

UNITED BANCORPORATION OF ALABAMA INC

Form 10-Q

November 12, 2008

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

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

For the quarterly period ended September 30, 2008

Commission file number 2-78572

UNITED BANCORPORATION OF ALABAMA, INC.

(Exact name of registrant as specified in its charter)

Delaware

63-0833573

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification Number)

200 East Nashville Avenue, Atmore, Alabama

36502

(Address of principal executive offices)

(Zip Code)

(251) 446-6000

(Registrant's telephone number, including area code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company
(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of November 10, 2008.

Class A Common Stock
Class B Common Stock

2,256,709 Shares
-0- Shares

UNITED BANCORPORATION OF ALABAMA, INC.
FORM 10-Q

For the Quarter Ended September 30, 2008

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PART I FINANCIAL INFORMATION
United Bancorporation of Alabama, Inc.
and Subsidiary
Consolidated Balance Sheets

Item 1. Financial Statements

	September 30, 2008 (Unaudited)	December 31, 2007
Assets		
Cash and due from banks	\$ 12,244,620	\$ 17,571,893
Interest bearing deposits in banks	9,011,933	31,547,422
Federal funds sold	6,000,000	5,000,000
Cash and cash equivalents	27,256,553	54,119,315
Securities available for sale (amortized cost of \$111,450,844 and \$111,718,759 respectively)	111,175,113	111,945,701
Security held to maturity (market values of \$1,050,000 and \$0 respectively)	1,050,000	0
Loans	294,176,681	267,137,723
Less: Allowance for loan losses	3,150,997	3,981,922
Net loans	291,025,684	263,155,801
Premises and equipment, net	18,586,469	16,808,578
Interest receivable	3,323,779	3,952,077
Intangible assets	934,763	934,763
Other assets	10,753,108	6,385,725
Total assets	464,105,469	457,301,960
Liabilities and Stockholders Equity		
Deposits:		
Non-interest bearing	61,045,352	62,854,927
Interest bearing	295,048,307	306,047,638
Total deposits	356,093,659	368,902,565
Securities sold under agreements to repurchase	61,766,047	41,203,851
Advances from Federal Home Loan Bank of Atlanta	1,634,850	1,774,700
Treasury, tax, and loan account	247,128	691,668
Interest payable	922,770	1,161,362
Accrued expenses and other liabilities	1,311,870	1,336,424
Note payable to Trust	10,310,000	10,310,000

Total liabilities	432,286,324	425,380,570
Stockholders equity		
Class A common stock, \$0.01 par value. Authorized 5,000,000 shares; issued and outstanding, 2,388,125 and 2,383,097 shares in 2008 and 2007, respectively	23,881	23,831
Class B common stock, \$0.01 par value. Authorized 250,000 shares; no shares issued or outstanding	0	0
Preferred stock of \$.01 par value. Authorized 250,000 shares; no shares issued or outstanding	0	0
Additional paid in capital	6,063,682	5,916,367
Unearned stock based compensation	(100,101)	(51,403)
Accumulated other comprehensive income (loss) net of tax	(176,799)	122,105
Retained earnings	26,828,638	26,700,500
	32,639,301	32,711,400
Less: 133,006 and 134,654 treasury shares, at cost, respectively	820,156	790,010
Total stockholders equity	31,819,145	31,921,390
Total liabilities and stockholders equity	\$ 464,105,469	\$ 457,301,960

See Notes to Consolidated Financial Statements

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**United Bancorporation of Alabama, Inc.
And Subsidiary
Consolidated Statements of Earnings and Comprehensive Income
(Unaudited)**

	Three Months Ended September 30		Nine Months Ended September 30	
	2008	2007	2008	2007
Interest income:				
Interest and fees on loans	\$ 5,207,737	\$ 5,616,402	\$ 15,230,042	\$ 16,188,641
Interest on investment securities available for sale:				
Taxable	771,681	839,446	2,476,620	2,883,701
Nontaxable	333,840	369,901	1,029,517	1,067,981
Total investment income	1,105,521	1,209,347	3,506,137	3,951,682
Other interest income	83,169	52,897	484,905	652,971
Total interest income	6,396,427	6,878,646	19,221,084	20,793,294
Interest expense:				
Interest on deposits	2,276,454	2,731,059	7,245,415	7,661,024
Interest on other borrowed funds	341,195	781,254	1,293,213	2,604,000
Total interest expense	2,617,649	3,512,313	8,538,628	10,265,024
Net interest income	3,778,778	3,366,333	10,682,456	10,528,270
Provision for loan losses	750,000	240,000	1,490,000	630,000
Net interest income after provision for loan losses	3,028,778	3,126,333	9,192,456	9,898,270
Noninterest income:				
Service charge on deposits	885,734	807,481	2,550,913	2,147,783
Investment securities losses, net	(238)		(177)	(306)
Mortgage loan and related fees	31,653	55,772	150,524	169,879
Other	212,722	204,798	686,322	585,560
Total noninterest income	1,129,871	1,068,051	3,387,582	2,902,916
Noninterest expense:				
Salaries and benefits	2,186,778	2,118,849	6,411,926	6,255,238
Net occupancy expense	725,162	665,035	2,109,184	1,885,163

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Other	1,322,475	1,099,973	3,664,234	3,268,264
Total noninterest expense	4,234,415	3,883,857	12,185,344	11,408,665
Earnings before income tax expense (benefits)	(75,766)	310,527	394,694	1,392,521
Income tax expense (benefits)	(166,192)	(6,461)	(240,273)	160,347
Net earnings	\$ 90,426	\$ 316,988	\$ 634,967	\$ 1,232,174
Basic earnings per share	\$ 0.04	\$ 0.14	\$ 0.28	\$ 0.55
Diluted earnings per share	\$ 0.04	\$ 0.14	\$ 0.28	\$ 0.55
Basic weighted average shares outstanding	2,252,698	2,239,815	2,251,078	2,237,323
Diluted weighted average shares outstanding	2,259,767	2,246,461	2,258,147	2,243,969
Cash dividend per share	\$ 0.08	\$ 0.08	\$ 0.23	\$ 0.23

Statement of Comprehensive Income

Net earnings	\$ 90,426	\$ 316,988	\$ 634,967	\$ 1,232,174
Other comprehensive income (loss), net of tax:				
Unrealized holding gain (losses) arising during the period	(157,301)	901,200	(299,010)	128,457
Reclassification adjustment for losses included in net earnings	143		106	184
Comprehensive income (loss)	\$ (66,732)	\$ 1,218,188	\$ 336,063	\$ 1,360,815

See Notes to Consolidated Financial Statements

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United Bancorporation of Alabama, Inc. and Subsidiary
Consolidated Statements of Cash Flows
(Unaudited)

	Nine Months Ended September 30	
	2008	2007
Cash flows from operating activities		
Net earnings	\$ 634,967	\$ 1,232,174
Adjustments to reconcile net earnings to net cash provided by operating activities		
Provision for loan losses	1,490,000	630,000
Depreciation of premises and equipment	992,540	826,626
Net amortization (accretion) of discount on investment securities	(796,266)	187,457
Loss on sales of investment securities available for sale, net	177	306
(Gain) loss on sale of other real estate	1,045	(28,016)
Writedown of other real estate	85,000	
Stock-based compensation	21,307	4,268
Gain on disposal of equipment	(14,316)	(3,435)
(Increase) decrease in interest receivable	628,298	(381,906)
Decrease in other assets	243,236	326,072
Increase (decrease) in interest payable	(238,592)	161,569
Increase (decrease) in accrued expenses and other liabilities	(25,055)	542,215
Net cash provided by operating activities	3,022,341	3,497,330
Cash flows from investing activities		
Proceeds from maturities, calls, and principal repayments of investment securities available for sale	1,032,513,350	104,585,075
Proceeds from sales of investment securities available for sale	12,492,231	16,958,673
Purchases of investment securities available for sale	(1,043,937,077)	(109,984,970)
Purchase of investment security held to maturity	(1,050,000)	
Net increase in loans	(33,970,557)	(17,614,920)
Purchases of premises and equipment, net	(2,779,715)	(4,561,036)
Proceeds from sale of premises and equipment	23,600	16,238
Insurance claim received		1,038,775
Proceeds from sale of other real estate	113,279	173,016
Net cash used in investing activities	(36,594,889)	(9,389,149)
Cash flows from financing activities		
Net decrease in deposits	(12,808,906)	(98,614)
Net increase (decrease) in securities sold under agreements to repurchase	20,562,196	(13,779,024)
Cash dividends	(506,328)	(561,758)
Proceeds from exercise of stock options	9,986	22,400
Proceeds from sale of common stock	6,732	
Purchase of treasury stock	(63,019)	

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Proceeds from sale of treasury stock	93,515	125,530
Repayments of advances from FHLB Atlanta	(139,850)	(5,139,850)
Decrease in other borrowed funds	(444,540)	(345,526)
Net cash provided by (used in) financing activities	6,709,786	(19,776,842)
Net decrease in cash and cash equivalents	(26,862,762)	(25,668,661)
Cash and cash equivalents, beginning of period	54,119,315	51,204,246
Cash and cash equivalents, end of period	\$ 27,256,553	\$ 25,535,585
Supplemental disclosures		
Cash paid during the period for:		
Interest	\$ 8,777,220	\$ 10,103,455
Income taxes	83,171	94,454
Noncash transactions		
Transfer of loans to other real estate through foreclosure	\$ 4,610,674	\$ 205,000

See Notes to Consolidated Financial Statements

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UNITED BANCORPORATION OF ALABAMA, INC.
AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements

NOTE 1 General

This report includes interim consolidated financial statements of United Bancorporation of Alabama, Inc. (the Corporation) and its wholly-owned subsidiary, United Bank (the Bank). The interim consolidated financial statements in this report have not been audited. In the opinion of management, all adjustments necessary to present fairly the financial position and the results of operations for the interim periods have been made. All such adjustments are of a normal recurring nature. The results of operations are not necessarily indicative of the results of operations for the full year or any other interim periods. For further information, refer to the consolidated financial statements and footnotes included in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2007.

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NOTE 2 Net Earnings per Share

Basic net earnings per share were computed by dividing net earnings by the weighted average number of shares of common stock outstanding during the three and nine month periods ended September 30, 2008 and 2007. Common stock outstanding consists of issued shares less treasury stock. Diluted net earnings per share for the three and nine month periods ended September 30, 2008 and 2007 were computed by dividing net earnings by the weighted average number of shares of common stock and the dilutive effects of the shares subject to options and restricted stock grants awarded under the Corporation's equity incentive plans, based on the treasury stock method using an average fair market value of the stock during the respective periods. Presented below is a summary of the components used to calculate diluted earnings per share for the three and nine months ended September 30, 2008 and 2007:

	Three Months Ended September 30		Nine Months Ended September 30	
	2008	2007	2008	2007
Diluted earnings per share	\$ 0.04	\$ 0.14	\$ 0.28	\$ 0.55
Weighted average common shares outstanding	2,252,698	2,239,815	2,251,078	2,237,323
Effect of the assumed exercise of stock options based on the treasury stock method using average market price	7,069	6,646	7,069	6,646
Total weighted average common shares and potential common stock outstanding	2,259,767	2,246,461	2,258,147	2,243,969

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NOTE 3 Allowance for Loan Losses

The following table summarizes the activity in the allowance for loan losses for the nine month periods ended September 30 (\$ in thousands):

	September 30	
	2008	2007
Balance at beginning of year	3,982	3,011
Provision charged to expense	1,490	630
Loans charged off	(2,361)	(355)
Recoveries	40	23
Balance at end of period	3,151	3,309

At September 30, 2008 and 2007, the amounts of nonaccrual loans were \$6,488,722 and \$6,980,236 respectively.

NOTE 4 Operating Segments

Statement of Financial Accounting Standard 131 (SFAS 131), *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for the disclosure made by public business enterprises to report information about operating segments in annual financial statements and requires those enterprises to report selected information about operating segments in interim financial reports issued to shareholders. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. The Corporation operates in only one segment – commercial banking.

NOTE 5 Stock Based Compensation

At September 30, 2008, the Corporation had two stock-based compensation plans, the 1998 Stock Option Plan and the 2007 Equity Incentive Plan, which are described more fully in Note 12 to the Consolidated Financial Statements in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2007. Effective January 1, 2006, the Corporation adopted SFAS 123R, *Share-Based Payment*, whereby compensation cost is recognized for all stock-based payments based upon the grant-date fair value.

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The following table represents stock option activity for the nine months ended September 30, 2008:

	Shares under option	Weighted average exercise price per share	Weighted average remaining contractual life
Options outstanding, beginning of period	53,600	\$ 14.38	
Granted			
Surrendered			
Exercised	(634)	15.75	
Options outstanding, end of period	52,966	14.36	2.9
Exercisable, end of period	50,966	14.83	2.7

The following table displays information pertaining to the intrinsic value of option shares outstanding and exercisable for the periods ended September 30, 2008 and 2007, respectively.

	2008	2007
Aggregate intrinsic value of outstanding options	\$48,461	\$301,237

Aggregate intrinsic value of exercisable options	\$48,461	\$290,037
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Shares available for future stock option grants to employees and directors under the 1998 Stock Option Plan of United Bancorporation of Alabama, Inc. were 170,400 at September 30, 2008. The Corporation does not intend to issue additional options under the 1998 Stock Option Plan.

2007 Equity Incentive Plan

The following table represents stock option activity for the nine months ended September 30, 2008:

	Shares under option	Weighted average exercise price per share	Weighted average remaining contractual life
Options outstanding, beginning of period	2,000	\$ 18.50	
Granted			
Surrendered			
Exercised			
Options outstanding, end of period	2,000	18.50	9.2

Exercisable, end of period	400	18.50	9.2
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The shares outstanding and exercisable under the 2007 Equity Incentive Plan had no intrinsic value as of September 30, 2008 as the fair market value was equal to or less than the exercise price.

The Corporation did not issue any stock options during the nine months ended September 30, 2008.

Cash received from the exercise of stock options was \$ 9,986 for the nine months ended September 30, 2008.

Restricted Stock

The following table represents restricted stock activity under the 2007 Equity Incentive Plan for the nine months ended September 30, 2008:

	Restricted stock activity	Weighted average fair value
Shares granted at beginning of period	5,626	\$18.00
Granted	4,459	16.51
Surrendered	(505)	18.00
Vested	(2,620)	18.00
Shares granted at end of period	6,960	17.05

Shares available for future stock grants to employees and directors under the 2007 Equity Incentive Plan of United Bancorporation of Alabama, Inc. were 296,420 at September 30, 2008.

As of September 30, 2008, there was \$117,290 of total unrecognized compensation costs related to the nonvested share based compensation arrangements granted under the 1998 and 2007 Plans. That cost is expected to be recognized over a period of approximately 3.3 years.

NOTE 6 Fair Value Measurements

On January 1, 2008, the Corporation adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 157 applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements; accordingly, the standard does not require any new fair value measurements of reported balances. On February 12, 2008, the Financial Accounting Standards Board (FASB) issued Staff Position 157-2 which defers the effective date of SFAS No. 157 for certain nonfinancial assets and liabilities to fiscal years beginning after November 15, 2008. All other provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years.

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On October 10, 2008, the FASB issued FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for that Asset Is Not Active*. This FSP clarifies the application of SFAS No. 157 in a market that is not active and reiterates that the results of distressed sales or forced liquidations are not determinative when measuring fair value. It emphasizes that when determining fair value, the use of management's internal assumptions concerning future cash flows discounted at an appropriate risk-adjusted interest rate is acceptable when relevant observable market data do not exist. In some situations, multiple inputs from a variety of sources may provide the best evidence of fair value. The FSP also describes how the use of broker quotes should be considered when assessing the relevance of observable and unobservable inputs.

As defined in SFAS No. 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Corporation uses various methods including market, income and cost approaches. Based on these approaches, the Corporation often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and / or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Corporation utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Based on the observability of the inputs used in the valuation techniques the Corporation is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities that are traded in an active exchange market, as well as U.S. Treasury securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments, as well as U.S. Government and agency mortgage-backed debt securities whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

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Assets Measured at Fair Value on a Recurring Basis

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Available-for-Sale Securities

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy. Currently, all of the Corporation's available-for-sale securities are considered to be Level 2 securities.

Assets Measured at Fair Value on a Nonrecurring Basis

Following is a description of the valuation methodologies used for instruments measured at fair value on a nonrecurring basis and recognized in the accompanying balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Impaired Loans

Loan impairment is reported when full payment under the loan terms is not expected. Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate, or the fair value of collateral if the loan is collateral dependent. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to require increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of a loan is confirmed. During the first nine months of 2008, certain impaired loans were partially charged-off or re-evaluated for impairment resulting in a remaining balance for these loans, net of specific allowances, of \$7,997,804 as of September 30, 2008. This valuation would be considered Level 3, consisting of appraisals of underlying collateral and discounted cash flow analysis.

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Other Real Estate Owned

Other real estate assets acquired through or in lieu of foreclosure are held for sale and are initially recorded at the lower of cost or fair value. Any write-downs to fair value at the time of transfer to foreclosed assets are charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less costs to sell. This valuation process would be considered Level 3, consisting of appraisals of real estate collateral. At September 30, 2008, the Corporation had \$4,962,126 of other real estate owned.

In February, 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115*. SFAS 159 allows companies to report selected financial assets and liabilities at fair value. The changes in fair value are recognized in earnings and the assets and liabilities measured under this methodology are required to be displayed separately in the balance sheet. While SFAS 159 is effective for the Corporation beginning January 1, 2008, the Corporation has not elected the fair value option that is offered by this statement.

