

AQUA AMERICA INC
Form 10-Q
November 02, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

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

For the transition period from _____ to _____

Commission File Number 1-6659

AQUA AMERICA, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction of
incorporation or organization)

23-1702594
(I.R.S. Employer
Identification No.)

762 W. Lancaster Avenue, Bryn Mawr, Pennsylvania
(Address of principal executive offices)

19010 -3489
(Zip Code)

(610) 527-8000
(Registrant's telephone number, including area code)

(Former Name, former address and former fiscal year, if changed since last report.)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer (do not check if a smaller reporting company) 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

October 20, 2016: 177,358,257

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AQUA AMERICA, INC. AND SUBSIDIARIES

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands of dollars, except per share amounts)

(UNAUDITED)

| | September 30, 2016 | December 31, 2015 |
|---|--------------------------|-------------------------|
| Assets | | |
| Property, plant and equipment, at cost | \$ 6,386,445 | \$ 6,088,011 |
| Less: accumulated depreciation | 1,484,959 | 1,399,086 |
| Net property, plant and equipment | 4,901,486 | 4,688,925 |
| Current assets: | | |
| Cash and cash equivalents | 3,712 | 3,229 |
| Accounts receivable and unbilled revenues, net | 109,986 | 99,146 |
| Inventory, materials and supplies | 12,298 | 12,414 |
| Prepayments and other current assets | 11,799 | 11,802 |
| Assets held for sale | 3,606 | 1,779 |
| Total current assets | 141,401 | 128,370 |
| Regulatory assets | 911,455 | 830,118 |
| Deferred charges and other assets, net | 30,903 | 28,878 |
| Investment in joint venture | 8,859 | 7,716 |
| Goodwill | 41,921 | 33,866 |
| Total assets | \$ 6,036,025 | \$ 5,717,873 |
| Liabilities and Equity | | |
| Stockholders' equity: | | |
| Common stock at \$.50 par value, authorized 300,000,000 shares, issued 180,268,028 and 179,363,660 as of September 30, 2016 and December 31, 2015 | \$ 90,134 | \$ 89,682 |
| Capital in excess of par value | 795,139 | 773,585 |
| Retained earnings | 1,017,261 | 930,061 |
| Treasury stock, at cost, 2,912,938 and 2,819,569 shares as of September 30, 2016 and December 31, 2015 | (70,990) | (68,085) |
| Accumulated other comprehensive income | 656 | 687 |
| Total stockholders' equity | 1,832,200 | 1,725,930 |
| Long-term debt, excluding current portion | 1,748,689 | 1,743,612 |
| Less: debt issuance costs | 22,196 | 23,165 |
| Long-term debt, excluding current portion, net of debt issuance costs | 1,726,493 | 1,720,447 |
| Commitments and contingencies (See Note 13) | - | - |

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| | | |
|--|--------------|--------------|
| Current liabilities: | | |
| Current portion of long-term debt | 83,777 | 35,593 |
| Loans payable | 47,990 | 16,721 |
| Accounts payable | 44,073 | 56,452 |
| Accrued interest | 18,236 | 12,651 |
| Accrued taxes | 18,475 | 21,887 |
| Other accrued liabilities | 39,447 | 49,895 |
| Total current liabilities | 251,998 | 193,199 |
| Deferred credits and other liabilities: | | |
| Deferred income taxes and investment tax credits | 1,236,516 | 1,118,923 |
| Customers' advances for construction | 93,023 | 86,934 |
| Regulatory liabilities | 250,108 | 259,507 |
| Other | 107,623 | 100,498 |
| Total deferred credits and other liabilities | 1,687,270 | 1,565,862 |
| Contributions in aid of construction | 538,064 | 512,435 |
| Total liabilities and equity | \$ 6,036,025 | \$ 5,717,873 |

See notes to consolidated financial statements beginning on page 9 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF NET INCOME

(In thousands, except per share amounts)

(UNAUDITED)

| | Three Months Ended September 30, | |
|--|-------------------------------------|------------|
| | 2016 | 2015 |
| Operating revenues | \$ 226,593 | \$ 221,051 |
| Operating expenses: | | |
| Operations and maintenance | 79,812 | 78,519 |
| Depreciation | 33,881 | 31,981 |
| Amortization | 389 | 816 |
| Taxes other than income taxes | 14,712 | 14,663 |
| Total operating expenses | 128,794 | 125,979 |
| Operating income | 97,799 | 95,072 |
| Other expense (income): | | |
| Interest expense, net | 20,168 | 19,239 |
| Allowance for funds used during construction | (2,267) | (1,708) |
| Gain on sale of other assets | (62) | (170) |
| Equity (earnings) loss in joint venture | (1,621) | 698 |
| Income before income taxes | 81,581 | 77,013 |
| Provision for income taxes | 8,411 | 9,584 |
| Net income | \$ 73,170 | \$ 67,429 |
| Net income per common share: | | |
| Basic | \$ 0.41 | \$ 0.38 |
| Diluted | \$ 0.41 | \$ 0.38 |
| Average common shares outstanding during the period: | | |
| Basic | 177,336 | 176,704 |
| Diluted | 177,817 | 177,495 |
| Cash dividends declared per common share | \$ 0.191 | \$ 0.178 |

See notes to consolidated financial statements beginning on page 9 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF NET INCOME

(In thousands, except per share amounts)

(UNAUDITED)

