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American Water

2002 Operational and Financial Report
Management Discussion and Analysis

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Missouri Public
Service Commission

RWE GROUP

A Brief Look at American Water

The primary mission of American Water is to provide high quality, reliable water and wastewater service at an affordable price to our customers while causing minimal impact on the environment in which we operate.

The bulk of the company's activities are centered in locally managed utility subsidiaries that are regulated by the state in which each operates. These water systems—and in some cases wastewater systems--are supported by the resources of American Water, but are essentially independently operated local enterprises that are an integral part of the communities they serve.

These regulated utility subsidiaries own the assets of the water system each operates, but the company also owns subsidiaries which manage municipal water systems under contract and other subsidiaries which supply individuals, businesses, and communities with other water resource management products and services.

The company's track record of financial success, environmental compliance and strong customer support is attributable to its rigorous operating discipline as well as insightful planning, ample capital investment, experienced managers, a knowledgeable staff, support for state-of-the-art water quality programs, and responsive customer service. In using those tools successfully for more than half a century, the company has achieved a standard of performance for our customers that is surpassed nowhere in our industry.

In 2003, American Water became part of RWE AG, one of the world's largest utility groups and the third largest provider of water and wastewater services in the world. With the support of RWE and its water subsidiary Thames Water, American Water is well positioned to meet the demand for investments that increase water system reach and capacity, preserve precious water supplies, and deliver water of unquestioned quality to the individuals and business that rely on us.

We consider our customers' reliance on us to be a sacred trust, and discharging our duties with diligence, skill and integrity is our highest priority.

Transition and Continuity

This report marks a notable transition. On January 10, 2003 American Water Works Company, Inc. ceased to be a publicly traded corporation, with the acquisition of all the common stock of American Water Works Company, Inc., by RWE AG, one of the world's largest utility groups.

In this new form, the company will be part of the third-largest provider of water and wastewater services in the world. The acquisition of American Water, and previously of the much larger U.K.-based Thames Water, means RWE companies now provide water service to some 70 million people worldwide. The new organization will manage former American Water Works Company, Inc., operating subsidiaries in the U.S. and Canada. As this acquisition itself demonstrates, American Water will continue to participate in the consolidation of the U.S. water and wastewater industry.

As important as this change is to matters such as access to lower cost capital, a vastly increased pool of financial and technical resources, and the ability to share best practices, much of what has defined American Water will change little if at all. The company's utility subsidiaries will still operate as local companies, with the same names, the same managers and the same staff that they had pre-merger. Their operating practices will remain focused on providing high quality service while continuously searching for new ways to improve that service.

Most important, the company's values will not change. RWE is an organization very much like American Water. Both companies put water quality, reliability and affordability at the top of the priority list. Both recognize that excellence in customer service is what keeps companies in business. And both have the same demanding standards when it comes to methods of operation, best practices, and a focus on customer well being.

Thus, this transition of American Water to a larger organization, one better equipped to deal with future demands on capital and water quality, is also the continuation of American Water as an organization of local, customer-oriented water systems committed to the values that have won the loyalty of its customers and made the company the standard of the industry.

Description of the Business

American Water is the premier water service provider in the United States. In that capacity, the company provides a wide range of water services to customers and communities throughout the U.S., and, now, throughout the entirety of North America. These services are delivered by operating subsidiaries that, broadly speaking, fall into one of two categories: regulated utility service and unregulated products and services.

Regulated Utility Service

The bulk of the company's activities are centered in locally managed utility subsidiaries that are regulated by the state in which each operates. These water systems-and in some cases wastewater systems-are supported by the resources of American Water, but are essentially local enterprises that are an integral part of the communities they serve.

These regulated utilities operate community water and wastewater systems whose assets are wholly owned by the subsidiary, the common stock of which is, in turn, wholly owned by American Water. The mission of these utility subsidiaries is to provide high quality, reliable water and wastewater service at an affordable price. To do that successfully requires efficient planning and capital investment, experienced managers, a knowledgeable staff, support for state-of-the-art water quality programs, and responsive customer service.

In addition to being subject to economic and customer service quality regulations prescribed by state regulatory commissions (with the exception of Michigan-American Water Company), each is also subject to regulation of environmental performance and water quality by those states and by the federal government.

Currently, operating subsidiaries in this category provide water or wastewater service to a population of approximately 9 million and account for the bulk of American Water's revenue and operating income.

Unregulated Products and Services

This second category includes subsidiaries that are subject to marketplace dynamics.

American Water Services, the company's fee-for-service subsidiary, generated $222 million in revenues during 2002 and has 800 contract clients. It operates 700 water facilities, 300 wastewater facilities and employs more than 1,300 professionals that provide service to a population of approximately 6 million in the United States and Canada. Several of the communities served by American Water Services are located in states or communities also served by regulated subsidiaries of American Water further strengthening vital community relationships.

The resources of American Water Services were considerably enhanced in 2002 with the integration of Azurix North America and Azurix Industrial Corp. (Azurix) acquired in November 2001. The talent acquired from Azurix combined with the municipal services experience of American Water Services, allowed the company to create an organization capable of providing a full range of water and wastewater management services. These services include operation and maintenance contracts for municipal and industrial water and wastewater treatment facilities and associated systems; residuals management services such as cleaning, dredging, de-watering and disposal solutions for municipal and industrial residuals with a focus on beneficial reuse; engineering services such a design, design/build and consulting services to municipal and industrial customers as well as affiliated companies and underground infrastructure services such as locating, cleaning, inspecting, repairing, rehabilitating and maintaining wastewater collection and water distribution systems.

The market potential for the types of services provided by American Water Services is significant in both the United States and Canada. Since market forces determine the fees generated by these activities rather than a regulatory process, revenue growth is limited only by a company's effectiveness in the marketplace and the value that municipalities, industries and businesses place on service quality, financial strength and technical competence. On all these measures, American Water Services has a proven and proud history of success.

As municipalities look for ways to cost-effectively meet ever-increasing water and wastewater quality standards, more contracts require capital investment by the contractor. Where capital is required, lower-priced capital becomes a critical advantage. American Water Service's access to the financial strength of RWE provides the type of advantage needed to continue to succeed in the competitive fee-for-service business.

American Water Resources offers water and wastewater related products and services to residential, governmental or business consumers. This subsidiary has developed two primary business lines:

Consumer Protection Programs - These service programs include water line protection (for a small monthly fee the customer's external water line is repaired or replaced when required) and the development of a similar service for wastewater line protection.

American Carbon Services - This is a service provided to water utilities that use granular activated carbon for filtration. American Carbon Services regenerates spent carbon for the utility's reuse. This recycling process is more cost effective and has less impact on the environment.

The American Water Business Model for Regulated Utility Systems

American Water utility subsidiaries are local businesses, locally run, and staffed by citizens of the communities they serve. These water systems-and in some cases wastewater systems-are supported by the resources of American Water and RWE/Thames, but their financial ownership matters little in day-to-day operations, coming into play largely in cases where additional capital or technical expertise is needed

This centralized-decentralized approach has been a successful business model for American Water for over 50 years. The company expects that the financial strength of RWE combined with the technical expertise of American Water and Thames Water, will create a water service organization unmatched in the United States for size and scope.

Business Environment

The water service industry faces numerous challenges to growth and profitability, among them: tougher water quality requirements; the growing need for capital investment; financial support for ongoing operations; a sluggish economy; and droughts. The industry must also contend with slow growth or no growth in per-capita consumption, and therefore the need for increased productivity. These factors that drive change in the water service business, can only be addressed by accessing larger, low-cost capital markets and creating greater economies of scale through customer growth – precisely the key elements in RWE's acquisition of American Water.

Acquisitions and Divestitures of Regulated Utility Systems

American Water grows its regulated subsidiaries by acquiring water and wastewater utilities that add value by complementing existing service territories or enhancing geographic diversification. Those newly acquired systems typically receive capital investments needed to meet water quality requirements or to reinforce, rehabilitate or replace existing service infrastructure.

In 2002, the company completed 14 acquisitions of water and wastewater systems, all of which operate in states already served by American Water and could, therefore, be "tucked in" to the existing operation. These tuck-in acquisitions offer the most efficient way to expand the company's customer base since they immediately improve economies of scale and create opportunities for further productivity increases in the acquired operation.

Six of those acquisitions were part of American Water's purchase of the water and wastewater assets of Citizens Communication completed in January 2002. That acquisition added more than 1 million people to the total served by American Water. In Arizona and California, the transaction added approximately 600,000 people to the 400,000 people American Water already serves in those states. In Illinois, Indiana and Ohio, approximately 250,000 people were added, further expanding the company's sizeable presence in the Midwest. In Pennsylvania, the 2 million people already served by American Water was increased by about 200,000.

This transaction also expanded American Water's presence in the wastewater sector by adding more than 400,000 to the population served. In addition to growth of the customer base, the Citizens acquisition provided $119 million in additional annual revenue and the expertise of 300 new employees.

The remaining acquisitions added more than 72,000 to the population served in six different states. Additionally, by the end of 2002, agreements had been executed for another 26 acquisitions, which, after regulatory approvals and completion, will add about 40,000 people in American Water's existing service areas. Offers were also pending for 23 other acquisitions, which, when completed, will add about 160,000 to the population served.

On April 25, 2002.American Water and Kelda Group plc completed a transaction under which Kelda's Aquarion Company subsidiary acquired American Water's former New England operations. The transaction price was approximately $118 million in cash plus the assumption of $115 million in debt. The subsidiaries that were sold served about 200,000 people in some of the company's slower growth areas and had annual revenues of $51 million in 2001.

More information regarding acquisitions and divestitures is included in Note 4 to the financial statements.

Capital Spending

Each utility subsidiary of American Water prepares a plan of capital expenditures devoted to the cost of investments in water quality, source-of-supply initiatives, operational improvements, system growth, regulatory compliance, and infrastructure replacements. The actual expenditures recorded in any given year, however, are influenced by many factors including the timing of required governmental approvals, weather, and the availability of labor, equipment and materials.

In 2002, investments in new facilities totaled $456 million, 20% above the 2001 construction expenditures of $381 million. This increase correlates closely with the growth of the company, most notably with the acquisition of the former Citizens Water systems in early 2002.

- Source-of-supply improvements accounted for approximately 8% of construction expenditures in 2002. Projects included the construction of new groundwater supplies in Agua Fria and Anthem, Arizona; Newburgh, Indiana; Clovis, New Mexico; and Ocean City, New Jersey.

  An industrial supply and delivery network is under construction in Hopewell, Virginia. Significant progress was made in the construction of a new Lake Michigan intake tunnel and pump station for the Gary, Indiana production facility.

- Investments in water treatment and pumping facilities comprised about 13% and investments in general structures and equipment accounted for 16% of the 2002 construction expenditures. Notable projects that were substantially completed in 2002 include treatment plant renovations and expansions in Village, California; Honolulu, Hawaii; Streator, Illinois; Monterey, California; and Yardley, Pennsylvania.

  Major projects in progress as of the end of 2002 included: the Anthem, Arizona Water & Wastewater Campus Phase 3 expansion; the Swimming River Treatment Facility Improvements serving Monmouth, New Jersey; the Oak Glen Regional Water Treatment Facility in Howell Township, New Jersey; the Clarion, Pennsylvania Water Treatment Facility; Phase II of the Streator, Illinois Water Treatment Facility; and improvements to the Sterling, Illinois and Charleston, West Virginia water treatment facilities.