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

Forward-Looking Statements

When used or incorporated by reference herein, the words anticipate, estimate, expect, project, target, goal, and similar expressions, are intended to identify forward-looking statements within the meaning of Section 27A of the Securities Act of 1933. Such forward-looking statements are subject to certain risk, uncertainties, and assumptions including those set forth herein. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those expected or projected. These forward-looking statements speak only as of the date they are made. The Corporation expressly disclaims any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained herein to reflect any change in the Corporation's expectations with regard to any change in events, conditions or circumstances on which any such statement is based.

Critical Accounting Estimates

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, which require management to make estimates and assumptions. Management believes that its determination of the allowance for loan losses is a critical accounting policy and involves a higher degree of judgment and complexity than the Bank's other significant accounting policies. Further, these estimates can be materially impacted by changes in market conditions or the actual or perceived financial condition of the Bank's borrowers, subjecting the Bank to significant volatility of earnings.

The allowance for loan losses is regularly evaluated by management and reviewed by the Board of Directors for accuracy by taking into consideration factors such as changes in the nature and volume of the loan portfolio; trends in actual and forecasted portfolio credit quality, including delinquency, charge-off and bankruptcy rates; and current economic conditions that may affect a borrower's ability to pay. The use of different estimates or assumptions could produce different provisions for loan losses. The allowance for credit losses is established through the provision for loan losses, which is a charge against earnings.

The estimation of fair value is significant to a number of the Corporation's assets, including, but not limited to, investment securities, other real estate, intangible assets and other repossessed assets. Investment securities are recorded at fair value while other real estate, intangible assets and other repossessed assets are recorded at either cost or fair value, whichever is lower. Fair values for investment securities are based on quoted market prices, and if not available, quoted prices on similar instruments. The fair values of other real estate and repossessions are typically determined based on third-party appraisals less estimated costs to sell. Intangible assets, such as the charter cost, discussed in Intangible Assets below, are periodically evaluated to determine if any impairment might exist. The estimation of fair value and subsequent changes to fair value of investment securities, other

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real estate, repossessions and intangible assets can have a significant impact on the value of the Corporation, as well as have an impact on the recorded values and subsequently reported net income.

Changes in interest rates are the primary determining factor in the fair value of investment securities, and the value at which these assets are reported in the Corporation's financial statements. Local economic conditions are often the key factor in the valuation of other real estate and repossessed assets. Changes in these factors can cause assets to be written down and have an impact on the financial results. The overall financial condition and results of operations of the banking unit is the primary determinant as to the value of recorded intangible assets.

Results of Operations

The following financial review is presented to provide an analysis of the results of operations of the Corporation and the Bank for the three and nine months ended September 30, 2008 and 2007, compared. This review should be used in conjunction with the consolidated financial statements included in the Form 10-Q.

Nine Months Ended September 30, 2008 and 2007, Compared

Summary

Net income for the nine months ended September 30, 2008 was \$634,967, a decrease of \$597,207, or 48.5%, from the same period in 2007. The primary reasons for the decrease were an increase in the provision for loan losses and increased operating expenses. Both of these items are discussed in detail below.

Net Interest Income

In comparison to the first nine months of 2007, total interest income in the 2008 period was \$19,221,084, a decrease of \$1,572,210 (7.6%). This decrease occurred during a period of significant rate reductions by the Federal Reserve, which produced declines in market rates. Specifically, the target Fed Funds rate was reduced to 2.00% at April 30, 2008 from 4.25% at December 31, 2007 and the prime rate declined to 5.00% from 7.25% during the same period. These decreases substantially reduced the interest rate charged on loans which are indexed to the prime rate or other market rates. Also contributing to the decline in interest income from loans was the level of nonaccrual loans that were carried during the 2008 period as compared to the same period in 2007. Although the amount of nonaccrual loans was approximately the same at September 30 of 2008 and 2007, the average for 2008 was much greater as the decline in economic activity did not begin until the third quarter of 2007. The effect of both of these factors was that the rate earned on loans for the 2008 period was 7.08% compared to 8.62% in the 2007 period. This revenue decline was partially offset by increased interest income on earning assets as average earning assets for the nine months ended September 30, 2008 were \$56,000,000 higher than the average for the same period in 2007.

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Total interest expense for the first nine months of 2008 was \$8,538,628, a decrease of \$1,726,396 (16.8%) as compared to the same period of 2007. The reduction in interest rates had a slower impact on the rate paid on interest bearing liabilities as time deposits maintain their rate until the rate can be adjusted at their maturity date. Additionally, the effect of lower rates was countered by the increase in interest bearing liabilities of \$59,000,000 (18.4%) between the periods. On September 30, 2007, as planned, the Corporation redeemed the \$4,000,000 of Trust Preferred Securities issued in 2002. This action had the effect of reducing both interest expense and the volume of Trust Preferred Securities outstanding.

Contributing to the increase in both earning assets and interest bearing liabilities was a large, temporary transaction, averaging approximately \$20,000,000 for the first nine months of 2008, which was an accommodation to a core customer in which the customer had received funds that were to be used in its business over a six month period (customer accommodation transaction). The Bank held the majority of these funds in repurchase agreement accounts and invested in short term, liquid collateral at higher interest rates. The increases in both interest earning assets and interest bearing liabilities from this transaction have declined significantly as the customer has withdrawn the funds for their intended use. As a result of the current, unsettled economic environment, the customer, during the quarter, altered its funding strategy and is expected to occasionally make additional deposits in this account over the next four to six months, which would keep the asset level elevated for that period of time. This transaction affects several areas of the balance sheet and income statement and is further discussed in other sections of this report.

The result of the changes in interest income and interest expense is a net interest income for the first nine months of 2008 of \$10,682,456, an increase of \$154,186 from the 2007 period. The percentage net interest margin for the nine months ended September 30, 2008 decreased to 3.42% from 3.89% in the same period in 2007. The difference in timing of the effect of lower rates on the assets and liabilities and the increased asset size at lower spreads caused by the customer accommodation transaction discussed above are major factors in this reduction.

Provision for Loan Losses

The provision for loan losses totaled \$1,490,000 for the first nine months of 2008 as compared to \$630,000 for the same period in 2007, an increase of \$860,000 or 136.5%. The increase to the Bank's provision reflects the growth of the loan portfolio, historical and current loan losses, the current assessment of nonaccrual loans, and the general economy. For a further, detailed discussion of these changes see Allowance for Loan Losses below.

Noninterest Income

Total noninterest income for the first nine months of 2008 was \$3,387,582, an increase of \$484,666 or 16.7% over the same period in 2007. Two factors are largely responsible for this increase. The first is the increase in service charges on deposits of \$403,130, or 18.8%. The Bank undertook a review of its service charges in mid 2007 which resulted in increases to several of these fees to current market levels at that time. These adjustments together with the expanded number of market

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areas contributed to the increase in service charges. The second factor is the increase of other noninterest income of \$100,762, or 17.2%. This increase in other noninterest income is primarily attributable to increases in income from financial services (trust, brokerage, and insurance) totaling \$94,000.

Noninterest Expense

Total noninterest expense for the first nine months of 2008 was \$12,185,344, an increase of \$776,679, or 6.8%, compared to the same period of 2007. The increase is primarily the result of the Bank's expansion into the Santa Rosa County, Florida and Baldwin County, Alabama markets. During the fourth quarter of 2007, new facilities were put into service in Summerdale and Spanish Fort, Alabama; and, Jay, Pace and Milton, Florida. Increases in personnel to staff the new facilities added to salary and benefit expense. The increases in operating expenses associated with these facilities produced an increase in occupancy expense of \$224,021 to \$2,109,184 as compared to the same nine month period in 2007. The increase was primarily comprised of depreciation on the new facilities and utilities used in their operation. Other expenses rose by \$395,970 to \$3,664,234. Legal expenses increased by \$164,000, largely attributable to matters relating to a large nonaccrual loan. Additionally, a loss of \$85,000 was incurred in the disposal of a parcel of foreclosed property. Insurance premiums paid to the Federal Deposit Insurance Corporation, or FDIC, increased \$113,000.

Income Taxes

Earnings before taxes for the first nine months of 2008 were \$394,694 as compared to \$1,392,521 in the same period of 2007, a decrease of \$997,827 or 71.7%. Income taxes for the period ended September 30, 2008 were a benefit of \$240,273 compared to an expense of \$160,347 for the same period in 2007.

Three Months Ended September 30, 2008 and 2007, Compared

Summary

Net earnings for the three months ended September 30, 2008 were \$90,426, a decrease of \$226,562, or 71.45% compared to the same period in 2007.

Net Interest Income

Total interest income was \$6,396,427, a decrease of \$482,219 or 7.0% for the third quarter of 2008 as compared to 2007. This was the result of the decreases in prevailing market rates described previously. Average loans continued to grow during the quarter and increased by \$31.6 million compared with the same quarter in 2007. The average rate earned during the third quarter of 2008 was 5.99% as compared to 7.56% in 2007, reflecting the substantial reduction in interest rates experienced beginning in the first quarter of 2008.

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Total interest expense for the third quarter of 2008 was \$2,617,649, a decrease of \$894,664, or 25.5%, compared to the same period in 2007. Average interest bearing liabilities for the third quarter increased approximately \$69,583,000 to approximately \$382,669,000 as compared to 2007 largely as the result of the customer accommodation transaction discussed above. The average rate paid decreased to 2.71% in 2008 as compared to 4.45% in 2007.

The net interest margin decreased to 3.61% for the third quarter of 2008, as compared to 3.81% for the same period in 2007. The reduction in the margin is a reflection of the reduction in the yield on loans that immediately reprice with movements in interest rates, with a slower reaction in the cost of funds as time deposits are repriced only as they reach maturity and are renewed. The effect of the temporary customer accommodation transaction is a reduction of the percentage net interest margin.

Provision for Loan Losses

The provision for loan losses totaled \$750,000 for the third quarter of 2008 as compared to \$240,000 for the same period in 2007. The increased level of both nonaccrual assets and charge offs experienced during the period are responsible for the increase. For further discussion of the provision for loan losses, see the Allowance for Loan Losses discussion below.

Noninterest Income

Total noninterest income for the third quarter of 2008 was \$1,129,871, an increase of \$61,820 or 5.8%. The primary source of the increase was service charges on deposits, as they increased \$78,253, or 9.7%, for the third quarter of 2008 as compared to 2007. This was primarily the result of increased activity as a result of the additional locations and increased instances of account overdrafts in a weakening economy.

Noninterest Expense

Total noninterest expense for the third quarter of 2008 was \$4,234,415, an increase of \$350,558, or 9.0%, compared to the same quarter of 2007. Salaries and benefits increased \$67,929, or 3.2%, in the third quarter of 2008 as compared to the same quarter of 2007. Occupancy expense increased \$60,127, or 9.0%, in the third quarter of 2008. Both of these increases were largely associated with the completion of the new branches discussed earlier that have staff and depreciation expenses in the current period that were not applicable in 2007. Other noninterest expense increased \$222,502, or 20.2%, to \$1,322,475 for the three months ended September 30, 2008. Increases in expenses associated with legal fees due to nonaccrual loans (\$62,000), FDIC insurance costs (\$61,000), communication expenses (\$51,000), loan related expenses (\$20,000), and data processing (\$16,000) contributed to the higher level of noninterest expense for the quarter ended September 30, 2008.

Income Taxes

Earnings before taxes for the third quarter of 2008 were negative \$75,766 as compared to \$310,527 in the third quarter of 2007, a decrease of \$386,293. Income taxes for the third quarter were a benefit of \$166,192 as compared to a benefit of \$6,461 for the same period in 2007.

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Financial Condition and Liquidity

Total assets on September 30, 2008 were \$464,105,469, an increase of approximately \$6,804,000 or 1.5% from December 31, 2007. The increase was primarily attributable to the increased repurchase agreements of approximately \$20,562,000 and the result of the customer accommodation transaction described above. The ratio of loans (net of allowance) to deposits plus repurchase agreements on September 30, 2008 was 69.7% as compared to 64.2% on December 31, 2007.

Cash and Cash Equivalents

Cash and cash equivalents as of September 30, 2008 totaled \$27,256,553, a decrease of approximately \$26,863,000, or 49.6%, from December 31, 2007. The decrease was caused by a \$36,000,000 reduction of a seasonal, public funds deposit held at December 31, 2007, which was partially offset by the customer accommodation transaction discussed previously.

Investment Securities Available-for-sale

Securities available-for-sale totaled \$111,175,113, a decrease of approximately \$771,000, or 0.7%, over the first nine months of 2008.

Investment Securities Held-to-maturity

Securities held-to-maturity totaled \$1,050,000, as the bank purchased a single security in September 2008 and classified it as held-to-maturity.

Loans

Net loans were \$291,025,684, an increase of \$27,869,883 or 10.6% at September 30, 2008, from December 31, 2007. This growth is a result of the increased presence in the new, higher growth markets and the strategic hires in 2007 of several commercial loan officers, who are now beginning to generate additional loan requests and approvals.

Allowance for Loan Losses

The allowance for losses on loans is maintained at levels that reflect the historic loss rate on the majority of the portfolio and the difference between the loan balance and the fair value for loans that are considered to be impaired. A loan is considered impaired when it is 1) probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreements or 2) the loan terms have been renegotiated to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrower. The historic loss rate is adjusted for the effects of: general economy, local economy, trends in nonaccrual loans and past due loans, growth in loans and peer levels of reserves. Loans that are deemed to be impaired are valued either at the present value of the cash flow anticipated or the value of the collateral, reduced by the cost of monetizing. Net charged-off loans for the first

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nine months of 2008 were approximately \$2,321,000, as compared to approximately \$332,500 for the same period in 2007. The loans charged off during the first nine months are among those previously identified as a nonaccrual loan by management in accordance with regulatory guidance pertaining to the allowance for loan losses. The foreclosure on one previously identified, nonaccrual loan caused approximately \$1,500,000 of the net charge-offs experienced in the first nine months and resulted in approximately \$1,500,000 being moved from loans to other real estate owned. The Corporation has procedures in place to identify and deal with problem loans and potential problem loans. It is the goal of the Corporation to identify any problems, to develop and execute strategies to deal with those identified and establish reserves to deal with identified and historic shortfalls. Although reserves may be considered appropriate at a point in time, future events may change the ability of a borrower to pay or the underlying value of collateral. As of September 30, 2008, the reserve level of \$3,150,997 is considered to be appropriate considering the reserves allocated on specifically identified credits and a general allowance based on historic losses adjusted as noted above. This reserve level is equivalent to 1.07% of gross loans. The Corporation will continue to monitor closely the condition of the portfolio and, in the current, uncertain economy, continue with its program to strengthen the level of reserves. The amount of impaired loans determined under SFAS No. 114 and 118 has been considered in the summary of non-performing assets below. These credits were considered in determining the adequacy of the allowance for loan losses and are regularly monitored for changes within a particular industry or general economic trends, which could cause the borrowers financial difficulties. At September 30, 2008 the Bank had \$8,122,755 of nonaccrual and restructured loans, compared to \$11,710,174 at December 31, 2007.

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Non-performing Assets: The following table sets forth the Corporation's non-performing assets at September 30, 2008 and December 31, 2007. Under the Corporation's nonaccrual policy, a loan is placed on nonaccrual status when collectibility of principal and interest is in doubt.

Description	September 30, 2008	December 31, 2007
	(Dollars in Thousands)	
A Loans accounted for on a nonaccrual basis	\$ 6,489	\$ 11,079
B Loans which are contractually past due ninety days or more as to interest or principal payments (excluding balances included in (A) above)	22	26
C Loans, the terms of which have been renegotiated to provide a reduction or deferral of interest or principal because of a deterioration in the financial position of the borrower	1,634	54
D Other non-performing assets (ORE)	4,962	551
Total	\$ 13,107	\$ 11,710

Premises and Equipment

Premises and equipment increased \$1,777,891 during the first nine months of 2008 as the Loxley branch facility was placed in service on September 15, 2008 and construction continued on the Milton, Florida permanent office. The approximate amount anticipated to complete these projects was \$700,000 as of September 30, 2008.

Intangible Assets

As of September 30, 2008 and December 31, 2007, the Corporation had recorded \$934,763 in intangible assets.

Florida Charter On July 2, 2004, the Corporation acquired a State of Florida banking charter from a financial institution for \$917,263. Subsequent to the purchase, the charter was terminated but the Corporation retained the legal right to branch into Florida through its existing Alabama bank charter. The Corporation accounts for the charter cost as an indefinite lived intangible

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asset because the legal right acquired does not have an expiration date under Florida banking laws and there is no renewal process to keep the branching rights. The Corporation tests the intangible asset each September 30 for impairment. At September 30, 2008, the Corporation operated three branch offices in Florida.

Internet Domain Address On March 21, 2007, the Bank purchased the rights to the internet domain name www.unitedbank.com for \$17,500. This internet domain is defined as an intangible asset with an indefinite life under FAS 142 and, as such, is not required to be amortized over any period of time.

For the three and nine months ended September 30, 2008 no impairment was recorded related to the intangible assets.