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------|
| | 2016 | 2015 |
| Operating revenues | \$ 623,076 | \$ 617,137 |
| Operating expenses: | | |
| Operations and maintenance | 227,347 | 231,454 |
| Depreciation | 97,645 | 93,530 |
| Amortization | 1,367 | 2,589 |
| Taxes other than income taxes | 43,094 | 43,079 |
| Total operating expenses | 369,453 | 370,652 |
| Operating income | 253,623 | 246,485 |
| Other expense (income): | | |
| Interest expense, net | 60,136 | 56,804 |
| Allowance for funds used during construction | (6,446) | (3,930) |
| Gain on sale of other assets | (390) | (338) |
| Equity (earnings) loss in joint venture | (1,143) | 1,496 |
| Income before income taxes | 201,466 | 192,453 |
| Provision for income taxes | 16,933 | 19,097 |
| Net income | \$ 184,533 | \$ 173,356 |
| Net income per common share: | | |
| Basic | \$ 1.04 | \$ 0.98 |
| Diluted | \$ 1.04 | \$ 0.98 |
| Average common shares outstanding during the period: | | |
| Basic | 177,243 | 176,891 |
| Diluted | 177,781 | 177,670 |
| Cash dividends declared per common share | \$ 0.547 | \$ 0.508 |

See notes to consolidated financial statements beginning on page 9 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands of dollars)

(UNAUDITED)

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Net income | \$ 73,170 | \$ 67,429 | \$ 184,533 | \$ 173,356 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized holding gain (loss) on investments, net of tax expense (benefit) of \$11 and \$(120) for the three months and \$14 and \$(90) for the nine months ended September 30, 2016 and 2015, respectively | 20 | (223) | 26 | (169) |
| Reclassification of gain on sale of investment to net income, net of tax of \$30 for the nine months ended September 30, 2016 (1) | - | - | (57) | - |
| Comprehensive income | \$ 73,190 | \$ 67,206 | \$ 184,502 | \$ 173,187 |

(1) Amount of pre-tax gain of \$87 reclassified from accumulated other comprehensive income to gain on sale of other assets on the consolidated statements of net income for the nine months ended September 30, 2016.

See notes to consolidated financial statements beginning on page 9 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CAPITALIZATION

(In thousands of dollars, except per share amounts)

(UNAUDITED)

| | September 30, 2016 | December 31, 2015 |
|---|--------------------------|-------------------------|
| Stockholders' equity: | | |
| Common stock, \$.50 par value | \$ 90,134 | \$ 89,682 |
| Capital in excess of par value | 795,139 | 773,585 |
| Retained earnings | 1,017,261 | 930,061 |
| Treasury stock, at cost | (70,990) | (68,085) |
| Accumulated other comprehensive income | 656 | 687 |
| Total stockholders' equity | 1,832,200 | 1,725,930 |
| Long-term debt of subsidiaries (substantially secured by utility plant): | | |
| Interest Rate Range | | Maturity Date Range |
| 0.00% to 0.99% | 4,661 | 2023 to 2033 5,148 |
| 1.00% to 1.99% | 15,837 | 2017 to 2035 20,811 |
| 2.00% to 2.99% | 20,073 | 2024 to 2031 19,167 |
| 3.00% to 3.99% | 296,622 | 2019 to 2047 297,275 |
| 4.00% to 4.99% | 488,367 | 2020 to 2054 487,093 |
| 5.00% to 5.99% | 213,196 | 2017 to 2043 221,435 |
| 6.00% to 6.99% | 52,980 | 2017 to 2036 52,964 |
| 7.00% to 7.99% | 33,243 | 2022 to 2027 33,762 |
| 8.00% to 8.99% | 6,678 | 2021 to 2025 14,502 |
| 9.00% to 9.99% | 26,400 | 2018 to 2026 27,100 |
| 10.00% to 10.99% | 6,000 | 2018 6,000 |
| | 1,164,057 | 1,185,257 |
| Notes payable to bank under revolving credit agreement, variable rate, due 2021 | 155,000 | 60,000 |
| Unsecured notes payable: | | |
| Bank notes at 1.921% and 1.975% due 2017 and 2018 | 100,000 | 100,000 |
| Notes at 3.57% and 3.59% due 2027 and 2030 | 120,000 | 120,000 |
| Notes ranging from 4.62% to 4.87%, due 2017 through 2024 | 133,600 | 144,400 |
| Notes ranging from 5.20% to 5.95%, due 2017 through 2037 | 159,809 | 169,548 |
| Total long-term debt | 1,832,466 | 1,779,205 |

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| | | |
|---|--------------|--------------|
| Current portion of long-term debt | 83,777 | 35,593 |
| Long-term debt, excluding current portion | 1,748,689 | 1,743,612 |
| Less: debt issuance costs | 22,196 | 23,165 |
| Long-term debt, excluding current portion, net of debt issuance costs | 1,726,493 | 1,720,447 |
| Total capitalization | \$ 3,558,693 | \$ 3,446,377 |

See notes to consolidated financial statements beginning on page 9 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EQUITY

(In thousands of dollars)