- Improvements to transmission and distribution facilities accounted for approximately 41% of construction expenditures last year and were spread across a large number of service areas. Additionally, the routine installation of services, meters and hydrants accounted for 17% of the 2002 construction expenditures. These projects improve existing service, provide service to new areas, and allow full utilization of existing supply and treatment facilities between neighboring systems.

  Prominent projects include continuing regionalization efforts in Jefferson, Monroe and Pike Counties, Pennsylvania and in Mercer and Summers Counties, West Virginia. Other major distribution/transmission projects, to improve system hydraulics or enhance system growth, were completed in Scott County, Kentucky; St. Charles County, St. Louis County and Joplin, Missouri; and Short Hills and Monmouth County, New Jersey. Distribution storage tanks were constructed in Anthem, Arizona; Monterey, California; Sacramento, California; Jefferson City, Missouri; Limerick, Pennsylvania; and Huntington, West Virginia.

- Capital expenditures for non-utility property are made primarily for equipment and office space used by American Water Works Service Company. Spending in this category decreased by $5.5 million in 2002 compared with 2001, and represents expenditures for the continued consolidation of customer and financial services.

Before committing to capital expenditures for improving, expanding or replacing facilities or infrastructure, the company makes a comprehensive evaluation of all aspects of public water supply. This process includes projection of future water demands, evaluation of source water supply reliability, adequacy of water treatment facilities and distribution systems, and the potential for regional water supply solutions and acquisitions.

In 2002, comprehensive planning studies were commissioned for the ten integrated systems comprising Pennsylvania's service areas in Luzerne and Lackawanna Counties; the Alexandria and Prince William service areas in Virginia; the Fayette County, Huntington and Montgomery service areas in West Virginia; and the West Lafayette service area in Indiana. Studies were already underway for subsidiaries in California, Indiana, Kentucky, New Jersey, New Mexico, New York, Pennsylvania, Virginia and West Virginia. These continuing studies encompass 19 service areas.

The company expects that regulatory authorities will approve rate requests necessitated by the capital cost of construction projects.

A Culture of Compliance with Environmental Regulations

It scarcely need be said that American Water's policy is to be in total compliance with all environmental regulations, especially rules regarding drinking water, since the company's compliance record is outstanding and its commitment to excellence goes beyond simply meeting regulatory requirements. In fact, American Water has long been a partner with the United States Environmental Protection Agency, the EPA, in the research and development of emerging water quality standards and testing.

That commitment to excellence is shared by RWE/Thames Water whose dedication to water quality and environmental protection is equally scrupulous.

In 2002, the company's compliance with drinking water health standards and wastewater discharge standards was rated at 99.99% for the regulated utility subsidiaries and at 99.94% for water systems managed by American Water Services. American Water also continues to be a leader in achieving the more stringent standards contained in the voluntary EPA Partnership for Safe Water. Awards from EPA have been received by 77% of American Water plants, compared to 1% for the rest of the industry. Of American's other plants, 9% are awaiting information on their award, and the others are new plants. Since qualifications for the award require accumulation of two year's data, approximately one-half of those plants will be able to qualify for the award during 2003 and the other one-half in 2004.

American Water's commitment to regulatory compliance and environmental protection are identical in many ways to Thames Water's regulatory compliance and environmental protection programs. As part of RWE/Thames Water, American Water will be in an even stronger financial position, with even more technical expertise, to address the more stringent regulations that will emerge throughout this decade.

- Participating in regulatory development

The company continues to be an active participant in the EPA regulatory development process, and has hosted expert workshops at its Corporate Center to share knowledge with the EPA. The company also shares its operating knowledge and expense data with health authorities to assist them in protecting public health and the environment in the most efficient way possible.

Thames Water intends to add to this knowledge base by furnishing research information gathered during many years of operation, water quality testing and its compliance with water quality standards around the world.

- Best Practices

RWE/Thames Water is a world leader in setting operating performance standards for water service systems and, like American Water, takes pride in using best practices as its operating norm.

For its part, American Water adheres to the same demanding standards: Waste residuals generated at American Water's drinking water and wastewater treatment plants are properly disposed, in compliance with permits. Discharges to streams comply with permit limits, and full disclosure is made if a deviation occurs. For many drinking water treatment plants, the residuals are being approved for beneficial use on farms, roadways, and in composting operations, thereby reducing disposal costs and preserving valuable landfill capacity. All chemicals are handled in the appropriate manner to prevent exposure to employees, and to prevent accidental releases to the environment. If such releases were to occur, the proper government agencies would be immediately notified and the material cleaned up. These practices are fully supported by Thames Water and will continue in the future.

Emerging Federal Environmental Regulation

In 1974, Congress passed the Safe Drinking Water Act mandating national health standards and charging the Environmental Protection Agency with its enforcement. An amendment to the Act, passed in 1996, requires the EPA to promulgate additional standards in furtherance of the Act, which it has done.

- Arsenic Levels

One of the new standards, adopted by the EPA in 2001, limits the arsenic level in drinking water to 10 parts per billion. That standard goes into effect in 2006. Studies began in 2002 to develop plans to phase in needed capital investment over time.

- Disinfection Byproducts

Lower permissible limits for the byproducts of disinfection in water treatment took effect in 2002, as did more stringent performance standards for the treatment of surface water. The operating systems of American Water's regulated subsidiaries were in compliance with these new standards prior to the deadline.

- Other Anticipated Regulations

In 2003, the EPA also plans to propose new regulations to assure water quality by controlling cross connections throughout water distribution systems, by requiring even greater disinfection of surface waters, and by lowering disinfection byproduct limits still further. These new regulations are slated to go into effect in stages from 2005 through 2008.

The effect of new and anticipated regulations on American Water

- Removal of radon will be necessary at a few of American Water's sites by the 2007 deadline. However, most states are expected to adopt alternate plans designed to reduce indoor air radon levels, and require treatment only of ground water with extremely high radon levels.
- The filter backwash recycling rule is expected to impact only one site, which has until 2006 to comply.
- The ground water disinfection rule will have virtually no impact since American Water voluntarily disinfects ground water at all but one site now and that site is scheduling disinfection in 2003.
- The distribution system protection rule is not likely to affect capital needs, but the required protection program will increase operational costs at some sites.
- Greater disinfection of surface waters will likely result in installation of UV for some systems.
- Lowering of disinfection byproducts will increase operating costs and require some improvements to treatment facilities. The company expects to have several years in which to implement these changes.

State Economic Regulation

Commissions in 18 states regulate the company's utility subsidiaries.

These utility commissions have broad authority to establish water rates, prescribe service standards, and approve utility rules and regulations. In most states, the commission's approval is required for long-term financing programs, transactions between a utility and affiliated interests, reorganizations, mergers and acquisitions. The jurisdiction of each commission is prescribed by state legislation and varies from state to state.

- The Rate Making Process

The purpose of this regulatory process is to set rates that will cover the reasonable operating costs of providing quality service to customers and which will also allow the utility the opportunity to earn a fair return on the investment necessary to provide that service. A rate proceeding generally focuses on four issues:

- The investment in facilities that provide a public service
- The operating cost and taxes associated with providing the service
- The capital costs of funds used to provide the facilities
- The tariff design which allocates revenue requirements equitably across the customer base

Ordinarily, it is a utility that initiates a rate adjustment proceeding. After receiving such a rate request and appropriate investigation by commission staff and interveners, public hearings are held. These hearings, which are economic and service quality fact-finding proceedings, are typically conducted in a trial-like setting where evidence is submitted, subject to cross examination. The facts developed in these hearings form the basis for a commission decision.

Since economic regulation deals with competing, and often conflicting, public interests and policy goals, the rate setting process is typically complex and lengthy. As result, the management of a utility files a rate adjustment request that will reflect the cost of providing service at the time the rates are likely to become effective, thus offsetting the adverse financial impact of regulatory lag-or at least attempting to do so.

Of the various methods of achieving this result, the forward looking test year seems to be one of the more effective. At least 16 states employ a future test year or recognition of known and measurable changes for some period beyond a historic test year. State regulators allow a variety of mechanisms to achieve similar results, however; here are several examples:

- American Water subsidiaries in three states have received rate orders allowing recovery of interest and depreciation expense related to the period from the time a major construction project is placed in service until new rates, which reflect the cost of the project, are placed into effect.
- Nine subsidiaries now recover a return on utility plant before it is in service instead of capitalizing an allowance for funds used during construction.
- Six subsidiaries have implemented staged rate increases over several years reflecting additional annual investments and expenses approximately when they are incurred and reducing the frequency of general rate increase requests.
- Four states allow utility subsidiaries to recover certain costs of system infrastructure replacement without the necessity of filing a full rate proceeding. Since infrastructure replacement is a significant element of capital expenditures made by subsidiaries, such programs can reduce regulatory lag and increase the time between full rate cases. Legislation has been drafted and proposed bills are being filed in three additional states in 2003 authorizing infrastructure replacement surcharges.
- Seven states permit a form of rate design known as single tariff pricing. Under this concept, the state sets similar rates for service to customers of subsidiaries with multiple service districts within a state. This approach simplifies administration and rate proceedings. This concept allows fixed costs to be spread over a larger customer base thus mitigating the adverse rate impact of making needed capital improvements. It also allows more flexibility in the timing of utility subsidiary financing.
- From the beginning of 2002 through January of 2003, regulatory commissions authorized rate increases for 11 subsidiaries that total $31.1 million annually. The driving force for price increases was obtaining a return on the additional investment the operating companies have made in essential water service facilities. The company expects this pattern of rate increase requests to continue for the foreseeable future, given the need for capital investments to improve and replace water utility infrastructure and to comply with increasing demanding water quality requirements.
- Recovery of Increased Security Costs

After the tragic events of September 11, 2001, system operating companies reviewed existing security measures designed to protect sources of supply and treatment and distribution facilities, and took appropriate action to increase the security of this essential infrastructure.

These operating companies have also implemented plans to obtain timely and appropriate recovery of the increased costs associated with enhanced security. These plans differ from state to state; generally, however, most seek security cost recovery in pending rate proceedings, or in the use of surcharge mechanisms, or defer security related costs for probable recovery in subsequent rate proceedings. Most or all of the increased security costs have been approved as part of rate structures in Iowa, Ohio, Virginia and New York.

In all states, operating companies are taking appropriate measures to protect the confidentiality of security-related information in the regulatory process.

Regulated Utility Operations

Throughout 2002, droughts had an adverse effect on several of the company's regulated businesses. The company anticipates droughts and has plans in place to cope with such severe weather conditions. Although subsidiaries in New Jersey and Pennsylvania were particularly hard hit and had to implement alternative water supply plans in order to comply with state-mandated restrictions, they were able, when called upon, to help other water service providers meet the needs of citizens throughout those two states. Drought conditions began to ease during the second half of the year, as above normal precipitation replenished surface and ground water.