Deposits

Total deposits decreased approximately \$12,809,000, or 3.5%, at September 30, 2008 from December 31, 2007, including decreases of approximately \$1,810,000 in non-interest bearing deposits and approximately \$10,999,000 in interest bearing deposits. The change in deposits has several components. A large public funds depositor has a seasonal deposit relationship, consistent with the collection and disbursement of property taxes, which has deposits increasing to a high balance in December and then declining in the first quarter. The change associated with this relationship between December, 2007 and September, 2008 was a reduction of approximately \$36,000,000. This decline was offset by: deposits from a new public funds relationship of approximately \$10,000,000 and core deposit increases of approximately \$12,000,000 attributable to growth throughout the branch network in the normal course of business.

Repurchase Agreements

Securities sold under agreements to repurchase increased \$20,562,196 to \$61,766,047, or 49.9%, as compared to the balance of \$41,203,851 as of December 31, 2007. This increase is attributable to the Bank's customer accommodation transaction, as described more fully in Net Interest Income above.

Liquidity

One of the Corporation's goals is to provide adequate funds to meet changes in loan demand or any potential increase in the normal level of deposit withdrawals. This goal is accomplished primarily by generating cash from operating activities and maintaining sufficient short-term assets. These sources, coupled with a stable deposit base, allow the Corporation to fund earning assets and maintain the availability of funds. Management believes that the Corporation's traditional sources of maturing loans and investment securities, cash from operating activities and a strong base of core deposits are adequate to meet the Corporation's liquidity needs for normal operations. To provide additional liquidity, the Corporation utilizes short-term financing through the purchase of federal funds, and maintains a borrowing relationship with the Federal Reserve Bank to provide liquidity. Should the Corporation's traditional sources of liquidity be constrained, forcing the Bank to pursue avenues of funding not typically used, the Corporation's net interest margin could be impacted

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negatively. The Corporation's bank subsidiary has an Asset Liability Management Committee, which has as its primary objective the maintenance of specific funding and investment strategies to achieve short-term and long-term financial goals. The Corporation's liquidity at September 30, 2008 is considered adequate by management.

Capital Adequacy

The Corporation has generally relied primarily on internally generated capital growth to maintain capital adequacy. Total stockholders' equity on September 30, 2008, was \$31,819,145, a decrease of \$102,245, or 0.3%, from December 31, 2007. This net decrease is a combination of current period earnings offset by a decrease in unrealized gains on securities available for sale.

The table below sets forth various capital ratios for the Corporation and the Bank. Under current regulatory guidelines, debt associated with Trust Preferred Securities qualifies as Tier 1 capital. At September 30, 2008, Trust Preferred Securities included in Tier 1 capital totaled \$10 million bringing total regulatory Tier 1 capital to \$41,061,181. This results in a risk based capital ratio of 12.88%.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and its Bank to maintain minimum total capital (Total Risk-Based Capital) of at least 8% of risk-weighted assets, minimum core capital (Tier I Risk-Based Capital) of at least 4% of risk-weighted assets, and a minimum leverage ratio of at least 4% of average assets. Management believes, as of September 30, 2008 that the Corporation and its Bank meet all capital adequacy requirements to which they are subject.

As of September 30, 2008, the most recent notification from the appropriate regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum Total Risk Based Capital, Tier I Risk-Based Capital, and leverage ratios of at least 10%, 6%, and 5%, respectively. There are no conditions or events since that notification that management believes have changed the Bank's category.

	September 30, 2008	Well Capitalized Treatment
United Bancorporation of Alabama, Inc.		
Total risk-based capital	12.88%	N/A
Tier 1 risk-based capital	11.96	N/A
Leverage Ratio	8.91	N/A
United Bank		
Total risk-based capital	12.70%	10.00%
Tier 1 risk-based capital	11.78	6.00
Leverage ratio	8.50	5.00

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Based on management's projections, existing internally generated capital and the capital previously raised by issuance of trust preferred securities should be sufficient to satisfy capital requirements in the foreseeable future for existing operations, and for some expansion efforts. Continued growth into new markets may require the Corporation to further access external funding sources. There can be no assurance that such funding sources will be available to the Corporation.

Under the Troubled Asset Relief Program Capital Purchase Program (TARP), adopted pursuant to the Emergency Economic Stabilization Act of 2008, the Department of Treasury will make up to \$250 billion available to U.S. financial institutions. The Corporation is evaluating its eligibility for, and the desirability of participating in, the TARP.

Off-Balance Sheet items

The Bank is a party to financial obligations with off-balance sheet risk in the normal course of business. The financial obligations include commitments to extend credit, standby letters of credit issued to customers, and standby letters of credit issued to the Bank by Federal Home Loan Bank of Atlanta (FHLB), which are pledged as collateral to insure public deposits held in the SAFE Program of the Alabama State Treasurer.

The following table sets forth the off-balance sheet risk of the Bank as of September 30, 2008.

	September 30, 2008
Commitments to extend credit	\$29,447,000
Standby letters of credit	1,617,277
FHLB letters of credit to United Bank	5,000,000

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Item 4T. Controls and Procedures

Based on evaluation of the Corporation's disclosure controls and procedures (as such term is defined in Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this quarterly report, the principal executive officer and the principal financial officer of the Corporation have concluded that as of such date the Corporation's disclosure controls and procedures were effective to ensure that information the Corporation is required to disclose in its filings under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms, and to ensure that information required to be disclosed by the Corporation in the reports that it files under the Exchange Act is accumulated and communicated to the Corporation's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

There were no changes in the Corporation's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

The Corporation engaged consultants to assist the Corporation in establishing its process for evaluation of internal controls in anticipation of the upcoming effectiveness of regulations under Section 404 of the Sarbanes-Oxley Act of 2002. There was no change in the Corporation's internal controls over financial reporting during the period covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Item 6. Exhibits

(a) Exhibits.

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

99.1 Report of United Bank mailed November 10, 2008

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SIGNATURES

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

UNITED BANCORPORATION OF
ALABAMA, INC.

Date: November 12, 2008

/s/ Robert R. Jones, III
Robert R. Jones, III
President and CEO

/s/ Allen O. Jones, Jr.
Allen O. Jones, Jr.
Senior Vice President and CFO

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INDEX TO EXHIBITS

EXHIBIT NUMBER	DESCRIPTION
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification pursuant to 18 U.S.C. Section 1350, adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification pursuant to 18 U.S.C. Section 1350, adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002
99.1	Report of United Bank mailed November 10, 2008 28

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

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

(In thousands, except per share data)

	Common Stock					Treasury Stock		Preferred Stock of Subsidiary Companies Without Mandatory Redemption Requirements	Total Stockholders' Equity
	Shares	Par Value	Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Shares	At Cost		
Balance at December 31, 2011	175,664	\$ 1,757	\$ 6,180,558	\$ (1,848,801)	\$ (97,677)	0	\$ 0	\$ 4,547	\$ 4,240,384
Net income				148,780					148,780
Direct stock reinvestment and purchase plan, net of expense of \$6	30	0	1,022						1,022
Employee stock purchase plan	26	0	1,056			31	1,046		2,102
Stock-based compensation activity	597	6	15,958	(399)		(31)	(1,046)		14,519
Other comprehensive income, net of tax of \$2,390					3,787				3,787
Dividends				(84,619)					(84,619)
Balance at June 30, 2012	176,317	\$ 1,763	\$ 6,198,594	\$ (1,785,039)	\$ (93,890)	0	\$ 0	\$ 4,547	\$ 4,325,975

	Common Stock					Treasury Stock		Preferred Stock of Subsidiary Companies Without Mandatory Redemption Requirements	Total Stockholders' Equity
	Shares	Par Value	Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Shares	At Cost		
Balance at December 31, 2010	174,996	\$ 1,750	\$ 6,156,675	\$ (1,959,235)	\$ (71,446)	(1)	\$ (19)	\$ 4,547	\$ 4,132,272
Net income				107,343					107,343
Direct stock reinvestment and purchase plan, net of expense of \$9	34	0	948						948
	59	1	1,586						1,587

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Employee stock purchase
plan

Stock-based compensation activity	349	3	10,838	(392)		1	19			10,468
Other comprehensive income, net of tax of \$1,496									2,750	2,750
Dividends				(117,456)						(117,456)
Balance at June 30, 2011	175,438	\$ 1,754	\$ 6,170,047	\$ (1,969,740)	\$ (68,696)	0	\$ 0	\$ 4,547		\$ 4,137,912

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

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American Water Works Company, Inc. and Subsidiary Companies

Notes to Consolidated Financial Statements (Unaudited)

(In thousands, except per share data)

Note 1: Basis of Presentation

The accompanying Consolidated Balance Sheet of American Water Works Company, Inc. and Subsidiary Companies (the Company) at June 30, 2012, the Consolidated Statements of Operations and Comprehensive Income for the three and six months ended June 30, 2012 and 2011, the Consolidated Statements of Cash Flows for the six months ended June 30, 2012 and 2011, and the Consolidated Statements of Changes in Stockholders' Equity for the six months ended June 30, 2012 and 2011, are unaudited, but reflect all adjustments, which are, in the opinion of management, necessary to present fairly the consolidated financial position, the consolidated changes in stockholders' equity, the consolidated results of operations and comprehensive income, and the consolidated cash flows for the periods presented. All adjustments are of a normal, recurring nature, except as otherwise disclosed. Because they cover interim periods, the unaudited consolidated financial statements and related notes to the consolidated financial statements do not include all disclosures and notes normally provided in annual financial statements and, therefore, should be read in conjunction with the Company's Consolidated Financial Statements and related Notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. The results of operations for interim periods are not necessarily indicative of the results that may be expected for the year, due primarily to the seasonality of the Company's operations.

During the fourth quarter of 2011, the Company discovered errors in the Company's calculations of gains or losses on discontinued operations that originated in the first and second quarters of 2011. As a result, the Company recorded after-tax charges totaling \$24,555, which included associated parent company goodwill, to reduce the net asset values of those businesses to their net realizable values. These charges were recognized within discontinued operations and net income and included in the operating results for the year ended December 31, 2011. In the footnotes to the Consolidated Financial Statements for the period ended December 31, 2011, the Company corrected the presentation of the first and second quarters of 2011. Additionally the Company reflected this correction in the corresponding prior periods presented in the Consolidated Statements of Operations and Comprehensive Income for the three and six-month periods ended June 30, 2012. The write-downs included in the first and second quarters of 2011 totaled \$21,099 and \$3,456, respectively.

Note 2: New Accounting Pronouncements

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

Fair Value Measurements

In May 2011, the Financial Accounting Standards Board (FASB) issued updated accounting guidance related to fair value measurements and disclosures that result in common fair value measurements and disclosures between U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards. This new guidance amends current fair value measurement and disclosure guidance to increase transparency around valuation inputs and investment categorization. This guidance is effective for interim and annual periods beginning on January 1, 2012 and is required to be applied prospectively. The adoption of this guidance did not have a significant impact on the Company's results of operations, financial position or cash flows.

Comprehensive Income

In June 2011, the FASB issued guidance on the presentation of comprehensive income. The new guidance allows an entity to present components of net income and other comprehensive income in either one continuous statement or two separate but consecutive statements. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. While the new guidance changes the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under current accounting guidance. In December 2011, the FASB deferred the requirement to present reclassification adjustments of other comprehensive income on the face of the income statement. The new guidance is effective for the Company beginning on January 1, 2012. As the Company already presents the components of net income and other comprehensive income in one continuous statement, the adoption of the new guidance did not have an impact on its results of operations, financial position or cash flows.

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Testing Goodwill for Impairment

In September 2011, the FASB updated the accounting guidance related to testing goodwill for impairment. This update permits an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test that is currently in place. Under the new guidance, an entity will not be required to calculate the fair value of a reporting unit unless the entity determines, based on the qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. This update is effective for annual and interim goodwill impairment tests performed by the Company beginning on January 1, 2012. The adoption of this update is not expected to have a significant impact on its results of operations, financial position or cash flows.

Note 3: Acquisitions and Divestitures

Acquisitions

As of June 30, 2012, the Company closed on five acquisitions of various regulated water and wastewater systems for a total aggregate purchase price of \$44,293. Included in this total was the Company's May 1, 2012 acquisition of all of the capital stock of Aqua New York, Inc. (the Acquisition) for a total cash purchase price of \$39,273 plus assumed liabilities, subject to post-closing purchase price adjustments that may occur during the second half of 2012. The Acquisition, which expanded the Company's service area in the state of New York, added approximately 50,000 customers to regulated operations.

The Acquisition was accounted for as a business combination; accordingly, operating results from May 1, 2012 were included in the Company's results of operations. The preliminary purchase price was allocated to the net tangible and intangible assets based upon their estimated fair values at the date of acquisition. The Company's regulatory practice has been followed whereby property, plant and equipment (rate base) is considered fair value for business combination purposes. Similarly, regulatory assets and liabilities acquired have been recorded at book value and are subject to regulatory approval where applicable. The acquired debt and employee benefit plans have been fair valued using common valuation techniques. The acquired debt has been valued in a manner consistent with the Company's Level 2 and Level 3 pre-acquisition debt. (See Note 13) The Company has recognized employee benefit plan liabilities on the acquisition date for the funded status of defined-benefit plans assumed as part of the business combination. The pro forma impact of this acquisition would not have been material to the Company's results of operations for the three and six months ended June 30, 2012 and 2011, respectively. Total assets acquired in the Acquisition were \$106,911, including \$58,669 of plant, \$32,884 of regulatory assets, \$2,855 of other assets and \$12,503 of goodwill; liabilities assumed totaled \$67,638, including long-term debt of \$25,215, \$15,377 of regulatory liabilities, \$15,029 of deferred taxes, \$2,307 of other liabilities and \$9,710 of pension and postretirement welfare liabilities.

Divestitures

As part of the Company's strategic review of its business investments, it has previously entered into agreements to sell assets or stock of certain subsidiaries.

In January 2012, the Company completed the close of the sale of its Arizona and New Mexico subsidiaries. Initial sales proceeds were \$461,057, and the Company recorded no gain or loss at the time of the sale closing. In June 2012, as part of post-closing adjustments to finalize the sale, the Company remitted \$2,448 to the purchaser, and recorded a pretax loss on sale for the same amount.

In May 2012, the Company completed the close of the sale of its Ohio subsidiary. Initial sales proceeds were \$101,083 and are subject to post-closing adjustments. The Company recorded a pretax loss on sale of \$5,166, primarily due to pension settlement costs calculated at closing.

As disclosed in Note 1 included herein, the Company previously revised its 2011 first quarter results for an after-tax impairment charge of \$21,099, which was recorded as an asset impairment charge to reduce parent company goodwill that had been allocated to the Arizona and New Mexico subsidiaries. An additional \$3,456 after-tax asset impairment charge was recorded in the Company's 2011 second quarter results for parent company goodwill allocated to the Ohio subsidiary transaction.

In June 2011, the Company completed the sale of the assets of its Texas subsidiary for sale proceeds of \$6,245. In the first quarter of 2011, the Company had previously recognized an after-tax impairment charge of \$552 for parent company goodwill allocated to the Texas subsidiary.

Charges recorded in connection with the discontinued operations include estimates that are subject to subsequent adjustments.

A summary of discontinued operations presented in the Consolidated Statements of Operations and Comprehensive Income follows:

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Operating revenues	\$ 3,160	\$ 45,329	\$ 19,377	\$ 83,456
Total operating expenses, net	15,465	33,101	27,918	81,266
Operating income (loss)	(12,305)	12,228	(8,541)	2,190
Other income (expenses), net	(47)	118	(167)	410
Income (loss) from discontinued operations before income taxes	(12,352)	12,346	(8,708)	2,600
Provision (benefit) for income taxes	(2,715)	6,053	8,427	10,773
Income (loss) from discontinued operations, net of tax	\$ (9,637)	\$ 6,293	\$ (17,135)	\$ (8,173)

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There were no assets or liabilities of discontinued operations at June 30, 2012. Assets and liabilities of discontinued operations at December 31, 2011 include the following:

Assets:	
Total property, plant and equipment	\$ 833,023
Current assets	21,906
Regulatory assets	43,849
Goodwill	29,608
Other	1,472
Total assets of discontinued operations	\$ 929,858

Liabilities:	
Long-term debt	\$ 11,697
Current portion of long-term debt	12,839
Other current liabilities	29,530
Advances for construction	205,034
Regulatory liabilities	4,617
Other	15,540
Contributions in aid of construction	102,961
Total liabilities of discontinued operations	\$ 382,218

Note 4: Goodwill

The Company's annual goodwill impairment test is conducted at November 30 of each calendar year. Interim reviews are performed when the Company determines that a triggering event that would more likely than not reduce the fair value of a reporting unit below its carrying value has occurred.

