of a stockholder's notice as described above. Such stockholder's notice shall set forth (A) as to each person whom the stockholder proposes to nominate for election or reelection as a director, all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors, or is otherwise required, in each case pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), in each case including any successor rule or regulation thereto, including such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected; (B) as to any other business that the stockholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting and any material interest in such business of such stockholder and of any beneficial owner on whose behalf the proposal is made; and (C) as to the stockholder giving the notice and any beneficial owner on whose behalf the nomination or proposal is made (1) the name and address of such stockholder, as they appear on the Corporation's books, and the name, address and phone number of such beneficial owner, (2) the number and class of shares of capital stock of the Corporation which are owned beneficially and of record by such stockholder and such beneficial owner, (3) a description of any and all arrangements or understandings between such stockholder and such beneficial owner, (4) a representation that the stockholder is a holder of record of stock of the Corporation entitled to vote at such meeting and intends to appear in person or by proxy at the meeting to propose such business or nomination and (5) a representation as to whether the stockholder or the beneficial owner, if any, intends or is part of a group which intends (x) to deliver a proxy statement and/or form of proxy to holders of at least the percentage of the Corporation's outstanding capital stock required to approve or adopt the proposal or elect the nominee and/or (y) otherwise to solicit proxies from stockholders in support of such proposal or nomination. The foregoing notice requirements shall be deemed satisfied by a stockholder if the stockholder has notified the Corporation of his or her intention to present a proposal at an annual meeting in compliance with Rule l4a-8 (or any successor thereto) promulgated under the Exchange Act and such stockholder's proposal has been included in a proxy statement that has been prepared by the Corporation to solicit proxies for such annual meeting. The Corporation may require any proposed nominee to furnish such other information as it may reasonably require to determine the eligibility of such proposed nominee to serve as a director of the Corporation.

(iii) Notwithstanding anything in the second sentence of paragraph (a)(ii) of this Section 7 to the contrary, in the event that the number of directors to be elected to the Board is increased and there is no public announcement made by the Corporation naming all of the nominees for director or specifying the size of the increased Board at least ninety days prior to the first anniversary of the date of the preceding year's annual meeting, a stockholder's notice under this paragraph shall also be considered timely, but only with respect to nominees for any new positions created by such increase, if it shall be delivered to the Secretary at the principal executive offices of the Corporation not later than the close of business on the tenth day following the day on which such public announcement is first made by the Corporation.

(b) Special Meetings of Stockholders. Only such business as shall have been brought before the special meeting of the stockholders pursuant to the notice or waiver of notice of the meeting shall be conducted at such meeting. Nominations of persons for election to the Board may be made at a special meeting of stockholders at which directors are to be elected pursuant to the notice or waiver of notice of the meeting (i) by or at the direction of the Board, (ii) by the stockholder or stockholders who called such meeting or (iii) by any other stockholder of the Corporation who is entitled to vote at such meeting, who complies with the notice procedures set forth in this Section 7 and who is a stockholder of record at the time such notice is delivered to the Secretary. Nominations by such other stockholders of persons for election to the Board may be made at such special meeting of stockholders if the stockholder's notice as required by paragraph (a)(ii) of this Section 7 shall be delivered to the Secretary at the principal executive offices of the Corporation not later than the ninetieth day prior to the date of the special meeting (or, if later, the tenth day following the day on which public announcement is first made of the date of the special meeting and of the nominees proposed by the Board to be elected at such meeting). In no event shall the adjournment of a special meeting commence a new time period for the giving of a stockholder's notice as described above.

(c) General. Other than as set forth in Article III, Section 5 hereof, only persons who are nominated in accordance with the procedures set forth in this Section 7 shall be eligible to serve as directors and only such business shall be conducted at a meeting of stockholders as shall have been brought before the meeting in accordance with the procedures set forth in this Section 7. Except as otherwise provided by law, the chairman of the meeting shall have the power and duty to determine whether a nomination or any business proposed to be brought before the meeting was made in accordance with the procedures set forth in this Section 7 and, if any proposed nomination or business is not in compliance with this Section 7, to declare that such defective proposal or nomination shall be disregarded.

SECTION 8. Postponement and Cancellation of Meeting. Any previously scheduled annual or special meeting of the stockholders may be postponed, and any previously scheduled annual or special meeting of the stockholders called by the Board may be canceled, by resolution of the Board upon public notice given prior to the time previously scheduled for such meeting of stockholders.

ARTICLE III

Board of Directors

SECTION 1. General Powers. The property, business and affairs of the Corporation shall be managed by or under the direction of the Board, which may exercise all such powers of the Corporation and do all such lawful acts and things as are not by law or by the Restated Certificate of Incorporation directed or required to be exercised or done by the stockholders.

SECTION 2. Number and Term of Office. The number of directors which shall constitute the whole Board shall be fixed from time to time by a duly adopted resolution of the Board. Directors need not be stockholders or citizens or residents of the United States of America. Except as provided in Section 5 of this Article III, directors shall be elected at the annual meeting of the stockholders by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote in the election of directors. Commencing with the 2011 annual meeting of stockholders and except as provided in Section 5 of this Article III, each director shall be elected by the vote of the majority of the votes cast with respect to the director at any meeting for the election of directors at which a quorum is present, provided that if as of a date that is 14 days in advance of the date the Corporation files its definitive proxy statement (regardless of whether or not thereafter revised or supplemented) with the Securities and Exchange Commission the number of nominees exceeds the number of directors to be elected, the directors shall be elected by the vote of a plurality of the shares represented in person or by proxy at any such meeting and entitled to vote on the election of directors. For purposes of this Section, a majority of the votes cast means that the number of shares voted for a director must exceed the number of votes cast against that director. The nominating/corporate governance committee has established procedures under which any director who is not elected shall offer to tender his or her resignation to the Board. The nominating/corporate governance committee will make a recommendation to the Board of Directors on whether to accept or reject such resignation, or whether other action should be taken. The Board will act on the tendered resignation, taking into account the nominating/corporate governance committee's recommendation, and publicly disclose (by a press release, a filing with the Securities and Exchange Commission or other broadly disseminated means of communication) its decision regarding the tendered resignation and the rationale behind the decision within 90 days from the date of the certification of the election results. Each of the directors of the Corporation shall hold office until his or her successor shall be elected and shall qualify or until his or her earlier death or resignation or removal in the manner hereinafter provided.

SECTION 3. Resignations. Any director may resign at any time by giving written notice of his or her resignation to the Chairman of the Board, the President or the Secretary. Any such resignation shall take effect at the time specified therein or, if the time when it shall become effective shall not be specified therein, then it shall take effect when accepted by action of the Board. Except as aforesaid, the acceptance of such resignation shall not be necessary to make it effective.

SECTION 4. Removal of Directors. Any director or the entire Board may be removed, with or without cause, at any time upon the affirmative vote of holders of a majority of the shares then entitled to vote at an election of directors.

SECTION 5. Vacancies. Vacancies in the Board and newly created directorships resulting from any increase in the authorized number of directors may be filled by a majority of the directors then in office, although less than a quorum, or by a sole remaining director or by the stockholders of the Corporation at the next annual meeting or any special meeting called for the purpose. Each director so chosen shall hold office until his or her successor shall be elected and shall qualify or until his or her earlier death or resignation or removal in the manner as herein provided.

SECTION 6. Place of Meetings. The Board may hold its meetings at such place or places within or without the State of Delaware as the Board may from time to time determine or as shall be designated in the respective notices or waivers of notice thereof.

SECTION 7. Annual and Regular Meetings. The annual meeting of the Board for the purpose of electing officers and for the transaction of such other business as may come before the meeting shall be held as soon as possible following adjournment of the annual meeting of the stockholders at the place of such annual meeting of the stockholders. Notice of such annual meeting of the Board need not be given. The Board from time to time may by resolution provide for the holding of regular meetings and fix the place (which may be within or without the State of Delaware), date and time of such meetings. Notice of regular meetings need not be given; provided, however, that if the Board shall fix or change the time or place of any regular meeting, notice of such action shall be mailed promptly, or sent by telephone, telegraph, facsimile, electronic mail or other electronic means to each director who shall not have been present at the meeting at which such action was taken, addressed to him or her at his or her usual place of business, or shall be delivered to him or her personally.

SECTION 8. Special Meetings. Special meetings of the Board shall be held whenever called by the Chairman of the Board, the President or at least two of the directors, at such place, date and time as may be specified in the respective notices or waivers of notice of such meetings. Special meetings of the Board may be called on at least twenty-four hours' notice to each director if notice is given to each director personally or by telephone, telegraph, facsimile, electronic mail or other electronic means, or on three days' notice from the official date of deposit in the mail if notice is sent by internationally recognized courier to each director, addressed to him or her at his or her usual place of business. Such notice need not state the purpose of, nor the business to be transacted at, that meeting, except as may otherwise be required by law. Notice need not be given to a director present at a meeting. A meeting may be held at any time without notice if all the directors are present or if those not present waive notice of the meeting in writing either before or after that meeting.

SECTION 9. Quorum and Manner of Acting. Except as provided by law, the Restated Certificate of Incorporation or these Bylaws, a majority of the total number of directors shall be present in person at any meeting of the Board in order to constitute a quorum for the transaction of business at such meeting, and the vote of a majority of those directors present at any such meeting at which a quorum is present shall be necessary for the passage of any resolution or act of the Board. In the absence of a quorum for any such meeting, a majority of the directors present thereat may adjourn such meeting from time to time until a quorum shall be present thereat. Notice of any adjourned meeting need not be given.

SECTION 10. Organization. The Board shall elect a Chairman of the Board from among the directors. Meetings of the Board shall be presided over by the Chairman of the Board, or such other person as the Board may determine. The Secretary shall act as secretary of the meeting, and in his or her absence such other person as the person presiding over the meeting may appoint.

SECTION 11. Action by Written Consent. Any action required or permitted to be taken at any meeting of the Board or of any committee thereof may be taken without a meeting if all members of the Board or of such committee, as the case may be, consent thereto in writing, and such writing or writings are filed with the minutes of the proceedings of the Board or such committee.

SECTION 12. Meetings by Telephone, etc. Any one or more members of the Board, or any committee designated by the Board, may participate in a meeting of the Board, or such committee, by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other, and participation in a meeting pursuant to this Section shall constitute presence in person at such meeting.

SECTION 13. Compensation. Each director, in consideration of his or her serving as such, shall be entitled to receive from the Corporation such amount per annum or such fees for attendance at meetings of the Board or of any committee, or both, as the Board shall from time to time determine. The Board may likewise provide that the Corporation shall reimburse each director or member of a committee for any expenses incurred by him or her on account of his or her attendance at any such meeting. Nothing contained in this Section shall be construed to preclude any director from serving the Corporation in any other capacity and receiving compensation therefor.

ARTICLE IV

Committees

SECTION 1. Committees. The Board shall, by resolution passed by a majority of the directors, designate a compensation committee, a nominating/corporate governance committee, an audit committee and, if so desired from time to time, other committees to serve at the pleasure of the Board. Each committee shall consist of two or more of the directors of the Corporation, which to the extent permitted by law and provided in such resolution or these Bylaws shall have and may exercise the powers of the Board in the management and affairs of the Corporation. Such committee(s) shall have such name(s) as may be determined from time to time by resolution adopted by the Board. Each committee shall keep regular minutes of its meetings and report the same to the Board when required. The Board may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. In the absence or disqualification of a member of the committee, the member or members thereof present at any meeting and not disqualified from voting, whether or not he, she or they constitute a quorum, may unanimously appoint another member of the Board to act at the meeting in place of any such absent or disqualified member.

SECTION 2. Committee Rules. Each committee of the Board may fix its own rules of procedure and shall hold its meetings as provided by such rules, except as may otherwise be provided by the resolution of the Board designating such committee or the charter adopted by the Board for such committee. In the absence of such rules, each committee shall conduct its business in the same manner as the Board conducts its business pursuant to Article III of these Bylaws.

ARTICLE V

Officers

SECTION 1. Number. The principal officers of the Corporation shall be designated by the Board and shall consist of a President, such number of Vice Presidents as the Board may determine from time to time, a Treasurer, a Secretary and such number of Assistant Treasurers and Assistant Secretaries as the Board may determine from time to time. The Board may, in its discretion, create such offices and confer such titles as Chief Executive Officer, Chief Financial Officer or Chief Operating Officer and designate any Vice President by a number or numbers or a word or words (including, without limitation, the words “Executive” and “Senior”) added before or after such title. The Board may appoint, and authorize the appointment of, such other officers of the Corporation as the Board deems necessary who shall have such authority and shall perform such duties as these Bylaws or as the Board may prescribe. Any number of offices may be held by the same person, except that no person may simultaneously hold the offices of President and Secretary.

SECTION 2. Term of Office. Each officer shall hold office until his or her successor is duly elected and qualified or until his or her earlier death or resignation or removal in the manner hereinafter provided.

SECTION 3. Removal and Resignation. All officers and agents of the Corporation shall be subject to removal, with or without cause, at any time by the affirmative vote of a majority of the Board, or, except in the case of any officer elected by the Board, by any committee or superior officer upon whom such power may be conferred by the Board. Designation of an officer shall not itself create contract rights. Any officer may resign at any time by giving written notice of his or her resignation to the President or the Secretary, and such resignation shall take effect at the time specified therein or, if the time when it shall become effective shall not be specified therein, shall take effect when accepted by action of the Board. Except as aforesaid, the acceptance of such resignation shall not be necessary to make it effective.

SECTION 4. President. The President, subject to the direction of the Board, shall have such powers and perform such duties as pertain to the office of President and as the Board may from time to time prescribe, shall have the direction of all subordinate officers, agents and employees and may assign such duties to such other officers as he or she deems appropriate, and shall perform such other duties and exercise such other powers as may from time to time be prescribed by these Bylaws or the Board.

SECTION 5. Vice Presidents. Each Vice President shall have such powers and perform such duties as the Board or the President may from time to time prescribe and shall perform such other duties as may be prescribed by these Bylaws. At the request of the President, or in case of his or her absence or inability to act, any of the Vice Presidents shall perform the duties of the President and, when so acting, shall have all the powers of, and be subject to all the restrictions upon, the President.

SECTION 6. Treasurer. The Treasurer shall have charge and custody of, and be responsible for, all funds and securities of the Corporation, and shall deposit all such funds in the name of the Corporation in such banks, trust companies or other depositories as shall be selected in accordance with the provisions of these Bylaws. He or she shall disburse the funds of the Corporation as may be ordered by the Board, making proper vouchers for such disbursements, and shall render to the Board whenever required to do so, and shall present at the annual meeting of the stockholders, if called upon to do so, a statement of all his or her transactions as Treasurer. He or she shall have such powers and perform such duties as pertain to the office of Treasurer and shall perform such other duties as may from time to time be assigned to him or her by the Board.

SECTION 7. Secretary. The Secretary shall keep the records of the proceedings of all meetings of the stockholders and the Board or any committees thereof. He or she shall affix the seal of the Corporation to all deeds, contracts, bonds or other instruments requiring the corporate seal when the same shall have been signed on behalf of the Corporation by a duly authorized officer and shall be the custodian of all contracts, deeds, documents and all other indicia of title to properties owned by the Corporation and of its other corporate records (except accounting records). He or she shall have such powers and perform such duties as pertain to the office of Secretary and shall perform such other duties as may from time to time be assigned to him or her by the Board.

SECTION 8. Other Officers, Assistant Officers and Agents. Officers, assistant officers and agents, if any, other than those whose duties are provided for in these Bylaws, shall have such authority and perform such duties as may from time to time be prescribed by resolution of the Board or by the person responsible for appointing such officers, assistant officers and agents, as the case may be.

SECTION 9. Execution of Contracts and Instruments. Notwithstanding the foregoing description of the duties and powers of corporate officers, the Board may from time to time limit or qualify such duties and powers by an instrument designated by the Board or pursuant to the Board's delegated authority as a corporate delegation of authority, and the duties and powers of the Corporation's officers shall be so limited. The Board may also from time to time specifically authorize one or more officers or agents of the Corporation to enter into such contracts, execute such instruments and take such other actions in the name of and on behalf of the Corporation for such specific purposes and in connection with such specific matters and transactions as the Board in its discretion may determine. Any instrument may be executed on behalf of and in the name of the Corporation: (a) by the Chairman of the Board, the President, the Chief Executive Officer (if any), the Chief Financial Officer (if any), the Chief Operating Officer (if any) or any Vice President, together with the Secretary, the Treasurer or any Assistant Secretary, or any Assistant Treasurer, in each case, subject to any instrument that the Board or those authorized by it may designate as a "corporate delegation of authority", (b) by such officers specifically authorized to act by Board resolution for a specific purpose or (c) by any other person authorized to do so by, and subject to the limits stated in, the instrument that the Board or those authorized by it may designate as a "corporate delegation of authority", and such persons shall be deemed agents of the Corporation for such purposes. Except as otherwise designated or expressly authorized by these Bylaws, or an instrument properly designated as a "corporate delegation of authority" no officer, employee or agent shall have any power or authority to bind the Corporation by any contract or engagement or to pledge its credit or to render it liable pecuniarily for any purpose or to any amount.

SECTION 10. Security. The Board may require any officer, agent or employee of the Corporation to provide security for the faithful performance of his or her duties, in such amount and of such character as may be determined from time to time by the Board.

ARTICLE VI

Proxies, Checks, Drafts, Bank Accounts, Etc.

The President, or any other officer designated by the Board as having such authority, shall have authority from time to time to exercise in the name and on behalf of the Corporation the powers and rights which the Corporation may have as the holder of stock or other securities or interests in any other corporation or business entity and to vote or consent in respect of such stock, securities or interest; the President or such designated officers may designate an agent or agents to perform such function and may instruct the person or persons so appointed as to the manner of exercising such powers and rights; and the President or such designated officers may execute or cause to be executed in the name and on behalf of the Corporation and under its corporate seal, or otherwise, such written proxies, powers of attorney or other instruments as they may deem necessary or proper in order that the Corporation may exercise its said powers and rights. All checks and drafts on the Corporation bank accounts and all bills of exchange and promissory notes, and all acceptances, obligations and other instruments for the payment of money, shall be signed by such officer or officers or agent or agents or other employee or employees as shall be thereunto authorized from time to time by the Board. Third parties shall be entitled to rely on the authority delegated by the Board or pursuant to its delegated authority in an instrument designated as a "corporate delegation of authority" as to all matters governed by this Article VI.

ARTICLE VII

Books and Records

The books and records of the Corporation may be kept at such places within or without the State of Delaware as the Board may from time to time determine.

ARTICLE VIII

Seal

The corporate seal shall have inscribed thereon the name of the Corporation and the words "Corporate Seal Delaware 1936." In lieu of the corporate seal, when so authorized by the Board or a duly empowered committee thereof and permitted by law, a facsimile thereof may be impressed or affixed or reproduced.