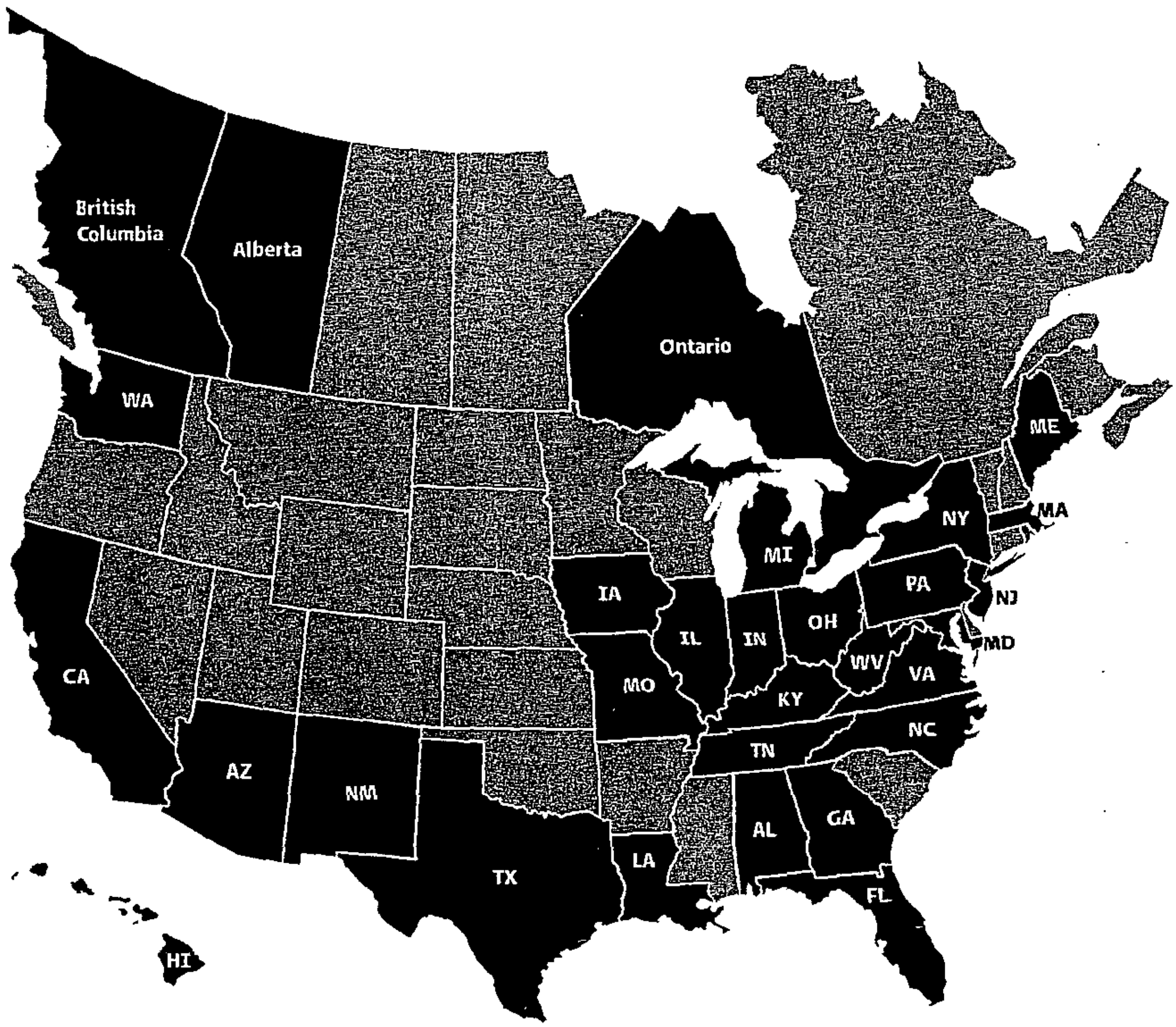
In addition to weather-related impacts, the company experienced declines in industrial water use as a weak economy caused industrial customers to close plants or reduce production and related water use.

Recognition

The former leaders of American Water Works Company, Inc.-Marilyn Ware, chairman, James Barr, president, and the members of the Board of Directors-have stepped aside, but have left in place an organization staffed and equipped to meet the challenges of the future. The people of American Water and RWE *are grateful for their inestimable contributions and their* insightful leadership that guided this organization so ably for so many years.

April 15, 2003
Voorhees, New Jersey

American Water served more than 15 million people in 27 states and 3 Canadian provinces at the end of 2002.



Report of Independent Accountants

To the Stockholders and Board of Directors of American Water Works Company, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income and comprehensive income and of retained earnings, of cash flows, of capitalization and of common stockholders' equity present fairly, in all material respects, the financial position of American Water Works Company, Inc. and Subsidiary Companies at December 31, 2002 and 2001, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, the Company adopted the provisions of *Statement of Financial Accounting Standards No. 141, Business Combinations, and of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets*, as of January 1, 2002.

PricewaterhouseCoopers LLP

February 6, 2003

Consolidated Financial Statements of American Water Works Company, Inc. And Subsidiary Companies

For the Years Ended
December 31, 2002
and December 31, 2001

Consolidated Balance Sheet

(Dollars in thousands)

At December 31,	**2002**	2001
Assets		
Property, plant and equipment		
Utility plant – at original cost less accumulated depreciation	**$6,178,317**	$5,458,909
Utility plant acquisition adjustments, net	**219,821**	68,916
Nonutility property, net of accumulated depreciation	**93,466**	94,149
Total property, plant and equipment	**6,491,604**	5,621,974
Current assets		
Cash and cash equivalents	**27,503**	19,691
Utility customer accounts receivable	**118,328**	105,101
Allowance for uncollectible accounts	**(3,400)**	(2,860)
Unbilled revenues	**85,639**	86,065
Other receivables, net	**69,190**	59,724
Materials and supplies	**33,347**	32,281
Deferred vacation pay	**9,977**	11,422
Other	**23,114**	19,164
Total current assets	**363,698**	330,588
Regulatory and other long-term assets		
Regulatory asset – *income taxes recoverable through rates*	**213,584**	217,330
Other investments	**30,963**	39,956
Debt and preferred stock expense	**47,271**	45,882
Deferred pension expense	**37,904**	30,712
Deferred postretirement benefit expense	**8,859**	9,318
Deferred security costs	**32,444**	7,058
Deferred business services project expenses	**40,464**	36,311
Deferred insurance expense	**11,340**	4,998
Deferred tank painting costs	**12,957**	16,585
Restricted funds	**33,165**	8,570
Goodwill	**253,352**	136,488
Intangible assets	**64,500**	23,400
Other	**76,278**	77,929
Total regulatory and other long-term assets	**863,081**	654,537
Total assets	**$7,718,383**	$6,607,099

	2002	2001
Capitalization and Liabilities		
Capitalization		
Common stockholders' equity	**$1,801,921**	$1,758,018
Preferred stocks called for redemption	**—**	11,673
Preferred stocks of subsidiaries with mandatory redemption requirements	**28,150**	30,474
Preferred stocks of subsidiaries without mandatory redemption requirements	**5,708**	7,268
Long-term debt		
American Water Works Company, Inc.	**169,000**	297,000
Subsidiaries	**3,301,751**	2,253,019
Total capitalization	**5,306,530**	4,357,452
Current liabilities		
Short-term debt	**394,712**	414,083
Current portion of long-term debt	**197,838**	166,087
Accounts payable	**51,461**	67,996
Taxes accrued, including federal income	**10,549**	21,756
Interest accrued	**50,003**	43,015
Accrued vacation pay	**10,125**	11,577
Other	**129,097**	100,220
Total current liabilities	**843,785**	824,734
Regulatory and other long-term liabilities		
Advances for construction	**303,235**	230,801
Deferred income taxes	**647,051**	624,449
Deferred investment tax credits	**35,527**	38,633
Accrued pension expense	**85,522**	62,355
Accrued postretirement benefit expense	**14,185**	13,808
Accrued insurance expense	**11,981**	5,020
Other	**38,039**	35,987
Total regulatory and other long-term liabilities	**1,135,540**	1,011,053
Contributions in aid of construction	**432,528**	413,860
Commitments and contingencies	**—**	—
Total capitalization and liabilities	**$7,718,383**	$6,607,099

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

C/S	1,801,921	30.55%
P/S	33,858	.57%
LTD	3,668,589	62.19%
STD	394,712	6.69%
	5,899,080	

Consolidated Statements of Income and Comprehensive Income and of Retained Earnings

(Dollars in thousands, except per share amounts)

For the years ended December 31,	2002	2001
Consolidated Income and Comprehensive Income		
Operating revenues	**$ 1,715,173**	$1,438,887
Operating expenses		
Operation and maintenance	**927,189**	664,549
Depreciation and amortization	**230,112**	185,211
General taxes	**141,002**	129,533
	1,298,303	979,293
Operating income	**416,870**	459,594
Other income (deductions)		
Interest	**(227,295)**	(192,522)
Allowance for other funds used during construction	**9,072**	4,905
Allowance for borrowed funds used during construction	**5,158**	4,043
Amortization of debt expense	**(2,877)**	(2,763)
Preferred dividends of subsidiaries	**(2,719)**	(2,985)
RWE acquisition expense	**(6,439)**	(9,992)
Gain on sale of operating systems	**50,709**	4,820
Gain on other investments, net	**9,714**	5,177
Gain on sale of land	**15,851**	4,969
Other, net	**(655)**	(3,439)
	(149,481)	(187,787)
Income before income taxes	**267,389**	271,807
Provision for income taxes	**123,004**	110,324
Income before cumulative effect of change in accounting principle	**144,385**	161,483
Cumulative effect of change in accounting principle	**2,679**	–
Net income	**147,064**	161,483
Dividends on preferred stocks	**146**	584
Net income to common stock	**146,918**	160,899
Other comprehensive income loss, net of tax		
Unrealized loss on securities	**(5,991)**	(16,187)
Reclassification adjustment for (gain) loss included in net income	**7,129**	(3,158)
Additional minimum pension liability	**(7,136)**	–
Foreign currency translation adjustment	**241**	–
Other comprehensive income (loss), net of tax	**(5,757)**	(19,345)
Comprehensive income	**$ 141,161**	$ 141,554
Average shares of basic common stock outstanding	**100,050**	99,465
Earnings per average common share outstanding:		
Income before cumulative effect of change in accounting principle	**$ 1.44**	$ 1.62
Cumulative effect of change in accounting principle	**0.03**	–
Basic	**$ 1.47**	$ 1.62
Income before cumulative effect of change in accounting principle	**$ 1.43**	$ 1.62
Cumulative effect of change in accounting principle	**0.03**	–
Diluted	**$ 1.46**	$ 1.62
Consolidated Retained Earnings		
Balance at January 1	**$ 1,137,772**	$ 1,069,486
Add: net income	**147,064**	161,483
Preferred stock redemption premium	**(62)**	–
Gain on treasury stock	**–**	801
	1,284,774	1,231,770
Deduct: dividends paid		
Preferred stock	**32**	128
Preference stock	**114**	456
Common stock – $.98 per share in 2002, $.94 per share in 2001	**98,041**	93,414
	98,187	93,998
Balance at December 31	**$1,186,587**	$ 1,137,772

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

Consolidated Statement of Cash Flows

(Dollars in thousands)