In the first quarter of 2011, the Company assessed fair value, including allocated goodwill, and recorded impairments of \$21,099 for the pending sales of its Arizona and New Mexico subsidiaries, and \$552 for the pending sale of the Company's assets of its Texas subsidiary. These impairment charges were included in operating results of discontinued operations. (see Note 3 above)

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

	Regulated Unit		Market-Based Operations		Consolidated Cost	Consolidated Accumulated Impairment	Total Net
	Cost	Accumulated Impairment	Cost	Accumulated Impairment			
Balance at January 1, 2012	\$ 3,399,368	\$ (2,332,670)	\$ 235,990	\$ (107,619)	\$ 3,635,358	\$ (2,440,289)	\$ 1,195,069
Goodwill from acquisitions	12,503	0	0	0	12,503	0	12,503
Balance at June 30, 2012	\$ 3,411,871	\$ (2,332,670)	\$ 235,990	\$ (107,619)	\$ 3,647,861	\$ (2,440,289)	\$ 1,207,572
Balance at January 1, 2011	\$ 3,399,884	\$ (2,332,670)	\$ 235,990	\$ (107,619)	\$ 3,635,874	\$ (2,440,289)	\$ 1,195,585
Reclassifications and other activity	(75)	0	0	0	(75)	0	(75)
Balance at June 30, 2011	\$ 3,399,809	\$ (2,332,670)	\$ 235,990	\$ (107,619)	\$ 3,635,799	\$ (2,440,289)	\$ 1,195,510

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

Table of Contents**Note 5: Stockholders Equity****Common Stock**

In March 2010, the Company established American Water Stock Direct, a dividend reinvestment and direct stock purchase plan (the "DRIP"). Under the DRIP, stockholders may reinvest cash dividends and purchase additional Company common stock, up to certain limits, through a transfer agent without commission fees. The Company's transfer agent may buy newly issued shares directly from the Company or shares held in the Company's treasury. The transfer agent may also buy shares in the public markets or in privately negotiated transactions. Purchases generally will be made and credited to DRIP accounts once each week. As of June 30, 2012, there were 4,843 shares available for future issuance under the DRIP. The following table summarizes information regarding issuances under the DRIP for the six months ended June 30, 2012 and 2011:

	2012	2011
Shares of common stock issued	30	34
Cash proceeds received	\$ 1,028	\$ 957

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

	2012	2011
Dividends per share, three months ended:		
March 31	\$ 0.23	\$ 0.22
June 30	0.23	0.22
Total dividends paid, three months ended:		
March 31	\$ 40,414	\$ 38,525
June 30	40,529	38,580

On May 11, 2012, the Company declared a quarterly cash dividend payment of \$0.25 per share payable on September 3, 2012 to all shareholders of record as of July 6, 2012. As of June 30, 2012, the Company had accrued dividends totaling \$44,079 included in other current liabilities in the accompanying Consolidated Balance Sheets.

Stock-Based Compensation

The Company has granted stock option and restricted stock unit awards to non-employee directors, officers and other key employees of the Company pursuant to the terms of its 2007 Omnibus Equity Compensation Plan (the "Plan"). As of June 30, 2012, a total of 10,215 shares were available for grant under the Plan. Shares issued under the Plan may be authorized but unissued shares of Company stock or reacquired shares of Company stock, including shares purchased by the Company on the open market for purposes of the Plan.

The Company recognizes compensation expense for stock awards over the vesting period of the award. The following table presents stock-based compensation expense recorded in operation and maintenance expense in the accompanying Consolidated Statements of Operations and Comprehensive Income for the three and six months ended June 30, 2012 and 2011:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Stock options	\$ 860	\$ 802	\$ 1,706	\$ 1,628
Restricted stock units	2,014	1,699	3,304	2,904
Employee stock purchase plan	121	111	253	208
Stock-based compensation in operation and maintenance expense	2,995	2,612	5,263	4,740
Income tax benefit	(1,169)	(1,019)	(2,053)	(1,849)

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After-tax stock-based compensation expense	\$ 1,826	\$ 1,593	\$ 3,210	\$ 2,891
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There were no significant stock-based compensation costs capitalized during the six months ended June 30, 2012 and 2011, respectively.

Stock Options

In the first six months of 2012, the Company granted non-qualified stock options to certain employees under the Plan. The stock options vest ratably over the three-year service period beginning January 1, 2012. These awards have no performance vesting conditions and the grant date fair value is amortized through expense over the requisite service period using the straight-line method. The following table presents the weighted-average assumptions used in the pricing model for 2012 grants and the resulting weighted-average grant date fair value per share of stock options granted:

Dividend yield	2.70%
Expected volatility	28.35%
Risk-free interest rate	0.78%
Expected life (years)	4.4
Exercise price	\$ 34.14
Grant date fair value per share	\$ 6.11

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Stock options granted under the Plan have maximum terms of seven years, vest over periods ranging from one to three years, and are granted with exercise prices equal to the market value of the Company's common stock on the date of grant. As of June 30, 2012, \$5,243 of total unrecognized compensation cost related to the non-vested stock options is expected to be recognized over the weighted-average period of 1.8 years.

The following table summarizes stock option activity for the six months ended June 30, 2012:

	Shares	Weighted-Average Exercise Price (per share)	Weighted-Average Remaining Life (years)	Aggregate Intrinsic Value
Options outstanding at January 1, 2012	3,112	\$ 22.70		
Granted	649	34.14		
Forfeited or expired	(68)	27.08		
Exercised	(457)	21.68		
Options outstanding at June 30, 2012	3,236	\$ 25.05	4.4	\$ 29,876
Exercisable at June 30, 2012	1,921	\$ 21.96	3.4	\$ 23,665

The following table summarizes additional information regarding stock options exercised during the six months ended June 30, 2012 and 2011:

	2012	2011
Intrinsic value	\$ 5,594	\$ 1,893
Exercise proceeds	9,896	6,517
Income tax benefit	1,443	253

Restricted Stock Units

In the first six months of 2012, the Company granted restricted stock units to certain employees under the Plan. The restricted stock units vest ratably over the three-year performance period beginning January 1, 2012 (the Performance Period); however, distribution of the shares is contingent upon the achievement of internal performance measures and, separately, certain market thresholds over the Performance Period. The restricted stock units granted with performance and service conditions are valued at the market value of the Company's common stock on the date of grant. The restricted stock units granted with market and service conditions are valued using a Monte Carlo model. Weighted-average assumptions used in the Monte Carlo simulation for the 2012 grants are as follows:

Expected volatility	22.47%
Risk-free interest rate	0.43%
Expected life (years)	3

The grant date fair value of the restricted stock awards that vest ratably and have market and/or performance and service conditions is amortized through expense over the requisite service period using the graded-vesting method. As of June 30, 2012, \$5,948 of total unrecognized compensation cost related to the non-vested restricted stock units is expected to be recognized over the weighted-average remaining life of 1.1 years.

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The following table summarizes restricted stock unit activity for the six months ended June 30, 2012:

	Shares	Weighted-Average Grant Date Fair Value (per share)
Nonvested total at January 1, 2012	577	\$ 25.09
Granted	172	37.40
Vested	(182)	23.01
Forfeited	(17)	29.69
Cancelled	(2)	22.08
Nonvested total at June 30, 2012	548	\$ 29.51

The following table summarizes additional information regarding restricted stock units distributed during the six months ended June 30, 2012 and 2011:

	2012	2011
Intrinsic value	\$ 5,804	\$ 1,695
Income tax benefit	798	99

If dividends are declared with respect to shares of the Company's common stock before the restricted stock units are distributed, the Company credits a liability for the value of the dividends that would have been paid if the restricted stock units were shares of Company common stock. When the restricted stock units are distributed, the Company pays the participant a lump sum cash payment equal to the value of the dividend equivalents accrued. The Company accrued dividend equivalents totaling \$399 and \$392 to retained earnings during the six months ended June 30, 2012 and 2011, respectively.

Employee Stock Purchase Plan

Under the Nonqualified Employee Stock Purchase Plan (the "ESPP"), employees can use payroll deductions to acquire Company stock at the lesser of 90% of the fair market value of (a) the beginning or (b) the end of each three-month purchase period. As of June 30, 2012 there were 1,535 shares of common stock reserved for issuance under the ESPP. During the six months ended June 30, 2012, the Company issued 57 shares under the ESPP.

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Note 6: Long-Term Debt

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

	Rate	Weighted-Average Rate	Maturity Date	June 30, 2012	December 31, 2011
Long-term debt of American Water Capital Corp. (AWCC)					
(a)					
Private activity bonds and government funded debt					
Fixed rate	4.85%-6.75%	5.72%	2018-2040	\$ 322,610	\$ 322,610
Senior notes					
Fixed rate	5.39%-10.00%	6.25%	2013-2040	3,089,409	3,089,409
Long-term debt of other subsidiaries					
Private activity bonds and government funded debt					
Fixed rate	0.00%-6.20%	4.77%	2012-2041	1,159,519	1,206,332
Mortgage bonds					
Fixed rate	5.48%-9.71%	7.40%	2012-2039	697,800	697,800
Mandatory redeemable preferred stock	8.47%-9.75%	8.61%	2019-2036	21,001	22,101
Notes payable and other (b)	9.49%-12.17%	11.70%	2013-2026	1,478	1,691
Long-term debt				5,291,817	5,339,943
Unamortized debt discount, net (c)				43,497	43,888
Fair value adjustment to interest rate hedge				7,383	6,111
Total long-term debt				\$ 5,342,697	\$ 5,389,942

(a) AWCC, which is a wholly-owned subsidiary of the Company, has a strong support agreement with its parent that, under certain circumstances, is the functional equivalent of a guarantee.

(b) Includes capital lease obligations of \$1,149 and \$1,264 at June 30, 2012 and December 31, 2011, respectively.

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

The following long-term debt was issued in 2012:

Company	Type	Interest Rate	Maturity	Amount
Other subsidiaries (1)	Private activity bonds and government funded debt fixed rate	0.00%-5.00%	2013-2041	\$ 83,476
Total issuances				\$ 83,476

(1) Included in the issuance amount above was \$68,746, which was initially kept in Trust pending the Company's certification that it has incurred qualifying capital expenditures. These issuances have been presented as non-cash in the accompanying Consolidated Statements of Cash Flows. Subsequent releases of all or a lesser portion of these funds by the applicable Trust are reflected as the release of restricted funds and are included in investing activities in the accompanying Consolidated Statements of Cash Flows.

The following long-term debt was retired through optional redemption or payment at maturity during 2012:

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Company	Type	Interest Rate	Maturity	Amount
Other subsidiaries	Mortgage bonds fixed rate	7.95%	2012	\$ 4,200
Other subsidiaries	Private activity bonds and government funded debt fixed rate	0.00%-5.90%	2012-2041	153,775
Other subsidiaries	Mandatory redeemable preferred stock	4.60%-6.00%	2013-2019	1,100
Other	Capital leases and other			213
Total retirements and redemptions				\$ 159,288

Other activity of long-term debt during the first six months of 2012 includes debt assumed in an acquisition totaling \$25,215 (see Note 3).

On July 2, 2012, the Company redeemed \$86,090 of outstanding bonds maturing in 2028 and 2029 with interest rates ranging from 5.00% to 5.10%. In addition, on July 6, 2012 the Company redeemed \$2,827 of preferred stock without mandatory redemption requirements with interest rates ranging from 5.00% to 5.75%. The redemptions were made using commercial paper borrowings.

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Interest income included in interest, net is summarized below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Interest income	\$ 2,821	\$ 2,754	\$ 5,633	\$ 5,403

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

At June 30, 2012 and December 31, 2011, the Company had a \$100,000 notional amount variable interest-rate swap fair value hedge outstanding. The following table provides a summary of the derivative fair value balance recorded by the Company and the line item in the Consolidated Balance Sheets in which such amount is recorded:

	June 30, 2012	December 31, 2011
Regulatory and other long-term assets		
Other	\$ 7,088	\$ 5,824
Long-term debt		
Long-term debt	7,383	6,111

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Interest, net				
Gain (loss) on swap	\$ 1,497	\$ 2,767	\$ 1,263	\$ 1,614
Gain (loss) on borrowing	(1,549)	(2,420)	(1,272)	(1,433)
Hedge ineffectiveness	(52)	347	(9)	181

Note 7: Short-Term Debt

The components of short-term debt are as follows:

	June 30, 2012	December 31, 2011
Commercial paper, net of \$28 and \$52 discount at June 30 and December 31, respectively	\$ 361,972	\$ 481,048
Bank overdraft	0	34,002
Total short-term debt	\$ 361,972	\$ 515,050

Prior to January 1, 2012, the Company had overdraft protection provided by a revolving credit line with PNC Bank, N.A. The Company did not renew this credit line at December 31, 2011. Accordingly, the Company's outstanding checks on its cash accounts with PNC Bank, N.A. are classified, as of January 1, 2012, as other current liabilities in the accompanying Consolidated Balance Sheets, and changes in those accounts are included in operating activities for 2012 in the accompanying Consolidated Statements of Cash Flows.

Note 8: Income Taxes

The Company's estimated annual effective tax rate for the six months ended June 30, 2012 was 40.2% compared to 40.5% for the six months ended June 30, 2011, excluding various discrete items. The Company's actual effective tax rates on continuing operations were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Actual effective tax rate on continuing operations	40.9%	40.7%	41.1%	40.7%

Table of Contents**Note 9: Pension and Other Postretirement Benefits**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Components of net periodic pension benefit cost				
Service cost	\$ 8,507	\$ 8,411	\$ 17,014	\$ 16,821
Interest cost	17,521	17,261	35,042	34,523
Expected return on plan assets	(19,618)	(18,027)	(39,237)	(36,054)
Amortization of:				
Prior service cost	180	181	361	361
Actuarial loss	7,403	4,637	14,805	9,275
Net periodic pension benefit cost	\$ 13,993	\$ 12,463	\$ 27,985	\$ 24,926

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Components of net periodic other postretirement benefit cost				
Service cost	\$ 3,525	\$ 3,484	\$ 7,051	\$ 6,969
Interest cost	7,858	7,804	15,716	15,609
Expected return on plan assets	(7,141)	(7,194)	(14,281)	(14,389)
Amortization of:				
Prior service credit	(478)	(481)	(957)	(962)
Actuarial loss	2,385	1,784	4,769	3,567
Net periodic other postretirement benefit cost	\$ 6,149	\$ 5,397	\$ 12,298	\$ 10,794

The Company contributed \$47,600 to its defined benefit pension plans in the first six months of 2012 and expects to contribute \$49,928 during the balance of 2012. In addition, the Company contributed \$14,991 for the funding of its other postretirement plans in the first six months of 2012 and expects to contribute \$15,083 during the balance of 2012.

Note 10: Commitments and Contingencies

The Company is routinely involved in legal actions incident to the normal conduct of its business. At June 30, 2012, the Company has accrued approximately \$3,200 as probable costs and it is reasonably possible that additional losses could range up to \$32,200 for these matters. For certain matters, the Company is unable to estimate possible losses. The Company believes that damages or settlements recovered by plaintiffs in such claims or actions, if any, will not have a material adverse effect on the Company's results of operations, financial position or cash flows.

The Company enters into agreements for the provision of services to water and wastewater facilities for the United States military, municipalities and other customers. The Company's military services agreements expire between 2051 and 2060 and have remaining performance commitments as measured by estimated remaining contract revenue of \$1,986,000 at June 30, 2012. The military contracts are subject to customary termination provisions held by the U.S. Federal Government prior to the agreed upon contract expiration. The Company's Operations and Maintenance agreements with municipalities and other customers expire between 2012 and 2048 and have remaining performance commitments as measured by estimated remaining contract revenue of \$1,032,000 at June 30, 2012. Some of the Company's long-term contracts to operate and maintain a municipality's, federal government's or other party's water or wastewater treatment and delivery facilities include responsibility for certain maintenance for some of those facilities, in exchange for an annual fee. Unless specifically required to perform certain maintenance activities, the maintenance costs are recognized when the maintenance is performed.

Note 11: Environmental Matters

The Company's water and wastewater operations are subject to federal, state, local and foreign requirements relating to environmental protection, and as such, the Company periodically becomes subject to environmental claims in the normal course of business. Environmental expenditures that relate to current operations or provide a future benefit are expensed or capitalized as

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appropriate. Remediation costs that relate to an existing condition caused by past operations are accrued, on an undiscounted basis, when it is probable that these costs will be incurred and can be reasonably estimated. Remediation costs accrued amounted to \$4,400 and \$5,500 at June 30, 2012 and December 31, 2011, respectively. The accrual relates to a conservation agreement entered into by a subsidiary of the Company with the National Oceanic and Atmospheric Administration (NOAA) requiring the Company to, among other provisions, implement certain measures to protect the steelhead trout and its habitat in the Carmel River watershed in the state of California. The Company has agreed to pay \$1,100 annually from 2010 through 2016. The Company pursues recovery of incurred costs through all appropriate means, including regulatory recovery through customer rates. The Company's regulatory assets at June 30, 2012 and December 31, 2011 include \$9,041 and \$9,187 respectively, related to the NOAA agreement.

Note 12: Earnings per Common Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Basic:				
Income from continuing operations	\$ 116,663	\$ 74,817	\$ 165,915	\$ 115,516
Income (loss) from discontinued operations, net of tax	(9,637)	6,293	(17,135)	(8,173)
Net income	107,026	81,110	148,780	107,343
Less: Distributed earnings to common shareholders	40,744	38,810	81,308	77,461
Less: Distributed earnings to participating securities	19	19	34	35
Undistributed earnings	66,263	42,281	67,438	29,847
Undistributed earnings allocated to common shareholders	66,235	42,261	67,411	29,834
Undistributed earnings allocated to participating securities	28	20	27	13
Total income from continuing operations available to common shareholders, basic	\$ 116,616	\$ 74,778	\$ 165,854	\$ 115,468
Total income available to common shareholders, basic	\$ 106,979	\$ 81,071	\$ 148,719	\$ 107,295
Weighted-average common shares outstanding, basic	176,331	175,469	176,122	175,364
Basic earnings per share: (a)				
Income from continuing operations	\$ 0.66	\$ 0.43	\$ 0.94	\$ 0.66
Income (loss) from discontinued operations, net of tax	\$ (0.05)	\$ 0.04	\$ (0.10)	\$ (0.05)
Net income	\$ 0.61	\$ 0.46	\$ 0.84	\$ 0.61

(a) Amounts may not sum due to rounding.