ARTICLE IX

Fiscal Year

The fiscal year of the Corporation shall end on the 31st day of December in each year, unless changed by resolution of the Board.

ARTICLE X

Indemnification

SECTION 1. Right to Indemnification. The Corporation shall indemnify to the fullest extent authorized by the Delaware General Corporation Law, as the same exists or may hereafter be amended, each person who was or is a party or is threatened to be made a party to or is involved in any action, suit or proceeding, whether civil, criminal, administrative or investigative (a "Proceeding"), by reason of the fact that he or she is or was or had agreed to become a director or officer of the Corporation or an employee of the Corporation specifically designated by the Board as an indemnified employee, or is or was serving or had agreed to serve at the request of the Corporation as a director, officer, partner, member, trustee or agent, or such an employee, of another corporation, partnership, limited liability company, joint venture, trust or other enterprise (including the heirs, executor, administrators or estate of such person), whether the basis of such Proceeding is alleged action in an official capacity as a director, officer, partner, member, trustee, agent or employee, or in any other capacity while serving as a director, officer, partner, member, trustee, agent or employee, against all expense, liability and loss (including attorneys' fees, judgments, fines, ERISA excise taxes, penalties and amounts paid or to be paid in settlement) reasonably incurred or suffered by such person in connection with such service; provided, however, that except as provided in Section 2 of this Article X the Corporation shall indemnify any such person seeking indemnification in connection with a Proceeding (or part thereof) initiated by such person only if such Proceeding was authorized by the Board, either generally or in the specific instance.

SECTION 2. Expenses. The right to indemnification shall include the advancement of expenses incurred by any person described in Section 1 of this Article X in defending any such Proceeding in advance of its final disposition in accordance with procedures established from time to time by the Board; provided, however, that the director, officer, partner, member, trustee, agent or employee shall deliver to the Corporation an undertaking to repay all amounts so advanced if it shall ultimately be determined by final judicial decision from which there is no further right to appeal that he or she is not entitled to be indemnified for such expenses under this Article X or otherwise, such undertaking to be in form and substance reasonably acceptable to the Corporation and which may further specify the conditions upon which indemnification for expenses is available given the facts and circumstances of such Proceeding.

SECTION 3. Continuation of Rights. The rights of indemnification provided in this Article X shall be in addition to any rights to which any person may otherwise be entitled by law or under any Bylaw, agreement, vote of stockholders or disinterested directors, or otherwise. Such rights shall continue as to any person who has ceased to be a director, officer, partner, member, trustee, agent or employee and shall inure to the benefit of his or her heirs, executors and administrators, and shall be applicable to proceedings commenced after the adoption hereof, whether arising from acts or omissions occurring before or after the adoption hereof.

SECTION 4. Contract Rights. The obligations of the Corporation to indemnify a director, officer, partner, member, trustee, agent or employee under this Article X, including the duty to advance expenses, shall be considered a contract between the Corporation and such individual, and no modification or repeal of any provision of this Article X shall affect, to the detriment of the individual, such obligations of the Corporation in connection with a claim based on any act or failure to act occurring before such modification or repeal.

SECTION 5. Insurance and Funding. The Corporation may purchase and maintain insurance to protect any person against any liability or expense asserted against or incurred by such person in connection with any Proceeding, whether or not the Corporation would have the power to indemnify such person against such liability or expense by law or under this Article X or otherwise, provided that such insurance is available on acceptable terms, which determination shall be made by the Board. The Corporation may create a trust fund, grant a security interest or use other means (including, without limitation, a letter of credit) to insure the payment of such sums as may become necessary to effect indemnification as provided herein.

SECTION 6. Severability. If this Article X or any portion hereof shall be invalidated on any ground by any court of competent jurisdiction, then the Corporation shall nevertheless indemnify and hold harmless each director and officer and any other person indemnified pursuant to this Article X as to all expense, liability and loss (including attorneys' fees, judgments, fines, ERISA excise taxes, penalties and amounts paid or to be paid in settlement) with respect to any Proceeding to the full extent permitted by any applicable portion of this Article X that shall not have been invalidated and to the fullest extent permitted by applicable law.

ARTICLE XI

Shares and Their Transfer

SECTION 1. Certificates for Shares. The shares of the Corporation shall be represented by certificates, or shall be uncertificated shares evidenced by a book-entry system, or a combination of both. Certificates shall be signed by, or in the name of the Corporation by, (i) the President or a Vice President and (ii) the Secretary or an Assistant Secretary, certifying the number and class of shares of the Corporation owned by the holder of such certificate. If such a certificate is countersigned (a) by a transfer agent or an assistant transfer agent other than the Corporation or its employee or (b) by a registrar other than the Corporation or its employee, the signature of any such President, Vice President, Secretary or Assistant Secretary may be a facsimile. In case any officer(s) who have signed, or whose facsimile signature(s) have been used on, any such certificate(s) shall cease to be such officer(s) of the Corporation, whether because of death, resignation or otherwise, before such certificate(s) have been delivered by the Corporation, such certificate(s) may nevertheless be issued and delivered as though the person or persons who signed such certificate(s) or whose facsimile signature(s) have been used thereon had not ceased to be such officer(s) of the Corporation.

SECTION 2. Record. A record shall be kept of the name of the person, firm or corporation owning each share of stock of the Corporation, including, in the case of stock represented by each certificate for stock of the Corporation issued, the number of shares represented by each such certificate, and the date thereof, and, in the case of cancellation, the date of cancellation. Except as otherwise expressly required by law, the person in whose name shares of stock stand on the books of the Corporation shall be deemed the owner thereof for all purposes as regards the Corporation.

SECTION 3. Transfers of Stock. Transfers of stock shall be made only upon the transfer books of the Corporation kept at an office of the Corporation or by transfer agents designated to transfer shares of the stock of the Corporation. Except when a certificate is issued in accordance with Section 4 of this Article XI, in the case of stock represented by a certificate, an outstanding certificate for the number of shares involved shall be surrendered for cancellation before a new certificate is issued therefor.

SECTION 4. Lost, Destroyed or Mutilated Certificates. In the case of an alleged loss or destruction or the mutilation of a certificate representing stock of the Corporation, a new certificate may be issued in place thereof, in the manner and upon such terms as the Board may prescribe.

ARTICLE XII

General Provisions

Section Headings. Section headings in these Bylaws are for convenience of reference only and shall not be given any substantive effect in limiting or otherwise construing any provision herein.

Inconsistent Provisions. In the event that any provision of these Bylaws is or becomes inconsistent with any provision of the Corporation's Certificate of Incorporation, the General Corporation Law of the State of Delaware or any other applicable law, such provision of these Bylaws shall not be given any effect to the extent of such inconsistency but shall otherwise be given full force and effect.

ARTICLE XIII

Exclusive Forum for Adjudication of Disputes

Unless the Corporation consents in writing to the selection of an alternative forum, the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director or officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim against the Corporation or any director or officer or other employee of the Corporation arising pursuant to any provision of the DGCL or the Corporation's Restated Certificate of Incorporation or Bylaws (in each case, as they may be amended from time to time), or (iv) any action asserting a claim against the Corporation or any director or officer or other employee of the Corporation governed by the internal affairs doctrine, shall be a state court located within the State of Delaware (or, if no state court located within the State of Delaware has jurisdiction, the federal district court for the District of Delaware), in all cases to the fullest extent permitted by law and subject to said court having personal jurisdiction over the indispensable parties named as defendants therein.

ARTICLE ~~XIII~~**XIV**

Amendments

These Bylaws, or any of them, may be altered, amended or repealed by the Board, or by the stockholders of the Corporation as provided in the Corporation's Restated Certificate of Incorporation.

DIRECTIONS TO

AMERICAN WATER WORKS COMPANY, INC.

2015 ANNUAL MEETING OF STOCKHOLDERS

The Mansion
3000 Main Street
Voorhees, New Jersey 08043

FROM PHILADELPHIA / CENTER CITY: Take Ben Franklin Bridge to Route 70 East. Follow Route 70 East to Route 73 South. Follow Route 73 South to Evesham Road. Turn right on Evesham Road. Continue for 1 ½ miles. Turn left into Main Street Complex.

FROM NORTH EAST PHILADELPHIA: Take Tacony Palmyra Bridge to Route 73 South. Follow Route 73 South to Evesham Road. Turn right on Evesham Road. Continue for 1 ½ miles. Turn left into Main Street Complex.

FROM PHILADELPHIA INTERNATIONAL AIRPORT: Take Walt Whitman Bridge to Route 42 South. Follow Route 42 South to 295 North. Follow 295 North to Exit 32 (Route 561, Voorhees). Follow Route 561 to Evesham Road. Turn left on Evesham Road. Continue for 1 ½ miles. Turn right into Main Street Complex.

FROM DELAWARE / MARYLAND: Take Delaware Memorial Bridge to 295 North. Follow 295 North to Exit 32 (Route 561, Voorhees). Follow Route 561 to Evesham Road. Turn left on Evesham Road. Continue for 1 ½ miles. Turn right into Main Street Complex.

FROM NORTH JERSEY / NEW YORK: Take New Jersey Turnpike South to Exit 4. Follow to Route 73 South. Follow Route 73 South to Evesham Road. Turn right on Evesham Road. Continue for 1 ½ miles. Turn left into Main Street Complex.

FROM ATLANTIC CITY AREA: Take Atlantic City Expressway to Route 73 North. Follow Route 73 North to Evesham Road. Turn left on Evesham Road. Continue for 1 ½ miles. Turn left into Main Street Complex.

PARKING

COMPLIMENTARY SELF-PARKING IS AVAILABLE AT THE MANSION, 3000 MAIN STREET, VOORHEES, NEW JERSEY, 08043.

INFORMATION ABOUT ADVANCE REGISTRATION FOR ATTENDING THE MEETING

An admission card will be required to enter American Water's annual meeting. Please follow the advance registration instructions below and an admission card will be mailed to you. Upon arrival at the annual meeting, you will be asked to present your admission card and appropriate picture identification to enter the meeting. If you do not have an admission card and appropriate picture identification, you will not be admitted to the building.

Attendance at the annual meeting is limited to American Water stockholders or their named representatives. We reserve the right to limit the number of representatives who may attend the meeting.

- **If you hold your American Water shares directly**, and not through a broker, bank or other nominee, and you plan to attend the annual meeting, please send an annual meeting advance registration request, containing the information listed below, to:

  American Water Investor Relations
  1025 Laurel Oak Road
  Voorhees, New Jersey 08043
  Attention: Annual Meeting Advance Registration

  Please include the following information:

  - Your name and complete mailing address;
  - If you will be naming a representative to attend the meeting on your behalf, the name, address and phone number of that individual.

- **If your American Water shares are held for you in a brokerage, bank or other institutional account** and you wish to attend the annual meeting, please send an annual meeting advance registration request containing the information listed below, to the address listed above:

  Please include the following information:

  - Your name and complete mailing address;
  - If you will be naming a representative to attend the meeting on your behalf, the name, address and phone number of that individual;
  - Proof that you own American Water shares (such as a letter from your bank or broker or a photocopy of a current brokerage or other account statement).

If you have questions regarding admission to the annual meeting, please visit our website at aw.investorrelations@amwater.com or call American Water's Investor Relations department at 1-877-310-7174.

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AMERICAN WATER

AMERICAN WATER WORKS COMPANY, INC.
1025 LAUREL OAK ROAD
VOORHEES, NJ 08043

VOTE BY INTERNET
Before The Meeting - Go to **www.proxyvote.com**

Use the Internet to transmit your voting instructions and for electronic delivery of information up until 11:59 p.m. Eastern Time the day before the cut-off date or meeting date. Have your proxy card in hand when you access the web site and follow the instructions to obtain your records and to create an electronic voting instruction form.

During The Meeting –
Go to **www.virtualshareholdermeeting.com/AWK2015**

You may attend the Meeting via the Internet and vote during the Meeting. Have the information that is printed in the box marked by the arrow available and follow the instructions.

VOTE BY PHONE - 1-800-690-6903
Use any touch-tone telephone to transmit your voting instructions up until 11:59 p.m. Eastern Time the day before the cut-off date or meeting date. Have your proxy card in hand when you call and then follow the instructions.

VOTE BY MAIL
Mark, sign and date your proxy card and return it in the postage-paid envelope we have provided or return it to Vote Processing, c/o Broadridge, 51 Mercedes Way, Edgewood, NY 11717.

TO VOTE, MARK BLOCKS BELOW IN BLUE OR BLACK INK AS FOLLOWS:

M68703-P46188 KEEP THIS PORTION FOR YOUR RECORDS

DETACH AND RETURN THIS PORTION ONLY

AMERICAN WATER WORKS COMPANY, INC.

The Board of Directors recommends you vote FOR the following proposals:

1. Election of Directors

Nominees:	**For**	**Against**	**Abstain**
1a. Julie A. Dobson	☐	☐	☐
1b. Paul J. Evanson	☐	☐	☐
1c. Martha Clark Goss	☐	☐	☐
1d. Richard R. Grigg	☐	☐	☐
1e. Julia L. Johnson	☐	☐	☐
1f. Karl F. Kurz	☐	☐	☐
1g. George MacKenzie	☐	☐	☐
1h. William J. Marrazzo	☐	☐	☐
1i. Susan N. Story	☐	☐	☐

	For	**Against**	**Abstain**
2. Ratification of the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal year ending December 31, 2015.	☐	☐	☐
3. An advisory vote to approve the compensation of our named executive officers.	☐	☐	☐
4. Re-approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan to allow certain equity grants under the plan to continue to be deductible under Section 162(m) of the Code.	☐	☐	☐
5. Approval of the material terms of the performance goals set forth in the American Water Works Company, Inc. Annual Incentive Plan to allow certain incentive awards under the plan to be deductible under Section 162(m) of the Internal Revenue Code.	☐	☐	☐
6. Adoption of an amendment to the bylaws of American Water Works Company, Inc. to provide that the courts located within the State of Delaware will serve as the exclusive forum for the adjudication of certain legal actions.	☐	☐	☐

NOTE: Such other business as may properly come before the meeting or any adjournment thereof.

For address changes and/or comments, please check this box and write them on the back where indicated. ☐

Please sign exactly as your name(s) appear(s) hereon. When signing as attorney, executor, administrator, or other fiduciary, please give full title as such. Joint owners should each sign personally. All holders must sign. If a corporation or partnership, please sign in full corporate or partnership name by authorized officer.

Signature [PLEASE SIGN WITHIN BOX] Date

Signature (Joint Owners) Date

Important Notice Regarding the Availability of Proxy Materials for the Annual Meeting:
The Notice and Proxy Statement and 2014 Annual Report on Form 10-K are available at www.proxyvote.com.

M68704-P46188

PRELIMINARY PROXY CARD
SUBJECT TO COMPLETION DATED MARCH 17, 2015

AMERICAN WATER WORKS COMPANY, INC.
Annual Meeting of Stockholders
May 15, 2015 10:00 AM, EDT
This proxy is solicited by the Board of Directors

The undersigned stockholder of AMERICAN WATER WORKS COMPANY, INC., a Delaware corporation, hereby appoints George MacKenzie and Susan N. Story, and each of them individually, attorneys and proxies for the undersigned, each with the full power to appoint his or her substitute, to act with respect to and to vote all of the shares of Common Stock which the undersigned is entitled to vote, with the powers the undersigned would possess if personally present at the 2015 Annual Meeting of Stockholders to be held at 10:00 a.m., Eastern Daylight Time, on May 15, 2015, at The Mansion, 3000 Main Street, Voorhees, New Jersey 08043, and any adjournment or postponement thereof, as directed on the reverse side with respect to the matters set forth on the reverse side, and with discretionary authority on all other matters that come before the meeting, all as more fully described in the Proxy Statement received by the undersigned stockholder. If no direction is made, the proxy will be voted: (a) "FOR" the election of the director nominees named on the reverse side, (b) in accordance with the recommendations of the Board of Directors on the other matters referred to on the reverse side and (c) in the discretion of the proxies upon such other matters as may properly come before the Annual Meeting.

The undersigned stockholder hereby revokes any other proxy heretofore executed by the undersigned for the 2015 Annual Meeting of Stockholders and acknowledges receipt of the Notice of the Annual Meeting and Proxy Statement dated March [27], 2015.

Address Changes/Comments: ______________________________

____

(If you noted any Address Changes/Comments above, please mark corresponding box on the reverse side.)

Unless voting electronically or by phone, please mark, sign and date this on thereverse side

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2004 Student Case Competition

Maynard Manufacturing:

An Analysis of GAAP-Based and

By William R. Ortega, CMA, and Gerry H. Grant, CPA

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The Student Case Competition is sponsored annually by IMA to promote sound financial/accounting analysis and presentation skills.

Operational Earnings Management Techniques

John Robbins, CFO of Maynard Manufacturing Company, sat back in his chair and reflected on the negative publicity that accountants have received over the past year. It appeared that an increased number of companies had been engaging in questionable earnings-management activities recently. As the CFO of a publicly held corporation, John understood the pressures to increase shareholder value and knew the importance of meeting analysts' quarterly earnings expectations. Indeed, three years earlier Maynard missed its third-quarter earnings expectation by one cent, and the market punished the stock—the price fell 15% the day earnings were announced. John vowed never to let that happen again.

He believed that the flexibility inherent in generally accepted accounting principles (GAAP) allowed him the discretion to close a one- or two-cent deficit needed in order to meet analysts' earnings expectations. He was certain that stockholders would approve of such actions and that they would view them as the right thing to do.

John never believed that he was doing anything unethical, but he was bothered by what he saw happening at Enron, WorldCom, and other companies. Clearly, management at these companies had crossed the line and had committed fraud. John wondered whether they started out making the same types of GAAP-based decisions that had become a regular part of his job. Although he still felt pressure to achieve earnings targets, he wanted to make sure that he fully understood what types of earnings-management activities were appropriate and what types were inappropriate. He wanted to make sure he was not on a slippery slope that would lead to fraudulent financial reporting.

In order to understand the issues surrounding earnings management and fraudulent financial reporting more fully, John read as much as he could on the subjects. Essentially, he was looking for answers to three questions:

1. What is earnings management?

2. What are the incentives for firms to engage in earnings management?

3. What specific techniques do firms use to manage earnings?

WHAT IS EARNINGS MANAGEMENT?

GAAP offers some flexibility because financial transactions and the economic conditions surrounding them are not identical. Preparing financial statements involves selecting among GAAP alternatives and using estimates and judgments in the application of these principles (Mulford and Comiskey, 2002, p. 50). Earnings management uses the flexibility in financial reporting to alter the financial results of a firm. The following definitions illustrate this.

Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy and Whalen, 1999, p. 368).

Earnings management is the active manipulation of earnings toward a predetermined target. That target may be one set by management, a forecast made by analysts, or an amount that is consistent with a smoother, more sustainable earnings stream. Often, earnings management entails taking steps to reduce and "store" profits during good years for use during slower years. This more limited

PHOTOGRAPH: DIGITAL VISION

form of earnings management is known as *income smoothing* (Mulford and Comiskey, 2002, p. 51).

Firms that attempt to alter their financial results take actions that range from decisions within GAAP to outright fraud. Decisions made within GAAP are often viewed as aggressive if the tactics push the envelope and stretch the flexibility of GAAP beyond its intended limits (Mulford and Comiskey, 2002, p. 26). If pushed too far, these actions may become *financial fraud*, which the National Association of Certified Fraud Examiners has defined as:

The intentional misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision (www.cfenet.com).

Thus, for financial reporting to be considered fraudulent, there must be a *preconceived intent to deceive* financial statement users in a material way. Technically, accounting practices are not said to be fraudulent until the intent to deceive has been alleged in an administrative, civil, or criminal proceeding (Mulford and Comiskey, 2002, p. 49). Clearly, fraudulent financial reporting is outside the bounds of GAAP. In contrast, the intent of choices made within the discretion afforded by GAAP is harder to distinguish. Without objective evidence, it's difficult to distinguish between legitimate choices made within GAAP and earnings management (Dechow and Skinner, 2000, p. 239).

EARNINGS MANAGEMENT INCENTIVES

Earnings management is undertaken in order to increase or decrease current-period earnings relative to their "unmanaged" level. Increasing earnings involves *overstating* revenues and gains and/or *understating* expenses and losses. The reverse is true if the goal is to reduce current-period earnings. That is, revenues and gains are *understated* and/or expenses and losses are *overstated* (Schilit, 2002, p. 26). Following are five situations that provide executives incentives to manage earnings. They are adapted from Mulford and Comiskey, pp. 60-81.

1. To Avoid a Significant Decrease in Stock Price Due to Missing an Earnings Expectation.

Because of the significant adverse market reaction resulting from missed earnings expectations, managers have the incentive to make sure expectations are met. Thus, managers have an incentive to take earnings-increasing measures if it appears that the market's expectation will be missed, especially if it will be missed by a small amount.

Although this benefits all stockholders, some would argue that it benefits top management even more as most executives are receiving a growing proportion of their compensation from stock options. Arthur Levitt, the former Chairman of the Securities & Exchange Commission (SEC), defined the problem when he said, "Companies try to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options" (Levitt, 1998, p. 5).

Ironically, it's often the companies themselves that create this pressure to meet the market's earnings expectations. It's common practice for companies to provide earnings estimates to analysts and investors. Management is then faced with the task of ensuring their targeted estimates are met. Several companies, including Coca-Cola Co., Intel Corp., and Gillette Co., have taken a contrary stance and no longer provide quarterly and annual earnings estimates to analysts. In doing so, these companies claim they have shifted their focus from meeting short-term earnings estimates to achieving their long-term strategies (McKay, 2002).

Recent academic studies indicate that earnings management in order to meet the market's earnings expectations may be widespread. Several studies (Degeorge, 1999) find an unusually high proportion of consensus quarterly earnings forecasts are exactly met or barely exceeded. Conversely, a very low number of earnings expectations are missed by a small amount. The theory behind these studies is that if earnings were not being managed, we would expect to see more symmetry in the earnings numbers around the market's expectation. That is, the percentage of firms just barely making their earnings expectation should be roughly the same as the percentage just barely missing their expectation. The fact that the results are very lopsided is generally interpreted as evidence of earnings management. Other studies have documented the same asymmetry with respect to *avoiding losses* (a high proportion of small profits and a small proportion of small losses) and *avoiding decreases in profits* (a high proportion of small increases in profits and a small proportion of small decreases in profits). This is additional evidence that firms manage earnings to avoid these undesirable outcomes.

2. To Smooth Earnings Toward a Long-Term Sustainable Trend.

For many years it has been believed that a firm should attempt to reduce the volatility in its earnings stream in order to maximize share price. Because a highly volatile earnings pattern indicates risk, the stock will lose value compared to others with more stable earnings patterns. Consequently, firms have incentives to manage earnings to help achieve a smooth and growing earnings stream.

This form of earnings management (income smoothing) is also related to meeting analysts' earnings expectations in future periods. Management may be concerned that beating the current-period expectation by a wide margin will cause analysts to increase next-period's earnings expectation to this higher earnings number. If management does not believe that the current level of earnings can be sustained, then they have an incentive to manage earnings downward in the current period. Thus, income smoothing is sometimes viewed as a way for management to convey inside information to analysts regarding future earnings (Scott, 1997, p. 206). In turn, this can help guide analysts' future earnings forecasts.

3. To Maximize Proceeds from Initial and Seasoned Public Offerings (IPOs and SPOs).

When issuing shares, management has an incentive to manage earnings upward in order to increase the selling price of shares. Empirical evidence shows that firms do engage in earnings management activities to present themselves in the best possible light. But evidence of whether this results in higher share prices is mixed. Some studies have shown that the market does not see through the earnings management, resulting in overpriced shares (Rangan, 1998), while other studies have shown that the market is not misled by the earnings management (Shivakumar, 2000).

4. To Maximize Earnings-Based Incentive Compensation Agreements.

Several studies (Healy, 1985) have provided evidence that earnings are managed in the direction that is consistent with maximizing executives' earnings-based incentive compensation (bonuses). When earnings will be below the minimum level needed to earn a bonus, then earnings are managed *upward* so that the minimum is achieved and a bonus is paid. Conversely, when earnings will be above the maximum level at which no additional bonus is paid, then earnings are managed *downward*. In essence, the "extra" earnings that generated no additional compensation in the current period are stored and used to earn a bonus next period. When earnings are between the minimum and maximum levels, then earnings are managed *upward* because this will increase the current-period bonus.

5. To Avoid Debt-Covenant Violations and Minimize Political Costs.

Rather than focus on the adverse effects of not meeting earnings expectations, early academic research often assumed that the market would be efficient and would not be fooled by such earnings management techniques. Academic researchers used *positive accounting theory*, developed by Watts and Zimmerman (1986), to examine situations where the market would not see through the earnings management techniques. Positive accounting theory hypothesizes that contractual arrangements a firm enters into present incentives for managers to manipulate earnings (Dechow and Skinner, 2000, p. 236). For example, firms have the incentive to avoid violating earnings-based debt covenants. If violated, the lender may be able to raise the interest rate on the debt or demand immediate repayment. Consequently, some firms may use earnings-management techniques to increase earnings to avoid such covenant violations.

Positive accounting theory also hypothesizes that some firms have incentives to lower earnings in order to minimize political costs associated with being seen as too profitable. For example, if gasoline prices have been increasing significantly and oil companies are achieving record profit levels, then there may be incentives for the government to intervene and enact an excess-profits tax or attempt to introduce price controls (Mulford and Comiskey, 2002, p. 80).

Overall, the results of the research using positive accounting theory to develop hypotheses for earnings management have been generally supportive. But only a small percentage of firms are exposed to the situations hypothesized by positive accounting theory. In contrast, the incentives provided by the stock market to manage earnings affect all companies with stock that is publicly traded. Managers of all these firms have a strong incentive to avoid the significant decline in stock price associated with missing market expectations.

EARNINGS-MANAGEMENT TECHNIQUES

As mentioned previously, the techniques used to manage earnings range from decisions that fall completely within the flexibility of GAAP to practices that are well beyond GAAP. These latter activities may be referred to as *abusive earnings management* and may become the basis for fraud charges by the SEC (Mulford and Comiskey, 2002, p. 86).

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In between these extremes are judgments that push the limits of GAAP and often result in misleading financial results. Such judgments may be referred to as *aggressive accounting*. Mulford and Comiskey (2002, p. 15) define aggressive accounting as "a forceful and intentional choice and application of accounting principles done in an effort to achieve desired results, typically higher current earnings, whether the practices followed are in accordance with generally accepted accounting principles or not." The aggressive application of GAAP has been the focus of significant attention since a 1998 speech titled "The Numbers Game" was given by Arthur Levitt. In the speech, Levitt accused companies of "exploiting the pliancy" of GAAP in order to create illusions in their financial reporting (Levitt, 1998, p. 3). Because managerial intent is not observable, however, it's difficult to determine the difference between legitimate choices allowed within the discretion of GAAP and aggressive accounting (Dechow and Skinner, 2000, p. 239).

Most earnings-management techniques used by firms can be grouped into four categories.

1. Revenue recognition—The focus of these activities is usually to recognize revenues prematurely in order to boost current-period earnings. In order to clarify current GAAP in this area, the SEC issued Staff Accounting Bulletin No. 101 (SEC, 1999). For example, the SEC determined that annual membership fees paid to discount clubs should be recorded as revenue on an accrued basis as earned, not when membership dues are paid.

2. Operating expense timing—These techniques generally shift expenses from one period to another to help manage earnings. For example, some discretionary expenses may be postponed to the next year if the firm is experiencing lower-than-expected earnings.

3. Unrealistic assumptions to estimate liabilities—Companies may use aggressive assumptions when accruing liabilities in order to manage earnings. For example, if earnings are low, managers may use an unrealistically low estimate for bad debt expense in order to boost earnings. Conversely, an unrealistically high estimate may be used if earnings are above the market's expectation in order to reduce current-period earnings. In the latter case, the over-accrued liability may be reversed in a future period to increase earnings. This technique has been called establishing a *cookie jar reserve* (Levitt, 1998, p. 4). The cookies (excess earnings) are stashed in a cookie jar (a reserve account) during good years and then are reversed when they are needed to boost earnings in a bad year.

4. Real (operating) actions—The main focus of GAAP-based earnings-management activities is the timing and recognition of revenues and expenses. In contrast, *operational* or *real activities* deal with voluntary business decisions that are made in the ordinary course of running a business. For example, if sales are lagging, a company may slash prices in order to stimulate sales and help achieve earnings goals.

Parfet (2000, p. 485) makes a strong distinction between GAAP-based and operational earnings management. With respect to GAAP-based earnings management, he says:

"'Bad' earnings management, that is, *improper earnings management*, is intervening to hide real operating performance by creating artificial entries or stretching estimates beyond the point of reasonableness.…This is the realm of the hidden reserves, improper revenue recognition, and overly aggressive or overly conservative accounting judgments. At a minimum, such actions are unproductive and create no real value. At their worst, they constitute fraud."

In contrast, Parfet views operational earnings management in a completely different light:

"However, there is also a 'good' kind of earnings management—reasonable and proper practices that are part of operating a well-managed business and delivering value to shareholders.…Sometimes this 'good' earnings management is called 'operational' earnings management, where management takes actions to try to create stable financial performance by acceptable, voluntary business decisions."

SPECIFIC EXAMPLES OF EARNINGS MANAGEMENT

There are many techniques that can be used to manage earnings. Some techniques fit neatly within one of the four categories of earnings management, but others do not. For instance, postponing factory maintenance in order to reduce current-period expenses involves the timing of operating expenses (category 2) and is also an operating activity (category 4). Some examples of possible earnings-management techniques are (developed from Mulford and Comiskey, 2002, and Schilit, 2002):

1. Revenue from a multi-year service contract is totally recognized in the year of sale.
2. Operating expenses that have been previously expensed are now being capitalized.
3. Maintenance expenditures are postponed until next year in order to reduce expenses.
4. Revenue is recognized when goods are shipped to a consignee.
5. The write-off of obsolete inventory is deferred until a

more appropriate time.

6. The books are kept open for the first week of the next quarter in order to record additional revenue in the current quarter.
7. More lenient credit terms are extended in order to increase sales. No adjustment is made to increase the allowance for bad debts.
8. Optimistic estimate of useful life is used to depreciate plant and equipment.
9. Costs associated with restructuring are significantly overestimated.
10. The allowance for warranty expenses (expressed as a percent of sales) is increased from the previous year.
11. Next year's price increases are leaked to customers in order to increase current-year sales.
12. Production of goods is increased so that more fixed manufacturing overhead is deferred in ending finished goods inventory.

FUTURE EARNINGS-MANAGEMENT ACTIVITIES AT MAYNARD MANUFACTURING COMPANY

After reviewing the material on earnings management, John Robbins felt uncomfortable with some of the GAAP-based earnings-management decisions he had made in the past. He now believed that the line between realistic judgments made within GAAP and aggressive accounting was too fuzzy. More troubling was the recent trend to label some forms of aggressive accounting as fraud. Consequently, John thought the best thing to do was avoid any form of aggressive GAAP-based earnings management.

John knew that he would still be under pressure to meet earnings expectations. Fortunately, he agreed with the characterization of operational earnings management as good and proper. Therefore, he believed that the best way to manage earnings at Maynard was to engage in such activities. Of particular interest to John was the ability to overproduce inventory in order to defer fixed manufacturing overhead costs in ending finished goods inventory. John wondered about the ability to increase earnings by overproducing. He looked at some recent operating information to help shed some light on his possibilities.

COMPANY INFORMATION

Maynard Manufacturing Company produces machine parts for manufacturing equipment used by various industries. Approximately 3,000 different parts are produced in Maynard's single manufacturing facility. Two years ago, Maynard replaced much of its machinery with state-of-the-art equipment. This equipment allowed Maynard to reduce its direct labor cost by over 25%. This changed Maynard's cost structure by shifting costs that were previously variable (direct labor) to fixed overhead (depreciation on the new equipment). The new equipment also decreased the setup times associated with producing many of its products. Consequently, Maynard now produces many products only after an order is received. Because 60% of Maynard's sales are generated from the sale of 200 parts, they are produced in large batches and are carried in inventory. The other 2,800 parts are pro-

TABLE 1

SECTION A: INCOME STATEMENT FOR THE YEAR ENDING 12/31/2002

	DOLLARS	PERCENT OF SALES
Sales	$ 851,217,896	100.00
Cost of Goods Sold	– 713,405,719	– 83.81
Gross Margin	137,812,177	16.19
Selling, General and Administrative Expenses	– 80,865,700	– 9.50
Operating Income	56,946,477	6.69
Other Income (principally interest)	+ 4,681,698	+ 0.55
Interest and Debt Expenses	– 9,533,640	– 1.12
Income Taxes	– 10,810,467	– 1.27
Net Income	$41,284,068	4.85
Number of Outstanding Shares	$11,932,000	
Earnings Per Share	$3.46	

SECTION B: BREAKDOWN OF COST OF GOODS SOLD (COGS) BY COST ELEMENT

	DOLLARS	PERCENT OF COGS
Direct materials	$324,162,284	45.44
Direct labor	141,702,684	19.86
Variable overhead	53,738,698	7.53
Fixed overhead	193,802,052	27.17
Total Cost of Goods Sold	$713,405,718	100.00

SECTION C: SIMPLIFIED DATA TO ILLUSTRATE THE EFFECT OF OVERPRODUCTION ON EARNINGS

- One product is produced. Each unit uses 5 machine hours and sells for $425.
- Normal capacity utilization is 2 million units (10 million machine hours).
- Budgeted fixed manufacturing overhead is $200 million.
- Actual fixed manufacturing overhead is $200 million.

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duced only upon the receipt of an order. In contrast, with the old equipment all 3,000 parts were produced for inventory. Because of unpredictable demand for many parts, Maynard used to carry high levels of inventory.

Table 1 provides financial information about Maynard Manufacturing. Section A of Table 1 shows an income statement and earnings per share (EPS) for 2002. Section B shows the breakdown of production costs by cost element. Section C provides a simplified example developed by John Robbins to help him evaluate the effect of overproduction on earnings.

REQUIRED QUESTIONS

1. The case presents 12 examples of possible earnings management techniques. Assume that each technique will have a material effect on the financial statements of a company. Identify which techniques are GAAP-based and which involve operational or real actions. For the GAAP-based techniques, determine whether you believe the action is within the latitude afforded by GAAP (in the white area), pushing the limits of GAAP (in the gray area), or beyond the limits of GAAP (in the black area).

2. Do the techniques you identified as beyond the limits of GAAP (i.e., in the black area) constitute financial fraud?

3. The case characterizes GAAP-based earnings-management techniques as bad and operational techniques as good. Do you agree with this characterization? Do you think operational techniques are always good business decisions? Do you think operational techniques are more ethical than GAAP-based techniques?

4. Use the information presented in Section C of Table 1 and the following four scenarios to illustrate the effect of overproducing inventory on earnings. Specifically, identify how much fixed manufacturing overhead will be expensed (via Cost of Goods Sold) and how much will be held back on the balance sheet (in Finished Goods Inventory). Use the *normal capacity utilization* to determine the fixed manufacturing overhead rate. Ignore income taxes.

A. Produce and sell 2 million units.

B. Produce 2.2 million units and sell 2 million units.

C. Produce 2.3 million units and sell 2 million units.

D. Produce 2.4 million units and sell 2 million units.

How many units would have to be overproduced in order for John Robbins to increase EPS by $.01? What about $.05? Do you believe it's feasible for John Robbins to close a small gap in earnings in order to meet the market's expectation by overproducing? ■

William R. Ortega, Ph.D., CMA, is an associate professor of accounting at the College of Business, Winona State University, Winona, Minn. You can reach him at (507) 457-5180 or wortega@winona.edu.

Gerry H. Grant, MPA, CPA, is a doctoral student at the School of Business, University of Mississippi, in Oxford. She can be reached at (662) 513-5463 or ggrant@bus.olemiss.edu.

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THE EFFECT OF BONUS SCHEMES ON ACCOUNTING DECISIONS*

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Studies examining managerial accounting decisions postulate that executives rewarded by earnings-based bonuses select accounting procedures that increase their compensation. The empirical results of these studies are conflicting. This paper analyzes the format of typical bonus contracts, providing a more complete characterization of their accounting incentive effects than earlier studies. The test results suggest that (1) accrual policies of managers are related to income-reporting incentives of their bonus contracts, and (2) changes in accounting procedures by managers are associated with adoption or modification of their bonus plan.

1. Introduction

Earnings-based bonus schemes are a popular means of rewarding corporate executives. Fox (1980) reports that in 1980 ninety percent of the one thousand largest U.S. manufacturing corporations used a bonus plan based on accounting earnings to remunerate managers. This paper tests the association between managers' accrual and accounting procedure decisions and their income-reporting incentives under these plans. Earlier studies testing this relation postulate that executives rewarded by bonus schemes select income-increasing accounting procedures to maximize their bonus compensation.[1] Their empirical results are conflicting. These tests, however, have several problems. First, they ignore the earnings' definitions of the plans; earnings are often defined so that certain accounting decisions do not affect bonuses. For exam-

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[1]These studies include Watts and Zimmerman (1978), Hagerman and Zmijewski (1979), Holthausen (1981), Zmijewski and Hagerman (1981), Collins, Rozeff and Dhaliwal (1981), and Bowen, Noreen and Lacey (1981).