For the years ended December 31,	2002	2001
Cash Flows from Operating Activities		
Net income	$ 147,064	$ 161,483
Adjustments		
Depreciation and amortization	230,112	185,211
Cumulative effect of change in accounting principle	(2,679)	–
Gain on sale of operating systems	(50,709)	(4,820)
Gain on sale of other investments	(22,466)	(5,177)
Loss on write down of other investments	12,752	–
Gain on sale of land	(15,851)	(4,127)
Provision for deferred income taxes	60,218	30,980
Provision for losses on accounts receivable	15,749	10,582
Allowance for other funds used during construction	(9,072)	(4,905)
Employee benefit expenses greater (less) than funding	3,092	(49)
Employee stock plan expense	4,479	4,808
Deferred regulatory costs	(34,483)	(44,415)
Amortization of deferred charges	17,146	15,986
Other, net	(13,101)	1,094
Changes in assets and liabilities, net of effects from acquisitions and dispositions		
Accounts receivable	(29,959)	(31,963)
Unbilled revenues	(859)	(2,187)
Other current assets	(6,846)	(1,125)
Accounts payable	(16,256)	4,907
Taxes accrued, including federal income	(13,090)	(4,759)
Interest accrued	8,522	374
Other current liabilities	29,170	15,714
Net cash from operating activities	312,933	327,612
Cash Flows from Investing Activities		
Construction expenditures	(456,382)	(380,656)
Allowance for other funds used during construction	9,072	4,905
Acquisitions	(898,047)	(214,378)
Proceeds from sale of assets	168,225	23,745
Removal costs from property, plant and equipment retirements	(14,655)	(16,639)
Restricted funds	(33,165)	(227)
Net cash used in investing activities	(1,224,952)	(583,250)
Cash Flows from Financing Activities		
Proceeds from long-term debt	1,157,101	457,997
Proceeds from common stock	1,586	36,082
Purchase of common stock for treasury	(36)	(932)
Net borrowings (repayments) under short-term debt agreements	(11,768)	1,904
Advances and contributions for construction, net of refunds	92,791	32,348
Debt issuance costs	(8,034)	(1,114)
Repayment of long-term debt	(199,372)	(182,251)
Redemption of preferred stocks	(14,250)	(3,278)
Dividends paid	(98,187)	(93,998)
Net cash from financing activities	919,831	246,758
Net increase in cash and cash equivalents	7,812	(8,880)
Cash and cash equivalents at January 1	19,691	28,571
Cash and cash equivalents at December 31	$ 27,503	$ 19,691

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

Consolidated Statement of Capitalization

(Dollars in thousands, except per share amounts)

At December 31,	2002	2001
Common Stockholders' Equity:		
Common stock – $1.25 par value, authorized 300,000,000 shares outstanding 100,091,056 shares in 2002 and 100,016,273 shares in 2001	**$ 125,114**	$ 125,020
Paid-in capital	**490,701**	489,868
Retained earnings	**1,186,587**	1,137,772
Accumulated other comprehensive income	**201**	5,958
Unearned compensation	**–**	(539)
Treasury stock at cost – 16,111 shares in 2002 and 1,891 shares in 2001	**(682)**	(61)
	1,801,921	1,758,018

At December 31, 2002, common shares reserved for issuance in connection with the Company's stock plans were 80,865,863 shares for the Stockholders Rights Plan, 1,641,852 shares for the Dividend Reinvestment and Stock Purchase Plan, 565,493 shares for the Employees' Stock Ownership Plan and 532,381 shares for the Savings Plan for Employees. Up to 4,234,367 shares of common stock may be issued under the 2000 Stock Award and Incentive Plan, of which approximately 3,300,000 shares were available to be granted at December 31, 2002.

	2002	2001
Preferred Stocks With Mandatory Redemption Requirements:		
Cumulative preferred stock – $25 par value, authorized 1,770,000 shares 8.5% series (non-voting)	**–**	–
Preferred Stocks Without Mandatory Redemption Requirements:		
(All shares redeemed March 1, 2002)		
Cumulative preferred stock – $25 par value		
5% series (one-tenth of a vote per share), 101,777 shares outstanding in 2001	**–**	2,544
Cumulative preference stock – $25 par value, 750,000 shares authorized in 2001		
5% series (non-voting), outstanding 365,158 shares	**–**	9,129
Cumulative preferential stock – $35 par value, authorized 3,000,000 shares, no outstanding shares	**–**	–
	–	11,673
Preferred Stocks of Subsidiaries:		
Dividend rate		
3.9% to less than 5%	**3,860**	4,444
5% to less than 6%	**3,555**	4,637
6% to less than 7%	**688**	1,365
7% to less than 8%	**1,854**	3,094
8% to less than 9%	**20,950**	21,250
9% to less than 10%	**2,951**	2,952
	33,858	37,742

Preferred stock agreements of certain subsidiaries require annual sinking fund payments in varying amounts and permit redemption at various prices at the option of the subsidiaries on thirty days notice, or in the event of involuntary liquidation, at par value plus accrued dividends. Sinking fund payments for the next five years will amount to $614 in 2003, $614 in 2004, $614 in 2005, $588 in 2006 and $438 in 2007.

	Current Maturities	2002	2001
Long-Term Debt of American Water Works Company, Inc.:			
7.41% Series C debentures, due May 1, 2003	**$ 81,000**	**$ —**	$ 81,000
6.28% Series D debentures, due July 2, 2003	***45,000***	**—**	45,000
6.32% Series D debentures, due July 2, 2004	**—**	**15,000**	15,000
7.02% Senior Note, due August 1, 2005	**2,000**	**4,000**	6,000
4.92% Senior Note, due November 6, 2006	**—**	**150,000**	150,000
	128,000	**169,000**	297,000
Long-Term Debt of Subsidiaries:			
Interest rate			
1% to less than 2%	**1,346**	**127,531**	25,363
2% to less than 3%	**174**	**4,627**	63
3% to less than 4%	**42**	**2,453**	314
4% to less than 5%	**481**	**1,078,187**	155,295
5% to less than 6%	**10,532**	**690,954**	487,563
6% to less than 7%	**17,240**	**566,271**	649,658
7% to less than 8%	**1,142**	**546,798**	588,571
8% to less than 9%	**1,100**	**91,000**	99,103
9% to less than 10%	**28,300**	**150,111**	194,189
10% to less than 11%	**8,500**	**41,000**	50,371
	68,857	**3,298,932**	2,250,490
Capital leases	**981**	**2,819**	2,529
	69,838	**3,301,751**	2,253,019
	$197,838	**$5,306,530**	$ 4,357,452

Maturities of long-term debt of subsidiaries, including sinking fund requirements, during the next five years will amount to $69,838 in 2003, $41,279 in 2004, $59,731 in 2005, $1,072,101 in 2006 and $84,956 in 2007.

Long-term debt of subsidiaries is substantially secured by utility plant and by a pledge of certain securities of subsidiaries and affiliates.

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

Consolidated Statement of Common Stockholders' Equity

(Dollars in thousands, except per share amounts)

	Common Stock Shares	Common Stock Par Value	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Unearned Compensation	Treasury Stock Shares	Treasury Stock At Cost	Common Stockholders' Equity
Balance at December 31, 2000	98,819,845	$123,525	$454,568	$1,069,486	$25,303	$(359)	129,216	$(2,846)	$1,669,677
Net income	–	–	–	161,483	–	–	–	–	161,483
Dividend reinvestment	240,350	300	6,963	–	–	–	–	–	7,263
Stock purchase	913,894	1,142	26,437	–	–	–	–	–	27,579
Incentive plan	42,184	53	1,187	–	–	(180)	–	–	1,060
Unrealized gain (loss) on securities, net	–	–	–	–	(19,345)	–	–	–	(19,345)
Treasury stock	–	–	713	801	–	–	(127,325)	2,785	4,299
Dividends:									
Preferred stocks	–	–	–	(584)	–	–	–	–	(584)
Common stock	–	–	–	(93,414)	–	–	–	–	(93,414)
Balance at December 31, 2001	100,016,273	125,020	489,868	1,137,772	5,958	(539)	1,891	(61)	1,758,018
Net income	–	–	–	**147,064**	–	–	–	–	**147,064**
Incentive plan	**74,783**	**94**	**833**	–	–	**539**	–	–	**1,466**
Unrealized gain (loss) on securities, net	–	–	–	–	**1,138**	–	–	–	**1,138**
Treasury stock	–	–	–	–	–	–	**14,220**	**(621)**	**(621)**
Preferred stock redemption premium	–	–	–	**(62)**	–	–	–	–	**(62)**
Additional minimum pension liability, net	–	–	–	–	**(7,136)**	–	–	–	**(7,136)**
Foreign currency translation	–	–	–	–	**241**	–	–	–	**241**
Dividends:									
Preferred stocks	–	–	–	**(146)**	–	–	–	–	**(146)**
Common stock	–	–	–	**(98,041)**	–	–	–	–	**(98,041)**
Balance at December 31, 2002	**100,091,056**	**$125,114**	**$490,701**	**$1,186,587**	**$201**	**$ –**	**16,111**	**$(682)**	**$1,801,921**

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

Notes to Financial Statements

(Dollars in thousands, except per share amounts)

Note 1: Organization and Operation

American Water Works Company, Inc. through its regulated and unregulated subsidiaries provides water and wastewater service in the United States of America and Canada. As public utilities, the regulated subsidiaries function under rules and regulations prescribed by state regulatory commissions. The Company provides water and wastewater management services through its unregulated subsidiary, American Water Services. In addition, American Water Resources is a wholly-owned subsidiary whose function is to primarily invest in water and wastewater related products and services.

The Company has identified Regulated Utility Services and Unregulated Services as its two reportable segments.

Note 2: Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the parent company and all of its subsidiaries. Intercompany accounts and transactions are eliminated in consolidation. The operating results related to the acquisition of the water and wastewater assets of Citizens Communications Company have been included in the consolidated statement of income since the completion of the acquisition on January 15, 2002. The operating results of Azurix North America and Azurix Industrials Corp. have been included in the consolidated statement of income since the completion of the acquisition on November 7, 2001.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Regulation

The utility subsidiaries have incurred various costs and received various credits which have been reflected as regulatory assets and liabilities on the Company's consolidated balance sheet. Accounting for such costs and credits as regulatory assets and liabilities is in accordance with Statement of Financial Accounting Standards No. 71 "Accounting for the Effects of Certain Types of Regulation" (SFAS 71). This statement sets forth the application of generally accepted accounting principles for those companies whose rates are established by or are subject to approval by an independent third-party regulator. Under SFAS 71, utility companies defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that those costs and credits will be recognized in the rate making process in a period different from the period in which they would have been reflected in income by an unregulated company. These deferred regulatory assets and liabilities are then reflected in the income statement in the period in which the same amounts are reflected in the rates charged for service.