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Diluted earnings per common share is based on the weighted-average number of common shares outstanding, adjusted for the dilutive effect of common stock equivalents related to the restricted stock units, stock options, and employee stock purchase plan. The dilutive effect of the common stock equivalents is calculated using the treasury stock method and expected proceeds on vesting of the restricted stock units, exercise of the stock options and purchases under the employee stock purchase plan. The following is a reconciliation of the Company's income from continuing operations, income (loss) from discontinued operations and net income and weighted-average common shares outstanding for calculating diluted earnings per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Diluted:				
Total income from continuing operations available to common shareholders, basic	\$ 116,616	\$ 74,778	\$ 165,854	\$ 115,468
Income (loss) from discontinued operations, net of tax	(9,637)	6,293	(17,135)	(8,173)
Total income available to common shareholders, basic	106,979	81,071	148,719	107,295
Undistributed earnings allocated to participating securities	28	20	27	13
Total income from continuing operations available to common shareholders, diluted	\$ 116,644	\$ 74,798	\$ 165,881	\$ 115,481
Total income available to common shareholders, diluted	\$ 107,007	\$ 81,091	\$ 148,746	\$ 107,308
Weighted-average common shares outstanding, basic	176,331	175,469	176,122	175,364
Stock-based compensation:				
Restricted stock units	573	475	550	443
Stock options	586	473	623	446
Employee stock purchase plan	1	2	1	2
Weighted-average common shares outstanding, diluted	177,491	176,419	177,296	176,255
Diluted earnings per share: (a)				
Income from continuing operations	\$ 0.66	\$ 0.42	\$ 0.94	\$ 0.66
Income (loss) from discontinued operations, net of tax	\$ (0.05)	\$ 0.04	\$ (0.10)	\$ (0.05)
Net income	\$ 0.60	\$ 0.46	\$ 0.84	\$ 0.61

(a) Amounts may not sum due to rounding.

The following potentially dilutive common stock equivalents were not included in the earnings per share calculations because they were anti-dilutive:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Stock options	634	729	634	729
Restricted stock units where certain performance conditions were not met	63	139	63	140

Note 13: Fair Value of Assets and Liabilities**Fair Value of Financial Instruments**

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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 amounts reported in the accompanying Consolidated Balance Sheets for current assets and current liabilities, including revolving credit debt due to the short-term maturities and variable interest rates, approximate their fair values.

Preferred stock with mandatory redemption requirements and long-term debt: The fair values of preferred stock with mandatory redemption requirements and long-term debt are categorized within the fair value hierarchy based on the inputs that are used to value each instrument. The fair value of long-term debt classified as Level 1 is calculated using quoted prices in active markets. Level 2 instruments are valued using observable inputs and Level 3 instruments are valued using observable and unobservable inputs. The fair values of instruments classified as Level 2 and 3 are determined by a valuation model that is based on a conventional discounted cash flow methodology and utilizes assumptions of current market rates. The Company calculated a base yield curve using a risk-free rate (a U.S. Treasury securities yield curve) plus a credit spread that is based on the following two factors: an average of the Company's own publicly-traded debt securities and the current market rates for U.S. Utility BBB+ debt securities. The Company used these yield curve assumptions to derive a base yield for the Level 2 and Level 3 securities. Additionally, the Company adjusted the base yield for specific features of the debt securities including call features, coupon tax treatment and collateral for the Level 3 instruments.

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The carrying amounts (including fair value adjustments previously recognized in acquisition purchase accounting) and fair values of the financial instruments are as follows:

Recurring Fair Value Measures	Carrying Amount	At Fair Value as of June 30, 2012			Total
		Level 1	Level 2	Level 3	
Preferred stocks with mandatory redemption requirements	\$ 20,925	\$ 0	\$ 0	\$ 27,013	\$ 27,013
Long-term debt (excluding capital lease obligations)	5,320,623	2,375,384	1,623,486	2,686,345	6,685,215

As of December 31, 2011	Carrying Amount	Fair Value
Preferred stocks with mandatory redemption requirements	\$ 22,036	\$ 26,458
Long-term debt (excluding capital lease obligations)	5,366,642	6,230,547

Recurring Fair Value Measurements

The following table presents assets and liabilities measured and recorded at fair value on a recurring basis and their level within the fair value hierarchy as of June 30, 2012 and December 31, 2011, respectively:

Recurring Fair Value Measures	At Fair Value as of June 30, 2012			
	Level 1	Level 2	Level 3	Total
Assets:				
Restricted funds	\$ 111,801			\$ 111,801
Rabbi trust investments		\$ 501		501
Deposits	1,866			1,866
Mark-to-market derivative asset		7,088		7,088
Total assets	\$ 113,667	\$ 7,589		\$ 121,256
Liabilities:				
Deferred compensation obligation		\$ 9,342		\$ 9,342
Total liabilities		\$ 9,342		\$ 9,342
Total net assets (liabilities)	\$ 113,667	\$ (1,753)		\$ 111,914

Recurring Fair Value Measures	At Fair Value as of December 31, 2011			
	Level 1	Level 2	Level 3	Total
Assets:				
Restricted funds	\$ 57,941			\$ 57,941
Rabbi trust investments		\$ 518		518
Deposits	2,287			2,287
Mark-to-market derivative asset		5,824		5,824
Total assets	\$ 60,228	\$ 6,342		\$ 66,570
Liabilities:				
Deferred compensation obligation		\$ 9,036		\$ 9,036

Total liabilities	\$ 9,036	\$ 9,036
Total net assets (liabilities)	\$ 60,228	\$ (2,694)
		\$ 57,534

Restricted funds The Company's restricted funds primarily represent proceeds received from financings for the construction and capital improvement of facilities and from customers for future services under operations and maintenance projects. The proceeds of these financings are held in escrow until the designated expenditures are incurred. Restricted funds expected to be released within twelve months subsequent to the balance sheet date are classified as current.

Rabbi trust investments The Company's rabbi trust investments consist primarily of fixed income investments from which supplemental executive retirement plan benefits are paid. The Company includes these assets in other long-term assets.

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

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

Mark-to-market derivative asset The Company utilizes fixed-to-floating interest-rate swaps, typically designated as fair value hedges, to achieve a targeted level of variable-rate debt as a percentage of total debt. The Company uses a calculation of future cash inflows and estimated future outflows, which are discounted, to determine the current fair value. Additional inputs to the present value calculation include the contract terms, counterparty credit risk, interest rates and market volatility.

Note 14: Segment Information

The Company has two operating segments which are also the Company's two reportable segments, referred to as Regulated Businesses and Market-Based Operations.

The following table includes the Company's summarized segment information from continuing operations, except as noted below:

	As of or for the Three Months Ended June 30, 2012			
	Regulated Businesses	Market-Based Operations	Other	Consolidated
Net operating revenues	\$ 667,601	\$ 82,795	\$ (4,789)	\$ 745,607
Depreciation and amortization	84,702	1,649	5,978	92,329
Total operating expenses, net	406,417	73,982	(5,424)	474,975
Income (loss) from continuing operations before income taxes	204,874	9,738	(17,347)	197,265
Total assets	12,434,806	281,572	1,696,383	14,412,761
Assets of discontinued operations (included in total assets above)	0	0	0	0
Capital expenditures	242,859	75	0	242,934
Capital expenditures of discontinued operations (included in above)	185	0	0	185

	As of or for the Three Months Ended June 30, 2011			
	Regulated Businesses	Market-Based Operations	Other	Consolidated
Net operating revenues	\$ 594,441	\$ 82,424	\$ (7,992)	\$ 668,873
Depreciation and amortization	79,797	1,727	5,818	87,342
Total operating expenses, net	400,719	75,753	(8,994)	467,478
Income (loss) from continuing operations before income taxes	138,020	7,259	(19,195)	126,084
Total assets	12,537,877	264,985	1,519,416	14,322,278
Assets of discontinued operations (included in total assets above)	906,547	7,188	4,428	918,163
Capital expenditures	214,045	1,336	0	215,381
Capital expenditures of discontinued operations (included in above)	5,139	26	0	5,165

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	As of or for the Six Months Ended June 30, 2012			
	Regulated Businesses	Market-Based Operations	Other	Consolidated
Net operating revenues	\$ 1,209,476	\$ 163,376	\$ (8,691)	\$ 1,364,161
Depreciation and amortization	169,490	3,330	11,613	184,433
Total operating expenses, net	801,059	144,747	(12,015)	933,791
Income (loss) from continuing operations before income taxes	295,290	20,208	(33,588)	281,910
Total assets	12,434,806	281,572	1,696,383	14,412,761
Assets of discontinued operations (included in total assets above)	0	0	0	0
Capital expenditures	476,057	243	0	476,300
Capital expenditures of discontinued operations (included in above)	2,884	0	0	2,884

	As of or for the Six Months Ended June 30, 2011			
	Regulated Businesses	Market-Based Operations	Other	Consolidated
Net operating revenues	\$ 1,122,722	\$ 157,806	\$ (14,940)	\$ 1,265,588
Depreciation and amortization	158,377	3,496	12,347	174,220
Total operating expenses, net	795,066	144,027	(18,150)	920,943
Income (loss) from continuing operations before income taxes	215,082	14,933	(35,287)	194,728
Total assets	12,537,877	264,985	1,519,416	14,322,278
Assets of discontinued operations (included in total assets above)	906,547	7,188	4,428	918,163
Capital expenditures	390,017	1,775	0	391,792
Capital expenditures of discontinued operations (included in above)	11,019	84	0	11,103

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FORWARD-LOOKING STATEMENTS**

Certain matters within this Quarterly Report on Form 10-Q include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements included in this Form 10-Q, other than statements of historical fact, may constitute forward-looking statements. Forward-looking statements can be identified by the use of words such as may, should, will, could, estimates, predicts, potential, continue, anticipates, believes, plans, expect, and similar expressions. Forward-looking statements may involve known and unknown risks, uncertainties and other factors that may cause the actual results or performance to differ from those projected in the forward-looking statements. These statements are not guarantees of future performance and are subject to risks, uncertainties and other factors, some of which are beyond our control and difficult to predict and could cause actual results to differ materially from those expressed or forecasted in the forward-looking statements. Factors that could cause or contribute to differences in results and outcomes from those in our forward-looking statements include, without limitation, those items discussed in the Risk Factors section or other sections in the Company's Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission (SEC), as well as in Item IA of Part II of this Quarterly Report. We undertake no obligation, other than as required by law, to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

General

American Water Works Company, Inc. (herein referred to as American Water or the Company) is the largest investor-owned United States water and wastewater utility company, as measured both by operating revenue and population served. Our primary business involves the ownership of water and wastewater utilities that provide water and wastewater services to residential, commercial, industrial and other customers. Our Regulated Businesses that provide these services are generally subject to economic regulation by state regulatory agencies (PUCs) in the states in which they operate. We report the results of these businesses in our Regulated Businesses segment. We also provide services that are not subject to economic regulation by state regulatory agencies. We report the results of these businesses in our Market-Based Operations segment. For further description of our businesses see the Business section found in our Form 10-K for the year ended December 31, 2011 filed with the SEC.

You should read the following discussion in conjunction with our Consolidated Financial Statements and related Notes included elsewhere in this Quarterly Report on Form 10-Q and in our Form 10-K for the year ended December 31, 2011 filed with the SEC.

Overview

All financial information in this Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), reflects only continuing operations. As previously disclosed in our Form 10-K for the year ended December 31, 2011, as part of our portfolio optimization initiative, we entered into agreements to sell our regulated subsidiaries in Arizona, New Mexico, Ohio and our regulated water and wastewater systems in Texas. The sale of the Texas subsidiary assets was completed in June 2011. In the first quarter of 2012, we completed the divestiture of the Arizona and New Mexico subsidiaries, and on May 1, 2012, we completed the divestiture of our Ohio subsidiary. Also, on December 31, 2011, we completed the sale of Applied Water Management, Inc. (AWM), which was part of our Contract Operations line of business within our Market-Based Operations segment. Therefore, the financial results of these entities have been presented as discontinued operations for all periods, unless otherwise noted. Additionally, during the fourth quarter of 2011, we discovered errors in our calculations of gains or losses on discontinued operations that originated in the first and second quarters of 2011. As a result, we recorded after-tax charges totaling \$24.6 million, which included associated parent company goodwill, to reduce the net asset values of those businesses to their net realizable values. These charges were recognized within discontinued operations and net income and included in the operating results for the year ended December 31, 2011. The write-down included in the first and second quarters of 2011 totaled \$21.1 million and \$3.5 million, respectively, and are reflected, where necessary, in the amounts reported for the three and six months ended June 30, 2011.

Financial Results. For the three months ended June 30, 2012, we reported net income of \$107.0 million, or diluted earnings per share (EPS) of \$0.60 compared to \$81.1 million, or diluted EPS of \$0.46 for the comparable period in 2011. Income from continuing operations was \$116.7 million for the second quarter of 2012 compared to \$74.8 million in the second quarter of 2011. Diluted income from continuing operations per average common share was \$0.66 for the second quarter of 2012 as compared to \$0.42 for the second quarter of 2011.

For the six months ended June 30, 2012, our net income amounted to \$148.8 million, or diluted earnings per share of \$0.84 compared to \$107.3 million, or diluted EPS of \$0.61 for the comparable period in 2011. Income from continuing operations was \$165.9 million for the six months ended June 30, 2012 compared to \$115.5 million for the same period in 2011. Diluted income from continuing operations per average common share was \$0.94 for the six months ended June 30, 2012 as compared to \$0.66 for the first six months of 2011.

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The primary drivers contributing to these increases in net income from continuing operations for both the three and six months ended June 30, 2012 were increased revenues in our Regulated Businesses resulting from rate increases and higher demand, as well as slightly higher revenues in our Market-Based Operations segment. Partially offsetting these increases were higher depreciation and amortization expense and general taxes. For further details, see *Consolidated Results of Operations and Variances* and *Segment Results* below.

In 2012, our focus is on executing our portfolio optimization initiative, actively addressing regulatory lag and declining usage, continuing to make efficient use of capital and continuing to improve our regulated operation and maintenance (O&M) efficiency ratio. Also, in 2012, we look to grow our Market-Based Operations with a focus on the Homeowners Services Group and Military Contract Operations and to optimize our municipal contract operations business model to provide for value creation for both American Water and the municipality. The progress that we have made in the first six months of 2012 with respect to three of these objectives is described below. In regards to our other 2012 goals not explicitly outlined below, we continue to make progress.

Portfolio Optimization Initiative. We continue to execute our plan for optimizing our Regulated Businesses portfolio. In the first quarter of 2012, we completed the sale of our regulated operations in Arizona and New Mexico. On May 1, 2012, we completed the divestiture of our Ohio subsidiary, which served approximately 58,000 customers.

Also, on May 1, 2012, we completed our purchase of seven regulated water systems in New York, for \$39.3 million in cash plus assumed liabilities of \$67.6 million. This acquisition added approximately 50,000 customers to our New York regulated operations.

Addressing Regulatory Lag and Declining Usage. During the second quarter of 2012, we filed a general rate case in Tennessee requesting additional annualized revenues of approximately \$10.6 million. Also, during the three months ended June 30, 2012, we were granted additional annualized revenues from general rate cases totaling \$60.4 million.

On May 1, 2012, our New Jersey rate case, which we filed in the third quarter of 2011, was approved by the Board of Public Utilities. The new rates were effective May 1, 2012. On June 6, 2012, the Indiana Utility Regulatory Commission (IURC) issued an order adjusting rates on a statewide basis for Indiana American Water. The IURC order became effective June 15, 2012. On June 7, 2012, our California general rate case was approved by California's Public Utilities Commission (CPUC), authorizing a total of approximately \$28.5 million in additional annualized revenues for 2012. The increased revenue requirement was retroactively effective back to January 1, 2012.

Also, in April, 2012, additional annualized revenues of \$1.7 million resulting from infrastructure charges for our Pennsylvania subsidiary became effective.

The table below provides further details of annualized revenues, assuming a constant volume, resulting from rate authorizations granted:

State	Annualized Rate Increases Granted	
	For the three months ended June 30, 2012	For the six months ended June 30, 2012
	(In millions)	
<i>General Rate Cases:</i>		
New Jersey	\$ 30.0	\$ 30.0
Missouri		24.0
New York (a)		5.6
Iowa		2.8
Indiana	1.9	1.9
California	28.5	28.5
Other		0.2
<i>Total General Rate Cases</i>	\$ 60.4	\$ 93.0
<i>Infrastructure Charges</i>		
Pennsylvania	\$ 1.7	\$ 1.7
Other	\$ 0.3	\$ 0.3

Total Infrastructure charges

\$ 2.0

\$

2.0

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a) Amount includes \$3.0 million increase effective April 1, 2012. The remainder of the \$5.6 million annualized revenue increase of \$1.4 million and \$1.2 million will become effective April 1, 2013 and April 1, 2014, respectively.

On July 1, 2012, additional annualized revenue of \$3.0 million resulting from infrastructure charges in our Pennsylvania subsidiary became effective. Also on July 20, 2012, our New Jersey subsidiary filed a Foundational Filing for a Distribution System Improvement Charge.

On July 12, 2012, the CPUC approved California's cost of capital application. This approval is retroactive to January 1, 2012 and is estimated to provide additional annualized revenues of \$4.4 million. Also, on July 12, 2012, interim rates which would provide for an additional \$6.0 million of annualized revenues, including \$5.7 million of jurisdictional revenue under bond and subject to refund, were put into effect for our Virginia subsidiary. There is no assurance that the bonded amount, or any portion thereof, will be approved.