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ple, more than half of the sample plans collected for my study define bonus awards as a function of income before taxes. It is not surprising, therefore, that Hagerman and Zmijewski (1979) find no significant association between the existence of accounting-based compensation schemes and companies' methods of recording the investment tax credit.

Second, previous tests assume compensation schemes always induce managers to select income increasing accounting procedures. The schemes examined in my study also give managers an incentive to select income-decreasing procedures. For example, they typically permit funds to be set aside for compensation awards when earnings exceed a specified target. If earnings are so low that no matter which accounting procedures are selected target earnings will not be met, managers have incentives to further reduce current earnings by deferring revenues or accelerating write-offs, a strategy known as 'taking a bath'. This strategy does not affect current bonus awards and increases the probability of meeting future earnings' targets.[2] Past studies do not control for such situations and, therefore, understate the association between compensation incentives and accounting procedure decisions.

This study examines typical bonus contracts, providing a more complete analysis of their accounting incentive effects than earlier studies. The theory is tested using actual parameters and definitions of bonus contracts for a sample of 94 companies. Two classes of tests are presented: accrual tests and tests of changes in accounting procedures. I define accruals as the difference between reported earnings and cash flows from operations. The accrual tests compare the actual sign of accruals for a particular company and year with the predicted sign given the managers' bonus incentives. The results are consistent with the theory. I also test whether accruals differ for companies with different bonus plan formats. The accrual differences provide further evidence of a relation between managers' accrual decisions and their income-reporting incentives under the bonus plan. Tests using changes in accounting procedures suggest that managers' decisions to change procedures are not associated with bonus plan incentives. However, additional tests find that changes in accounting procedures are related to the adoption or modification of a bonus plan.

Section 2 outlines the provisions of bonus agreements. The accounting incentive effects generated by bonus plans are discussed in section 3. Section 4 describes the sample design and data collection, and section 5 reports the results of accrual tests. Tests of changes in accounting procedures are described in section 6. The conclusions are presented in section 7.

2. Description of accounting bonus schemes

Deferred salary payment, insurance plans, non-qualified stock options, restricted stock, stock appreciation rights, performance plans and bonus plans

[2] See Holthausen (1981) and Watts and Zimmerman (1983).

are popular forms of compensation.[3] Two of these explicitly depend on accounting earnings: bonus schemes and performance plans. Performance plans award managers the value of performance units or shares in cash or stock if certain long-term (three or five years) earnings' targets are attained. The earnings' targets are typically written in terms of earnings per share, return on total assets, or return on equity. Bonus contracts have a similar format to performance contracts except that they specify annual rather than long-term earnings goals.

A number of companies operate bonus and performance plans simultaneously. Differences in earnings definitions and target horizons of these two plans make it difficult to identify their combined effect on managers' accounting decisions. I therefore limit the study to firms whose only remuneration explicitly related to earnings is bonuses. Fox (1980) finds that in 1980 ninety percent of the one thousand largest U.S. manufacturing corporations used a bonus plan to remunerate managers, whereas only twenty-five percent used a performance plan. Bonus awards also tend to constitute a higher proportion of top executives' compensation than performance payments. In 1978, for example, Fox reports that for his sample the median ratio of accounting bonus to base salary was fifty-two percent. The median ratio for performance awards was thirty-four percent.

The formulae and variable definitions used in bonus schemes vary considerably between firms, and even within a single firm across time. Nonetheless, there are common features of these contracts. They typically define a variant of reported earnings (E_t) and an earnings target or lower bound (L_t) for use in bonus computations. If reported earnings exceed their target, the contract defines the maximum percentage (p_t) of the difference that can be allocated to a bonus pool. If earnings are less than their target, no funds are allocated to the pool. The formula for the maximum transfer to the bonus pool (B_t) is

$$B_t = p_t \max\{(E_t - L_t), 0\}.$$

Standard Oil Company of California, for example, defines its 1980 bonus formula as follows:

> ...the annual fund from which awards may be made is two percent of the amount by which the company's annual income for the award year exceeds six percent of its annual capital investment for such year.

Standard Oil defines 'annual income' as audited net income before the bonus expense and interest, and 'capital investment' as the average of opening and closing book values of long-term liabilities plus equity. Variations on these definitions are found in other companies' plans. Earnings are defined before or after a number of factors including interest, the bonus expense, taxes, extraor-

[3] For a discussion of these types of compensation, see Smith and Watts (1982).

dinary and non-recurring items, and/or preferred dividends. Capital is a function of the book value of equity when incentive income is earnings after interest and a function of the sum of long-term debt and equity when incentive income is earnings before interest. Bonus plans for ninety-four companies are examined in this study and only seven do not use these definitions of earnings and capital.

Some schemes specify an upper limit (U_t') on the excess of earnings over target earnings. When the difference between actual and target earnings is greater than the upper limit, the transfer to the bonus pool is limited, implying the formula for allocation to the bonus pool (B_t') is

$$B_t' = p_t\{\min\{U_t', \max\{(E_t - L_t), 0\}\}\}.$$

The upper limit is commonly related to cash dividend payments on common stock.[4] The 1980 bonus contract for Gulf Oil Corporation, for example, limits the transfer to the bonus reserve to six percent of the excess of earnings over six percent of capital 'provided that the amount credited to the Incentive Compensation Account shall not exceed ten percent of the total amount of the dividends paid on the corporation's stock'.

Administration of the bonus pool and awards to executives are made by a committee of directors who are ineligible to participate in the scheme. Awards are made in cash, stock, stock options or dividend equivalents.[5] The bonus contract usually permits unallocated funds to be available for future bonus awards. Plans also provide for award deferrals over as many as five years, either at the discretion of the compensation committee or the manager.

3. Bonus plans and accounting choice decisions

Watts (1977) and Watts and Zimmerman (1978) postulate that bonus schemes create an incentive for managers to select accounting procedures and accruals to increase the present value of their awards. This paper proposes a more complete theory of the accounting incentive effects of bonus schemes.[6] The firm is assumed to comprise a single risk-averse manager and one or more

[4] Contracts taking this form create an incentive for the manager to increase dividend payments when the upper limit is binding, thereby counteracting the over-retention problem noted in Smith and Watts (1983).

[5] Dividend equivalents are claims which vary with the dividend payments on common stock.

[6] The theory does not explain the form of bonus contracts or why executives are awarded earnings-based bonuses. For a discussion of these issues, see Jensen and Meckling (1976), Holmstrom (1979), Miller and Scholes (1980), Fama (1980), Hite and Long (1980), Holmstrom (1982), Smith and Watts (1983), Larcker (1983), and Demski, Patell and Wolfson (1984).

owners. The manager is rewarded by the following bonus formula:

$$B_t' = p\left\{\min\left\{U',\max\left\{\left(E_t - L\right),0\right\}\right\}\right\},$$

where L is the lower bound on earnings (E_t), U' is the limit on the excess of earnings over the lower bound ($E_t - L$), and p is the payout percentage defined in the bonus contract. The manager receives $p(E_t - L)$ in bonus if earnings exceed the lower bound and are less than the bonus plan limit (the upper bound) on earnings, U, given by the sum $(U' + L)$. The bonus is fixed at pU' when earnings exceed this upper bound.

Accounting earnings are decomposed into cash flows from operations (C_t), non-discretionary accruals (NA_t) and discretionary accruals (DA_t). Non-discretionary accruals are accounting adjustments to the firm's cash flows mandated by accounting standard-setting bodies (e.g., the Securities Exchange Commission and the Financial Accounting Standards Board). These bodies require, for example, that companies depreciate long-lived assets in some systematic manner, value inventories using the lower of cost or market rule, and value obligations on financing leases at the present value of the lease payments. Discretionary accruals are adjustments to cash flows selected by the manager. The manager chooses discretionary accruals from an opportunity set of generally accepted procedures defined by accounting standard-setting bodies. For example, the manager can choose the method of depreciating long-lived assets; he can accelerate or delay delivery of inventory at the end of the fiscal year; and he can allocate fixed factory overheads between cost of goods sold and inventories.

Accruals modify the timing of reported earnings. Discretionary accruals therefore enable the manager to transfer earnings between periods. I assume that discretionary accruals sum to zero over the manager's employment horizon with the firm. The magnitude of discretionary accruals each year is limited by the available accounting technology to a maximum of K and a minimum of $-K$.

The manager observes cash flows from operations and non-discretionary accruals at the end of each year and selects discretionary accounting procedures and accruals to maximize his expected utility from bonus awards.[7] The choice of discretionary accruals affects his bonus award and the cash flows of the firm. I assume that these cash effects are financed by stock issues or repurchases and, therefore, do not affect the firm's production/investment decisions.

Healy (1983) derives the manager's decision rule for choosing discretionary accruals when his employment horizon is two periods. The choice of discretion-

[7] The manager's accrual decision is motivated by factors other than compensation. Watts and Zimmerman (1978) suggest that the manager also considers the effect of accounting choices on taxes, political costs, and the probability and associated costs of violating lending agreements.

ary accruals in period one fixes his decision in the second period because discretionary accruals are constrained to sum to zero over these two periods. Fig. 1 depicts discretionary accruals in the first period as a function of earnings before discretionary accruals. These results are discussed in three cases.

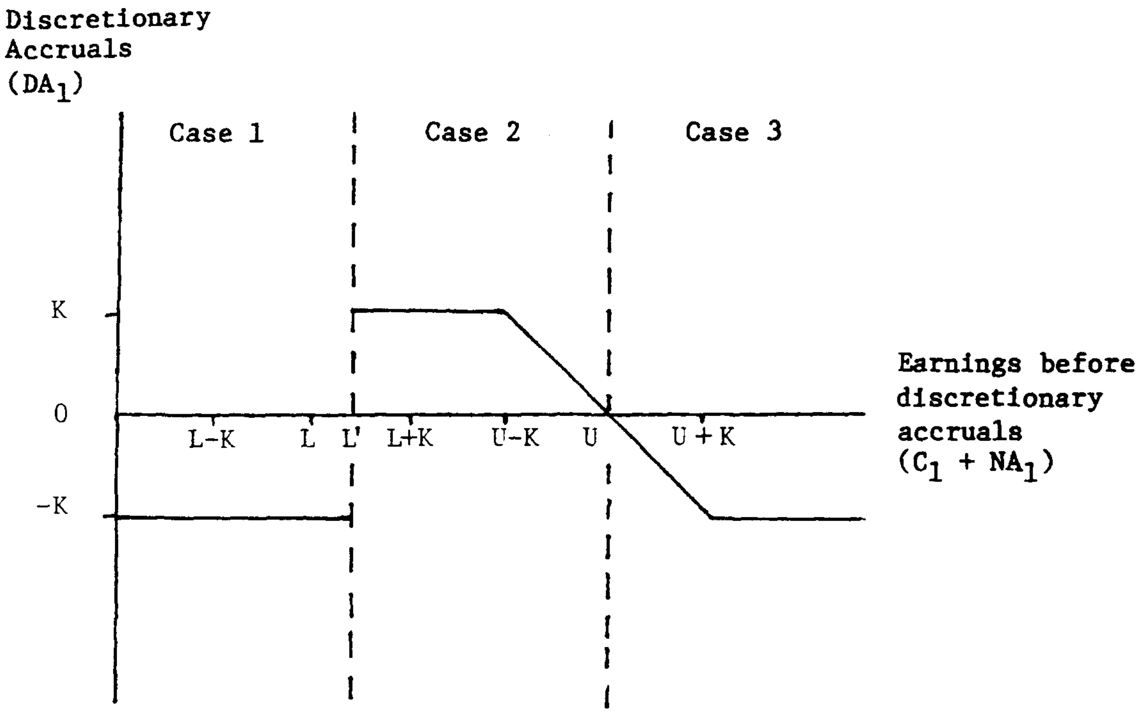

Fig. 1. Managerial discretionary accrual decisions as a function of earnings before discretionary accruals and bonus plan parameters in the first period of a two-period model. L = the lower bound defined in the bonus plan, U = the upper bound on earnings, L' = a cutoff point which is a function of the lower bound, the manager's risk preference, expected earnings in period 2 and the discount rate, K = the limit on discretionary accruals, C = cash flows from operations, and NA = non-discretionary accruals.

Case 1

In Case 1, the manager has an incentive to choose income-decreasing discretionary accruals, that is to take a bath. This case has two regions. In the first, earnings before discretionary accruals are more than K below the lower bound (i.e., $C_1 + NA_1 < L - K$). The manager selects the minimum discretionary accrual ($DA_1 = -K$) because even if he chooses the maximum, reported income will not exceed the lower bound and no bonus will be awarded. By deferring earnings to period two, he maximizes his expected future award.

In the second region of Case 1, earnings before discretionary accruals in period 1 ($C_1 + NA_1$) are within $\pm K$ of the lower bound (L). The manager either selects the minimum ($DA_1 = -K$) or maximum ($DA_1 = K$) discretionary accrual. If he chooses the maximum accrual, he receives a bonus in period 1 but foregoes some expected bonus in period 2 because he is now constrained to report the minimum accrual in that period ($DA_2 = -K$). If he selects the minimum discretionary accrual in period 1 the manager maximizes his expected bonus in period 2, but receives no bonus in the first period. He trades off present value and certainty advantages of receiving a bonus in period 1 against the foregone expected bonus in period 2. Conditional on the bonus plan parameters, expected earnings before discretionary accruals in period 2, the discount rate, and his risk aversion, the manager estimates a threshold (denoted by L' in fig. 1) where he is indifferent between reporting the minimum and maximum accrual in period 1. In fig. 1, the threshold (L') exceeds the lower bound in the bonus plan (L). However, the threshold can also be less than the lower bound, depending on expected earnings in period 2. The manager selects the minimum discretionary accrual ($DA_1 = -K$) when earnings before discretionary accruals are less than the threshold, i.e., $C_1 + NA_1 < L'$.

Case 2

In Case 2, the manager has an incentive to choose income-increasing discretionary accruals. If first-period earnings before discretionary accruals exceed the threshold L', the present value and certainty advantages of accelerating income and receiving a bonus in period 1 outweigh foregone expected awards in period 2. The manager, therefore, selects positive discretionary accruals. When earnings before accounting choices are less than $(U - K)$, he chooses the maximum accrual ($DA_1 = K$). When earnings before accounting choices are within K of the upper bound, the manager selects less than the maximum discretionary accrual because income beyond the upper bound is lost for bonus calculations. He chooses $DA_1 = (U - C_1 - NA_1)$, thereby reporting earnings equal to the upper bound. If the bonus plan does not specify an upper bound, the manager selects the maximum discretionary accrual ($DA_1 = K$) when earnings before accounting choices exceed the threshold L'.

Case 3

In Case 3, the manager has an incentive to select income-decreasing discretionary accruals. When the bonus plan upper bound is binding, earnings before discretionary accruals exceeding that bound are lost for bonus purposes. By deferring income that exceeds the upper bound, the manager does not reduce his current bonus and increases his expected future award. When earnings before discretionary accruals are less than $U + K$, he selects $DA_1 = (C_1 + NA_1 - U)$, reporting earnings equal to the upper bound. When earnings before discretionary accruals exceed $(U + K)$, he chooses the minimum accrual ($DA_1 = -K$).

In summary, the sign and magnitude of discretionary accruals are a function of expected earnings before discretionary accruals, the parameters of the bonus plan, the limit on discretionary accruals, the manager's risk preferences and the discount rate. Three implications of this theory are tested:

(1) If earnings before discretionary accruals are less than the threshold represented by L', the manager has an incentive to select income-decreasing discretionary accruals.

(2) If earnings before discretionary accruals exceed the lower threshold, denoted by L' in fig. 1, but not the upper limit, the manager has an incentive to select discretionary accruals to increase income.

(3) If the bonus plan specifies an upper bound and earnings before discretionary accruals exceed that limit, the manager has an incentive to select discretionary accruals to decrease income.

Earlier studies on the smoothing hypothesis postulate that discretionary accruals are a function of earnings before accruals.[8] However, the predictions of the compensation theory outlined here differ from those of the smoothing hypothesis: when earnings before accrual decisions are less than the threshold L', the compensation theory predicts that the manager selects income-decreasing discretionary accruals; the smoothing hypothesis implies that he chooses income-increasing accruals.

4. Sample design and collection of financial data

4.1. Sample design

The population selected for this study is companies listed on the 1980 Fortune Directory of the 250 largest U.S. industrial corporations.[9] It is common for stockholders of these companies to endorse the implementation of a bonus plan at the annual meeting. Subsequent plan renewals are ratified, usually every three, five or ten years and a summary of the plan is included in the proxy statement on each of these occasions. The first available copy of the bonus plan is collected for each company from proxy statements at one of three sources: Peat Marwick, the Citicorp Library and the Baker Library at Harvard Business School. Plan information is updated whenever changes in the plan are ratified.

[8] See Ronen and Sadan (1981) for an extensive review of the smoothing literature.

[9] Fox (1980) provides evidence that the probability of a corporation employing a bonus plan is not independent of size or industry. The inferences drawn from this study are, therefore, strictly limited to the sample population. Nonetheless, that population is a non-trivial one – the largest 250 industrials account for more than 40 percent of sales of all U.S. industrial corporations.

One hundred and fifty-six companies are excluded from the final sample. The managers of 123 of these firms receive bonus awards but the details of the bonus contracts are not publicly available. Six companies do not appear to reward top management by bonus during any of the years proxy statements are available. A further twenty-seven companies have contracts which limit the transfer to the bonus pool to a percentage of the participating employees' salaries. Since this information is not publicly disclosed, no upper limit can be estimated for these companies.

Some of the sample companies operate earnings-based bonus and performance plans simultaneously. To control for the effect of performance plans on managers' accounting decisions, companies are deleted from the sample in years when both plans are used. This restriction reduces the number of company years by 239.

The useable sample comprises ninety-four companies. Thirty of these have bonus plans which specify both upper and lower bounds on earnings. The contract definitions of earnings, the net upper bound and the lower bound for the sample are summarized in table 1. Earnings are defined as earnings before

Table 1

Summary of useable bonus plan definitions for a sample from the Fortune 250 over the period 1930–1980.