Property, Plant and Equipment

Additions to utility plant and replacements of retirement units of property are capitalized. Costs include material, direct labor and such indirect items as engineering and supervision, payroll taxes and benefits, transportation and an allowance for funds used during construction. The costs incurred to acquire and internally develop computer software for internal use are capitalized as a unit of property. Repairs, maintenance and minor replacements of property are charged to current operations. The cost of property units retired in the ordinary course of business plus removal cost (less salvage) is charged to accumulated depreciation. The cost of property, plant and equipment is generally depreciated using the straight-line method over the estimated service lives of the assets. The depreciation rates, based on the average balance of depreciable property, were 2.98% in 2002, 2.64% in 2001 and 2.54% in 2000.

Non-utility property consists primarily of buildings and equipment utilized by American Water Works Service Company which provides various services to affiliated companies and by American Water Services in its unregulated management services business. This property is stated at cost, net of accumulated depreciation calculated using the straight-line method over the estimated useful lives of the assets, ranging from three to 40 years.

Utility plant acquisition adjustments include the difference between the purchase price of utility plant and its original cost (less accumulated depreciation) and are generally being amortized over a period of 40 years.

Cash and Cash Equivalents

Substantially all of the Company's cash is invested in interest bearing accounts. The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Cash equivalents consist primarily of investment grade commercial paper, bank certificates of deposit and United States Government securities. Cash equivalents are stated at cost plus accrued interest which approximates market value.

Materials and Supplies

Materials and supplies are stated at the lower of average purchased cost and net realizable value.

Regulatory Assets

The Company has recorded a regulatory asset for the additional revenues expected to be realized as the tax effects of temporary differences previously flowed through to customers reverse. These temporary differences are primarily related to the difference between book and tax depreciation on property placed in service before the adoption by the regulatory authorities of full normalization for rate making purposes.

The regulatory asset for income taxes recoverable through rates is net of the reduction expected in future revenues as deferred taxes previously provided, attributable to the difference between the state and federal income tax rates under prior law and the current statutory rates, reverse over the average remaining service lives of the related assets.

Debt expense is amortized over the lives of the respective issues. Call premiums on the redemption of long-term debt, as well as unamortized debt expense, are deferred and amortized to the extent they will be recovered through future service rates. Expenses of preferred stock issues without sinking fund provisions are amortized over 30 years from date of issue; expenses of issues with sinking fund provisions are charged to operations as shares are retired.

(Dollars in thousands, except per share amounts)

Pension expense in excess of the amount contributed to the pension plans is deferred by certain subsidiaries. These costs will be recovered in future service rates as contributions are made to the pension plan.

Postretirement benefit expense in excess of the amount recovered in rates through 1997 has been deferred by certain subsidiaries. These costs are now recognized in the rates charged for water service and will be fully recovered over a 20-year period ending in 2012 as authorized by the regulatory authorities.

The cost of additional security measures that were implemented to protect facilities after the terrorist attacks on September 11, 2001 has been deferred by certain subsidiaries. These costs are recognized in the rates charged for water service by certain subsidiaries, and for others are being deferred as it is expected that these costs will be recovered in the rates charged for utility service in the future.

Deferred business services project expenses consist of reengineering and start-up activities for consolidated customer and shared administrative service centers that began operations in 2001. These costs are recognized in the rates charged for water service by certain subsidiaries, and for others are being deferred as it is expected that these costs will be recovered in the rates charged for utility service in the future.

Tank painting costs are generally deferred and amortized to current operations on a straight-line basis over periods ranging from 4 to 20 years, as authorized by the regulatory authorities in their determination of rates charged for service.

Intangible Assets and Goodwill

Intangible assets and goodwill are associated with the Citizens acquisition and acquisitions made by American Water Services. The Citizens acquisition intangible assets amounted to $59,813 and include contracts with a weighted-average useful life of 20 years and communications site licenses with useful lives ranging from 15-21 years. Goodwill amounting to $84,864 was recorded with this acquisition.

The American Water Services' intangible assets are contracts with a weighted-average useful life of approximately 12 years that were acquired in the acquisition of Azurix North America and Azurix Industrials Corp. that was completed on November 7, 2001 and the acquisition of a former joint venture partner's interest in EA2 Systems that was completed on September 20, 2001. $110,634 and $4,630 of the goodwill is associated with the Azurix and EA2 acquisitions and the remaining $29,830 of goodwill is associated with the Company's December 31, 1999 acquisition of its joint venture partner's interest in AmericanAnglian Environmental Technologies. In accordance with the provisions of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (see New Accounting Standards), the goodwill associated with the Azurix and EA2 acquisitions is not being amortized and the goodwill associated with the AmericanAnglian acquisition will no longer be amortized after December 31, 2001. The annual amortization of the tax deductible goodwill on the AmericanAnglian acquisition had been $1,657.

Other Investments and Accumulated Other Comprehensive Income

Other investments include primarily equity securities of publicly and privately held companies. Investments in publicly traded securities are classified as available for sale and are recorded in the balance sheet at fair market value with the change in market value, net of the tax effect, recorded as part of other comprehensive income. The cost basis of these publicly traded securities is $10,322 and the fair value of these investments is determined using quoted market prices. Investments in privately held companies are carried at cost. The principal publicly traded investments are approximately 1,300,000 shares of Deutsche Telekom (NYSE:DT) and 50,000 shares of SJW Corp. (AMEX: SJW).

In 2002 the Company tendered approximately 2.2 million shares of its 3.5 million shares of ITC Holding Company (ITC) common stock. The Company tendered the shares as part of ITC's program to repurchase its own stock. The Company acquired this stock with the 1999 acquisition of National Enterprises Inc. (NEI) as it was part of NEI's non-water related investments. The sale resulted in a gain of $22,466, $13,979 after-tax, which was reflected in the 2002 results. This gain was offset by a loss of $12,752, $7,989 after tax, that was also recorded in 2002 when the Company determined that the value of three other securities had become permanently impaired. The Company also has equity investments in ITC Holding Company, Inc., and United States Sugar Corporation. The cost basis of these securities, that are not publicly traded, was $4,516 at December 31, 2002.

The components of accumulated other comprehensive income balances at December 31 are as follows:

	2002	2001
Beginning balance	**$ 5,958**	$25,303
Unrealized gains (losses) on securities	**1,924**	(32,684)
Income taxes, net on other comprehensive income	**3,776**	13,339
Foreign currency translation	**241**	–
Additional minimum pension liability	**(11,698)**	–
Ending balance	**$ 201**	$ 5,958

In 2002 a loss of $11,698 and related tax benefits of $4,562 were recognized when the value of the Company's pension plan assets decreased reflecting negative equity returns.

In 2001 a gain of $5,177, and related tax of $2,019, were recognized on the sale of a portion of the Company's investment in Deutsche Telekom.

Other Current Liabilities

Other current liabilities at December 31, 2002 and 2001 include payables to banks of $36,690 and $29,076 respectively, which represent checks issued but not presented to banks for payment, net of the related bank balance.

Advances and Contributions in Aid of Construction

Utility subsidiaries may receive advances and contributions to fund construction necessary to extend service to new areas. As determined by the regulatory authorities, advances for construction are refundable for limited periods of time as new customers begin to receive service. Amounts which are no longer refundable are reclassified to contributions in aid of construction. Utility plant funded by advances and contributions is excluded from rate base and is generally not depreciated for rate making purposes. Generally, advances and contributions received during the period January 1, 1987 through June 12, 1996 have been included in taxable income and the related property is depreciable for tax purposes. As a result of a tax law change, advances and contributions received subsequent to June 12, 1996 are excluded from taxable income and the related property is not depreciable for tax purposes.

On January 11, 2001 the Internal Revenue Service issued regulations that excluded lateral service lines from its definition of contributions in aid of construction that are not included in taxable income. These customer connection fees are defined as the cost of installing a connection or service line from the Company's main lines to the lines owned by the customer. The regulations were effective immediately, and the Company is now paying tax on money or property received for these connections.

Recognition of Revenues
Revenues of the regulated utility subsidiaries include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the date of the latest meter reading to the end of the accounting period.

Revenue from American Water Services' residuals management, underground infrastructure development, engineering and large multi-year operations and maintenance contracts are recognized over the contract term based on the estimated percentage of services provided during the period compared to the total estimated services to be provided over the entire contract. Losses on contracts are recognized during the period in which the loss first becomes known. Revenue recognized in excess of billings on service contracts are recorded as unbilled revenue. Billings in excess of revenues recognized on service contracts are recorded as a liability on the Company's balance sheet until the above revenue recognition criteria are met. Changes in contract performance and related estimated contract profitability may result in revisions to costs and revenues and are recognized in the period in which revisions are determined. For other water and wastewater treatment contracts and for time and material contracts, revenue is recognized as services are provided.

Income Taxes
The Company and its subsidiaries participate in a consolidated federal income tax return for U.S. tax purposes. Members of the consolidated group are charged with the amount of federal income tax expense determined as if they filed separate returns, except that the tax rate applicable to the consolidated group is applied to separate company taxable income and the benefit of net operating losses, principally at the parent company level, is recognized currently.

Certain income and expense items are accounted for in different time periods for financial reporting than for income tax reporting purposes. Deferred income taxes have been provided on the difference between the tax bases of assets and liabilities and the amounts at which they are carried in the financial statements. These deferred income taxes are based on the enacted tax rates to be in effect when such temporary differences are expected to reverse. The utility subsidiaries also recognize regulatory assets and liabilities for the effect on revenues expected to be realized as the tax effects of temporary differences previously flowed through to customers reverse.

Investment tax credits have been deferred by the utility subsidiaries and are being amortized to income over the average estimated service lives of the related assets.

Allowance For Funds Used During Construction (AFUDC)
AFUDC is a non-cash credit to income with a corresponding charge to utility plant which represents the cost of borrowed funds and a return on equity funds devoted to plant under construction. The utility subsidiaries record AFUDC to the extent permitted by the regulatory authorities.

Environmental Costs
Environmental expenditures that relate to current operations or provide a future benefit are expensed or capitalized as appropriate. Remediation costs that relate to an existing condition caused by past operations are accrued when it is probable that these costs will be incurred and can be reasonably estimated.

Asset Impairment
Long-lived assets and certain identifiable intangible assets held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets, on a separate entity basis, may not be recoverable. If the sum of the future cash flows expected to result from the use of the assets and their eventual disposition is less than the carrying amount of the assets, an impairment loss is recognized. Measurement of an impairment loss is based on the fair value of the assets. A regulatory asset is charged to earnings if and when future recovery in rates of that asset is no longer probable. Indefinite lived intangible assets are reviewed for impairment annually or whenever events occur indicating the carrying value may be impaired.

Earnings Per Share
The average number of shares used to calculate diluted earnings per share includes 0 and 14,142 of potential common shares issuable in connection with the long-term incentive program in 2002 and 2001 respectively, and 291,679 and 163,414 potential common shares for employee stock options in 2002 and 2001, respectively (see Note 11).