(UNAUDITED)

| | Common Stock | Capital in Excess of Par Value | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income | Total |
|--|-----------------|--------------------------------------|----------------------|-------------------|---|--------------|
| Balance at December 31, 2015 | \$ 89,682 | \$ 773,585 | \$ 930,061 | \$ (68,085) | \$ 687 | \$ 1,725,930 |
| Net income | - | - | 184,533 | - | - | 184,533 |
| Other comprehensive loss, net of income tax benefit of \$16 | - | - | - | - | (31) | (31) |
| Dividends | - | - | (96,994) | - | - | (96,994) |
| Stock issued for acquisition (439,943 shares) | 220 | 12,625 | - | - | - | 12,845 |
| Sale of stock (34,699 shares) | 17 | 1,012 | - | - | - | 1,029 |
| Repurchase of stock (93,369 shares) | - | - | - | (2,905) | - | (2,905) |
| Equity compensation plan (225,712 shares) | 113 | (113) | - | - | - | - |
| Exercise of stock options (204,014 shares) | 102 | 3,734 | - | - | - | 3,836 |
| Stock-based compensation | - | 3,642 | (339) | - | - | 3,303 |
| Employee stock plan tax benefits | - | 1,263 | - | - | - | 1,263 |
| Other | - | (609) | - | - | - | (609) |
| Balance at September 30, 2016 | \$ 90,134 | \$ 795,139 | \$ 1,017,261 | \$ (70,990) | \$ 656 | \$ 1,832,200 |

See notes to consolidated financial statements beginning on page 9 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOW

(In thousands of dollars)

(UNAUDITED)

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------|
| | 2016 | 2015 |
| Cash flows from operating activities: | | |
| Net income | \$ 184,533 | \$ 173,356 |
| Adjustments to reconcile net income to net cash flows from operating activities: | | |
| Depreciation and amortization | 99,012 | 96,119 |
| Deferred income taxes | 15,345 | 13,855 |
| Provision for doubtful accounts | 3,533 | 3,693 |
| Stock-based compensation | 3,642 | 4,728 |
| Gain on sale of utility system and market-based business unit | (1,824) | - |
| Gain on sale of other assets | (390) | (338) |
| Net change in receivables, inventory and prepayments | (15,235) | (18,677) |
| Net change in payables, accrued interest, accrued taxes and other accrued liabilities | (241) | 16,450 |
| Other | (116) | (6,804) |
| Net cash flows from operating activities | 288,259 | 282,382 |
| Cash flows from investing activities: | | |
| Property, plant and equipment additions, including the debt component of allowance for funds used during construction of \$1,626 and \$1,015 | (270,019) | (257,478) |
| Acquisitions of utility systems and other, net | (5,626) | (26,327) |
| Release of funds previously restricted for construction activity | - | 47 |
| Net proceeds from the sale of utility system and other assets | 6,545 | 513 |
| Other | (32) | (1,027) |
| Net cash flows used in investing activities | (269,132) | (284,272) |
| Cash flows from financing activities: | | |
| Customers' advances and contributions in aid of construction | 6,006 | 4,286 |
| Repayments of customers' advances | (1,882) | (2,332) |
| Net proceeds of short-term debt | 31,269 | 9,632 |
| Proceeds from long-term debt | 234,288 | 313,440 |
| Repayments of long-term debt | (181,359) | (203,851) |
| Change in cash overdraft position | (12,586) | (14,918) |
| Proceeds from issuing common stock | 1,029 | 344 |
| Proceeds from exercised stock options | 3,836 | 4,518 |
| Stock-based compensation windfall tax benefits | 1,263 | 1,469 |

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| | | |
|---|-----------|-----------|
| Repurchase of common stock | (2,905) | (20,268) |
| Dividends paid on common stock | (96,994) | (89,842) |
| Other | (609) | (655) |
| Net cash flows (used in) from financing activities | (18,644) | 1,823 |
| Net change in cash and cash equivalents | 483 | (67) |
| Cash and cash equivalents at beginning of period | 3,229 | 4,138 |
| Cash and cash equivalents at end of period | \$ 3,712 | \$ 4,071 |
| Non-cash investing activity: | | |
| Property, plant and equipment additions purchased at the period end, but not yet paid for | \$ 23,548 | \$ 24,724 |

See notes to consolidated financial statements beginning on page 9 of this report.

See note 3 - Acquisitions for a description of non-cash activities.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 1 – Basis of Presentation

The accompanying consolidated balance sheets and statements of capitalization of Aqua America, Inc. and subsidiaries (the “Company”) at September 30, 2016, the consolidated statements of net income and comprehensive income for the three and nine months ended September 30, 2016 and 2015 the consolidated statements of cash flow for the nine months ended September 30, 2016 and 2015, and the consolidated statement of equity for the nine months ended September 30, 2016 are unaudited, but reflect all adjustments, consisting of only normal recurring accruals, which are, in the opinion of management, necessary to present fairly the consolidated financial position, the consolidated changes in equity, the consolidated results of operations, and the consolidated cash flow for the periods presented. Because they cover interim periods, the statements and related notes to the 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 Annual Report on Form 10-K for the year ended December 31, 2015. The results of operations for interim periods may not be indicative of the results that may be expected for the entire year. The December 31, 2015 consolidated balance sheet data presented herein was derived from the Company’s December 31, 2015 audited consolidated financial statements, but does not include all disclosures and notes normally provided in annual financial statements. Certain prior period amounts have been reclassified to conform to the current period presentation of debt issuance costs (see Note 15 - Recent Accounting Pronouncements).