Total number of sample companies	94
Total number of company-years	1527
Number of company-years subject to an upper bound constraint	447
Adjustments to earnings specified in the bonus contract	*Percentage of company-year observations*
Additions to net income	
Income Tax	52.7%
Extraordinary items	27.5
Interest	33.5
Deductions from net income	
Preferred dividends	12.1
Variables used to define lower bounds in the bonus contract	
Net worth	42.0
Net worth plus long-term liabilities	37.2
Earnings per share	8.3
Other	17.8
Variables used to define upper bounds in the bonus contract	
Cash dividends	22.4
Net worth or net worth plus long-term liabilities	2.5
Other	4.5

taxes for 52.7 percent of the company-years and earnings before interest for 33.5 percent of the observations. Bonus contracts typically define the lower bound as a function of net worth (42.0 percent of the observations) or as a function of net worth plus long-term liabilities (37.2 percent). Some contracts define the lower bound as a function of more than one variable. For example, the 1975 bonus contract of American Home Products Corporation defines the lower bound as 'the greater of (a) an amount equal to 12 percent of Average Net Capital or (b) an amount equal to $1.00 multiplied by the average number of shares of the Corporation's common stock outstanding at the close of business on each day of the year'. The upper bound is commonly written as a function of cash dividends.

4.2. Collection of financial data

Earnings and upper and lower bounds for each company-year are estimated using actual bonus plan definitions. The definitions are updated whenever the plan is amended. The data to compute these variables is collected from COMPUSTAT for the years 1964–80 and from Moody's Industrial Manual for earlier years.

Two proxies for discretionary accruals and accounting procedures are used: total accruals and the effect of voluntary changes in accounting procedures on earnings. Total accruals (ACC_t) include both discretionary and non-discretionary components ($ACC_t = NA_t + DA_t$), and are estimated by the difference between reported accounting earnings and cash flows from operations. Cash flows are working capital from operations (reported in the funds statement) less changes in inventory and receivables, plus changes in payables and income taxes payable:

$$ACC_t = -DEP_t - XI_t \cdot D_1 + \Delta AR_t + \Delta INV_t$$
$$-\Delta AP_t - \{\Delta TP_t + D_t\} \cdot D_2,$$

where

DEP_t = depreciation in year t;
XI_t = extraordinary items in year t;
ΔAR_t = accounts receivable in year t less accounts receivable in year $t-1$;
ΔINV_t = inventory in year t less inventory in year $t-1$;
ΔAP_t = accounts payable in year t less accounts payable in year $t-1$;
ΔTP_t = income taxes payable in year t less income taxes payable in year $t-1$;
DEF_t = deferred income tax expense (credit) for year t;
D_1 = 1 if bonus plan earnings are defined after extarordinary items,
= 0 if bonus plan earnings are defined before extarordinary items;
D_2 = 1 if bonus plan earnings are defined after income taxes,
= 0 if bonus plan earnings are defined before income taxes.

The only accrual omitted is the earnings effect of the equity method of accounting for investments in associated companies.

The second proxy for discretionary accruals and accounting procedures is the effect of voluntary changes in accounting procedures on reported earnings. Accounting changes are collected for sample companies from 1968 to 1980 using two sources: the sample of depreciation changes used by Holthausen (1981) and changes documented by Accounting Trends and Techniques. The effect of each change on current and retained earnings is collected from the companies' annual reports. This data is further described in section 6.

5. Accrual tests and results

5.1. Contingency tests and results

Contingency tables are constructed to test the implications of the theory. Managers have an incentive to select income-decreasing discretionary accruals when their bonus plan's upper and lower bounds are binding. When these bounds are not binding the manager has an incentive to choose income-increasing discretionary accruals. Total accruals proxy for discretionary accruals.

Each company-year is assigned to one of three portfolios: (1) Portfolio UPP, (2) Portfolio LOW, or (3) Portfolio MID. Portfolio UPP comprises observations for which the bonus contract upper limit is binding. Company-years are assigned to this portfolio when cash flows from operations exceed the upper bound defined in the bonus plan. The theory implies that observations should be assigned to portfolio UPP when cash flows from operations plus nondiscretionary accruals exceed the upper bound. Cash flows are a proxy for the sum of cash flows and non-discretionary accruals because nondiscretionary accruals are unobservable. This method of identifying company-years when the upper bound is binding leads to misclassifications which increase the probability of incorrectly rejecting the null hypothesis. Discussion of this problem and tests to control for the bias are presented later in this section.

Portfolio LOW comprises observations for which the bonus plan lower bound is binding. Company-years are assigned to this portfolio if earnings are less than the lower bound specified in the bonus plan. The theory implies that observations should be assigned to portfolio LOW when cash flows from operations plus non-discretionary accruals are less than the lower threshold L'. This threshold is a function of the bonus plan lower bound, the managers' risk preferences and their expectations of future earnings. Since the threshold is unobservable, the method of assigning company-years to portfolio UPP, using cash flows as a proxy for cash flows plus non-discretionary accruals, cannot be used for portfolio LOW. Instead, company-years are assigned to portfolio LOW when earnings are less than the lower bound since no bonus is awarded

Table 2

Summary of the association between accruals and bonus plan parameters.

Portfolio[a]	Proportion of accruals with given sign: Positive	Negative	Number of company-years	Mean accruals[b]	t-test for difference in means
Sample A: Plans with a lower bound but no upper bound					
Portfolio LOW	0.38	0.62	74	−0.0367	2.5652[d]
Portfolio MID	0.36	0.64	1006	−0.0155	
χ^2 (d.f. = 1)	0.1618				
Sample B: Plans with both a lower bound and upper bound					
Portfolio LOW	0.09	0.91	22	−0.0671	4.2926[c]
Portfolio MID	0.46	0.54	281	0.0021	8.3434[c]
Portfolio UPP	0.10	0.90	144	−0.0536	
χ^2 (d.f. = 2)	61.3930[c]				
Sample C: Aggregate of samples A and B					
Portfolio LOW	0.31	0.69	96	−0.0437	4.3247[c]
Portfolio MID	0.38	0.62	1287	−0.0117	7.4593[c]
Portfolio UPP	0.10	0.90	144	−0.0536	
χ^2 (d.f. = 2)	43.7818[c]				

[a]Portfolio LOW comprises company-years when the bonus plan lower bound is binding. Portfolio MID contains observations for which the lower and upper bounds are not binding. Portfolio UPP contains company years when the upper bound is binding.
[b]Accruals are deflated by the book value of total assets.
[c]Significant at the 0.005 level.
[d]Significant at the 0.010 level.

in these years, and managers have an incentive to select income-decreasing discretionary accruals. This assignment method induces a selection bias which increases the probability of incorrectly rejecting the null hypothesis. Discussion of this problem is deferred to later in the section.

Portfolio MID contains observations where neither the upper nor lower bounds are binding. Company-years that are not assigned to portfolios UPP or LOW are included in portfolio MID, and are expected to have a higher proportion of positive accruals than the other two portfolios.

The incidence of positive and negative accruals for portfolios LOW, MID and UPP is presented in the form of a contingency table in table 2. The row denotes the portfolio to which each company-year is assigned. The column denotes the sign of the accrual and each cell contains the proportion of observations fulfilling each condition. Mean accruals, deflated by the book value of total assets at the end of each company-year[10] are also displayed for

[10]Accruals are also deflated by sales and the book value of assets at the beginning of the year. The test results are insensitive to alternative size deflators.

each portfolio. If managers select accruals to increase the value of their bonus compensation, there will be a higher incidence of negative accruals and lower mean accruals for portfolios LOW and UPP than for portfolio MID. Chi-square and t-statistics, testing these hypotheses, are reported in table 2. The chi-square test is a two-tailed test which compares the number of observations in each contingency table cell with the number expected by chance.[11] The t-tests are one-tailed tests of differences in mean deflated accruals for the three portfolios.[12]

Sample A reports results for plans with a lower bound, but no upper bound. There is a lower proportion of negative accruals for portfolio LOW than for portfolio MID, inconsistent with the theory. However, the chi-square statistic is not statistically significant. The mean standardized accruals support the theory: the mean for portfolio LOW is less than the mean for portfolio MID and the t-statistic, comparing the difference in means, is statistically significant at the 0.010 level. This result suggests that managers are more likely to take a bath, that is, select income-decreasing accruals, when the lower bound of their bonus plan is binding than when it is not.

Sample B comprises plans which specify both an upper and lower bound. The chi-square statistic is significant at the 0.005 level, indicating that there is a greater incidence of negative accruals when the bonus plan lower and upper limits are binding than otherwise. Tests of mean standardized accruals reinforce the chi-square results: the means for portfolios LOW and UPP are less than the mean for the MID portfolio. The t-tests, evaluating differences in means, are statistically significant at the 0.005 level. These results are consistent with the hypothesis that managers are more likely to select income-decreasing accruals when the lower and upper bounds of their bonus plans are binding. Sample C aggregates samples A and B and confirms the results.

There are several differences in the results for samples A and B. First, the results for the MID portfolio are stronger for the sample of plans with upper bounds. One explanation is that bonus plan administrators enforce an informal upper bound when one is not specified in the contract. If this informal bound is binding, some of the companies included in the MID portfolio for sample A are misclassified; they should be included in sample B and assigned to

[11] The chi-square test assumes that the sample is a random one from the population, and the sample size is large. The statistic is drawn from a chi-square distribution with $(R-1)(C-1)$ degrees of freedom, where R is the number of rows and C the number of columns in the contingency table.

[12] This statistical test assumes that the populations are normal with equal variances. Each t-value is then drawn from a t-distribution with $(N+M-2)$ degrees of freedom, where N is the number of observations in one sample and M the number in the other. Both the t and chi-square tests assume that accruals are independent. This assumption is violated if accruals are autocorrelated or sensitive to market-wide and industry factors. Accruals exhibit significant positive first-order autocorrelation. The test statistics reported in table 2 are therefore overstated.

Table 3

Summary of the association between accrual subcomponents and bonus plan parameters.

Portfolio[a]	Proportion of accrual subcomponents with given sign: Positive	Proportion of accrual subcomponents with given sign: Negative	Mean accruals[b]	t-test for difference in means
	Change in inventory			
Portfolio LOW	0.59	0.41	0.0096	
Portfolio MID	0.80	0.20	0.0246	2.6880[c]
Portfolio UPP	0.69	0.31	0.0078	4.0515[c]
χ^2 (d.f. = 2)	26.3171[c]			
	Change in accounts receivable			
Portfolio LOW	0.59	0.41	0.0092	
Portfolio MID	0.83	0.17	0.0218	3.1152[c]
Portfolio UPP	0.84	0.16	0.0135	2.8119[c]
χ^2 (d.f. = 2)	35.4581[c]			

[a]Portfolio LOW comprises company years when the bonus plan lower bound is binding. Portfolio MID contains observations for which the lower and upper bounds are not binding. Portfolio UPP contains company years when the upper bound is binding.
[b]Accruals are deflated by the book value of total assets.
[c]Significant at the 0.005 level.

portfolio UPP. A second difference between the samples is the stronger result for portfolio LOW for sample B than sample A. I have no explanation for this result.

Contingency tables are constructed for the following subcomponents of accruals: changes in inventory, changes in receivables, depreciation, changes in payables and, where relevant to the bonus award, changes in income taxes payable. The changes in inventory and receivable accrual subcomponents are most strongly associated with management compensation incentives. Contingency table results for the aggregate sample are presented for these two subcomponents in table 3.[13] There are more negative inventory accruals when the upper and lower constraints are binding than for the MID portfolio. The results for receivable accruals confirm the theory for portfolios LOW and MID. However, there is no difference in the proportion of negative accruals for portfolios MID and UPP. The chi-square statistics for both inventory and receivable accruals are significant at the 0.005 level. Differences in mean inventory and receivable accruals for portfolios LOW, MID and UPP are consistent with the theory: the means for portfolios UPP and LOW are significantly lower than the mean for portfolio MID at the 0.005 level.

[13]Results for other subcomponents, and for different plan forms – those with and without an upper bound – are reported in Healy (1983). The upper bound results for depreciation, changes in accounts payable and changes in taxes payable are consistent with the theory, but the lower bound results are inconsistent.

In summary, the evidence in tables 2 and 3 is generally inconsistent with the null hypothesis that there is no association between discretionary accruals and managers' income-reporting incentives under the bonus plan. There is a greater incidence of negative accruals when the upper and lower bounds in the bonus contracts are binding. The contingency tables for decomposed accruals identify changes in inventory and accounts receivables as the accrual subcomponents most highly related to managers' bonus plan incentives.

There are several limitations of the contingency test. First, the method of assigning observations to portfolio LOW induces a selection bias. Company-years are assigned to Portfolio LOW when reported earnings are less than the lower bound. A high incidence of negative accruals are observed for this portfolio, consistent with the theory. However, both reported earnings and total accruals include non-discretionary accruals. Company-years with negative non-discretionary accruals are therefore likely to be assigned to portfolio LOW and they will also tend to have negative total accruals. This selection bias increases the probability of incorrectly rejecting the null hypothesis.

A second limitation of the contingency tests arises from errors in measuring discretionary accruals. Total accruals are used as a proxy for discretionary accruals. Measurement errors for this proxy are correlated with the firm's cash flows from operations and earnings, the variables used to assign company-years to portfolio UPP, MID and LOW. This relation could explain the contingency results. For example, inventory accruals reflect physical inventory levels.[14] If there is an unexpected increase in demand, physical inventory levels and non-discretionary accruals will fall and cash flows from operations increase, consistent with the results reported for portfolio UPP in table 3. However, an unexpected decrease in demand will increase physical inventory levels and nondiscretionary accruals and decrease cash flows from operations, opposite to the theory's predictions for portfolio LOW.

A third limitation of the contingency tests arises from errors in measuring earnings before discretionary accruals. Cash flows are a proxy for this variable and are used to assign company-years to portfolios MID and UPP. Errors in measuring earnings before discretionary accruals are perfectly negatively correlated with measurement errors in discretionary accruals since the sum of the actual variables (earnings before discretionary accruals and discretionary accruals) are constrained to equal the sum of the measured variables (cash flows and total accruals) by the accounting earnings identity. This implies that a disproportionate number of company-years with positive measurement error in earnings before discretionary accruals will be assigned to portfolio UPP. These observations have negative measurement errors in discretionary accruals, increasing the probability of incorrectly rejecting the null hypothesis.

[14] Managers therefore have an incentive to manage inventory levels, as well as to select accounting procedures, to maximize the value of their bonus compensation [see Biddle (1980)].

The tests presented in sections 5.2 and 6 are designed to control for the effects on the contingency results of measurement errors in discretionary accruals and in earnings before discretionary accruals.

5.2. Additional tests and results

Additional tests compare accruals for firms whose bonus plans include an upper bound with accruals for firms whose plans contain no upper limit. The theory predicts that managers whose bonus plans include an upper bound have an incentive to select income-decreasing discretionary accruals when that limit is triggered. Ceteris paribus, managers compensated by schemes with no ceilings on earnings are expected to select income-increasing discretionary accruals. This implies that, holding earnings before discretionary accruals constant, discretionary accruals are lower for company plans with a binding upper bound than for firms whose bonus plans exclude an upper bound. This relation reverses when the upper bound is not binding since I assume that discretionary accruals affect only the timing of reported earnings. Discretionary accruals are therefore higher for company plans with a non-binding upper bound than for firms whose plans do not include an upper bound.

Tests of these implications of the theory control for measurement errors in discretionary accruals. They compare measured discretionary accruals (total accruals) for company-years with equivalent cash flows but different bonus plans – plans with and without an upper bound. If the measurement errors are independent of the existence of an upper bound in the bonus plan,[15] the tests isolate discretionary accrual differences between companies with these different types of bonus plans.

The tests also control for errors in measuring earnings before discretionary accruals by comparing accruals for company-years with equivalent measured earnings before discretionary accruals (cash flows) but with bonus plans that include and exclude an upper bound. If measurement errors are independent of the existence of an upper bound in the bonus plan, the estimates of discretionary accrual differences between companies with these two types of bonus plans are unbiased.

The additional predictions of the theory are tested using all company-years for which earnings exceed the lower bound (i.e., portfolios MID and UPP). The observations are divided into two samples: company-years when the bonus plan specifies an upper bound, and company-years when no such limit is defined. The tests are constructed to compare accruals for these two samples holding cash flows constant. The following test design is implemented:

[15] Weak evidence to support this assumption is presented in Healy (1983). He finds that companies whose bonus plans include and exclude an upper limit do not have different means and variances of leverage, firm value, the ratio of gross fixed assets to firm value, and systematic risk. Leverage is defined as the ratio of long-term debt to firm value, and firm value is the sum of the book values of debt and preferred stock and the market value of common stock.

(1) Company-years with a bonus plan upper bound are assigned to one of two portfolios. The first comprises observations whose cash flows exceed the upper bound. The second contains company-years when the upper bound is not binding.

(2) Company-years with a binding upper bound are arrayed on the basis of cash flows (deflated by the book value of total assets) and deciles are constructed. Mean accruals and cash flows (both deflated by total assets) are estimated by decile.

(3) Company-years with no bonus plan upper bound are assigned to one of ten groups. The groups are constructed to have mean deflated cash flows approximately equal to the means of the deciles formed in Step 2. The high and low deflated cash flows for each decile are used as cutoffs to form the ten groups; a company-year with no upper bound is assigned to a group if deflated cash flows are within its cutoffs. Mean deflated accruals and cash flows are estimated for each group.

The mean deflated accruals and cash flows are reported in table 4 by decile for company-years with a binding upper bound and by a group for company-years with no upper bound. The theory predicts that, holding cash flows constant, accruals are lower for companies with a binding bonus plan upper bound, than for companies with no upper bound. The results support the theory: mean accruals are less for company-years with a binding upper bound in nine of the ten pairwise comparisons reported in table 4, panel A. The Sign and Wilcoxon Signed-Ranks tests are used to evaluate whether this result is statistically significant.[16] The Sign test is significant at the 0.0107 level and the Wilcoxon Signed-Ranks test at the 0.0020 level.

The test design is replicated to compare company-years whose upper bound is not binding with company-years whose bonus plan contains no upper bound. The theory predicts that, holding cash flows constant, accruals are higher for companies with a non-binding bonus plan upper bound, than for companies whose plan contains no upper bound. Company-years for which the upper bound is not binding are arrayed on the basis of cash flows and deciles are formed. The high and low cash flows for these deciles are used to form ten groups for company-years with no plan upper bound. Mean deflated accruals and cash flows are reported in table 4, panel B by decile for company-years with a non-binding upper bound, and by group for company-years with no upper bound. The results are consistent with the theory: mean accruals for company-years when the bonus plan upper bound is not binding are greater than mean accruals for company-years with no upper bound in nine of the ten pairwise comparisons. The Sign test is significant at the 0.0107 level and the Wilcoxon Signed-Ranks test at the 0.0068 level.

[16]The Sign test and Wilcoxon Signed-Ranks test assume that assignments to test and control groups are random. For a detailed description of the tests see Siegel (1956, pp. 67–83).

Table 4

Results of tests comparing accruals for companies whose bonus plans include and exclude an upper bound holding cash flows constant.