As of July 31, 2012, we are awaiting final orders in three states, requesting additional annualized revenues of \$54.1 million. There is no assurance that all, or any portion of any requested increase, will be granted.

In regards to another regulatory matter, in June 2012, the CPUC approved our request to permanently remove the San Clemente Dam from the Carmel River on the Monterey Peninsula. The estimated project construction cost is \$83 million, of which \$49 million will be recovered from rate payers and \$34 million will come from the State Coastal Conservancy. This decision also permitted California-American Water Company rate recovery of approximately \$27 million in historical costs.

Continue Improvement in O&M Efficiency Ratio for our Regulated Businesses. Our O&M efficiency ratio (a non-GAAP measure) is calculated only on our Regulated operations and is defined as operation and maintenance expense divided by operating revenues where both operation and maintenance expense and operating revenues are adjusted for purchased water expense. Our operating efficiency ratio was 37.9% for the three months ended June 30, 2012 compared to 43.2% for the three months ended June 30, 2011. Our operating efficiency ratio was 41.2% for the six months ended June 30, 2012 compared to 45.5% for the same period in 2011.

The improvement in our O&M efficiency ratio was driven by our continued focus on operating expense control as well as an increase in revenue relating to rate cases and increased customer usage. We evaluate our operating performance using this measure because management believes it is one measure of the efficiency of our regulated operations. This information is intended to enhance an investor's overall understanding of our operating performance. The O&M efficiency ratio is not a measure defined under GAAP and may not be comparable to other companies' operating measures and should not be used in place of the GAAP information provided elsewhere in this report. The following table provides a reconciliation that compares operation and maintenance expense and operating revenues, as determined in accordance with GAAP, to Adjusted Regulated O&M expense and Adjusted Regulated Operating Revenues, and also shows our operating efficiency ratio for the three and six months ended June 30, 2012 as compared to the same periods in 2011:

Regulated O&M Efficiency Ratio (a Non-GAAP Measure)

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
	(In thousands)			
Total O&M expense	\$ 327,577	\$ 327,157	\$ 637,581	\$ 637,978
Less:				
O&M expense - Market-Based Operations	71,118	72,702	138,891	137,238
O&M expense - Other	(13,572)	(16,928)	(29,272)	(35,596)
Total Regulated O&M expense	270,031	271,383	527,962	536,336
Less: Regulated purchased water	27,597	25,565	50,007	46,380
Adjusted Regulated O&M expense(a)	\$ 242,434	\$ 245,818	\$ 477,955	\$ 489,956
Total Operating Revenues	\$ 745,607	\$ 668,873	\$ 1,364,161	\$ 1,265,588
Less:				
Operating revenues - Market-Based Operations	82,795	82,424	163,376	157,806

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Operating revenues	Other	(4,789)	(7,992)	(8,691)	(14,940)
Total Regulated operating revenues		667,601	594,441	1,209,476	1,122,722
Less: Regulated purchased water expense*		27,597	25,565	50,007	46,380
Adjusted Regulated operating revenues(b)		\$ 640,004	\$ 568,876	\$ 1,159,469	\$ 1,076,342
Regulated O&M efficiency ratio(a)/(b)		37.9%	43.2%	41.2%	45.5%

* Calculation assumes purchased water revenues approximate purchased water expenses.

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On August 1, 2012, our new business systems associated with Phase I of our business transformation project went live. Phase I consisted of the roll-out of the Enterprise Resource Planning systems, which encompass applications that will handle human resources, finance, and supply chain/procurement management. Phase II consists of the roll-out of a new Enterprise Asset Management system, which will manage an asset's lifecycle, and a Customer Information system, which contains all billing and data pertaining to American Water's customers for our Regulated segment. Phase II is expected to be completed by December 31, 2013. As we make adjustments to our operations as a result of this project, we may incur incremental expenses prior to realizing the benefits of a more efficient workforce and operating structure. A project of this size will have an impact on our control environment. Although efforts have been made to minimize any adverse impact, we cannot assure that all such impacts have been mitigated. Through June 30, 2012, we have spent \$211.5 million on the project with \$71.7 million spent in 2012.

Expenditures associated with the project are included in the estimated capital investment spending of \$900 million for 2012 and \$800 million to \$1 billion in 2013.

Consolidated Results of Operations and Variances

(In thousands)	For the three months ended June 30,			For the six months ended June 30,		
	(In thousands, except per share data)					
	2012	2011	Favorable (Unfavorable) Change	2012	2011	Favorable (Unfavorable) Change
Operating revenues	\$ 745,607	\$ 668,873	\$ 76,734	\$ 1,364,161	\$ 1,265,588	\$ 98,573
Operating expenses						
Operation and maintenance	327,577	327,157	(420)	637,581	637,978	397
Depreciation and amortization	92,329	87,342	(4,987)	184,433	174,220	(10,213)
General taxes	55,282	52,951	(2,331)	112,403	108,449	(3,954)
(Gain) loss on asset dispositions and purchases	(213)	28	241	(626)	296	922
Total operating expenses, net	474,975	467,478	(7,497)	933,791	920,943	(12,848)
Operating income	270,632	201,395	69,237	430,370	344,645	85,725
Other income (expenses)						
Interest, net	(79,730)	(78,469)	(1,261)	(159,384)	(154,660)	(4,724)
Allowance for other funds used during construction	5,076	2,535	2,541	9,438	5,363	4,075
Allowance for borrowed funds used during construction	2,313	1,198	1,115	4,394	2,402	1,992
Amortization of debt expense	(1,361)	(1,255)	(106)	(2,627)	(2,547)	(80)
Other, net	335	680	(345)	(281)	(475)	194
Total other income (expenses)	(73,367)	(75,311)	1,944	(148,460)	(149,917)	1,457
Income from continuing operations before income taxes	197,265	126,084	71,181	281,910	194,728	87,182
Provision for income taxes	80,602	51,267	(29,335)	115,995	79,212	(36,783)
Income from continuing operations	116,663	74,817	41,846	165,915	115,516	50,399
Income (loss) from discontinued operations, net of tax	(9,637)	6,293	(15,930)	(17,135)	(8,173)	(8,962)
Net income	\$ 107,026	\$ 81,110	\$ 25,916	\$ 148,780	\$ 107,343	\$ 41,437
Basic earnings per common share:(a)						
Income from continuing operations	\$ 0.66	\$ 0.43		\$ 0.94	\$ 0.66	

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Income from discontinued operations, net of tax	\$ (0.05)	\$ 0.04	\$ (0.10)	\$ (0.05)
Net income	\$ 0.61	\$ 0.46	\$ 0.84	\$ 0.61
Diluted earnings per common share:(a)				
Income from continuing operations	\$ 0.66	\$ 0.42	\$ 0.94	\$ 0.66
Income from discontinued operations, net of tax	\$ (0.05)	\$ 0.04	\$ (0.10)	\$ (0.05)
Net income	\$ 0.60	\$ 0.46	\$ 0.84	\$ 0.61
Average common shares outstanding during the period:				
Basic	176,331	175,469	176,122	175,364
Diluted	177,491	176,419	177,296	176,255

(a) Amounts may not sum due to rounding

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The following is a discussion of the consolidated results of operations for the three and six months ended June 30, 2012 compared to the three and six months ended June 30, 2011:

Three Months Ended June 30, 2012 Compared To Three Months Ended June 30, 2011

Operating revenues. Consolidated operating revenues for the three months ended June 30, 2012 increased \$76.7 million, or 11.5%, compared to the same period in 2011 and is mainly attributable to a \$73.2 million increase in our Regulated Businesses segment mainly as a result of rate increases as well as increased usage in the second quarter of 2012. For further information, see the respective Operating Revenues discussions within the Segment Results.

Operation and maintenance. Consolidated operation and maintenance expense for the three months ended June 30, 2012 increased by \$0.4 million, or 0.1%, compared to the same period in 2011. For further information, see the respective Operation and Maintenance discussions within the Segment Results.

Depreciation and amortization. Depreciation and amortization expense increased by \$5.0 million, or 5.7%, for the three months ended June 30, 2012 compared to the same period in the prior year as a result of additional utility plant placed in service.

General taxes. General taxes expense, which includes taxes for property, payroll, gross receipts, and other miscellaneous items, increased by \$2.3 million, or 4.4%, for the three months ended June 30, 2012 compared to the three months ended June 30, 2011. This increase was principally due to higher property taxes of \$1.8 million, primarily related to our recently acquired New York properties.

Other income (expenses). Other expenses decreased by \$1.9 million, or 2.6%, for the three months ended June 30, 2012 compared to the same period in the prior year. This decrease is attributable to an increase in allowance for funds used during construction (AFUDC) of \$3.7 million, which is mainly attributable to increased construction activity, including the replacement of a water treatment facility in our New Jersey regulated subsidiary. Partially offsetting this decrease was an increase in interest expense, net of interest income, of \$1.3 million, or 1.6%, for the three months ended June 30, 2012 compared to the same period in the prior year, primarily attributable to higher interest expense associated with our interest rate swap and incremental interest expense on borrowings associated with certain restricted funds in 2012.

Provision for income taxes. Our consolidated provision for income taxes increased \$29.3 million, or 57.2%, to \$80.6 million for the three months ended June 30, 2012. The effective tax rates for the three months ended June 30, 2012 and 2011 were 40.9% and 40.7%, respectively.

Income (loss) from discontinued operations, net of tax. As noted above, the financial results of our regulated water and wastewater systems in Arizona, New Mexico, Texas and Ohio, as well as those of our AWM subsidiary within the Market-Based Operations segment, have been classified as discontinued operations for all periods presented. The increase in the loss from discontinued operations, net of tax is primarily attributable to the disposition of our Ohio subsidiary, which accounted for \$5.2 million, and a \$2.4 million pre-tax sales price adjustment in connection with the disposition of our Arizona and New Mexico subsidiaries. Additionally, the 2011 amount included net income associated with the discontinued operations for the period and a benefit of \$3.2 million related to the cessation of depreciation for our Arizona, New Mexico, and Texas subsidiaries offset by \$3.5 million after-tax write-down recorded in the second quarter of 2011 to reduce the net asset values of certain of the discontinued operations. Under GAAP, operations that are considered discontinued operations cease to depreciate their assets.

Six Months Ended June 30, 2012 Compared To Six Months Ended June 30, 2011

Operating revenues. Consolidated operating revenues for the six months ended June 30, 2012 increased \$98.6 million, or 7.8%, compared to the same period in 2011. This change reflects an \$86.8 million increase in our Regulated Businesses segment, which was mainly attributable to rate increases and usage, and a \$5.6 million increase in our Market-Based Operations segment, which was due to contract growth and price increases in homeowner services, and incremental revenues associated with military construction and operations. For further information, see the Operating Revenues discussions within the Segment Results.

Operation and maintenance. Consolidated operation and maintenance expense for the six months ended June 30, 2012 decreased \$0.4 million, or 0.1%, compared to the same period in 2011. For further information, see the Operation and Maintenance discussions within the Segment Results.

Depreciation and amortization. Depreciation and amortization expense increased by \$10.2 million, or 5.9%, for the six months ended June 30, 2012 compared to the same period in the prior year as a result of additional utility plant placed in service.

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General taxes. General taxes expense increased by \$4.0 million, or 3.6%, for the six months ended June 30, 2012 compared to the six months ended June 30, 2011. This increase was principally due to higher property taxes of \$2.2 million, which is primarily related to our recently acquired New York properties, as well as higher payroll and gross receipt taxes.

Other income (expenses). Other expenses decreased by \$1.5 million, or 1.0%, for the six months ended June 30, 2012 compared to the same period in the prior year and is primarily attributable to an increase in AFUDC of \$6.1 million related to increased construction activity,

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including the water treatment facility replacement project in our New Jersey subsidiary. Partially offsetting this decrease was an increase in interest expense, net of interest income, of \$4.7 million, or 3.1%, for the six months ended June 30, 2012 compared to the same period in the prior year. This increase is mainly attributable to accelerated amortization recorded in 2011 of \$3.1 million in unamortized debt discounts associated with debt that was redeemed during the first quarter of 2011, as well as higher interest expense associated with our interest rate swap and incremental interest expense on borrowings associated with certain restricted funds.

Provision for income taxes. Our consolidated provision for income taxes increased \$36.8 million, or 46.4%, to \$116.0 million for the six months ended June 30, 2012. The effective tax rates for the six months ended June 30, 2012 and 2011 were 41.1% and 40.7%, respectively.

Income (loss) from discontinued operations, net of tax. As noted above, the financial results of our regulated water and wastewater systems in Arizona, New Mexico, Texas and Ohio as well as those of our AWM subsidiary within the Market-Based Operations segment, have been classified as discontinued operations for all periods presented. The increase in loss from discontinued operations, net of tax is primarily related to the disposition of our Ohio subsidiary, \$9.7 million in charges for income taxes resulting from the divestiture of our Arizona and New Mexico subsidiaries and the \$2.4 million pre-tax sales price adjustment in connection with the disposition of our Arizona and New Mexico subsidiaries. Additionally, the 2011 amount included net income as a result of the operations of those subsidiaries and an after-tax benefit of \$7.9 million related to the cessation of depreciation for our Arizona, New Mexico, and Texas subsidiaries. Under GAAP, operations that are considered discontinued operations cease to depreciate their assets. Partially offsetting the 2011 income (loss) from discontinued operations, net of tax amount was \$24.6 million after-tax write-downs recorded in 2011 to reduce the net asset values of certain of our discontinued operations.

Segment Results

We have two operating segments that are also our reportable segments: the Regulated Businesses and the Market-Based Operations. We evaluate the performance of our segments and allocate resources based on several factors, with the primary measure being income from continuing operations before income taxes.

Regulated Segment

The following table summarizes certain financial information for our Regulated Businesses for the periods indicated:

	For the three months ended June 30,			For the six months ended June 30,		
	2012	2011	Increase (Decrease) (In thousands)	2012	2011	Increase (Decrease)
Operating revenues	\$ 667,601	\$ 594,441	\$ 73,160	\$ 1,209,476	\$ 1,122,722	\$ 86,754
Operation and maintenance expense	270,031	271,383	(1,352)	527,962	536,336	(8,374)
Operating expenses, net	406,417	400,719	5,698	801,059	795,066	5,993
Income from continuing operations before income taxes	204,874	138,020	66,854	295,290	215,082	80,208

Operating revenues. Our primary business involves the ownership of water and wastewater utilities that provide services to residential, commercial, industrial and other customers. This business is generally subject to state regulation and our results of operations are impacted significantly by rates authorized by the regulatory commissions in the states in which we operate.

Operating revenues increased by \$73.2 million, or 12.3%, for the three months ended June 30, 2012 and \$86.8 million, or 7.7%, for the six months ended June 30, 2012, respectively, as compared to the same periods in 2011. The increase in revenues was primarily due to rate increases obtained through rate authorizations for a number of our operating companies, higher demand, additional revenues associated with acquisitions and a retroactive adjustment in the second quarter of 2012 totaling \$7.2 million resulting from the issuance of a final rate order in California.

The impact of rate increases on revenues was approximately \$32.0 million and \$52.2 million for the three and six months ending June 30, 2012, respectively. The increase in revenues associated with higher demand amounted to approximately \$27 million and \$21 million for the three and six months ended June 30, 2012, respectively, which is attributable to increased customer consumption in 2012 compared to 2011, which we believe is primarily attributable to the warmer/drier weather in the second quarter of 2012. Lastly, revenues were higher by \$7.9 million and \$8.5 million for the three and six months ended June 30, 2012, respectively, compared to the same period in 2011 as a result of acquisitions, with the most significant being our New York acquisition in the second quarter of 2012.

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The following table provides information regarding the Regulated Businesses' revenues and billed water sales volume by customer class:

Customer Class	For the three months ended June 30,							
	2012		2011		2012		2011	
	Operating Revenues (Dollars in thousands)				Billed Water Sales Volume (Gallons in millions)			
Water service:								
Residential	\$ 383,879	57.5%	\$ 335,772	56.5%	45,304	51.0%	42,473	51.0%
Commercial	130,917	19.6%	117,829	19.8%	20,371	23.0%	19,103	22.9%
Industrial	35,860	5.4%	30,391	5.1%	9,754	11.0%	9,491	11.4%
Public and other	79,567	11.9%	74,796	12.6%	13,353	15.0%	12,193	14.7%
Other water revenues	7,960	1.2%	6,020	1.0%				
Total water revenues	638,183	95.6%	564,808	95.0%	88,782	100.0%	83,260	100.0%
Wastewater service	19,669	2.9%	19,411	3.3%				
Other revenues	9,749	1.5%	10,222	1.7%				
	\$ 667,601	100.0%	\$ 594,441	100.0%				

Customer Class	For the six months ended June 30,							
	2012		2011		2012		2011	
	Operating Revenues (Dollars in thousands)				Billed Water Sales Volume (Gallons in millions)			
Water service:								
Residential	\$ 689,776	57.0%	\$ 633,217	56.4%	83,779	50.7%	81,610	50.7%
Commercial	237,589	19.6%	219,069	19.5%	37,656	22.8%	36,453	22.7%
Industrial	62,788	5.2%	57,049	5.1%	18,729	11.3%	18,761	11.7%
Public and other	150,848	12.5%	144,842	12.9%	25,079	15.2%	24,026	14.9%
Other water revenues	10,699	0.9%	11,318	1.0%				
Total water revenues	1,151,700	95.2%	1,065,495	94.9%	165,243	100.0%	160,850	100.0%
Wastewater service	38,790	3.2%	37,902	3.4%				
Other revenues	18,986	1.6%	19,325	1.7%				
	\$ 1,209,476	100.0%	\$ 1,122,722	100.0%				

Water Services Water service operating revenues from residential customers for the three months ended June 30, 2012 increased by \$48.1 million, or 14.3%, compared to the three months ended June 30, 2011. For the six months ended June 30, 2012 these revenues increased by \$56.6 million, or 8.9%, over the same period in 2011. The increases are primarily due to rate increases as well as increased sales volumes. For the three months ended June 30, 2012, the volume of water sold to residential customers increased by 6.7% compared to the same period in 2011. For the six months ended June 30, 2012, the volume sold to these customers increased by 2.7% as compared to the same period in 2011. We believe this higher consumption for both the three and six month periods is driven by the warmer/drier weather in June 2012 in our eastern and midwestern operating states as compared to June 2011. Also contributing to the increased sales volumes was the additional consumption resulting from our New York acquisition.