Note 2 – Goodwill

The following table summarizes the changes in the Company’s goodwill, by business segment:

| | Regulated Segment | Other | Consolidated |
|--|----------------------|----------|--------------|
| Balance at December 31, 2015 | \$ 27,246 | \$ 6,620 | \$ 33,866 |
| Goodwill acquired | 10,095 | - | 10,095 |
| Reclassification to utility plant acquisition adjustment | (82) | - | (82) |

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| | | | |
|------------------------------------|-----------|----------|-----------|
| Disposition | - | (996) | (996) |
| Classified as assets held for sale | - | (803) | (803) |
| Other | (159) | - | (159) |
| Balance at September 30, 2016 | \$ 37,100 | \$ 4,821 | \$ 41,921 |

The reclassification of goodwill to utility plant acquisition adjustment results from a mechanism approved by the applicable utility commission. The mechanism provides for the transfer over time, and the recovery through customer rates, of goodwill associated with some acquisitions upon achieving specific objectives.

Goodwill is not amortized but is tested for impairment annually, or more often, if circumstances indicate a possible impairment may exist, to determine whether it's more likely than not that the fair value of a reporting unit is less than its carrying amount. When testing goodwill for impairment, we may assess qualitative factors, including macroeconomic conditions, industry and market considerations, cost factors, overall financial performance, and entity specific events. Alternatively, we may bypass this qualitative assessment for some of our reporting units and perform a quantitative goodwill impairment test by determining the fair value of a reporting unit based on a discounted cash flow analysis. The Company

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

tested the goodwill attributable for each of our reporting units for impairment as of July 31, 2016, in conjunction with the timing of our annual strategic business plan, and concluded that the estimated fair value of each reporting unit, which has goodwill recorded, exceeded the reporting unit's carrying amount, indicating that none of the Company's goodwill was impaired.

Note 3 – Acquisitions

Pursuant to our strategy to grow through acquisitions, in January 2016, the Company acquired Superior Water Company, Inc., which provides public water service to approximately 3,900 customers in portions of Berks, Chester, and Montgomery counties in Pennsylvania. The total purchase price for the utility system was \$16,750, which consisted of the issuance of 439,943 shares of the Company's common stock and \$3,905 in cash. The purchase price allocation for this acquisition consisted primarily of acquired property, plant and equipment of \$25,167, contributions in aid of construction of \$16,565, and goodwill of \$8,622. Additionally, during 2016, the Company completed nine acquisitions of water and wastewater utility systems in various states. The total purchase price of these utility systems consisted of \$1,721 in cash, and there was no goodwill recorded. In 2016, the Company recorded goodwill of \$1,473 for an acquisition that was completed in a prior period. The pro forma effect of the businesses acquired is not material either individually or collectively to the Company's results of operations.

In April 2015, the Company acquired the water and wastewater utility system assets of North Maine Utilities located in the Village of Glenview, Illinois serving approximately 7,400 customers. The total purchase price consisted of \$23,079 in cash. The purchase price allocation for this acquisition consisted primarily of acquired property, plant and equipment. Additionally, in 2015, the Company completed 14 acquisitions of water and wastewater utility systems in various states. The total purchase price of these utility systems consisted of \$5,210 in cash.

Note 4 – Assets Held for Sale

In December 2015, the Company decided to sell a business unit which provides liquid waste hauling and disposal services. This business unit was reported within the Company's market-based subsidiary, Aqua Resources, and was reported as assets held for sale in the Company's December 31, 2015 consolidated balance sheet included in this report. During the second quarter of 2016, this business unit was sold for \$3,400 in cash and resulted in a gain on sale of \$537. The gain on sale is reported as a reduction to operations and maintenance expense in the consolidated statements of net income. This business unit was included in "Other" in the Company's segment information.

In the second quarter of 2016, the Company decided to market for sale business units which install and test devices that prevent the contamination of potable water and repair water and wastewater systems. Further, in the third quarter of 2016, the Company decided to market for sale a business unit which inspects, cleans and repairs storm and sanitary wastewater lines. These business units are reported within the Company's market-based subsidiary, Aqua Resources. These business units are reported as assets held for sale in the Company's consolidated balance sheets included in this report, and are included in "Other" in the Company's segment information.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 5 – Capitalization

In February 2016, the Company amended its unsecured revolving credit facility to extend the expiration from March 2017 to February 2021, to increase the facility from \$200,000 to \$250,000, and to add a fourth bank to the lending group. Funds borrowed under this facility are classified as long-term debt and are used to provide working capital as well as support for letters of credit for insurance policies and other financing arrangements. Interest under this facility is based at the Company's option, on the prime rate, an adjusted Euro-Rate, an adjusted federal funds rate or at rates offered by the banks. A facility fee is charged on the total commitment amount of the agreement.

Note 6 – Fair Value of Financial Instruments

The Company follows the Financial Accounting Standards Board's ("FASB") accounting guidance for fair value measurements and disclosures, which defines fair value and establishes a framework for using fair value to measure assets and liabilities. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1: unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access;
- Level 2: inputs other than Level 1 that are observable, either directly or indirectly, such as quoted market prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in non-active markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; or
- Level 3: inputs that are unobservable and significant to the fair value measurement.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs. There have been no changes in the valuation techniques used to measure fair value or asset or liability transfers between the levels of the fair value hierarchy for the quarter ended September 30, 2016.

Financial instruments are recorded at carrying value in the financial statements and approximate fair value as of the dates presented. The fair value of these instruments is disclosed below in accordance with current accounting guidance related to financial instruments.