	Average cash flows[b] by decile for company-years whose bonus plan		Average accruals[b] by decile for company-years whose bonus plan		
Decile[a]	Includes an upper bound	Excludes an upper bound	Includes an upper bound	Excludes an upper bound	Difference in average accruals[c]
Panel A: Accruals for company-years when the bonus plan's upper bound is binding compared with accruals for company-years with no upper limit defined in their bonus plan					
1	0.0681	0.0658	−0.0044	0.0099	−0.0143
2	0.0912	0.0927	−0.0048	−0.0091	0.0043
3	0.1066	0.1066	−0.0341	−0.0191	−0.0150
4	0.1158	0.1163	−0.0585	−0.0280	−0.0305
5	0.1271	0.1277	−0.0611	−0.0320	−0.0291
6	0.1368	0.1382	−0.0611	−0.0349	−0.0262
7	0.1481	0.1485	−0.0660	−0.0399	−0.0330
8	0.1580	0.1574	−0.0729	−0.0399	−0.0330
9	0.1784	0.1775	−0.0908	−0.0456	−0.0452
10	0.2445	0.2183	−0.0870	−0.0694	−0.0176
	Sign test			0.0107	
	Wilcoxon Signed-Rank test			0.0020	
Panel B: Accruals for company-years when the bonus plan's upper bound in not binding compared with accruals for company-years with no upper limit defined in their bonus plan					
1	−0.0754	−0.0444	0.1235	0.1011	0.0224
2	0.0355	0.0342	0.0277	0.0348	−0.0121
3	0.0612	0.0628	0.0150	0.0099	0.0051
4	0.0857	0.0840	−0.0040	−0.0042	0.0002
5	0.1039	0.1045	0.0055	−0.0161	0.0216
6	0.1257	0.1263	−0.0174	−0.0323	0.0321
7	0.1482	0.1465	−0.0261	−0.0354	0.0093
8	0.1687	0.1675	−0.0314	−0.0449	0.0135
9	0.1953	0.1962	−0.0430	−0.0587	0.0157
10	0.2547	0.2499	−0.0474	−0.0836	0.0362
	Sign test			0.0107	
	Wilcoxon Signed-Rank test			0.0068	

[a] Company-years for which the bonus plan upper limit is binding (panel A) or not binding (panel B) are arrayed on the basis of cash flows (deflated by total assets) and deciles are formed. The high and low cash flow values for these deciles are used to form ten groups for company-years with no upper bound. Mean cash flows and accruals (both deflated by total assets) are estimated for each group/decile.

[b] Cash flows and accruals are deflated by the book value of total assets.

[c] The compensation theory predicts that the difference is negative (panel A) or positive (panel B).

7. Changes in accounting procedure tests and results

The effect of voluntary changes in accounting procedures on earnings is also used to test the implications of the theory. The proxy used in section 6, accruals, reflects both discretionary and non-discretionary accruals and accounting procedures. Voluntary changes in accounting procedures reflect purely discretionary accounting procedure decisions.

Reported changes in accounting procedures are available from two sources: the sample of depreciation switches used by Holthausen (1981) and changes reported by Accounting Trends and Techniques. Accounting changes are collected from these sources for the sample companies from 1968 to 1980. Procedure changes are decomposed according to the type of change and a summary is presented in table 5 for the full sample (342 changes) and for the changes whose effect on earnings is disclosed in the footnotes (242).

The effect of each accounting procedure change on earnings and equity is collected from the financial statement footnotes. In 100 cases the effect of the change is described as immaterial or not disclosed. A further 49 changes report only the sign of the effect on earnings. These are coded to indicate whether the effect is positive or negative.

7.1. Contingency tests

The contingency tests are replicated using the effect of changes in accounting procedures on earnings available for bonuses as a proxy for discretionary accounting decisions. Earnings available for bonuses are reported earnings, defined in the bonus plan, less the lower bound. If the effect of the accounting change on this variable is positive (negative), the change is classified as income-increasing (income-decreasing). Company-years are assigned to portfolios LOW, MID and UPP using the method adopted in section 6, and contingency tables are constructed to compare the incidence of income-increasing and income-decreasing accounting procedure changes for each portfolio. The results do not support the theory. However, there are several potential explanations of this finding:

(1) Casual evidence suggests that it is more costly for managers to transfer earnings between periods by changing accounting procedures than by changing accruals. Companies rarely change accounting procedures annually – for example, changes to straight line depreciation in one year are typically not followed by a change to other depreciation methods in succeeding years. Managers appear to have greater flexibility to change accruals. For example, they can accelerate or defer recognition of sales, and capitalize or expense repair expenditures.

(2) Changes in accounting procedures affect earnings and the bonus plan lower bound in the current and future years. Managers consider the effect of

alternative accounting methods on the present value of their bonus awards. However, the effect of a procedure change on the accounting numbers is only publicly disclosed for the year of the change. This proxy therefore fails to control for the effect of accounting procedures on bonus awards in future years.

The tests presented in section 7.2 control for these problems.

Table 5

Summary and decomposition of changes in accounting procedures for a sample from the Fortune 250 over the period 1968–1980.

Type of change	Full sample (342 changes)	Subsample with earnings effect disclosed (242 changes)
Miscellaneous	19	12
Inventory		
Miscellaneous	16	9
To LIFO	64	63
To FIFO	3	3
Depreciation		
Miscellaneous	11	6
To accelerated	3	1
To straight-line	27	25
To replacement cost	2	1
Other expenses		
Miscellaneous	20	12
To accrual	12	8
To cash	5	4
Actuarial assumptions for pensions	68	54
Revenue recognition	3	1
Entity accounting		
Miscellaneous	21	8
To inclusion in consolidation	21	1
To equity from unconsolidated	47	34
	342	242

Disclosure of effect on net income		
Effect on earnings disclosed		242
Estimate given in dollars	193	
Directional effect reported	49	
Effect undisclosed or described as immaterial		100
		342

Table 6

Association between voluntary changes in accounting procedures and the adoption or modification of a bonus plan.

	Mean number of voluntary accounting changes per firm		
Year[a]	Sample changing bonus plan	Sample not changing bonus plan	Difference in means
1968	0.6364	0.1161	0.5203
1969	1.0000	0.0932	0.9068
1970	1.3333	0.2250	1.1080
1971	0.2000	0.1780	0.0220
1972	0.2000	0.1102	0.0898
1973	0.2500	0.1739	0.0761
1974	0.5000	0.4132	0.0868
1975	0.4000	0.2458	0.1542
1976	0.5000	0.1818	0.3182
1977	0.0000	0.0250	−0.0250
1978	0.0000	0.0417	−0.0417
1980	0.0000	0.1983	−0.1983
		Sign test	0.0730
		Wilcoxon Signed-Rank test	0.0212

[a]No results are reported for 1979 since none of the sample companies adopted or modified their bonus plan in that year.

7.2. Tests of the association between bonus plan changes and changes in accounting procedures

Watts and Zimmerman (1983) postulate that changes in the contracting or political processes are associated with changes in accounting methods. For example, companies are more likely to voluntarily change accounting procedures during years following the adoption or modification of a bonus plan, than when there is no such contracting change. To test this hypothesis, useable sample companies[17] are partitioned into two portfolios for each of the years 1968 to 1980. One portfolio comprises companies that adopt or modify their bonus plan; the other contains companies that have no such contracting change.

Bonus plans are adopted or modified at the annual meeting, which typically occurs three or four months after the fiscal year end. The mean number of voluntary accounting changes per firm reported at the end of the following fiscal year is estimated for companies that modify and adopt bonus plans and for companies with no bonus plan change for each of the years 1968 to 1980. A greater number of voluntary changes are expected for the sample of firms

[17]The sample includes the 94 companies used in earlier tests and the 27 companies formerly excluded because their bonus plan upper limit was a function of participating employees' salaries.

adopting or modifying bonus plans, than for firms with no such change. The Sign and Wilcoxon Ranked-Sign tests are used to evaluate whether the mean number of changes per firm differ for firms with and without a bonus plan change.

The test mitigates one of the limitations of the contingency tests. The proxy for the managers' accounting decisions in those tests, the effect of an accounting procedure change on bonus earnings in the year of the change, ignores the effect on future years' bonus earnings. Tests of the association between bonus plan modifications/adoptions and the incidence of changes in accounting procedures avoid estimating this effect.

Test results are reported in table 6. The mean number of voluntary changes in accounting procedures is greater for firms with bonus plan changes than for firms with no such change in nine of the twelve years. No means are reported for 1979 because no sample companies introduced or modified bonus plans in that year. The Sign and Wilcoxon Signed-Rank tests are statistically significant at the 0.0730 and 0.0212 levels respectively, consistent with the hypothesis that changes in bonus schemes are associated with changes in accounting procedures.

8. Conclusions

Bonus schemes create incentives for managers to select accounting procedures and accruals to maximize the value of their bonus awards. These schemes appear to be an effective means of influencing managerial accrual and accounting procedure decisions. There is a strong association between accruals and managers' income-reporting incentives under their bonus contracts. Managers are more likely to choose income-decreasing accruals when their bonus plan upper or lower bounds are binding, and income-increasing accruals when these bounds are not binding. Results of tests comparing accruals for firms whose bonus plans include and exclude an upper bound further support the theory: holding cash flows constant, accruals are lower for company-years with binding bonus plan upper bounds than for company-years with no upper bound. This difference in the timing or reported earnings is offset when bonus plan upper limits are not binding.

Tests of the theory also use voluntary changes in accounting procedures as a proxy for discretionary accounting decisions. The results suggest that there is a high incidence of voluntary changes in accounting procedures during years following the adoption or modification of a bonus plan. However, managers do not change accounting procedures to decrease earnings when the bonus plan upper or lower bounds are binding.

The paper raises several questions for future investigation. First, why do bonus contracts reward managers on the basis of earnings, rather than stock price? Second, what are the other incentive effects of bonus contracts? Finally, what are the joint incentive effects of bonus schemes and other forms of compensation, such as performance plans?

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REPORT OF STAFF'S FINDINGS INTO THE ADEQUACY OF THE CALL CENTERS SERVING MISSOURI AMERICAN WATER COMPANY

CASE NO. WO-2014-0362

PREPARED BY:

MISSOURI PUBLIC SERVICE COMMISSION

ENGINEERING AND MANAGEMENT SERVICES UNIT

June 15, 2015

**** <u>Denotes Highly Confidential Information</u> ****

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REPORT OF STAFF'S FINDINGS

CASE NO. WO-2014-0362

MISSOURI-AMERICAN WATER COMPANY CALL CENTERS

ENGINEERING AND MANAGEMENT SERVICES UNIT

Lisa Kremer and Debbie Bernsen

INTRODUCTION AND EXECUTIVE SUMMARY

On June 20, 2014, the Staff of the Missouri Public Service Commission ("Staff") filed *Staff's Motion To Open Investigatory Docket* and it was assigned Case No. WO-2014-0362, *In the Matter of Staff's Investigation into the Adequacy of the Call Centers serving Missouri American Water Company ("MAWC", "Missouri American" or "Company")*. This motion was filed in response to the Staff Report filed March 14, 2014, in Case No. WC-2014-0138. Case No. WC-2014-0138 is a case consisting of the consolidation of a numerous formal customer complaints and was filed by the Office of the Public Counsel ("OPC") on November 13, 2013. The complaints were from the Company's Stonebridge Village, Branson West, Missouri service area ("Stonebridge" or "Stonebridge Village"). In its report, "… *Staff found MAWC violated 16 distinct provisions of Chapters 10 and 13 of 4 CSR 240, did not take timely or reasonable actions to mitigate those violations or prevent additional violations …*".

The Staff Report in Case No. WC-2014-0138 stated "*Staff began receiving an increase in customer complaints and inquiries from not only MAWC's customers in Stonebridge, but from other customers throughout MAWC's other service territories.*" The increase in complaints appeared to coincide with the implementation of a new billing customer information system (CIS) which was part of the Business Transformation Missouri project in May 2013. Total Missouri American PSC residential customer complaints from 2008 through April 30, 2015 are presented in Schedule 1 (attached). The Company serves approximately 460,000 customers.

In Case No. WO-2014-0362, *Staff's Motion To Open Investigatory Docket* indicated that many of the customer complaints that culminated in the creation of Case No. WC-2014-0138 concerned MAWC's Call Centers. Customer complaints received by Staff indicated that Call Center personnel were not reliably knowledgeable and courteous. Staff's motion to open Case No. WO-2014-0362 went on to state that the billing inaccuracies that were found at Stonebridge

Village were significantly exacerbated by the failure of MAWC's Call Centers to allay customer concerns, promptly resolve billing errors and disseminate accurate information.

Six recommendations were made to MAWC management regarding the operation of its Call Centers in the context of Case No. WC-2014-0138. Staff is of the opinion that those six recommendations continue to require the Company's diligent action to not only verify their completion but to ensure their continued implementation. Staff concerns remain regarding the Company's operation of its Call Center.

The Call Center recommendations the Staff made in the context of Case No. WC-2014-0138 are reiterated, with minor revision, in this present report as well as additional recent findings. Staff's present report is organized in the following manor:

- Introduction and Executive Summary
- Implementation Reporting
- Staff's Investigation Activities In Case No. WO-2014-0362
- Significance of Missouri's Regulated Utility Call Centers
- American Water Works Company, Inc.: Call Center Structure
- Customer Complaints that Prompted Staff's Investigation
- Special Care Group For Stonebridge Customers
- Call Center Training
- Findings, Conclusions and Recommendations

Staff's recommendations to the Company resulting from its investigation include the following:

<u>STAFF RECOMMENDS THAT COMPANY MANAGEMENT</u>:

1. *<u>Ensure that Customer Service Representatives are sufficiently trained to respond in a timely manner to all customer inquiries including those regarding customer billing statements, service territories served and other inquiries. Evaluate training materials periodically and the manner in which Call Center representatives are trained regarding issues such as billing calculations, wastewater usage calculations, service territories and make improvements when necessary.</u>*

2. *<u>Implement methods to ensure that the Company's Call Escalation Policy is followed and review periodically to ensure compliance for all Missouri calls.</u>*

3. *Perform a comprehensive operational audit of the American Water Works Company, Inc. Call Centers that serve MAWC customers. The audit should commence in calendar year 2016 and include but not be limited to operational areas such as: call quality control, adherence to Company Call Center policies and procedures, accurate and timely responses to customer inquiries including those regarding billing, appropriate call escalation to supervisory personnel, verification of return calls to customers, accurate calculation of bills from multiple Missouri service territories with differing tariffs and call center performance metrics.*

4. *Design and implement a procedure to ensure all Missouri American customers requesting a return or follow-up phone call from the Company's Call Center, including those requested from supervisory personnel, have their calls returned.*

5. *Ensure that all Missouri customer calls to the Company's Call Center are documented with detail on the customer's account and include steps and Company commitments made to obtain resolution.*

6. *Develop a system to monitor the types of inbound calls received at the Company's Call Center so that the Company can identify critical customer reported trends and respond with corrective action if necessary.*

7. *Evaluate the benefits of reducing the number of regulated utilities, in the American Water Works Company, Inc., in which Call Center representatives are required to be experts. Analyze the merits of specializing Call Center representatives into fewer states.*

8. *Inform the Staff and the Office of the Public Counsel promptly when significant operational or service quality performance changes are planned or occur.*

9. *Record 100 percent of all customer calls between Call Center Representatives and Missouri-regulated customers. Archive recorded phone calls for a period of no less than 12 months and in a manner that they may be retrieved and reviewed by the Company, Staff and OPC.*

IMPLEMENTATION REPORTING

In the Staff's opinion, it is important that the Company document and inform Staff regarding the specific actions the Company plans to take to address each of the recommendations in this report. It is further important that the Company keep Staff informed of its progress toward implementation of these recommendations. To that end, the Staff requests the Commission to order the Company to provide Staff, within 30 days of the filing of the report, a formal implementation plan that addresses each recommendation within the report. In addition, the Staff also requests the Commission to order the Company to file in the PSC's Electronic Filing and Information System ("EFIS"), bi-annual status reports regarding utility progress toward addressing each recommendation. Such reporting will continue until such time as Staff verifies that the intent of the recommendations has been fulfilled.

STAFF'S INVESTIGATION ACTIVITIES IN CASE NO. WO-2014-0362

During its' investigatory work in Case No. WO-2014-0362, Staff submitted 123 data requests (DR). The DRs were submitted on July 3, 2014; July 22, 2014; August 26, 2014; October 7, 2014; October 27, 2014; November 12, 2014; December 23, 2014; March 31, 2015; April 1, 2015 and April 24, 2015. Staff has also conducted numerous on-site meetings, observations, and conference calls with Company representatives throughout its investigation as well as listened to numerous call recordings.

Four PSC staff members conducted an introductory meeting on October 7, 2014, at the Alton Illinois Call Center and also conducted call monitoring and employee interviews at the Alton Call Center on October 7 and 8, 2014. Two staff members conducted employee interviews at the Alton Call Center and conducted live call monitoring at the Alton and Pensacola, Florida Call Centers on October 29 and 30, 2014. Additional employee interviews were conducted by Staff at the Alton Call Center on January 13 and 14, 2015. On March 9, 2015, Staff met with Company personnel at the Alton Call Center to review the Company's response to DR No. 31. The Staff met with Company personnel and shadowed Company employees at its Belleville, Illinois Workforce Management Center on Tuesday, March 10, 2015. Staff also reviewed recorded customer calls on February 3 and 4, 2015, at the Commission's office. These recorded customer calls were ones chosen by Company personnel.

Additional specific customer call recordings were requested by Staff regarding a March 25, 2015 fire in the Stonebridge Village community that occurred at the home of ** ____________ . ** Staff and Company listened to one specific call together on May 5, 2015 at the Commission's Jefferson City office as well as observed various screens the Call Center representative reviewed and utilized in responding to the call.

During Staff's investigation in Case No. WO-2014-0362, the periodic meetings continued between Staff and the Company. Two periodic meetings were held at the Company's corporate office on July 24, 2014 and on November 6, 2014. A periodic meeting via a conference call was held January 29, 2015. A periodic meeting was also conducted May 29, 2015 via a conference call.

The Staff filed Status Reports to the Commission in Case No. WO-2014-0362 on August 4, 2014; September 8, 2014; October 6, 2014; November 12, 2014; December 5, 2014; January 9, 2015; February 9, 2015; March 6, 2015; April 4, 2015; May 4, 2015, and June 2, 2015.