Water service operating revenues from commercial water customers for the three months ended June 30, 2012 increased by \$13.1 million, or 11.1%, compared to the same period in 2011. For the six months ended June 30, 2012, these revenues increased by \$18.5 million, or 8.5%, to \$237.6 million, compared to June 30, 2011. These increases were mainly due to rate increases as well as increased sales volume. The volume of

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water sold to commercial customers increased by 6.6% and 3.3% for the three and six months ended June 30, 2012, respectively, compared to the same periods in 2011.

Water service operating revenues from industrial customers, increased \$5.5 million, or 18.0%, for the three months ended June 30, 2012 compared to those recorded for the same period of 2011, mainly due to rate increases and an increase in sales volume. For the three months ended June 30, 2012, the volume of water sold to industrial customers increased by 2.8% compared to the same

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period in 2011. For the six months ended June 30, 2012, water service operating revenues from industrial customers increased \$5.7 million, or 10.1%, compared to the same period of 2011 and is primarily due to rate increases. The volume of water sold to industrial customers for the six months ended June 30, 2012 decreased 0.2% compared to the six months ended June 30, 2011.

Water service operating revenues from public and other customers, including municipal governments, other governmental entities and resale customers increased \$4.8 million, or 6.4%, and \$6.0 million, or 4.1%, for the three and six months ended June 30, 2012, respectively, mainly due to increased sale volumes.

Wastewater services Our subsidiaries provide wastewater services in nine states. Revenues from these services increased by \$0.3 million, or 1.3%, to \$19.7 million for the three months ended June 30, 2012, compared to the same period of 2011. Revenues from these services for the six months ended June 30, 2012 increased by \$0.9 million, or 2.3%, to \$38.8 million, compared to the same period of 2011. The increases in both periods were primarily attributable to rate increases in a number of our operating companies.

Operation and maintenance. Operation and maintenance expense decreased \$1.4 million, or 0.5%, for the three months ended June 30, 2012, compared to the three months ended June 30, 2011. Operation and maintenance expense decreased \$8.4 million, or 1.6%, for the six months ended June 30, 2012, compared to the same period in the prior year. The following table provides information regarding operation and maintenance expense for the three and six months ended June 30, 2012 and 2011, by major expense category:

	For the three months ended June 30,				For the six months ended June 30,			
	2012	2011*	Increase (Decrease)	Percentage	2012	2011*	Increase (Decrease)	Percentage
	(Dollars in thousands)							
Production costs	\$ 67,427	\$ 65,711	\$ 1,716	2.6%	\$ 125,887	\$ 124,284	\$ 1,603	1.3%
Employee-related costs	117,647	119,909	(2,262)	(1.9%)	233,008	242,491	(9,483)	(3.9%)
Operating supplies and services	46,294	47,475	(1,181)	(2.5%)	94,869	96,302	(1,433)	(1.5%)
Maintenance materials and services	15,922	16,187	(265)	(1.6%)	32,056	33,642	(1,586)	(4.7%)
Customer billing and accounting	10,337	12,761	(2,424)	(19.0%)	19,407	20,859	(1,452)	(7.0%)
Other	12,404	9,340	3,064	32.8%	22,735	18,758	3,977	21.2%
Total	\$ 270,031	\$ 271,383	\$ (1,352)	(0.5%)	\$ 527,962	\$ 536,336	\$ (8,374)	(1.6%)

* Certain reclassifications have been made between categories in order for 2011 to conform with 2012 presentation. Production costs and employee-related costs, which account for approximately 70% of the total Regulated Businesses operation and maintenance expense, are discussed in more detail below.

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Production costs by major expense type were as follows:

	For the three months ended June 30,				For the six months ended June 30,			
	2012	2011	Increase (Decrease)	Percentage	2012	2011	Increase (Decrease)	Percentage
	(Dollars in thousands)							
Fuel and power	\$ 21,008	\$ 21,401	\$ (393)	(1.8%)	\$ 41,108	\$ 41,470	\$ (362)	(0.9%)
Purchased Water	27,597	25,565	2,032	7.9%	50,007	46,380	3,627	7.8%
Chemicals	12,522	11,728	794	6.8%	22,030	22,005	25	0.1%
Waste disposal	6,300	7,017	(717)	(10.2%)	12,742	14,429	(1,687)	(11.7%)
Total	\$ 67,427	\$ 65,711	\$ 1,716	2.6%	\$ 125,887	\$ 124,284	\$ 1,603	1.3%

Overall production costs increased for the three and six months ended June 30, 2012 compared to the same periods in the prior year, resulting from increased production and sales during the second quarter of 2012. This increase was partially offset by lower fuel and power costs attributable to favorable pricing in 2012 compared to 2011 in one of our regulated operating subsidiaries.

Employee-related costs, including salaries and wages, group insurance, and pension expense, decreased \$2.3 million, or 1.9%, for the three months ended June 30, 2012 compared to the same period in the prior year. These employee-related costs represent approximately 44% of operation and maintenance expense for the three months ended June 30, 2012 and 2011. Employee related costs also decreased \$9.5 million, or 3.9%, for the six months ended June 30, 2012 compared to the same period in the prior year. These employee-related costs represent approximately 44% and 45%, of operation and maintenance expense for the six months ended June 30, 2012 and 2011, respectively. The following table provides information with respect to components of employee-related costs for the three and six months ended June 30, 2012 and 2011:

	For the three months ended June 30,				For the six months ended June 30,			
	2012	2011	Increase (Decrease)	Percentage	2012	2011	Increase (Decrease)	Percentage
	(In thousands)							
Salaries and wages	\$ 82,530	\$ 81,227	\$ 1,303	1.6%	\$ 160,918	\$ 161,876	\$ (958)	(0.6%)
Pensions	14,484	15,685	(1,201)	(7.7%)	27,823	32,841	(5,018)	(15.3%)
Group insurance	16,562	18,550	(1,988)	(10.7%)	35,431	38,719	(3,288)	(8.5%)
Other benefits	4,071	4,447	(376)	(8.5%)	8,836	9,055	(219)	(2.4%)
Total	\$ 117,647	\$ 119,909	\$ (2,262)	(1.9%)	\$ 233,008	\$ 242,491	\$ (9,483)	(3.9%)

For the three months ended June 30, 2012, the overall decrease in employee-related costs was primarily driven by decreased group insurance and pension expense partially offset by an increase in salaries and wages. For the six months ended June 30, 2012, the decrease was driven by lower pension and group insurance expense. The reduction in group insurance costs for the three and six months ended June 30, 2012 compared to the same periods in 2011 is mainly attributable to lower headcount as a result of vacancies, a decrease in the overall cost per person as well as higher capitalization rates. The decrease in pension expense for both the three and six months ended June 30, 2012 was primarily due to decreased contributions in certain of our regulated operating companies whose costs are recovered based on our funding policy, which is to fund at least the minimum amount required by the Employee Retirement Income Security Act of 1974. This was partially offset by a \$1.7 million incremental charge resulting from the finalization of our California rate case.

Operating supplies and services include the day-to-day expenses of office operation, legal and other professional services, transportation expenses, information systems rental charges and other office equipment rental charges. These costs decreased \$1.2 million, or 2.5%, and \$1.4 million, or 1.5%, for the three and six months ended June 30, 2012, respectively. The overall decrease was primarily due to lower transportation expenses due to a reduction in leased vehicle costs and \$2.1 million in credit adjustments resulting from the finalization of our California rate case. These decreases were offset by higher contracted services for the three and six months ended June 30, 2012, respectively, mainly as a

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result of backfilling positions, including those left open by employees who are working on our transformation project as well as the use of contractors for other specific projects.

Customer billing and accounting expenses, which includes uncollectible accounts expense, postage and collection agency fees, decreased by \$2.4 million, or 19.0%, and \$1.5 million, or 7.0%, for the three and six months ended June 30, 2012, respectively, and is mainly the result of reductions in uncollectible accounts expense, reflecting improved collections in our receivables aged in excess of 120 days.

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Other operation and maintenance expenses include casualty and liability insurance premiums and regulatory costs. The increase in these costs was driven by higher insurance costs for the three and six months ended June 30, 2012, as 2012 insurance costs reflected incremental expense resulting from the resolution of prior years' claims.

Operating expenses. The increase in operating expenses for the three and six months ended June 30, 2012 is primarily due to higher depreciation expense of \$4.9 million and \$11.1 million, respectively, resulting from additional utility plant placed in service, and increased general taxes of \$2.2 million and \$3.4 million, respectively, principally attributable to higher property taxes, which are primarily related to our recently acquired New York properties, and higher payroll taxes. These increases were partially offset by the decrease in operation and maintenance expense for both the three and six months ended June 30, 2012 as explained above.

Market-Based Operations

The following table provides financial information for our Market-Based Operations segment for the periods indicated:

	For the three months ended June 30,			For the six months ended June 30,		
	2012	2011	Increase (Decrease)	2012	2011	Increase (Decrease)
	(In thousands)					
Operating revenues	\$ 82,795	\$ 82,424	\$ 371	\$ 163,376	\$ 157,806	\$ 5,570
Operation and maintenance expense	71,118	72,702	(1,584)	138,891	137,238	1,653
Operating expenses, net	73,982	75,753	(1,771)	144,747	144,027	720
Income from continuing operations before income taxes	9,738	7,259	2,479	20,208	14,933	5,275

Operating revenues. Revenues for the three months ended June 30, 2012 increased \$0.4 million compared to the same period in 2011 and is primarily attributable to an increase in the Homeowner Services Group revenues of \$3.1 million partially offset by decreases in Contract Operations Group revenues of \$1.5 million and in Carbon Services Group revenues of \$1.8 million.

The net increase in revenues for the six months ended June 30, 2012 compared to the same period in 2011 is primarily attributable to a \$2.7 million increase in our Homeowner Services Group revenues associated with continued contract growth, a price increase and a \$3.5 million increase in our Contract Operations Group revenues, which is mainly due to incremental revenues associated with military construction and operation and maintenance projects.

Operation and maintenance. Operation and maintenance expense decreased \$1.6 million, or 2.2%, for the three months ended June 2012, and increased \$1.7 million, or 1.2%, for the six months ended June 30, 2012 compared to the same periods in the prior year.

The following table provides information regarding categories of operation and maintenance expense for the three and six months ended June 30, 2012 and 2011:

	For the three months ended June 30,				For the six months ended June 30,			
	2012	2011	Increase (Decrease)	Percentage	2012	2011*	Increase (Decrease)	Percentage
	(Dollars in thousands)							
Production costs	\$ 11,479	\$ 12,329	\$ (850)	(6.9%)	\$ 23,518	\$ 24,670	\$ (1,152)	(4.7%)
Employee-related costs	18,964	18,705	259	1.4%	36,482	36,266	216	0.6%
Operating supplies and services	28,303	28,899	(596)	(2.1%)	56,107	52,181	3,926	7.5%
Maintenance materials and services	9,826	10,556	(730)	(6.9%)	18,834	19,913	(1,079)	(5.4%)
Other, including uncollectible expense	2,548	2,213	335	15.1%	3,950	4,208	(258)	(6.1%)
Total	\$ 71,120	\$ 72,702	\$ (1,582)	(2.2%)	\$ 138,891	\$ 137,238	\$ 1,653	1.2%

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* Certain reclassifications have been made between categories in order for 2011 to conform with 2012 presentation.

As noted in the table above, total operation and maintenance expense decreased for the three months ended June 30, 2012 as compared to the same period in 2011, with the main contributors being lower production costs and maintenance materials and supplies. For the six months ended June 30, 2012, an increase in operating supplies and services was partially offset by decreases in production costs and maintenance materials and supplies. The increase in operating supplies and services is attributable to increased construction activity for our military contracts. The decrease in production costs for the six months ended June 30, 2012 compared to the same period in 2011 is primarily due to a decrease in waste disposal costs, while the decrease in maintenance materials and services is due to reduced tank painting costs in 2012.

Operating expense. The change in operating expenses for the three and six months ended June 30, 2012 compared to 2011 is primarily due to the variances in the operation and maintenance expense for those respective periods and is explained above.

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For a general overview of our sources and uses of capital resources, see the introductory discussion under Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources, contained in part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2011.

We believe that our ability to access the capital markets, our revolving credit facility and our cash flows from operations will generate sufficient cash to fund our short-term capital requirements. We fund liquidity needs for capital investment, working capital and other financial commitments through cash flows from operations, public and private debt offerings, commercial paper markets and a revolving credit facility with \$840.0 million in aggregate total commitments from a diversified group of banks. We closely monitor the financial condition of the financial institutions associated with its credit facility.

In order to meet our short-term liquidity needs, we, through American Water Capital Corp. (AWCC), our financing subsidiary, issue primarily commercial paper, which is supported by the revolving credit facility. The revolving credit facility is also used, to a limited extent, to support our issuance of letters of credit. AWCC had no outstanding borrowings and \$35.2 million of outstanding letters of credit under the revolving credit facility as of June 30, 2012. As of June 30, 2012, AWCC had \$804.8 million available under our credit facility that we can use to fulfill our short-term liquidity needs, to issue letters of credit and support our \$362.0 million outstanding commercial paper. We can provide no assurances that our lenders will meet their existing commitments or that we will be able to access the commercial paper or loan markets in the future on terms acceptable to us or at all.

Cash Flows from Operating Activities

Cash flows from operating activities primarily result from the sale of water and wastewater services and, due to the seasonality of demand, are generally greater during the third quarter of each fiscal year. Cash flows from operating activities for the six months ended June 30, 2012 were \$316.9 million compared to \$262.4 million for the six months ended June 30, 2011.

The following table provides a summary of the major items affecting our cash flows from operating activities for the six months ended June 30, 2012 and 2011:

	For the six months ended	
	June 30,	
	2012	2011
	(In thousands)	
Net income	\$ 148,780	\$ 107,343
Add (subtract):		
Non-cash operating activities(1)	260,206	306,930
Changes in working capital(2)	(29,524)	(79,871)
Pension and postretirement healthcare contributions	(62,591)	(72,006)
Net cash flows provided by operations	\$ 316,871	\$ 262,396

(1) Includes, depreciation and amortization, provision for deferred income taxes, amortization of deferred investment tax credits, provision for losses on utility accounts receivable, allowance for other funds used during construction, (gain) loss on asset dispositions and purchases, pension and non-pension post retirement benefits expense and other non-cash items. Details of each component can be found in the Consolidated Statements of Cash Flows.

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

The increase in cash flows from operations for the six months ended June 30, 2012 compared to the same period in 2011 is primarily driven by the increase in operating revenues and the changes in working capital.

Cash Flows from Investing Activities

The following table provides information regarding cash flows used in investing activities for the periods indicated:

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	For the six months ended June 30,	
	2012	2011
	(In thousands)	
Net capital expenditures	\$ (476,300)	\$ (391,792)
Proceeds from sale of assets and securities	560,010	6,657
Acquisitions	(44,293)	(4,769)
Other investing activities, net(1)	(9,748)	14,479
Net cash flows provided by (used in) investing activities	\$ 29,669	\$ (375,425)

(1) Includes removal costs from property, plant and equipment retirements, net and net funds released.

Cash flows provided by investing activities for the six months ended June 30, 2012 was \$29.7 million compared to cash flows used in investing activities of \$375.4 million for the six months ended June 30, 2011. The variance from 2011 to 2012 is mainly attributable to the proceeds received from the sale of our Arizona and New Mexico subsidiaries in January 2012. The increase of \$84.5 million in net capital expenditures from 2011 to 2012 is attributable to increased spending on infrastructure replacement programs due to the milder winter weather in the first quarter of 2012 as compared to 2011, an increase in capital spending for our business transformation project and expenditures associated with the replacement of one of our New Jersey water treatment facilities.

Cash Flows from Financing Activities

Our financing activities, primarily focused on funding capital expenditures, include the issuance of long-term and short-term debt, primarily through AWCC. We intend to access the capital markets on a regular basis, subject to market conditions. In addition, new infrastructure may be financed with customer advances and contributions for construction (net of refunds).

The following table provides information on long-term debt that was issued during the first six months of 2012:

Company	Type	Interest Rate	Maturity		Amount (In thousands)
Other subsidiaries	Private activity bonds and government funded debt	0.00%- 5.00%	2013- 2041	(a)	\$ 68,746
Other subsidiaries	Private activity bonds and government funded debt	1.00%- 2.41%	2029- 2032	(b)	\$ 14,730
Total issuances					\$ 83,476

(a) Proceeds from these issuances were received from New Jersey Environmental Infrastructure Trust and will be used to fund certain specific projects. The proceeds are kept in Trust pending our certification that we have incurred qualifying expenditures. These issuances have been presented as non-cash on the Consolidated Statements of Cash Flows. Subsequent releases of all or a lesser portion of the funds by the Trust are reflected as the release of restricted funds and are included in investing activities in the Consolidated Statements of Cash Flows.