The fair value of loans payable is determined based on its carrying amount and utilizing Level 1 methods and assumptions. As of September 30, 2016 and December 31, 2015, the carrying amount of the Company's loans payable was \$47,990 and \$16,721, respectively, which equates to their estimated fair value. The fair value of cash and cash equivalents, which is comprised of a money market fund, is determined based on the net asset value per unit utilizing Level 2 methods and assumptions. As of

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

September 30, 2016 and December 31, 2015, the carrying amounts of the Company's cash and cash equivalents was \$3,712 and \$3,229, respectively, which equates to their fair value.

The carrying amounts and estimated fair values of the Company's long-term debt is as follows:

| | September 30, 2016 | December 31, 2015 |
|----------------------|--------------------------|-------------------------|
| Carrying Amount | \$ 1,832,466 | \$ 1,779,205 |
| Estimated Fair Value | 2,130,383 | 1,905,393 |

The fair value of long-term debt has been determined by discounting the future cash flows using current market interest rates for similar financial instruments of the same duration utilizing Level 2 methods and assumptions. The Company's customers' advances for construction have a carrying value of \$93,023 as of September 30, 2016, and \$86,934 as of December 31, 2015. Their relative fair values cannot be accurately estimated because future refund payments depend on several variables, including new customer connections, customer consumption levels, and future rate increases. Portions of these non-interest bearing instruments are payable annually through 2026 and amounts not paid by the respective contract expiration dates become non-refundable. The fair value of these amounts would, however, be less than their carrying value due to the non-interest bearing feature.

Note 7 – Net Income per Common Share

Basic net income per common share is based on the weighted average number of common shares outstanding. Diluted net income per common share is based on the weighted average number of common shares outstanding and potentially dilutive shares. The dilutive effect of employee stock-based compensation is included in the computation of diluted net income per common share. The dilutive effect of stock-based compensation is calculated using the treasury stock method and expected proceeds upon exercise or issuance of the stock-based compensation. The treasury stock method assumes that the proceeds from stock-based compensation are used to purchase the Company's common stock at the

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average market price during the period. The following table summarizes the shares, in thousands, used in computing basic and diluted net income per common share:

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2016 | |
|---|--|---------|---|---------|
| | 2015 | 2016 | 2015 | 2016 |
| Average common shares outstanding during the period for basic computation | 176,704 | 177,336 | 176,891 | 177,243 |
| Dilutive effect of employee stock-based compensation | 791 | 481 | 779 | 538 |
| Average common shares outstanding during the period for diluted computation | 177,495 | 177,817 | 177,670 | 177,781 |

For the three and nine months ended September 30, 2016 and 2015, all of the Company's employee stock options were included in the calculations of diluted net income per share as the calculated cost to exercise

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

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the stock options was less than the average market price of the Company's common stock during these periods.

Note 8 – Stock-based Compensation

Under the Company's 2009 Omnibus Equity Compensation Plan, as amended as of February 27, 2014 (the "2009 Plan"), as approved by the Company's shareholders to replace the 2004 Equity Compensation Plan (the "2004 Plan"), stock options, stock units, stock awards, stock appreciation rights, dividend equivalents, and other stock-based awards may be granted to employees, non-employee directors, and consultants and advisors. The 2009 Plan authorizes 6,250,000 shares for issuance under the plan. A maximum of 3,125,000 shares under the 2009 Plan may be issued pursuant to stock awards, stock units and other stock-based awards, subject to adjustment as provided in the 2009 Plan. During any calendar year, no individual may be granted (i) stock options and stock appreciation rights under the 2009 Plan for more than 500,000 shares of Company stock in the aggregate or (ii) stock awards, stock units or other stock-based awards under the 2009 Plan for more than 500,000 shares of Company stock in the aggregate, subject to adjustment as provided in the 2009 Plan. Awards to employees and consultants under the 2009 Plan are made by a committee of the Board of Directors of the Company, except that with respect to awards to the Chief Executive Officer, the committee recommends those awards for approval by the non-employee directors of the Board of Directors. In the case of awards to non-employee directors, the Board of Directors makes such awards. At September 30, 2016, 3,982,401 shares were still available for issuance under the 2009 Plan. No further grants may be made under the 2004 Plan.

Performance Share Units – A performance share unit ("PSU") represents the right to receive a share of the Company's common stock if specified performance goals are met over the three-year performance period specified in the grant, subject to exceptions through the respective vesting period, generally three years. Each grantee is granted a target award of PSUs, and may earn between 0% and 200% of the target amount depending on the Company's performance

against the performance goals. The following table provides compensation costs for stock-based compensation related to PSUs:

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2015 | |
|---|--|--------|---|----------|
| Stock-based compensation within operations and maintenance expenses | \$ 1,012 | \$ 836 | \$ 2,504 | \$ 3,475 |
| Income tax benefit | 411 | 339 | 1,013 | 1,414 |

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

The following table summarizes the PSU transactions for the nine months ended September 30, 2016:

| | Number of Share Units | Weighted Average Fair Value |
|---|-----------------------------|-----------------------------------|
| Nonvested share units at December 31, 2015 | 424,858 | \$ 25.78 |
| Granted | 152,533 | 28.89 |
| Performance criteria adjustment | 37,551 | 26.18 |
| Forfeited | (17,661) | 26.79 |
| Share units vested in prior period and issued in current period | 44,625 | 26.88 |
| Share units issued | (189,885) | 23.25 |
| Nonvested share units at September 30, 2016 | 452,021 | \$ 27.99 |