The Staff does receive monthly call center metrics regarding average speed of answer ("ASA"), abandoned call rate (ACR), staffing, call volume and other useful data by which the Staff monitors specific aspects of the American Water Works Company, Inc.'s call center performance. Such measurements provide critical information in aspects of call performance and the Staff has not had significant concerns with the specific answer and call abandoned data it has been receiving from the Company. This information, however, will not capture other crucial "qualitative" aspects of performance, which is the subject of this investigation, such as specific information customers are provided and whether that information is in compliance with Commission rule and Company tariffs, the manner in which customers are treated, whether the Call Center returns calls when requested, whether calls are appropriately escalated and other critical information that does not readily lend itself to metrics.

SIGNIFICANCE OF MISSOURI'S REGULATED UTILITY CALL CENTERS

Regulated utility call centers perform a critical function in that they often serve as the primary means for customers to contact their utilities. Customers require contact with their utilities regarding a wide range of issues including:

- Report emergencies and service outages.
- Begin, discontinue, transfer or restore service.
- Make inquiries regarding bills and delinquent accounts.
- Make payment arrangements.
- Convey complaints and/or disputes.

It is imperative that call centers function in an effective manner. As many regulated utilities have done in Missouri, Missouri American has closed local business offices that once accommodated walk-in-traffic and provided customers with a utility presence in their community. As local business offices have closed, the role of utility call centers has become increasingly important as the primary point of customer communication and contact.

Call centers function in a variety of ways with varying degrees of performance. Factors that contribute to a call center's success include the sophistication of a Company's customer information system (CIS); the call center's recruitment, selection and hiring processes; the thoroughness of the training of the call center's representatives, the number of experienced staff and sufficient staffing levels; and the continual monitoring and review of call handling.

Call center representative recruitment, training and retention are particularly important in that representatives must be prepared to answer a variety of customer inquiries. These inquiries include questions regarding Company policies and procedures as well as Company tariffs and Commission rules. Accurately documenting customer information is also a critical element in the utility customer service function as well as "soft" skills of tone and demeanor.

AMERICAN WATER WORKS COMPANY, INC.: CALL CENTER STRUCTURE

Missouri American customers are served by two "Customer Service Centers" (CSCs) owned by American Water Works Company, Inc. frequently referred to as 'Call Centers.' One Call Center is located in Alton, Illinois and the other in Pensacola, Florida. The Company indicates that these two locations operate as a 'one virtual' customer service center. The two Call Centers serve 15 state regulated water and sewer operations the Company owns including: California American Water, Hawaii American Water, Illinois American Water, Indiana American Water, Iowa American Water, Kentucky American Water, Maryland America Water, Michigan American Water, Missouri American Water, New Jersey American Water, New York American Water, Pennsylvania American Water, Tennessee American Water, Virginia American Water and West Virginia America Water. All Call Center representatives respond to all calls.

The Company's business model includes having its Call Center representatives respond to a myriad of customer questions, requests and concerns from 15 different states. However, Staff has strong reservations regarding the operational practicality of such expectations upon representatives being required to be proficient and adept in knowing and distinguishing between the unique rules and regulations of 15 state utility commissions. Although Staff's ability to make a conclusive finding is limited without recorded phone calls, Staff suspects this operational practice has contributed in some manner to the deficiencies identified and reported by Missouri American customers when calling the American Water Works Company, Inc. Call Centers.

Customers calling Missouri American encounter the Company's 'interactive voice response unit' or IVR to make a selection for information or assistance. Interactive voice response units are commonly used by the other Call Centers of Missouri regulated utility companies. Main menu options of the IVR exist to assist customers without the initial aid of a Customer Service representative (CSR) and to direct calls by subject area to either a self-serve option or to subsequently speak to a representative. Self-serve options include the ability to make a payment, response to certain billing questions, initiating and terminating service and reporting emergencies. From the menu selections in the IVR, customer calls flow into queues based upon the menu choices selected and are answered by CSRs. Customers calling to report emergencies can have their calls routed to a CSR through the IVR. All calls routed to a CSR are transferred to the next available representative, whether the representative is located in Alton or Pensacola as all calls are responded to out of a shared queue.

CUSTOMER COMPLAINTS THAT PROMPTED STAFF'S INVESTIGATION

During the course of its investigation into Case No. WC-2014-0138, *The Office of the Public Counsel et al., Complainants v. Missouri-American Water Company, Respondent*, Staff was made aware of significant customer dissatisfaction with Missouri American's Call Center. Twenty-five formal customer complaints were filed that comprised Case No. WC-2014-0138, which in addition to billing errors, identified concerns, deficiencies and/or dissatisfaction with the Company's Call Center performance. Specifically identified were allegations of ineffective and/or poor customer service ranging from the Company's inability to explain the Stonebridge customers' billing statements, inaccurate information, lack of requested returned calls to customers, and service that was discourteous. Specific customer remarks included comments that service was "unfriendly" and not "accommodating."

Forty-six public comments submitted in EFIS in Case No. WC-2014-0138 included 44 customers' public comments related to billing issues and also expressed concerns with the Call Center's inability to answer the Stonebridge customers' questions. Of the 44 public comments, 23 customers expressed dissatisfaction with the Call Center representatives being unable to resolve customer issues or transfer them to another employee that could explain their bills. Some Stonebridge customers asserted the Company had committed to return customer phone calls directly from the Billing Department, but such follow-up phone calls from the

Billing Department were never received. Staff attempted, but was unable to make contact with all 44 customers to further investigate customer comments.

On November 21, 2013, a customer meeting was held at the Stonebridge clubhouse and was attended by Missouri American representatives, OPC, Staff and approximately 130 customers. Many types of service quality concerns were raised by Missouri American customers regarding multiple, inaccurate bills, and dissatisfaction and frustration with the Company's Call Center representatives' responsiveness when they called to try to resolve their billing issues.

The Company indicates that five percent of all customer calls to the Call Center received by CSRs are recorded. Even with only five percent of the calls being recorded, Staff was able to listen and evaluate 46 phone calls which were provided by the Company in response to DR No. 3, which was submitted in the individual Stonebridge customer complaints prior to the consolidation of the Complaints in Case No. WC-2014-0138. These recorded calls were between the Company and the Stonebridge customers that filed individual formal complaints. The following observations were noted:

- CSRs were generally unable to explain or answer customers' questions.
- Incorrect information was provided to the Stonebridge customers.
- Six of the 46 calls reviewed during the formal complaint investigation were placed prior to the implementation of the Company's Business Transformation system and were not related to specific billing errors in the Stonebridge area.
- CSRs were not able to resolve the matter of issue in 34 of the 46 Stonebridge calls reviewed by Staff.
- CSRs did not transfer the call to appropriate employees.
- CSRs appeared to be unfamiliar with the billing errors in the Stonebridge area.
- 27 instances were noted in which CSRs provided customers incorrect information or promised a billing review follow-up that did not occur or the follow-up call was not received by the customer.
- Two of the 27 customers were informed the bills were late due to the holiday and another customer was informed of an incorrect method of calculating a sewer bill. Six instances in which customers experienced hold times greater than four minutes in length in which the CSR did not

communicate with the customer or ***provided*** an updated status while researching the account.

- One customer experienced a hold time of 30 minutes and another customer was holding 15 minutes with a result ending in a disconnected call.
- Eighty-five percent of the calls reviewed occurred after the Business Transformation (BT) implementation did not result in appropriate resolution.
- Four calls Staff considered resolved on first contact, but they were not related to the Stonebridge Village billing issues and included such things as customers requesting an account number, initiating service, making a payment and reporting a problem with a grinder pump.
- CSRs interrupted and were discourteous to customers that had additional questions or had concerns with the explanation provided.
- CSRs were argumentative and failed to listen to the customers' requests for information.

Staff also identified numerous opportunities for improvement in the quality of the call recordings which supports customer comments made during the investigation of the individual formal customer complaints, in the public comments and at the Stonebridge November 21, 2013, meeting. In Staff's opinion, the majority of the incoming calls regarding the Stonebridge billing errors were not handled appropriately. These calls required additional information from the Company and/or identified coaching and additional training opportunities for the CSRs to obtain resolution. Schedule 2 (attached) presents MAWC PSC customer complaints that included comments to PSC Consumer Services Staff of service quality concerns when calling the MAWC Call Center.

SPECIAL CARE GROUP FOR STONEBRIDGE CUSTOMERS

In response to Staff's DR No. 5 in Case No. WC-2014-0138, the Company informed Staff that customers contacting the Company's Call Center with billing questions could contact a "Special Care Group" through direct telephone numbers which were provided to the Stonebridge customers. The Company further stated that the Special Care Group consisted of nine employees and had voicemail in the event the group was unavailable to accept the customers' calls. The Company's response to DR No. 4 (Case No. WC-2014-0138) stated "*All billing inquiries* *from customers in the Stonebridge area are to be escalated to the ART Team (Account Resolution Team) for a detailed explanation of the charges and corrections on their bills were the instructions provided to CSR's via talking points*."

Some of the Stonebridge customers informed the Staff that a Special Care Group was available when they contacted the Company's Call Center; but, the majority of Stonebridge customers reported that when they contacted the Company's Call Center and informed the Call Center representative that they needed to be transferred to the "Special Care Group", the CSRs were unaware of any such group. This caused increased confusion and frustration for the Stonebridge customers and encouraged many customers to cease efforts to continue to work with the Company. This situation also identified deficiencies in the communication and ongoing training of the Company's Call Center.

In response to Staff's DR No. 6 (Case No. WC-2014-0138), the Company provided a list of customers that the Special Care Group attempted to contact; however, the response lacked results of the communication and whether or not contact was made between the Company and the Stonebridge customers. Staff was unable to determine from the Company's response the overall outcome and results from the attempt to reach out to the customers. Some customers provided feedback and informed Staff that they were contacted by Company personnel, but in most instances their bill was still not fully and clearly explained to them. Staff was later informed by the Company that there was no tracking mechanism in place for all the incoming Stonebridge customer inquiries.

In response to DR No. 46 (Case No. WC-2014-0138), the Company informed Staff "*The Account Resolution Team did make outbound calls to Stonebridge customers. The team was not and is not exclusive to Stonebridge customers. The team has not been disassembled, and is still available for customer escalations for all American Water Customers, not exclusive to Missouri.*" Staff is uncertain if the nine employees listed in the Company's response to DR No. 3 (Case No. WC-2014-0138), is considered the entire ART team, if these members received special training, or even how familiar the Special Care Group was with the billing errors that had occurred at Stonebridge. Furthermore, Staff is uncertain if the CSRs at the two Call Centers were made aware prior to January 22, 2014, that they were to transfer the Stonebridge customer calls to the ART team. Subsequently, in an update meeting between Staff and the

Company on January 3, 2014, Staff was made aware by the Company that the Special Care Group had been disbanded.

Staff also heard from multiple Stonebridge customers that their requests to have their call to the Call Center escalated to a supervisor were denied. Staff also observed this denial when Staff listened to available recorded phone calls provided by the Company. Staff is aware of no other Missouri regulated utility that has had such an extent of customer allegations of Company refusals to escalate calls. In Case No. WC-2013-0010, *Marcia Eason, Complainant v. Missouri-American Water Company, Respondent*, the same allegation of customer calls being denied escalation was made. Likewise, few available recorded customer phone calls to the Company's Call Center limited Staff's ability to thoroughly investigate the customer's concern, although the Company did provide evidence it had revised its call escalation process. The Staff Memorandum filed on October 5, 2012, in the Marcia Eason case addressed staff's investigation into two other recent informal customer complaints that involved the Company's alleged denial to escalate calls. The report also addressed the Engineering and Management Services review of 631 public comments in the context of Case No. WR-2011-0337 that included twenty-nine instances in which customers indicated they requested to speak to a supervisor and were denied. Without call recordings, the Company's internal control and Staff's ability to thoroughly investigate such allegations is hindered. Documented account notes coupled with call recordings is the most effective manner to determine what actually was committed to, expressed and occurred between a customer and the utility by which it is served.

CALL CENTER TRAINING

The Company and Staff began participating in bi-weekly meetings in August 23, 2013. The training of the Company's CSRs was discussed at length during a number of those meetings. The bi-weekly meetings discontinued the end of June 2014 and the Staff and Company personnel moved to meeting on a less frequent, periodic basis to discuss Call Center operations and other topics. Such Company and Staff meetings to address service quality concerns were defined in a Non-Unanimous Stipulation and Agreement filed on February 24, 2012, and ordered by the Commission on March 7, 2012 in Case No. WR-2011-0337.

The Company indicates that one training method utilized includes a scrolling text in the broadcast bar located at the bottom of the CSR's computer screen. While a scrolling text is one method of communication to the CSRs, Staff is concerned that the CSRs may not always read the scrolling text or recall it after the scroll is completed. Further, the Company has indicated that it is possible that some CSRs would only read the scrolling text when they would receive a customer call regarding the subject matter. The complexity, magnitude and variability of the Stonebridge customer billing statement errors required significantly more training than the scrolling text.

The Company indicated that other types of Call Center training includes 'Water Coolers' which include brief written and verbal communications regarding specific topics and training relayed in team meetings; in spite of these efforts, it is apparent that CSRs were unable to appropriately respond to customer questions regarding the billing statements of the Stonebridge customers.

Staff requested in DR No. 47 (Case No. WC-2014-0138), the talking points the Company provided to its CSRs to enable them to explain payment arrangements and the process for the Stonebridge customers to remit payment beyond the billing due date for their December 2013 billing statements. The Company made Staff aware of these talking points at the bi-monthly meeting held January 3, 2014. Prior to receiving the response to DR No. 47 (Case No. WC-2014-0138), Staff was under the impression that all incoming calls relating to the Stonebridge customers were transferred to the Special Care Group; however, the date on the talking points was January 22, 2014, indicating the CSRs did not have the needed information prior to that time.

It is concerning to Staff that such talking points were provided to the CSRs on January 22, 2014, for them to respond to calls addressing complicated, multiple billing issues that began in May 2013. Some customers were instructed during the December 2013 Stonebridge individual customer meetings to contact the Call Center to let them know they wanted a payment extension. Staff is aware of at least one customer that followed the instructions of an American Water Works Company, Inc., Billing Supervisor at the December 2013 meetings and the Company's CSR still required him to make a payment in order to initiate a payment arrangement. The customer was also charged a fee for processing the payment by telephone and both actions were contrary to the prior commitments made by the Company to the Stonebridge customers.

It is imperative that the Company's CSRs be provided correct and sufficient information that enables them to appropriately address customer concerns and questions in a timely manner. Not providing the Company's CSRs these talking points far earlier in the process is indicative of a lack of internal control in the management of the Company's Call Center and lack of appropriate utility response to the numerous multifaceted billing errors of the Stonebridge customer accounts. The Company does attempt to evaluate eight recorded phone calls and notes' documentation each month for each Call Center representative. Staff reviewed a number of such evaluations while on-site at the Company's offices during its March 9 and 10, 2015 meetings.

Since the Company's CSRs did not have adequate and timely information to respond to the Stonebridge customer inquiries and concerns, many of the Stonebridge customers were required to contact the Company's Call Center numerous times in hopes of obtaining adequate responses to their billing questions and concerns. Many of these numerous Call Center contacts would have been unnecessary had CSRs been properly trained and adequately equipped with appropriate information to address the billing concerns of the Stonebridge customers.

The lack of recorded customer calls is of significant concern to Staff as the customers' recorded calls provide a level of Call Center monitoring and performance like no other Call Center tool. The topic of recorded calls has been addressed during numerous bi-monthly meetings and the Company has continued to indicate to Staff that it is evaluating whether or not to record phone calls; however, recently the Company has expressed that it believes it may begin recording calls by the end of 2015. The only reason the Company has given Staff as to why it does not record its customer calls is that it is a costly technology. The Company has indicated that prior to 2009 it did record customer phone calls to its Call Center.

While Commission rules do not specifically require utilities that utilize call centers to record calls, the rules clearly provide that companies should ensure "*Qualified personnel shall be available and prepared at all times during normal business hours to receive and respond to all customer inquiries, service requests and complaints.*" (Rule 4 CSR 240-13.040[2][A]). Substantial evidence exists that MAWC's Call Center has been unable to provide the level of service that is required by this Commission rule.

It is Staff's understanding that a variety of call center recording technologies exist, including more sophisticated technology that records actual "key strokes" for each call. Staff is not recommending that the Company utilize this advanced type of customer call recording technology, nor does it believe it is necessary for effective call center performance monitoring; but Staff is recommending that calls be recorded. Staff has also been informed by a number of Missouri-regulated utilities over the years that the recording of customer phone calls to their Call Centers has been highly beneficial. Some companies are presently evaluating longer periods than 12 months for archival purposes.

Staff is unaware of any large regulated utility in the state of Missouri, other than MAWC, with a centralized Call Center that does not record 100 percent of the calls between customers and CSRs. Recorded customer calls serve many managerial purposes including training, documentation, performance evaluations and quality control and assurance. The normal period of storage for recorded customer phone calls by utilities is approximately one year.

Missouri American's continued decision not to reinstate the policy of recording 100 percent of its customers' phone calls to its Call Center is, in Staff's opinion, detrimental to the service the Company is providing its Missouri customers.

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

Call Center Representative Training

Missouri American Call Center representatives were unable to adequately respond to the calls regarding billing errors received by its Stonebridge Village customers. The Staff was informed by Company personnel during a September 16, 2014 conference call that due to the complexity of the issues and difficulty of the calls received from the Stonebridge customers, Call Center representatives were unable to adequately respond to and serve its customers. The Company is required by Commission rule to have qualified personnel available to respond to all customer inquiries, service requests, safety concerns and complaints. The Companies inability to provide such qualified personnel is a violation of Commission Rule 4 CSR-240-13.040(2)(A) Inquiries, which states:

> (2) A utility shall establish personnel procedures which, at a minimum, ensure that—
>
> (A) At all times during normal business hours qualified personnel shall be available and prepared to receive and respond to all customer inquiries, service request, safety concerns, and complaints.

Significant customer evidence as discussed previously indicated that the Company was not able to adequately address customer questions and concerns during the Stonebridge billing error period and a number of reports of discourteous Call Center performance were alleged.

In the Company's response to Case No. WO-2014-0362 DR Nos. 100, 104 and 105, 32 recorded calls were provided. The following observations were made on those calls: On March 25, 2015, the General Manager of the Stonebridge Village was informed that Missouri American did not serve his community when he called to report that a fire was occurring in Stonebridge. Only one recording of three calls made the evening of March 25, 2015, by the General Manager to the American Water Works Company, Inc.'s Call Center regarding the fire that occurred in the Stonebridge Village area exits. This perhaps is one of the most disturbing aspects of the lack of recorded phone calls as these calls would be considered "emergency calls."

Representatives from Missouri American traveled to Jefferson City, Missouri, and played the one available call recording for Staff on May 5, 2015. The Company also logged-into its CIS system during its visit and Staff was able to observe the various system research the Call Center representative performed that lead the representative to inform the Stonebridge General Manager that the area was not served by Missouri American. An error in the search process led the CSR to inform the customer that the area was not served, which included the failure to use a closing 'asterisk' after a key word related to the street address was entered into the Company's customer information system. In addition, the representative did not ask further 'probing' questions which should be incumbent in any Call Center training, particularly in circumstances of emergency.