(b) Proceeds from these issuances were received from the Pennsylvania Infrastructure Investment Authority and funded specified projects.

Also, in the second quarter of 2012, and in connection with the acquisition of our additional subsidiaries in New York, we assumed debt of \$25.2 million with coupon rates of 5.00% to 6.00% and maturity dates ranging from 2015 to 2035.

The following long-term debt was retired through optional redemption, sinking fund provisions or payment at maturity during the first six months of 2012:

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Company	Type	Interest Rate	Maturity	Amount (In thousands)
Other subsidiaries	Mortgage bonds fixed rate	7.95%	2012	\$ 4,200
Other subsidiaries	Private activity bonds and government funded debt	0.00%-5.90%	2012-2041	153,775
Other subsidiaries	Mandatory redeemable preferred stock	4.60%-6.00%	2013-2019	1,100
Other	Capital leases and other			213
Total retirements and redemptions				\$ 159,288

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Included in the long-term debt redemptions/retirements is \$4.2 million related to our previously held Ohio subsidiary, which was classified in discontinued operations prior to its divestiture.

During the second quarter of 2012, we issued notices of redemption for \$150.4 million of outstanding bonds with original maturity dates ranging from 2026 to 2038 and interest rates ranging from 5.25% to 5.90%. These bonds were redeemed at various dates in the second quarter. Additionally, on July 2, 2012, we redeemed \$86.1 million of outstanding bonds with original maturity dates of 2028 to 2029 and interest rates ranging from 5.00% to 5.10%. In addition, on July 6, 2012 we redeemed \$2.8 million of preferred stock without mandatory redemption requirements with interest rates ranging from 5.00% to 5.75%. Both the July, 2012 redemptions as well as those occurring in the second quarter were made using commercial paper borrowing.

From time to time, and as market conditions warrant, we may engage in additional long-term debt retirements via tender offers, open market repurchases or other viable transactions.

Credit Facilities and Short-Term Debt

The components of short-term debt at June 30, 2012 were as follows:

	Amount (In thousands)
Commercial paper, net	\$ 361,972
Total short-term debt	\$ 361,972

The following table provides information as of June 30, 2012, regarding letters of credit sub-limits under our revolving credit facility and available funds under the revolving credit facility, as well as outstanding amounts of commercial paper and borrowings under the revolving credit facilities.

	Credit Facility Commitment	Available Credit Facility Capacity	Letter of Credit Sub-limit	Available Letter of Credit Capacity	Outstanding Commercial Paper (Net of Discount)	Credit Line Borrowings
	(In thousands)					
June 30, 2012	\$ 840,000	\$ 804,845	\$ 150,000	\$ 114,845	\$ 361,972	\$ 0

Interest rates on advances under the revolving credit facility are based on either prime rate or LIBOR, plus an applicable margin based upon our credit ratings, as well as total outstanding amounts under the facility at the time of the borrowing. The current spread over LIBOR is 22.5 basis points and the maximum spread over LIBOR under our revolving credit facility is 55 basis points.

The weighted-average interest rate on short-term borrowings for the six months ended June 30, 2012 was approximately 0.51% compared to 0.39% for the six months ended June 30, 2011.

Capital Structure

The following table provides information regarding our capital structure for the periods presented:

	At June 30, 2012	At December 31, 2011
Common stockholders equity and preferred stock without mandatory redemption rights	43%	42%
	52%	53%

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Long-term debt and redeemable preferred stock at redemption value

Short-term debt and current portion of long-term debt	5%	5%
	100%	100%

Debt Covenants

Our debt agreements contain financial and non-financial covenants. To the extent that we are not in compliance, we or our subsidiaries may be restricted in our ability to pay dividends, issue new debt or access our revolving credit facility. We were in compliance with our covenants as of June 30, 2012. Our failure to comply with restrictive covenants under our credit facility could accelerate repayment obligations. Our long-term debt indentures contain a number of covenants that, among other things, limit the Company from issuing debt secured by the Company's assets, subject to certain exceptions.

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Certain long-term notes and the revolving credit facility require us to maintain a ratio of consolidated debt to consolidated capitalization of not more than 0.70 to 1.00. As of June 30, 2012, our ratio was 0.57 and therefore we were in compliance with the covenant.

Security Ratings

Our access to the capital markets, including the commercial paper market, and respective financing costs in those markets, is directly affected by securities ratings of the entity that is accessing the capital markets. We primarily access the capital markets, including the commercial paper market, through AWCC. However, we also issue debt through our regulated subsidiaries, primarily in the form of tax exempt securities, to lower our overall cost of debt.

On January 30, 2012, Standard & Poor's Ratings Service, which we refer to as S&P, reaffirmed its BBB+ corporate credit rating on AWCC and American Water and AWCC's A2 short-term rating. On June 18, 2012, S&P revised its rating outlook for American Water and AWCC to positive from stable. Moody's rating outlook for both American Water and AWCC continues to be stable. The following table shows the Company's securities ratings as of June 30, 2012:

Securities	Moody's Investors Service	Standard & Poor's Ratings Service
Senior unsecured debt	Baa2	BBB+
Commercial paper	P2	A2

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

As part of the normal course of business, we routinely enter into contracts for the purchase and sale of water, energy, fuels and other services. These contracts either contain express provisions or otherwise permit us and our counterparties to demand adequate assurance of future performance when there are reasonable grounds for doing so. In accordance with the contracts and applicable contract law, if we are downgraded by a credit rating agency, especially if such downgrade is to a level below investment grade, it is possible that a counterparty would attempt to rely on such a downgrade as a basis for making a demand for adequate assurance of future performance, which could include a demand that we provide collateral to secure our obligations. We do not expect that our posting of collateral would have a material adverse impact on our results of operations, financial position or cash flows.

Dividends

Our board of directors has adopted a dividend policy to distribute to our shareholders a portion of our net cash provided by operating activities as regular quarterly dividends, rather than retaining that cash for other purposes. Since the dividends on our common stock will not be cumulative, only declared dividends will be paid.

In March and June 2012, the Company made cash dividend payments of \$0.23 per share to all shareholders of record as February 3, 2012 and April 20, 2012, respectively. In March 2011 and June 2011, the Company made cash dividend payments of \$0.22 per share to all shareholders of record as of February 18, 2011 and May 18, 2011, respectively.

On May 11, 2012, our board of directors declared a quarterly cash dividend payment of \$0.25 per share payable on September 3, 2012 to all shareholders of record as of July 6, 2012. As of June 30, 2012, these dividends totaling \$44.1 million had been accrued in other current liabilities on the accompanying Consolidated Balance Sheets.

Market Risk

There have been no significant changes to our market risk since December 31, 2011. For a discussion of our exposure to market risk, refer to Part II, Item 7A. Quantitative and Qualitative Disclosures about Market Risk, contained in our Annual Report on Form 10-K for the year ended December 31, 2011.

Application of Critical Accounting Policies and Estimates

Our financial condition, results of operations and cash flows are impacted by the methods, assumptions and estimates used in the application of critical accounting policies. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates, in our Form 10-K for the year ended December 31, 2011 filed with the SEC for a discussion of our critical accounting policies.

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Recent Accounting Pronouncements

See Part I, Item 1 Financial Statements (Unaudited) Note 2 New Accounting Pronouncements in this Quarterly Report on Form 10-Q for a discussion of new accounting standards recently adopted or pending adoption.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. For further discussion of market risks see Market Risk in Part I, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

American Water Works Company, Inc. maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its reports filed or submitted under the Securities Exchange Act of 1934 (the Exchange Act) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

Our management, including the Chief Executive Officer and the Chief Financial Officer, conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) of the Exchange Act) as of June 30, 2012 pursuant to 15d-15(e) under the Exchange Act.

Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of June 30, 2012, our disclosure controls and procedures were effective at a reasonable level of assurance. Our disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the three months ended June 30, 2012, that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

As noted under *Business Transformation Project* in Part I, Item 2- Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q, we have undertaken a project with the goals of increasing our operating efficiency and effectiveness and controlling the costs associated with the operation of our business, all of which are important to providing quality service to our customers and communities we serve. The focus of the project is the implementation of Enterprise Resource Planning systems, which encompass applications that will handle human resources, finance and supply chain/procurement management; an Enterprise Asset Management system, which will handle the management of asset lifecycles; and a Customer Information system. The project is reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The following information updates and amends the information provided in the Company's annual report on Form 10-K for the year ended December 31, 2011 (the Form 10-K) in Part I, Item 3, Legal Proceedings, and in the Company's quarterly report on Form 10-Q for the quarter ended March 31, 2012 (the Form 10-Q) in Part II, Item 1, (Legal Proceedings).

Alternative Water Supply in Lieu of Carmel River Diversions

As described in the Form 10-K, the California State Water Resources Control Board (the State Water Board) adopted a Cease and Desist Order applicable to California-American Water Company (CAWC) on October 20, 2009 (the 2009 Order), and CAWC appealed the 2009 Order

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to the Superior Court of California, challenging the findings and requirements of the 2009 Order. In July 2012, CAWC, the State Water Board, and other parties to CAWC's action and a related action entered into a Stipulation For Dismissal, Without Prejudice, Agreement to Toll Statute of Limitations and Proposed Order (the Stipulation). Under the Stipulation, the actions against the State Water Board generally would be dismissed without prejudice and, subject to limited exceptions, CAWC and the other parties could not initiate a civil action for judicial review of the 2009 Order prior to August 1, 2013. In addition, the statute of limitations related to any future judicial review of the 2009 Order as to claims alleged in the CAWC's appeal of the 2009 Order and in a related action would be tolled. From CAWC's perspective, the Stipulation would enable it to focus its efforts on providing a viable alternative water supply in lieu of diversions from the Carmel River, while retaining its right to seek judicial review of the 2009 Order in the future, if necessary. Although not required, the Stipulation has been submitted to the Superior Court for its approval. If the Superior Court does not approve the Stipulation, CAWC will reassess its position with respect to the Stipulation.

As also described in the Form 10-K, CAWC filed a petition (the Petition) with the California Public Utilities Commission (CPUC) seeking clarification that it may go forward with constructing four pipelines and two pump stations (the Ancillary Facilities), regardless of the status of the Regional Desalination Project (the Project) that was to be implemented through a Water Purchase Agreement (WPA) and ancillary agreements (the Agreements) among the Marina Coast Water District (MCWD), the Monterey County Water Resources Agency (MCWRA) and CAWC. In addition, as described in the Form 10-Q, CAWC filed an application with the CPUC for approval of the Monterey Peninsula Water Supply Project (the New Project). The New Project involves construction of a desalination plant and related facilities, all to be owned by CAWC. In addition, the New Project may encompass CAWC's purchase of water from the proposed Monterey Peninsula Groundwater Replenishment Project, a joint project between the Monterey Regional Water Pollution Control Agency and the Monterey Peninsula Water Management District (MPWMD). The New Project also would involve aquifer storage and recovery through an already established aquifer storage and recovery program between CAWC and the MPWMD.

On April 23, 2012, CAWC filed a withdrawal of the Petition, stating that the application for the New Project renders the Petition moot. The CPUC treated the withdrawal as a motion to withdraw and, on July 12, 2012, granted the motion and closed the proceedings relating to the Project. In its decision, the CPUC stated that there may be costs that have been incurred with respect to the Project that may be recoverable in rates, but that it would examine the recoverability of such costs in other proceedings.

As noted in the Form 10-Q, CAWC's ability to move forward on the New Project will be subject to extensive administrative review. In addition, a large number of federal, state and local approvals must be obtained, and other possible impediments, including a Monterey County (County) ordinance limiting sponsorship of a desalination project to government-owned enterprises, must be addressed.

On June 21, 2012, counsel for CAWC sent a letter to the County Counsel of Monterey County stating that, because CAWC is a CPUC-regulated water utility and a public water system regulated by the California Department of Public Health, the ordinance is not enforceable against CAWC. In the letter, CAWC counsel requested that the County Board of Supervisors (Board of Supervisors) decide, at its meeting on June 26, 2012, that the ordinance does not apply to and may not be enforced against the desalination facility proposed by CAWC as part of the New Project. Counsel for CAWC added that if the Board of Supervisors decided otherwise or declined to make a decision, CAWC would file suit against the County to resolve the issue. In response, on June 26, 2012, the County filed a complaint for declaratory relief against CAWC and others, in the California Superior Court in and for the County of San Francisco. In its complaint, the County asserts, among other things, that the ordinance applies to CAWC. The County seeks a declaration of the parties' rights and duties with regard to the application of the ordinance to CAWC and CAWC's right to lawfully operate a desalination facility in the County without a permit from the County's Director of Environmental Health. The matter is pending.

We cannot assure you that CAWC's application for the New Project will be approved or that the New Project will be completed.

San Clemente Dam

As noted in the Form 10-K, CAWC challenged the Proposed Decision, as revised (the PD), of the administrative law judge assigned to CAWC's application for approval of the Carmel River Reroute and San Clemente Dam Removal Project (the Dam Project). As also noted in the Form 10-Q, a CPUC Commissioner subsequently issued an Alternate Proposed Decision (the Alternate PD) that includes significant changes from the PD.

On June 21, 2012, the PUC issued a Decision approving the Dam Project that is substantially similar to the Alternate PD. Specifically, the decision provides for rate recovery by CAWC of the \$49 million in prospective costs over a 20 year period: CAWC may file an application with the CPUC to increase the amount of costs subject to rate recovery if project costs exceed \$49 million. In addition, the Decision permits CAWC to earn its full rate of equity return on this investment by allowing CAWC to draw interest at its authorized cost of capital, which includes both the debt and equity rates set by the CPUC. While the \$49 million to be recovered by CAWC would be offset by tax benefits derived by CAWC's donation of certain land, the offset will not apply to a parcel being used for utility purposes and which is not part of the Dam Project. In addition, the Decision permits CAWC's rate recovery of approximately \$27 million in historical costs. The Decision places all authorized and estimated costs in a regulatory asset/balancing account and provides for recovery of the regulatory asset/balancing account over a twenty-year period beginning July 1, 2012. The decision also finds that CAWC did not make a misrepresentation regarding descriptions of the use of the dam as a point of water diversion.

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On July 27, 2012, the Division of Ratepayer Advocates of the CPUC (the DRA) filed an application for rehearing of the Decision. While supporting the Dam Project, the DRA challenged the portion of the Decision authorizing CAWC to earn a full rate of return on expenses of the Dam Project. The CPUC has not yet ruled on the DRA 's application.

Other Matters

On June 29, 2012, a pipe bridge that supported three pipes carrying raw and treated water to and from the New Jersey American Water (NJAW) Monmouth County Swimming River Treatment plant collapsed, substantially reducing the plant 's capacity. This plant provides approximately 50% of the total capacity needed to meet maximum day demands for NJAW 's Coastal North system, which serves 95,000 customers: other sources provide the remaining capacity. An estimated 200 to 300 customers at the highest elevations of the service area were left without water service for a six hour period on June 30, and the drop in water pressure resulted in the declaration of a state of emergency by Monmouth County and a precautionary boil water advisory for all customers served by the system. NJAW distributed 51,000 cases of bottled water to its customers in the system. Emergency, temporary piping across a road bridge was constructed and substantial capacities were restored by July 1, at which time the boil water advisory was lifted. Full plant capacity completed on July 4, and the state of emergency was lifted on July 9.

NJAW has retained a forensic engineer to conduct an assessment as to the cause of the bridge collapse. The New Jersey Board of Public Utilities (the BPU) has directed NJAW to preserve documents and damaged portions of the bridge and piping pending an investigation that the BPU will be undertaking. The BPU also has advised NJAW that it will be directing NJAW to retain a special reliability master to conduct that investigation and present findings to the BPU. We are unable to predict the outcome of the assessment and investigations at this early stage. NJAW is cooperating fully with the BPU.

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ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in the "Risk Factors" in the Company's Form 10-K for the year ended December 31, 2011, and our other public filings, which could materially affect our business, financial condition or future results. There have been no material changes from risk factors previously disclosed in "Risk Factors" in the Company's Form 10-K for the year ended December 31, 2011.

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

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

Exhibit

Number	Exhibit Description
*10.1	American Water Works Company, Inc. 2007 Omnibus Equity Compensation Plan 2012 Form of Stock Unit Grant Agreement for Non-Employee Directors
*31.1	Certification of Jeffrey Sterba, President and Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act
*31.2	Certification of Ellen C. Wolf, Senior Vice President and Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act
*32.1	Certification of Jeffrey Sterba, President and Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act
*32.2	Certification of Ellen C. Wolf, Senior Vice President and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act
101	The following financial statements from American Water Works Company, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2012, filed with the Securities and Exchange Commission on August 2, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations and Comprehensive Income; (iii) the Consolidated Statements of Cash Flows; (iv) the Consolidated Statements of Changes in Stockholders' Equity; and (v) the Notes to Consolidated Financial Statements.

* filed herewith.

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Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 2nd day of August, 2012.

American Water Works Company, Inc.

(Registrant)

/s/ Jeffry Sterba
Jeffry Sterba

President and Chief Executive Officer

(Principal Executive Officer)

/s/ Ellen C. Wolf
Ellen C. Wolf

Senior Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)

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