A portion of the fair value of PSUs was estimated at the grant date based on the probability of satisfying the market-based conditions using the Monte Carlo valuation method, which assesses probabilities of various outcomes of market conditions. The other portion of the fair value of the PSUs is based on the fair market value of the Company's stock at the grant date, regardless of whether the market-based condition is satisfied. The per unit weighted-average fair value at the date of grant for PSUs granted during the nine months ended September 30, 2016 and 2015 was \$28.89 and \$26.45, respectively. The fair value of each PSU grant is amortized monthly into compensation expense on a straight-line basis over their respective vesting periods, generally 36 months. The accrual of compensation costs is based on our estimate of the final expected value of the award, and is adjusted as required for the portion based on the performance-based condition. The Company assumes that forfeitures will be minimal, and recognizes forfeitures as they occur, which results in a reduction in compensation expense. As the payout of the PSUs includes dividend equivalents, no separate dividend yield assumption is required in calculating the fair value of the PSUs. The recording of compensation expense for PSUs has no impact on net cash flows.

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Restricted Stock Units – A restricted stock unit (“RSU”) represents the right to receive a share of the Company’s common stock. RSUs are eligible to be earned at the end of a specified restricted period, generally three years, beginning on the date of grant. The Company assumes that forfeitures will be minimal, and recognizes forfeitures as they occur, which results in a reduction in compensation expense. As the payout of the RSUs includes dividend equivalents, no separate dividend yield assumption is required in calculating the fair value of the RSUs. The following table provides compensation costs for stock-based compensation related to RSUs:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|--|--------|---------------------------------------|--------|
| | 2016 | 2015 | 2016 | 2015 |
| Stock-based compensation within operations and maintenance expenses | \$ 299 | \$ 209 | \$ 763 | \$ 888 |
| Income tax benefit | 124 | 86 | 315 | 367 |

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

The following table summarizes the RSU transactions for the nine months ended September 30, 2016:

| | Number of Stock Units | Weighted Average Fair Value |
|---|--------------------------------|-----------------------------------|
| Nonvested stock units at December 31, 2015 | 88,353 | \$ 24.94 |
| Granted | 50,324 | 32.09 |
| Stock units vested and issued | (24,318) | 23.37 |
| Forfeited | (3,952) | 27.81 |
| Nonvested stock units at September 30, 2016 | 110,407 | \$ 28.44 |

The per unit weighted-average fair value at the date of grant for RSUs granted during the nine months ended September 30, 2016 and 2015 was \$32.09 and \$25.97, respectively.

Stock Options – The following table provides the income tax benefit for stock-based compensation related to stock options granted in prior periods:

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2015 | |
|--------------------|--|-------|--|--------|
| Income tax benefit | \$ 15 | \$ 28 | \$ 249 | \$ 143 |

For the nine months ended September 30, 2016 and 2015, there were no compensation costs for stock-based compensation related to stock options, as stock options were fully amortized in 2013. Additionally, there were no

stock options granted during the nine months ended September 30, 2016 or 2015.

The following table summarizes stock option transactions for the nine months ended September 30, 2016:

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| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Life (years) | Aggregate Intrinsic Value |
|---|-----------|--|--|---------------------------------|
| Outstanding at December 31, 2015 | 659,533 | \$ 16.62 | | |
| Forfeited | - | - | | |
| Expired / Cancelled | (3,436) | 16.15 | | |
| Exercised | (204,014) | 18.80 | | |
| Outstanding and exercisable at September 30, 2016 | 452,083 | \$ 15.64 | 2.1 | \$ 6,709 |

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

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Stock Awards – The following table provides compensation costs for stock-based compensation related to stock awards:

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Stock-based compensation within operations and maintenance expenses | \$ 131 | \$ - | \$ 375 | \$ 365 |
| Income tax benefit | 54 | - | 155 | 151 |

The following table summarizes stock award transactions for the nine months ended September 30, 2016:

| | Number of Stock Awards | Weighted Average Fair Value |
|--|------------------------|-----------------------------|
| Nonvested stock awards at December 31, 2015 | - | \$ - |
| Granted | 11,509 | 32.57 |
| Vested | (11,509) | 32.57 |
| Nonvested stock awards at September 30, 2016 | - | \$ - |

The per unit weighted-average fair value at the date of grant for stock awards granted during the nine months ended September 30, 2016 and 2015 was \$32.57 and \$26.44, respectively.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

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Note 9 – Pension Plans and Other Postretirement Benefits

The Company maintains a qualified defined benefit pension plan (the “Pension Plan”), a nonqualified pension plan and other postretirement benefit plans for certain of its employees. The net periodic benefit cost is based on estimated values and an extensive use of assumptions about the discount rate, expected return on plan assets, the rate of future compensation increases received by the Company’s employees, mortality, turnover, and medical costs. The following tables provide the components of net periodic benefit cost:

| | Pension Benefits | | | |
|------------------------------------|-------------------------|---------|-------------------|----------|
| | Three Months Ended | | Nine Months Ended | |
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | \$ 784 | \$ 750 | \$ 2,394 | \$ 2,600 |
| Interest cost | 3,251 | 3,255 | 9,787 | 9,699 |
| Expected return on plan assets | (4,215) | (4,677) | (12,696) | (14,025) |
| Amortization of prior service cost | 145 | 44 | 435 | 130 |
| Amortization of actuarial loss | 1,797 | 1,465 | 5,354 | 4,529 |
| Settlement charge | - | - | 3,028 | - |
| Special termination benefit charge | - | - | 302 | - |
| Net periodic benefit cost | \$ 1,762 | \$ 837 | \$ 8,604 | \$ 2,933 |
| | Other | | | |
| | Postretirement Benefits | | | |
| | Three Months | | Nine Months Ended | |
| | Ended | | September 30, | |
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | \$ 253 | \$ 273 | \$ 761 | \$ 952 |
| Interest cost | 726 | 681 | 2,202 | 2,120 |
| Expected return on plan assets | (645) | (731) | (2,001) | (2,192) |
| Amortization of prior service cost | (137) | (211) | (411) | (476) |
| Amortization of actuarial loss | 220 | 309 | 707 | 972 |
| Net periodic benefit cost | \$ 417 | \$ 321 | \$ 1,258 | \$ 1,376 |