New Accounting Standards

- Business Combinations/ Goodwill and Other Intangible Assets

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, "Business Combinations" (SFAS 141) and No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), collectively referred to as the "Standards" SFAS 141 supersedes Accounting Principles Board Opinion (APB) No. 16, "Business Combinations". The provisions of SFAS 141 (1) require that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, (2) provide specific criteria for the initial recognition and measurement of intangible assets apart from goodwill, and (3) require that unamortized negative goodwill be written off immediately as an extraordinary gain instead of being deferred and amortized. SFAS 141 also requires that upon adoption of SFAS 142 the Company reclassify the carrying amounts of certain intangible assets into or out of goodwill, based on certain criteria. SFAS 142 supersedes APB 17, "Intangible Assets", and is effective for fiscal years beginning after December 15, 2001. SFAS 142 primarily addresses the accounting for goodwill and intangible assets subsequent to their initial recognition. The provisions of SFAS 142 (1) prohibit the amortization of goodwill and indefinite-lived intangible assets, (2) require that goodwill and indefinite-lived intangibles assets be tested annually for impairment (and in interim periods if certain events occur indicating that the carrying value of goodwill and/or indefinite-lived intangible assets may be impaired), (3) require that reporting units be identified for the purpose of assessing potential future impairments of goodwill, and (4) remove the forty-year limitation on the amortization period of intangible assets that have finite lives. The Company adopted the provisions of the Standards on January 1, 2002.

The Standards require the excess of the fair values of acquired net assets over cost recorded in the statement of financial position to be recognized as the effect of a change in accounting principle as of the date SFAS 141 is initially applied in its entirety. In compliance with this transition requirement the Company recognized a $2,679 gain on January 1, 2002.

During 2002 the Company completed the process of making the determinations as to what its reporting units are and what amounts of goodwill, intangible assets, other assets and liabilities should be allocated to those reporting units as of January 1, 2002. The Company's reporting units are the separate regulated utility subsidiaries (including the five New England subsidiaries that were sold on April 25, 2002) and unregulated services reporting units at American Water Resources and American Water Services. The Company's carrying value of goodwill at January 1, 2002 was $139,167, of which $23,394 was assigned to various regulated subsidiaries and $115,773 was assigned to American Water Services. Intangible assets with an assigned value of $23,400 (subsequently adjusted to $6,800 in 2002) were management contracts at American Water Services that have a finite life.

A transitional impairment test for goodwill as of January 1, 2002 was completed by the Company. Income and market approaches were used for reporting unit valuations. The methodologies used to implement the market approach were the market multiples methodology, which results in an indication of value by comparing the business being valued to guideline publicly traded companies, and the similar transactions methodology, which develops an indication of value based on prices paid for comparable businesses. The methodology used to implement the income approach was the capitalized income approach that bases the value of an asset on the future cash flows attributable to that asset. Based on these approaches the Company determined that goodwill is not currently impaired. The Company performed required annual impairment tests in the fourth quarter after the long-term planning process was completed.

The Company is no longer recording $1,657 of annual tax deductible amortization relating to the goodwill associated with the 1999 acquisition of its joint venture partner's interest in AmericanAnglian Environmental Technologies. The remainder of the goodwill and intangible assets at January 1, 2002 were not being amortized because they are related to business combinations completed after the July 1, 2001 effective date of SFAS 141 or the goodwill was related to acquisitions that occurred prior to October 31, 1970 that was not being amortized because in the opinion of management there had been no diminution in value.

- *Guarantor's Accounting and Disclosure Requirements for Guarantees*

In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34." FIN 45 clarifies that upon issuance of certain types of guarantees, the guarantor must recognize an initial liability for the fair value of the obligation it assumes under the guarantee. FIN 45 does not provide detailed guidance on the offsetting entry to be made when recognizing the liability or on measuring the obligation subsequent to its initial recognition. The offsetting entry will be dependent upon the circumstances under which the guarantee is issued, and the initial liability should typically be reduced as the guarantor is released from risk under the guarantee. FIN 45 also requires a guarantor to make significant new disclosures for virtually all guarantees. The provisions relating to the initial recognition and measurement of guarantee obligations must be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The Company adopted FIN 45 effective January 1, 2003. The initial adoption did not have an impact on the Company. However, FIN 45 may impact the accounting treatment of future guarantee obligations. The disclosure provisions are effective for financial statements of interim and annual periods ending after December 15, 2002. See Note 19 for disclosure of guarantees and other assurances existing as of December 31, 2002.

Reclassification

Certain reclassifications have been made to conform previously reported data to the current presentation.

Note 3: Merger with RWE Aktiengesellschaft

On September 16, 2001 the Company entered into an Agreement and Plan of Merger (the "Agreement") with RWE Aktiengesellschaft ("RWE") and Thames Water Aqua Holdings GmbH ("Thames"), which is RWE's holding company for its global water business, to merge with a subsidiary of RWE and become a wholly owned indirect subsidiary of RWE. On January 10, 2003 Apollo Acquisition Company, a Delaware corporation ("Sub"), merged (the "Merger") with and into the Company, pursuant to the Agreement, with the Company surviving the Merger. Pursuant to the Merger Agreement, each issued and outstanding share of common stock, par value $1.25 per share, of the Company has been canceled and converted into the right to receive $46.00 in cash without interest, plus a stub period dividend of $0.2153333 per share. As a result of the Merger, the Company became a wholly owned subsidiary of Thames Water Aqua US Holdings, Inc., a wholly owned subsidiary of Thames.

The Company's Proxy Statement filed on Schedule 14A for the special meeting of stockholders approving the Merger, which was first mailed to shareholders of the Company on or about December 7, 2001, sets forth certain information regarding RWE, Thames and Sub. RWE obtained the approximately $4.6 billion required to fund the merger consideration and pay related fees and expenses from (a) the capital and money markets and (b) internally available funds.

RWE is a global multi-utility company that does business through its subsidiaries and affiliates in over 120 countries. Its core businesses are electricity, gas, water, and waste and recycling.

The transaction was approved at a special meeting of the stockholders of American Water Works Company on January 17, 2002.

During 2002 and 2001 the Company recorded charges of $6,439 and $9,992, reflecting costs incurred in connection with the merger. The merger related costs have been reported on a separate line in the consolidated statement of income and comprehensive income.

On November 6, 2001 the Company and its financing subsidiary, American Water Capital Corp. ("AWCC"), executed a Note Purchase Agreement with RWE for up to $1.2 billion in senior unsecured notes at an interest rate of 4.92%. The notes were purchased at par by RWE and mature on November 6, 2006. The Company and its subsidiaries used the proceeds from the sale of the notes to acquire the common stock of Azurix North America and Azurix Industrials, to fund the acquisition of the water and wastewater assets of Citizens Communications Company and to reduce outstanding short-term debt. Closing occurred in two tranches, one on November 6, 2001 in the amount of $298,500 and another on January 14, 2002 in the amount of $900,000.

On June 12, 2002 the Company and AWCC executed a Note Purchase Agreement with RWE for $320,000 in senior unsecured notes. The agreement calls for up to $170,000 in notes at an interest rate of 5.65% maturing on June 12, 2007 and $150,000 in notes at a floating interest rate based on LIBOR rates plus 20 basis points maturing on June 26, 2003. Closing occurred on $40,000 of the 5.65% senior notes on June 12, 2002 and closing on the remaining $130,000 of 5.65% notes took place on September 30, 2002. The closing on the $150,000 of floating rate notes took place on December 18, 2002. AWCC used the proceeds from this issuance to pay down maturing commercial paper.

Note 4: Acquisitions and Divestitures

Water and Wastewater Assets of Citizens Communications Company

On January 15, 2002 the Company and its subsidiaries completed their acquisition of all of the water and wastewater assets of Citizens Communications Company (NYSE: CZN) for $859,065 in cash and $120,685 of assumed liabilities. The purchase price is subject to adjustment upon the completion of an audited closing statement of net assets. At this time the Company expects a minor decrease in the purchase price. The acquired operations provide water and wastewater service to approximately 300,000 customers in Arizona, California, Illinois, Indiana, Ohio and Pennsylvania. Citizens also had developed a water supply project in Illinois with the possibility of additional wholesale customers along the pipeline. For the fiscal year ended December 31, 2001, the operations had revenues of $119,000.

At December 31, 2002, $84,864 and $59,813 were recorded as goodwill and intangibles, respectively, in connection with this transaction. A value of $54,538 was assigned to intangible assets with an indefinite life, and $5,275 of value was assigned to intangible assets with lives ranging from 15 to 21 years.

The purchase price for these assets was consistent with the multiples paid in other similar transactions. Regulatory and strategic considerations contributed to a purchase price that resulted in the recognition of goodwill. The assets reside in progressive regulatory environments where the Company currently operates and broadens the geographic diversity of the Company's total operations. The inclusion of the acquired customers in California and Arizona increases the Company's customers in the Western United States to 10% of its total customer base. With the acquisition, the Company becomes one of the principal water purveyors in the Phoenix area and strengthens its competitive position for the privatization opportunities in this rapidly growing region and the other states included in the acquisition footprint.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed.

	January 15, 2002
Current assets	$ 13,928
Property, plant, and equipment	811,710
Other long-term assets	9,435
Intangible assets	59,813
Goodwill	84,864
Total assets acquired	979,750
Current liabilities	(3,890)
Long-term debt	(90,399)
Other long term liabilities	(26,396)
Total liabilities assumed	(120,685)
Net assets acquired	$ 859,065

Other 2002 Acquisitions

During 2002, the Company acquired eight other local water and wastewater utilities for a total cost of $31,935, which was paid primarily in cash. These systems provide water and wastewater service to 29,000 customers in Missouri, Indiana, Pennsylvania, Kentucky and New Mexico. There were no goodwill or intangible assets recognized in these transactions.

(Dollars in thousands, except per share amounts)

Divestiture of New England Operations
On August 30, 2001, Kelda Group plc and the Company jointly announced that they had reached an agreement whereby Kelda's Aquarion Company would acquire the Company's New England operations. On April 25, 2002 the Company completed the divestiture with a transaction price of approximately $118,000 plus the assumption of $115,000 in debt. An $18,600 after-tax gain was reflected in 2002 results.

The utility operations acquired by Aquarion serve a total of 65,000 customers and had revenues of $51,000 in 2001. A finance subsidiary of the Company, which owned and leased certain assets to its affiliated operating company in Massachusetts, was also acquired by Aquarion as part of the transaction.

Azurix North America And Azurix Industrials
On November 7, 2001 the Company completed its acquisition of Azurix North America Corp. and Azurix Industrials Corp. for $153,300 in cash and assumption of $6,500 of debt. Azurix North America and Azurix Industrials were wholly-owned subsidiaries of Azurix Corp. and provide a range of water and wastewater services, including operations and maintenance, engineering, carbon regeneration, underground infrastructure rehabilitation and residuals management. Azurix North America and Azurix Industrials had revenues totaling approximately $134,000 in 2001.

This transaction enables the Company to offer a comprehensive portfolio of quality water management services to municipal and industrial customers. The acquisition also expands the Company's presence into the southeastern and northwestern U.S. and three Canadian provinces.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed.

	November 7, 2001
Current assets	$ 44,900
Property, plant, and equipment	46,700
Other long-term assets	4,700
Intangible assets	22,300
Goodwill	73,800
Total assets acquired	192,400
Current liabilities	(32,600)
Long-term debt	(6,500)
Total liabilities assumed	(39,100)
Net assets acquired	$ 153,300

Other 2001 Acquisitions
During 2001, the Company acquired eight other local water and wastewater utilities for a total cost of $55,900, which was paid primarily in cash. These systems provide water and wastewater service to 20,000 customers in Missouri, Indiana, Pennsylvania and Kentucky. There were no goodwill or intangible assets recognized in these transactions.