The Stonebridge General Manager was placed on hold for approximately ten minutes after he was first instructed that the Company did not serve the area about which he was reporting. When the representative returned to the call, she further indicated that Company "*did not serve the area*." While the General Manager had given an incorrect street address (** ____ **), the Company acknowledged and Staff concludes that some further 'simple' probing questions by the representative would have correctly identified the location as being one served by Missouri American. Instead, the representative informed the customer twice during the recorded conversation "*we don't serve that area.*" The extended silence the customer experienced on the call with no periodic communication from the representative indicating the status of her research, assuring the customer his matter was being continuing to be reviewed etc., is also indicative of deficient Call Center processes.

Other observations of the 32 calls include four calls with hold times in excess of seven minutes, five calls with long pauses and several calls where the representative lacked empathy. Multiple calls revealed CSRs being rude, interrupting customers and not exhibiting basic listening skills.

Regarding the Stonebridge customers billing errors and the Company's Call Center performance, the Company did experience periodic inability to attach billing statements to customer accounts which prevented Call Center personnel from being able to respond to customer inquiries regarding their bills. The Company stated in its response to DR No. 31, "*We aren't implementing those statements into our system; if the statement balance didn't match we made adjustments to the customer accounts. The statements were then scanned and attached to all of the customer accounts via PDF and can therefore be accessed by those through our billing system.*" Subsequently the Company responded in DR No. 47 that it did not know why the billing summaries were not attaching properly in the customer accounts. Without billing summaries, the CSRs lacked sufficient information to respond to customer inquiries. The Stonebridge customers should have been able to contact the Company's Call Center and obtain correct and prompt responses to their questions regarding this billing period should it be necessary. Appropriate education and call scripting would have been valuable to CSRs during the Stonebridge billing error occurrences to provide more acceptable and accurate information to customers calling into the Call Center.

The MAWC customers pay for every aspect of the service they receive including the control processes, systems, toll-free services, practices and procedures employed by utility management to provide quality service, including the Company's Call Center performance. The MAWC customers pay the costs for customer information systems; Call Center hardware and software; and the hiring, training, retention, salaries and benefits of its personnel. MAWC's Call Center is no exception to the costs included in customer rates and customers are entitled to knowledgeable and courteous Call Center representatives and good Call Center performance. When MAWC customers contact the Call Center and are provided inaccurate, conflicting or no information, not only are customers inadequately and poorly served, they may be required to contact the Call Center again to obtain their necessary information. Such repeated calls to the

Call Center are a disservice to customers and ultimately more costly as call volume is a significant factor in Staffing.

It is incumbent upon the Company to ensure that its Call Center representatives are able to provide customers contacting the Call Center in a courteous manner the accurate information being requested. Contacting the MAWC Call Center is some customers only means of obtaining necessary information and MAWC must be cognizant of this.

Staff Recommends Company Management:

1. *Ensure that Customer Service Representatives are sufficiently trained to respond in a timely manner to all customer inquiries including those regarding customer billing statements, service territories served and other inquiries. Evaluate training materials periodically and the manner in which Call Center representatives are trained regarding issues such as billing calculations, wastewater usage calculations, service territories and make improvements when necessary.*

Appropriate Call Escalations

During the course of Staff's investigation into Case No. WC-2014-0138, Staff was made aware of numerous customers reporting that their requests to speak to utility supervisory personnel were denied by the Company. In Customer Complaint/Inquiry No. I201500502 the customer stated that she contacted MAWC's Call Center twice on Monday, September 22, 2014. Neither of the two CSRs was able to answer the customer's questions and both CSRs denied the customer's request to speak to the CSR's supervisor. The customer was required to call the Commission's Consumer Service Hotline and Staff was able to contact Company personnel to obtain the answer to the customer's questions.

The Staff is aware of and has been provided revisions the Company has made periodically to its escalation policy, but policies are of limited value if they are not adhered to, repeatedly trained on, evaluated and reviewed for control. The Company's lack of recorded phone calls is detrimental to the Company's ability to control and identify deficiencies to properly escalate customer calls. If calls are not recorded, the Company's review of proper and appropriate call documentation is significantly hindered. Without recording 100 percent of all calls, Company management has limited internal control and ability to verify the adherence of its actual Call Center performance as compared to its policies, procedures and standards.

Call Center representatives who are handling customer calls and are unable to handle the customers' inquiries and then denies a customer's request to speak to a supervisor is a violation of Commission Rule 4 CSR-240-13.040(2)(A) Inquiries, which states:

> (2) A utility shall establish personnel procedures which, at a minimum, ensure that—
>
> (A) At all times during normal business hours qualified personnel shall be available and prepared to receive and respond to all customer inquiries, service request, safety concerns, and complaints.

Staff Recommends Company Management:

2. *<u>Implement methods to ensure that the Company's Call Escalation Policy is followed and review periodically to ensure compliance for all Missouri calls.</u>*

<u>Call Center Operational Audit</u>

The Company has not performed an internal or external operational audit of its Call Centers. The Company responded in Case No. WO-2014-0362 DR No. 23, that "*there were no internal or external audits of either location during that time frame*", which was 2012, 2013 and YTD May 2014. During the conference call held September 2, 2014 with Company representatives, Staff was informed that there had never been any internal or external audits performed at either of its Call Center locations.

The Company's Call Center performs a critical function for the customers of Missouri American. For some customers, the Call Center is the only means of communication with the Company. The Company's Call Center provides the opportunity for the Company to understand the needs of its customers. The need exists to optimize the triad of customers, processes and technology. A comprehensive and periodic operational audit of the Company's Call Center performance would allow the Company to determine whether it was performing qualitatively and quantitatively in the manner it should while adequately utilizing all existing information technology in its Call Center. Such a review would assist the Company in identifying necessary changes, reveal opportunities that may exist to improve standards, procedures and policies; improve business process mapping for efficient workflow; evaluate and improve management and Call Center Staff skills' training; identify needed expansion and/or upgrades of existing equipment and/or corporate culture changes.

Staff Recommends Company Management:

3. *Perform a comprehensive operational audit of the American Water Works Company, Inc. Call Centers that serve MAWC customers. The audit should commence in calendar year 2016 and include but not be limited to operational areas such as: call quality control, adherence to Company Call Center policies and procedures, accurate and timely responses to customer inquiries including those regarding billing, appropriate call escalation to supervisory personnel, verification of return calls to customers, accurate calculation of bills from multiple Missouri service territories with differing tariffs and call center performance metrics.*

Verification of Returned Phone Calls

The Company does not have a procedure in place that confirms that Team Supervisors and Team Leads return requested customer phone calls. In the Company's response to Case No. WO-2014-0362 DR No. 21, the third step of the Customer Complaint Escalation Process states:

> If a Supervisor or Team Lead is not available, the CSR should advise the customer that the supervisor is currently on another call and has requested to call the customer back. The CSR should complete a BPEM ("Business Process Exception Case") case and the supervisor will be required to contact the customer by the end of their shift, same day. However, a 24 hour call back expectation should be set.

During the September 2, 2014, conference call between the Company and Staff, Company personnel indicated that the supervisors are aware of the request from the customer to have a return phone call when the CSR completes the BPEM. However, the Company has no procedure in place that verifies all requested customer calls are returned by the Call Center supervisors. Company personnel indicated during the September 2, 2014, conference call that it is possible for the Company to "*marry up*" its information to determine if any requested customer phone calls have not been returned by the supervisors. Given the extensive customer allegations of lack of supervisory returned phone calls made to customers, greater control and verification that calls are returned is necessary.

In Case No. WC-2014-0138, the Staff heard from numerous Stonebridge customers that their requested phone calls from the Call Center were not returned. When the customers' requested phone calls are not returned, the customers are required to call the Call Center again and typically obtain a different CSR and are required to re-explain their reason for calling. Such failure to return customer phone calls delays resolution to customer inquiries and complaints. Calling the Call Center is some customers only means of contacting the Company to obtain their requested information. Therefore, the customers are dependent upon the supervisors' returning their requested phone calls to resolve their inquiry.

Further, recent review of 64 Missouri American PSC complaints from August 2013 through April 2015 noted 27 comments from customers indicating no resolution or return call from the Call Center. A spread sheet presenting the areas reported in the context of customer PSC complaints that including specific dissatisfaction with the Company's Call Center is presented as Schedule 2. As stated previously, without recorded phone calls, neither the Company nor Staff has sufficient means to thoroughly and appropriately investigate specific requests for return calls made by customers and specific commitments made by the Company to its customers. Account notes can present only a limited portion of actual utility Call Center performance. Further customer complaints typically are representative of a much larger body of customers with similar concerns. A frequently cited statistic is that 26 out of 27 customers will not complain but are as equally dissatisfied as the one customer who voices concern.[1]

It is incumbent upon the Company to provide accurate information in a courteous manner to its customers which includes returning phone calls. MAWC must ensure that all commitments to return calls from the Company's Call Center including commitments for supervisory returned phone calls to customers are honored.

Staff Recommends Company Management:

4. *<u>Design and implement a procedure to ensure all Missouri American customers requesting a return or follow-up phone call from the Company's Call Center, including those requested from supervisory personnel, have their calls returned.</u>*

<u>Customer Account Documentation</u>

Numerous customer comments received during the course of Staff's investigation into Case No. WC-2014-0138 have included customer statements of inaccurate or no information included on customer account records in the Company's Customer Information System. Staff has received numerous reports of discrepancies regarding Missouri American customer accounts including 6 of the 64 customer complaints mentioned previously that identified such issues.

[1] A Complaint Is A Gift, Janelle Barlow and Claus Moller. Second Edition Copyright 2008, p 100.

Formal PSC Commission Complaint No. C201201448 ** ________ ** embodied the seriousness and criticality of accurate account records which has been severely hindered by the Company's lack of recorded phone calls. Summarized, ** ________ ** was held responsible by the Company for service he had verbally discontinued with Missouri American but the Company had no record of such contact and held the customer liable for an approximate $2,000 arrearage. Documentation from other utilities, including Laclede Gas Company, demonstrated the customer had successfully terminated service with them but Missouri American had no record of numerous contacts with the Company the customer had alleged. The matter was later resolved in the customer's favor.

Without recorded phone calls, it is the "Company's word against the customer's word" and the majority of all 'control' regarding customer payments, reports of inadequate service, requests to discontinue and initiate service remain with the utility.

Staff Recommends Company Management:

5. *Ensure that all Missouri customer calls to the Company's Call Center are documented with detail on the customer's account and include steps and Company commitments made to obtain resolution.*

Categorization of Inbound Calls

The Company presently does not categorize the types of inbound calls it receives from its Missouri customers. Such lack of call categorization hinders the Company's ability to determine trends being reported by its Missouri customers. Such trends may include any number of customer issues such as: billing errors, Call Center training opportunities including "soft-skills," water quality reports and others. The Company's present operations of not recording customer phone calls placed significant disadvantage on the Company and its ability to monitor and control Call Center performance. A system to monitor the types of inbound calls received at the Company's Call Center would more readily enable the Company to identify and respond to issues impacting its customer service.

Staff Recommends Company Management:

6. *Develop a system to monitor the types of inbound calls received at the Company's Call Center so that the Company can identify critical customer reported trends and respond with corrective action if necessary.*

Merits of Specializing Call Center Representatives Into Smaller State Regions

As stated previously, the Staff has concerns regarding the practical ability of Call Center representatives of regulated utilities to be sufficiently capable of responding to customers served by 15 different regulated states, regardless of a new and robust customer information system. Although advances in technology have changed Call Center operations significantly over the years, Staff questions the Company's management model of requiring all American Water Works Company, Inc. representatives to ultimately be 'subject matter experts' on the unique tariffs, service territories, Commission rules and other matters for all 15 regulated states. Staff encourages the Company to explore and evaluate whether a more narrow state service territory area of responsibility may be a more efficient and effective way for Missouri customers to be served.

Other large regulated utilities in the state of Missouri, even those with significant outsourced Call Center work forces, require those work forces to serve only Missouri or a small number of states where the utilities operate. American Water Works Company, Inc. is a large corporation and its present Call Center model should be reviewed toward improving the service it provides to Missouri American customers.

Staff Recommends Company Management:

7. *Evaluate the benefits of reducing the number of regulated utilities, in the American Water Works Company, Inc., in which Call Center representatives are required to be experts. Analyze the merits of specializing Call Center representatives into fewer states.*

Increased Communication with Regulatory Personnel

Given the historical service quality issues that have occurred with Missouri American, the Staff is of the opinion that increased communication regarding known or planned operational changes, service quality performance issues and other topics should occur between the Company, Staff and OPC. Such communications regarding utility processes and practices that involve customers have multiple benefits. Missouri regulated utilities interact in various ways with the Staff and OPC including the numbers and types of communications and issues that are addressed.

Company personnel changes that have critical service quality responsibilities should be communicated with the Staff and OPC. This is a practice most, if not all, the large regulated Missouri utilities engage.

Staff Recommends Company Management:

8. *Inform the Staff and the Office of the Public Counsel promptly when significant operational or service quality performance changes are planned or occur.*

Recorded Customer Calls

The lack of 100 percent of Missouri American's customer calls being recorded is a significant detriment to the service received by those customers and is of great hindrance to the Company's ability to effectively and efficiently manage and control its Call Centers. Missouri American, like all organizations has primary management responsibilities which include: planning, organizing, directing and controlling critical resources such as people, capital, technology and time. The lack of recorded phone calls, particularly in a corporation the size of Missouri American, which serves approximately 460,000 Missouri customers, is an impediment to adequate service. As indicated above, there are numerous managerial reasons to record 100 percent of all customer calls and retaining the calls for an amount of sufficient time, such as 12 months. All other large regulated utilities in the state of Missouri record 100 percent of their customer's calls and even some of the smaller utilities record similarly as well.

Staff Recommends Company Management:

9. *Record 100 percent of all customer calls between Call Center Representatives and Missouri-regulated customers. Archive recorded phone calls for a period of no less than 12 months and in a manner that they may be retrieved and reviewed by the Company, Staff and OPC.*

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Staff's Investigation into the Adequacy of the Call Centers serving Missouri American Water Company	)))))	Case No. WO-2014-0362

AFFIDAVIT OF LISA KREMER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW LISA KREMER and on her oath declares that she is of sound mind and lawful age; that she contributed to the attached *Report of Staff's Findings into the Adequacy of the Call Centers serving Missouri American Water Company*; and that the same is true and correct according to her best knowledge and belief.

Further the Affiant sayeth not.

Lisa Kremer

LISA KREMER

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 15th day of June, 2015.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Staff's Investigation into the Adequacy of the Call Centers serving Missouri American Water Company	)))))	Case No. WO-2014-0362

AFFIDAVIT OF DEBBIE BERNSEN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW DEBBIE BERNSEN and on her oath declares that she is of sound mind and lawful age; that she contributed to the attached *Report of Staff's Findings into the Adequacy of the Call Centers serving Missouri American Water Company*; and that the same is true and correct according to her best knowledge and belief.

Further the Affiant sayeth not.

Debbie Bernsen
DEBBIE BERNSEN

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 15th day of June, 2015.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin
Notary Public

Missouri American PSC Complaints
Case No. WO-2014-0362

MAWC Residential Customer Complaints Received by Commission's EFIS	
2008	171
2009	148
2010	210
2011	223
2012	165
2013	132
2014	188
2015	68*

*January 1, 2015 – April 30. 2015

Missouri American PSC Complaints
Reporting Deficient Call Center Performance
Case No. WO-2014-0362

Complaint Number	Alleged Mistakes By CSR-Incorrect Information Provided Or No Information Placed In CIS	Call Center Calls With No Resolution Or Return Calls To Customer	Call Center Rude Or Consumer Advised They Were Treated Poorly	Call Center Contact With Billing Uncorrected/Changed/Or After Long Period Was Corrected	Long Hold Times Or Could Not Get Through	Call Center Reps Unkowledgeable And/Or Provided Incorrect Information
C201400251		X				
C201400266		X				
C201400424		X				
C201400434				X		
C201400477		X				
C201400540	X					
C201400582		X				
C201400611						X
C201400670				X		
C201400723		X				X
C201400759		X				
C201400807					X	
C201400815		X				
C201400846						X
C201400860				X		
C201400885		X				
C201400945		X				
C201400997					X	
C201401019						X
C201401047	X					
C201401057	X					
C201401093					X	
C201401105					X	
C201401143	X					
C201401233			X			
C201401336				X		
C201401404				X		
C201401470				X		X
C201401523		X				
C201401533				X		
C201401538		X				
C201401586		X				
C201401672						X
C201401691	X					
C201401722		X				
C201401761				X		
C201500064		X				X
C201500136					X	
C201500227		X				
C201500228		X				
C201500371				X		
C201500394		X				
C201500560		X				
C201500703						X
C201500733				X		
C201500752		X				
C201500769					X	
C201500777				X		
C201500832						X
C201500896		X				
C201500998		X				
C201501059						X
C201501104						X
C201501118		X				
C201501138			X			
C201501200		X				
C201501213	X					
C201501250		X				
C201501273				X		
C201501287				X		
C201501392				X		
C201501403						X
C201501462		X				
C201501477		X				X

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Staff Investigation into	)	
the Adequacy of the Call Centers Serving	)	File No. WO-2014-0362
Missouri American Water Company	)	

<u>MAWC'S COMMENTS CONCERNING STAFF'S REPLY</u>

COMES NOW Missouri-American Water Company (MAWC or Company) and, after review of Staff's Reply to the Response of Missouri-American to Staff's Final Report and Motion for Order Requiring Company to Comply with Staff's Continued Monitoring (Staff's Reply), respectfully provides the following comments to the Missouri Public Service Commission (Commission):

1. The Staff's Reply "agrees that this docket may now be closed." However, it further requests that the Commission order MAWC to perform certain actions "in order to permit Staff to continue to monitor [MAWC's] progress toward resolving all identified Call Center and customer service issues." Those actions include: 1) the submission of "Implementation Status Reports;" 2) provide copies of certain studies, analysis and audits; and, 3) to continue meeting with the Staff as necessary to address call center and other matters as they arise.

2. MAWC has no objection to taking the actions identified by Staff and will agree to do so.

WHEREFORE, MAWC respectfully requests that the Commission consider these comments and, thereafter, issue such order as the Commission deems reasonable and just.

Respectfully submitted,

D. L. Cooper

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ATTORNEYS FOR MISSOURI-AMERICAN
WATER COMPANY

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been transmitted by electronic mail to the following on this 12th day of August, 2015:

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