Effective July 1, 2015, the Company added a permanent lump sum option to the form of benefit payments offered to participants of the qualified defined benefit pension plan and non-qualified retirement plans upon retirement or termination. During the first quarter of 2016, the lump sum payments paid to participants who elected this option for payments from the non-qualified retirement plans resulted in a settlement charge. The Company made cash contributions of \$8,145 to its Pension Plan during the first nine months of 2016, which completed the Company's 2016 cash contributions.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

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Note 10 – Water and Wastewater Rates

During the first nine months of 2016, the Company's operating divisions in Ohio, Texas, Virginia, and New Jersey were granted base rate increases designed to increase total operating revenues on an annual basis by \$3,434. Further, during the first nine months of 2016, the Company's operating divisions in Illinois, Pennsylvania (wastewater), and North Carolina received approval to bill infrastructure rehabilitation surcharges designed to increase total operating revenues on an annual basis by \$2,062.

Note 11 – Taxes Other than Income Taxes

The following table provides the components of taxes other than income taxes:

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------------|-----------------------|-----------|-----------------------|-----------|
| | September 30, 2016 | 2015 | September 30, 2016 | 2015 |
| Property | \$ 7,007 | \$ 6,945 | \$ 20,119 | \$ 20,776 |
| Capital stock | 430 | 538 | 1,287 | 1,619 |
| Gross receipts, excise and franchise | 2,979 | 2,859 | 8,181 | 7,855 |
| Payroll | 2,140 | 2,072 | 7,775 | 7,425 |
| Regulatory assessments | 639 | 693 | 1,991 | 2,033 |
| Other | 1,517 | 1,556 | 3,741 | 3,371 |
| Total taxes other than income | \$ 14,712 | \$ 14,663 | \$ 43,094 | \$ 43,079 |

Note 12 – Segment Information

The Company has identified ten operating segments and has one reportable segment named the “Regulated” segment. The reportable segment is comprised of eight operating segments for the Company’s water and wastewater regulated utility companies which are organized by the states where we provide these services. In addition, two segments are not quantitatively significant to be reportable and are comprised of the Company’s market-based activities: Aqua Resources, Inc. and Aqua Infrastructure, LLC. Aqua Resources provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties in close proximity to our utility companies’ service territories; and offers, through a third party, water and wastewater line repair service and protection solutions to households. In addition, Aqua Resources provided liquid waste hauling and disposal services in a business unit that the Company sold in the second quarter of 2016, and that was reported as assets held for sale in the Company’s consolidated balance sheets included in this report. Additionally, Aqua Resources installs and tests devices that prevent the contamination of potable water; designs and builds water and wastewater systems; and provides other market-based water and wastewater services in business units that, in the second quarter of 2016, the Company decided to market for sale. Further, in the third quarter of 2016, the Company decided to market for sale a business unit within Aqua Resources, which inspects, cleans and repairs storm and sanitary wastewater lines. These business units are reported as assets held for sale in the Company’s consolidated balance sheets included in this report. Aqua Infrastructure provides non-utility raw water supply services for firms in the natural gas drilling industry. These two segments are included as

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a component of “Other” in the tables below. Also included in “Other” are corporate costs that have not been allocated to the Regulated segment and intersegment eliminations. Corporate costs include general and administrative expense, and interest expense.

The following table presents information about the Company’s reportable segment:

| | Three Months Ended September 30, 2016 | | | Three Months Ended September 30, 2015 | | |
|---|--|-----------|--------------|--|-----------|--------------|
| | Regulated | Other | Consolidated | Regulated | Other | Consolidated |
| Operating revenues | \$ 222,231 | \$ 4,362 | \$ 226,593 | \$ 213,023 | \$ 8,028 | \$ 221,051 |
| Operations and maintenance expense | 73,013 | 6,799 | 79,812 | 72,373 | 6,146 | 78,519 |
| Depreciation | 34,025 | (144) | 33,881 | 31,890 | 91 | 31,981 |
| Operating income (loss) | 100,563 | (2,764) | 97,799 | 93,828 | 1,244 | 95,072 |
| Interest expense, net | 19,167 | 1,001 | 20,168 | 18,169 | 1,070 | 19,239 |
| Allowance for funds used during construction | 2,267 | - | 2,267 | 1,708 | - | 1,708 |
| Income tax expense (benefit) | 9,027 | (616) | 8,411 | 9,883 | (299) | 9,584 |
| Net income (loss) | 74,681 | (1,511) | 73,170 | 67,654 | (225) | 67,429 |
| | Nine Months Ended September 30, 2016 | | | Nine Months Ended September 30, 2015 | | |
| | Regulated | Other | Consolidated | Regulated | Other | Consolidated |
| Operating revenues | \$ 606,323 | \$ 16,753 | \$ 623,076 | \$ 590,519 | \$ 26,618 | \$ 617,137 |
| Operations and maintenance expense | 210,014 | 17,333 | 227,347 | 210,639 | 20,815 | 231,454 |
| Depreciation | 98,445 | (800) | 97,645 | 93,276 | 254 | 93,530 |
| Operating income (loss) | 255,431 | (1,808) | 253,623 | 243,101 | 3,384 | 246,485 |
| Interest expense, net | 57,061 | 3,075 | 60,136 | 54,015 | 2,789 | 56,804 |
| Allowance for funds used during construction | 6,446 | - | 6,446 | 3,930 | - | 3,930 |
| Income tax expense (benefit) | 18,610 | (1,677) | 16,933 | 19,679 | (582) | 19,097 |
| Net income (loss) | 186,579 | (2,046) | 184,533 | 173,670 | (314) | 173,356 |
| Capital expenditures | 269,046 | 973 | 270,019 | 256,924 | 554 | 257,478 |