Divestiture of Town of Salisbury Massachusetts Operating System
On September 28, 2001 the Company completed the sale under threat of condemnation of its Salisbury Water Supply Company's operating system to the Town of Salisbury, Massachusetts for $11,500 in cash plus outstanding accounts receivables. The Salisbury system serves 3,000 customers and had annual revenues of $1,900.

Note 5: Acquired Intangible Assets

	As of December 31, 2002 Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets		
O&M contracts	**$11,100**	**$(2,068)**
Communication site licenses	**975**	**(45)**
Total	**$12,075**	**$(2,113)**
Unamortized intangible assets		
Franchise rights	**$54,538**	
Estimated amortization expense:		
For year ended 12/31/03	**$ 1,335**	
For year ended 12/31/04	**$ 1,164**	
For year ended 12/31/05	**$ 850**	
For year ended 12/31/06	**$ 768**	
For year ended 12/31/07	**$ 671**	

Note 6: Goodwill

	Regulated Utility Services	Unregulated Services	Total
Balance as of December 31, 2001	$ 20,715	$115,773	$136,488
Cumulative effect of change in accounting principle	2,679	–	2,679
Balance as of January 1, 2002	23,394	115,773	139,167
Goodwill acquired during year	84,864	–	84,864
Adjust purchase accounting	--	29,321	29,321
Balance as of December 31, 2002	**$108,258**	**$145,094**	**$253,352**

Note 7: Utility Plant
The components of utility plant by category at December 31 are as follows:

	2002	2001
Water plant		
Sources of supply	**$ 339,993**	$ 301,875
Treatment and pumping	**1,644,198**	1,521,214
Transmission and distribution	**3,561,441**	3,106,076
Services, meters and fire hydrants	**1,281,567**	1,126,589
General structures and equipment	**592,450**	564,664
Wastewater plant	**296,566**	100,586
Construction work in progress	**190,330**	156,029
	7,906,545	6,877,033
Less-accumulated depreciation	**1,728,228**	1,418,124
	$6,178,317	$5,458,909

Note 8: Dividend Reinvestment and Stock Purchase Plan

Until September 17, 2001 the Company's Dividend Reinvestment and Stock Purchase Plan provided for optional cash purchases of newly issued common stock of the Company. In addition to permitting record holders of common stock to have all or part of their dividends automatically reinvested in additional shares of common stock, the plan permitted stockholders to purchase up to five thousand dollars of common stock each month directly from the Company. This plan was suspended in connection with the anticipated merger with RWE.

Note 9: Shareholders Rights Plan

On June 1, 2000 the Company announced that it had amended its Shareholder Rights Agreement. The Agreement provides for certain consequences if more than a stated percentage of the Company's common stock is acquired by any person or group of persons without prior consent of the Company's Board of Directors. The amendment lowered that percentage, and the percentage of ownership that triggers the dilutive effect of the rights issued under the Agreement, to 10% of the Company's outstanding common shares.

Each Right under the amended plan entitles shareholders to buy one share of the Company's common stock at an exercise price of $150. Each Right entitles its holder to purchase, at the Right's then-current exercise price, shares of the Company's common stock, or a number of shares of an acquiring company's stock, which would have a market value of two times the exercise price. The Rights become exercisable if there is a public announcement that a person or group acquires, or commences a tender offer to acquire, 10% or more of the outstanding shares of the Company. The Rights also become exercisable if the Company is acquired in a merger or a person or group acquires 10% or more of the outstanding shares of the Company.

The Rights are redeemable, in whole, but not in part, by the Company at a price of $.0005 per Right under certain circumstances. The Rights do not have voting or dividend rights and, until they become exercisable, have no dilutive effect on the earnings per share of the Company.

In accordance with the RWE merger agreement, as of September 16, 2001, the Company amended the rights agreement to provide that none of the approval, execution, delivery or performance of the merger agreement or the voting agreement or the completion of the transactions contemplated thereby will cause the rights under the rights agreement to be adjusted or become exercisable. The amendment also provides that the rights will terminate immediately prior to the completion of the merger.

Note 10: Employee Benefits

Pension and Other Postretirement Benefits

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

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

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

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

(Dollars in thousands, except per share amounts)

	Pension Benefits		Other Postretirement Benefits	
	2002	2001	**2002**	2001
Change in benefit obligation				
Benefit obligation at January 1	**$476,759**	$ 423,463	**$260,114**	$ 240,193
Service cost	**18,011**	15,963	**8,178**	7,391
Interest cost	**34,805**	32,663	**18,734**	17,293
Plan participants' contributions	**–**	–	**988**	916
Amendments	**(338)**	325	**(741)**	(10,389)
Actuarial (gain) loss	***40,345***	*13,954*	***27,329***	*15,734*
Acquisitions (divestitures)	**(10,529)**	–	**(5,675)**	–
Benefits paid	**(11,136)**	(9,609)	**(12,945)**	(11,024)
Benefit obligation at December 31	**$547,917**	$ 476,759	**$295,982**	$ 260,114
Change in Plan Assets				
Fair value of plan assets at January 1	**$365,930**	$ 380,773	**$151,077**	$ 150,347
Actual return on plan assets	**(26,560)**	(6,406)	**(11,946)**	(7,369)
Employer contribution	**7,474**	1,172	**19,449**	18,207
Plan participants' contributions	**–**	–	**988**	916
Acquisitions (divestitures)	**(8,664)**	–	**(4,134)**	–
Benefits paid	**(11,136)**	(9,609)	**(12,945)**	(11,024)
Fair value of plan assets at December 31	**$327,044**	$ 365,930	**$142,489**	$ 151,077
Funded status at December 31	**$(220,874)**	$(110,829)	**$(153,494)**	$(109,037)
Unrecognized net transition obligation (asset)	**(134)**	(1,394)	**63,708**	75,044
Unrecognized prior service cost	**5,272**	6,184	**(8)**	(4,389)
Unrecognized net actuarial (gain) loss	**141,911**	43,684	**75,609**	24,574
Net amount recognized	**$(73,825)**	$ (62,355)	**$(14,185)**	$ (13,808)
Amounts recognized in the balance sheet consist of:				
Prepaid benefit cost	**$ 422**	$ 312	**$ –**	$ –
Accrued benefit liability	***(74,246)***	*(62,667)*	***(14,185)***	*(13,808)*
Additional minimum liability	**(16,550)**	(945)	**–**	–
Intangible asset	**4,851**	945	**–**	–
Accumulated other comprehensive income	**11,698**	–	**–**	–
Net amount recognized	**$(73,825)**	$ (62,355)	**$(14,185)**	$(13,808)

At December 31, 2002 and 2001, the accumulated benefit obligation exceeded the fair value of plan assets as follows:

Qualified plans		
Projected benefit obligation	**$520,506**	
Accumulated benefit obligation	**$395,131**	
Fair value of plan assets	**$327,044**	
Nonqualified plans		
Projected benefit obligation	**$ 27,411**	$ 23,709
Accumulated benefit obligation	**$ 21,847**	$ 19,130
Fair value of plan assets	**$ 0**	$ 0

	2002	2001
Components of net periodic pension benefit cost		
Service cost	**$18,011**	$15,963
Interest cost	**34,805**	32,663
Expected return on plan assets	**(32,008)**	(33,921)
Amortization of transition asset	**(1,381)**	(1,161)
Amortization of prior service cost	**780**	1,496
Recognized net actuarial (gain) loss	**512**	(1,927)
Net periodic pension benefit cost	**$20,719**	$13,113
Components of net periodic other postretirement benefit cost		
Service cost	**$ 8,178**	$ 7,391
Interest cost	**18,734**	17,293
Expected return on plan assets	**(13,004)**	(12,865)
Amortization of transition obligation	**6,463**	6,637
Amortization of prior service cost	**–**	248
Recognized net actuarial (gain) loss	**(3)**	(564)
Net periodic other postretirement benefit cost	**$20,368**	$18,140

	Pension Benefits		Other Postretirement Benefits	
	2002	*2001*	**2002**	*2001*
Weighted-average assumptions as of December 31				
Discount rate	**6.75%**	7.25%	**6.75%**	7.25%
Expected return on plan assets	**9.00%**	9.00%	**8.30%**	8.30%
Rate of compensation increase	**4.75%**	4.75%	**4.75%**	4.75%

The health care cost trend rate, used to calculate the Company's cost and obligation for postretirement health care benefits, is a 9.0% annual rate in 2003 that is assumed to decrease gradually to a 5.0% annual rate in 2007 and remain at that level thereafter.

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

	One-Percentage-Point Increase	One-Percentage-Point Decrease
Effect on total of service and interest cost components	$ 4,795	$ (4,193)
Effect on other postretirement benefit obligation	$37,438	$(34,688)

Savings Plans for Employees
The Company maintains 401(k) savings plans that allows associates to save for retirement on a tax-deferred basis. Compensation expense associated with these savings plans was $3,671 in 2002, and $3,836 in 2001.

Included in the above expenses were the Company's matching contributions to the primary savings plan totaling $3,097 for 2002 and $3,398 for 2001 that are invested in a fund of Company common stock.

Employees' Stock Ownership Plan
The Company maintains an Employees' Stock Ownership Plan , which provides for beneficial ownership of Company common stock by associates who are not included in a bargaining unit. Each participating associate can elect to contribute an amount that does not exceed 2% of their wages. In addition to the associate's participation, the Company makes a contribution equivalent to 1/2% of each participant's qualified compensation, and matches 100% of the contribution by each participant. The Company recorded as an expense contributions of $1,782 for 2002 and $1,721 for 2001 that it made to the plan.

Note 11: Stock-Based Compensation

In May 2000 the Company's shareholders approved the 2000 Stock Award and Incentive Plan (2000 Plan). The Plan replaced the Company's previous Long-Term Performance-Based Incentive Plan (Previous Plan) which had been in effect since 1994. Under the Previous Plan, awards could be paid in the form of cash, restricted shares of common stock, or a combination of both. The 2000 Plan allows the Company to continue to grant long-term performance-based awards similar to those that could be paid under the Previous Plan, and also authorizes a broad range of other awards, including options, reload options, deferred stock, performance awards, stock appreciation rights and other stock-based awards, as well as cash-based awards. Up to 4,276,551 shares of common stock may be issued under the 2000 Plan, of which approximately 3,300,000 shares were available to be granted at December 31, 2002.

Stock Options
In May 2000 the Board of Directors approved the issuance of non-qualified stock options to executives and other key associates as permitted under the 2000 Plan. Under this plan the options generally are granted at prices not less than the market value of the stock at the date of grant, become exercisable ratably over a three-year period beginning one-year from the date of grant, and expire ten years from the date of grant. The options vested immediately upon the completion of the Merger on January 10, 2003 (see Note 3). Shortly after the completion of the Merger, total options payments were made amounting to $4,863. The remaining vested options of $12,967 were deferred by participants.

The following table summarizes information about options for the years ended December 31:

	2002		2001	
	Options to Purchase Shares	Weighted-Average Exercise Price	Options to Purchase Shares	Weighted-Average Exercise Price
Outstanding at beginning of year	**895,751**	**$23.66**	781,631	$22.58
Granted	**25,714**	**$43.80**	163,892	28.67
Exercised	**(97,280)**	**$23.63**	(42,184)	22.56
Cancelled/Expired	**(4,200)**	**$31.09**	(7,588)	25.91
Outstanding at end of year	**819,985**	**$24.26**	895,751	$23.66
Exercisable at year end	**473,009**	**$23.31**	273,025	$22.80

The following table summarizes information about fixed stock options outstanding at December 31, 2002:

Exercise Prices	Number Outstanding	Weighted-Average Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$22.56	655,642	7.2	$22.58	418,842	$22.58
26.84	134,179	7.9	28.48	52,683	28.93
31.32	4,450	8.3	31.42	1,484	31.42
35.79 to 44.74	25,714	8.1	43.80	-	-

Options granted under the Company's long-term incentive program were 25,714 and 163,892 for the three-year performance cycles beginning on January 1, 2002 and 2001, respectively.

Restricted Stock
Under the 2000 Plan and the Previous Plan, designated executives and other key associates are eligible to receive restricted stock awards if performance cycle goals based on earnings-per-share growth and total return to Company shareholders in comparison to a designated peer group of companies are met. The fair value of the restricted stock is being charged to expense over each three-year performance cycle.

(Dollars in thousands, except per share amounts)

Note 12: General Taxes

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

	2002	2001
Gross receipts and franchise	**$ 45,105**	$ 42,975
Property and capital stock	**69,367**	64,164
Payroll	**20,588**	17,278
Other general	**5,942**	5,116
	$141,002	$129,533

Note 13: Income Taxes

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

	2002	2001
State Income Taxes:		
Current	**$ 17,038**	$ 13,725
Deferred		
Current	**(39)**	(49)
Non-current	**3,675**	3,457
	$ 20,674	$ 17,133
Federal Income Taxes:		
Current	**$ 46,191**	$ 69,356
Deferred		
Current	**(404)**	36
Non-current	**58,019**	25,338
Amortization of deferred investment tax credits	**(1,476)**	(1,539)
	$102,330	$ 93,191

A reconciliation of income tax expense at the statutory federal income tax rate to actual income tax expense is as follows:

	2002	2001
Income tax at statutory rate	**$ 93,586**	$ 95,132
Increases (decreases) resulting from –		
State taxes, net of federal taxes	**13,438**	11,136
Flow through differences	**2,640**	1,359
Amortization of investment tax credits	**(1,476)**	(1,539)
Subsidiary preferred dividends	**952**	1,046
Other, net	**13,864**	3,190
Actual income tax expense	**$123,004**	$110,324

The following table provides the components of the net deferred tax liability at December 31:

	2002	2001
Deferred Tax Assets:		
Advances and contributions	**$ 61,622**	$ 69,333
Deferred investment tax credits	**13,438**	12,939
Postretirement benefits	**1,655**	1,010
Pension benefits	**5,206**	3,260
Other	**31,870**	39,611
	113,791	126,153
Deferred Tax Liabilities:		
Utility plant, principally due to depreciation differences	**614,213**	602,614
Income taxes recoverable through rates	**48,240**	44,390
Deferred security costs	**11,994**	2,498
Deferred financial and customer service costs	**5,199**	5,050
Other comprehensive income	**4,324**	3,538
Other	**76,872**	92,512
	760,842	750,602
	$(647,051)	$ (624,449)

No material valuation allowances were required on deferred tax assets at December 31, 2002 and 2001.

Note 14: Leases

The Company has entered into operating leases involving certain facilities and equipment. Rental expenses under operating leases were $ 14,641 for 2002 and $17,579 for 2001. Capital leases currently in effect are not significant.

At December 31, 2002, the minimum annual future rental commitment under operating leases that have initial or remaining noncancellable lease terms in excess of one year are $14,001 in 2003, $11,977 in 2004, $9,679 in 2005, $6,531 in 2006, $4,207 in 2007 and $8,606 thereafter.

Note 15: Revolving Credit Agreements

In June 2000 the Company completed the formation of a new wholly owned subsidiary, American Water Capital Corp. ("AWCC"), a special purpose corporation that serves as the primary funding vehicle for American Water Works Company and its regulated subsidiaries. American Water Works has fully and unconditionally guaranteed the securities of AWCC.

AWCC has a 364-day $500,000 revolving credit agreement with a group of eleven domestic and international banks. The renewal date for this facility is July 31, 2003. Borrowing under the revolving credit line, at the Company's option, bears interest at a rate based upon either a defined base rate or the London Interbank Offered Rate (LIBOR). The Company pays a commitment fee of 12.5 basis points on the entire amount of the commitment (whether borrowed or not borrowed) and a usage fee of 50 basis points (62.5 basis points if borrowings exceed $165,000). These fees may fluctuate based upon the Company's current bond rating. Under the credit agreement, the Company must maintain certain financial ratios and meet certain balance sheet tests. No compensating balances are required under the agreement.

AWCC had $233,708 and $395,561 outstanding under commercial paper borrowings at December 31, 2002 and 2001, respectively, all of which was classified as short-term debt. AWCC's revolving credit agreement supports these borrowings. Commercial paper borrowings at December 31, 2002 and 2001 had weighted-average interest rates of 1.55% and 2.35%, respectively.

At December 31, 2002 and 2001, there was $161,004 and $18,522 of short-term debt outstanding, respectively. The weighted average interest rate on these borrowings was 1.67% and 3.52%, respectively.

The total of the unused lines of credit and commercial paper borrowings at December 31, 2002 was $276,292.

Note 16: Segment Information

The Company has identified Regulated Utility Services and Unregulated Services as its two reportable segments. The Company has organized its business based upon the products and services provided and based upon similar environments. The results of operations reported by segment include costs allocated by American Water Works Service Company. The "other items" include corporate costs of American Water Works Company and intersegment eliminations.

The Regulated Utility Services segment includes subsidiaries that provide water and wastewater to customers in the United States of America. All of these companies are subject to both federal and state regulation regarding the quality of water distributed and the discharge of waste residuals. With the exception of one company that serves 4,000 customers, the utility subsidiaries also function under economic regulations prescribed by state regulatory commissions. A subsidiary which owns a treatment plant in Massachusetts that is leased to an affiliated utility subsidiary is also included in this segment.

The Unregulated Services segment includes American Water Services and its subsidiaries and American Water Resources. American Water Services provides a broad range of water and wastewater services including operations and maintenance, residuals management, underground infrastructure development and engineering throughout the U.S. and Canada. American Water Resources currently offers a consumer protection program for residential water service lines and a service to regenerate granular activated carbon that is used by water utilities in the filtration process. Intersegment revenues include carbon regeneration services and leased equipment and office space.

The following table presents information about the Company's reportable segments:

	Regulated Utility Services	Unregulated Services	Other Items	Consolidated
2002				
Revenues from external customers	**$1,486,576**	**$228,597**	**$ -**	**$1,715,173**
Intersegment revenues	**-**	**7,255**	**(7,255)**	**-**
Depreciation and amortization	**216,369**	**13,759**	**(16)**	**230,112**
EBITDA	**682,596**	**6,498**	**35,702**	**724,796**
Interest expense	**186,164**	**7,237**	**33,894**	**227,295**
Income before income taxes	**280,063**	**(14,998)**	**1,824**	**267,389**
Net income	**172,849**	**(10,291)**	**(15,494)**	**147,064**
Total assets	**7,351,347**	**346,163**	**20,873**	**7,718,383**
Capital expenditures	**450,345**	**6,037**	**-**	**456,382**
2001				
Revenues from external customers	$1,376,637	$62,250	$ -	$1,438,887
Intersegment revenues	-	6,980	(6,980)	-
Depreciation and amortization	178,120	6,959	132	185,211
EBITDA	669,332	5,976	(25,768)	649,540
Interest expense	173,213	1,829	17,480	192,522
Income before income taxes	317,999	(2,812)	(43,380)	271,807
Net income	196,097	(2,362)	(32,252)	161,483
Total assets	6,316,667	313,080	(22,648)	6,607,099
Capital expenditures	365,259	15,883	17	381,159

(Dollars in thousands, except per share amounts)

Note 17: Fair Values of Financial Instruments
The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Current assets and current liabilities: The carrying amount reported in the balance sheet for current assets and current liabilities, including revolving credit debt due to the short-term maturities and variable interest rates, approximates their fair values.

Preferred stocks with mandatory redemption requirements and long-term debt: The fair values of the Company's preferred stocks with mandatory redemption requirements and long-term debt are estimated using discounted cash flow analyses based on the Company's current incremental financing rates for similar types of securities.

The carrying amounts and fair values of the Company's financial instruments at December 31 are as follows:

2002	Carrying Amount	Fair Value
Preferred stocks of subsidiaries with mandatory redemption requirements	$ 28,150	$ 28,411
Long-term debt of the Company	297,000	309,600
Long-term debt of subsidiaries	3,367,789	3,681,505

2001	Carrying Amount	Fair Value
Preferred stocks of subsidiaries with mandatory redemption requirements	$ 30,474	$ 32,679
Long-term debt of the Company	309,000	307,907
Long-term debt of subsidiaries	2,404,137	2,436,153

Note 18: Commitments and Contingencies
Construction programs of subsidiaries for 2003 are estimated to cost approximately $350,000. Commitments have been made in connection with certain construction programs.

In connection with obtaining the regulatory approvals necessary to complete the Merger (see Note 3), certain state regulatory bodies have issued orders which prohibit certain of the Company's regulated subsidiaries from requesting rate increases for periods of time not exceeding three years.

The Company is routinely involved in condemnation proceedings and legal actions relating to several subsidiaries. In the opinion of management, none of these matters will have a material adverse effect, if any, on the financial position or results of operations of the Company.

Note 19: Guarantees
The Company's lease arrangements include certain indemnifications in favor of the lessors (e.g., indemnifications for environmental matters) with terms that range in duration and scope and that are not explicitly defined. Where appropriate, an obligation for such indemnifications is recorded as a liability. Because the obligated amounts of these types of indemnifications often are not explicitly stated, the overall maximum amount of the obligation under such indemnifications cannot be reasonably estimated. As of December 31, 2002, the Company has not recorded any liability on its financial statements in connection with these indemnification obligations, as it does not believe, based on information currently available, that it is probable that any amounts will be paid under these guarantees.

In connection with many financing transactions, the Company engages trustees or custodial, escrow or other agents to act for the benefit of the investors or to provide other agency services. The Company typically provides indemnification to these agents for any liability or expenses incurred by them in performing their obligations. No liability is recorded for these indemnifications because the Company believes that it is unlikely that they will be required to perform or otherwise incur any losses associated with these indemnification provisions.

The Company also has various guarantees in contracts entered into in the normal course of business. These guarantees are primarily in the form of indemnities that range in duration and coverage and that do not explicitly state the amount of the indemnification obligation. These guarantees would only result in immaterial increases in future costs and do not represent significant commitments or contingent liabilities of the indebtedness of others. To date, the Company has not made any significant payments for these indemnification obligations.

The Company, on behalf of itself and its subsidiaries, maintains insurance that covers liability assumed under contract for bodily injury and property damage. This insurance may be applicable to certain obligations under the contractual arrangements discussed above.

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