| | September 30, 2016 | December 31, 2015 |
|---------------|--------------------------|-------------------------|
| Total assets: | | |
| Regulated | \$ 5,853,618 | \$ 5,541,335 |
| Other | 182,407 | 176,538 |
| Consolidated | \$ 6,036,025 | \$ 5,717,873 |

Note 13 – Commitments and Contingencies

The Company is routinely involved in various disputes, claims, lawsuits and other regulatory and legal matters, including both asserted and unasserted legal claims, in the ordinary course of business. The status of each such matter, referred to herein as a loss contingency, is reviewed and assessed in accordance with applicable accounting rules regarding the nature of the matter, the likelihood that a loss will be incurred, and the amounts involved. As of September 30, 2016, the aggregate amount of \$14,804 is accrued for loss contingencies and is reported in the Company's consolidated balance sheet as other accrued liabilities and other liabilities. These accruals represent management's best estimate of probable loss (as defined in the accounting guidance) for loss contingencies or the low end of a range of losses if

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

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no single probable loss can be estimated. For some loss contingencies, the Company is unable to estimate the amount of the probable loss or range of probable losses. While the final outcome of these loss contingencies cannot be predicted with certainty, and unfavorable outcomes could negatively impact the Company, at this time in the opinion of management, the final resolution of these matters are not expected to have a material adverse effect on the Company's financial position, results of operations or cash flows. Further, the Company has insurance coverage for certain of these loss contingencies, and as of September 30, 2016, estimates that approximately \$1,366 of the amount accrued for these matters are probable of recovery through insurance, which amount is also reported in the Company's consolidated balance sheet as deferred charges and other assets, net.

In addition to the aforementioned loss contingencies, the Company self-insures its employee medical benefit program, and maintains stop-loss coverage to limit the exposure arising from these claims. The Company's reserve for these claims totaled \$1,770 at September 30, 2016 and represents a reserve for unpaid claim costs, including an estimate for the cost of incurred but not reported claims.

Note 14 – Income Taxes

During the nine months ended September 30, 2016, the Company utilized \$45,412 of its Federal net operating loss ("NOL") carryforward. In addition, during the nine months ended September 30, 2016, the Company's state NOL carryforward increased by \$298. As of September 30, 2016, the balance of the Company's Federal NOL was \$112,864. The Company believes its Federal NOL carryforward is more likely than not to be recovered and requires no valuation allowance. As of September 30, 2016, the balance of the Company's gross state NOL was \$563,999, a portion of which is offset by a valuation allowance because the Company does not believe the NOLs are more likely than not to be realized. The Company's Federal and state NOL carryforwards begin to expire in 2032 and 2023, respectively. The Company's Federal and state NOL carryforwards are reduced by an unrecognized tax position, on a gross basis, of \$64,424 and \$89,364, respectively. The amounts of the Company's Federal and state NOL carryforwards prior to being reduced by the unrecognized tax positions were \$177,288 and \$653,364 respectively. The Company records its unrecognized tax benefit as a reduction to its deferred income tax liability.

In accordance with a 2012 settlement agreement with the Pennsylvania Public Utility Commission, Aqua Pennsylvania expenses, for tax purposes, qualifying utility asset improvement costs, which results in a substantial reduction in income tax expense and greater net income and cash flows. The Company's effective income tax rate for the third quarter of 2016 and 2015 was 10.3% and 12.4%, respectively, and for the first nine months of 2016 and 2015 was 8.4% and 9.9%, respectively.

As of September 30, 2016, the total gross unrecognized tax benefit was \$28,735, of which \$20,673, if recognized, would affect the Company's effective tax rate as a result of the regulatory treatment afforded for qualifying infrastructure improvements in Pennsylvania. At December 31, 2015, the Company had unrecognized tax benefits of \$28,016.

Accounting rules for uncertain tax positions specify that tax positions for which the timing of resolution is uncertain should be classified as long-term liabilities. Judgment is required in evaluating the Company's uncertain tax positions and determining the provision for income taxes. Management

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(In thousands of dollars, except per share amounts)

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believes that an adequate provision has been made for any adjustments that may result from tax examinations. Although the timing of income tax audit resolutions and negotiations with taxing authorities is highly uncertain, the Company does not anticipate a significant change to the total amount of unrecognized income tax benefits within the next 12 months.

Note 15 – Recent Accounting Pronouncements

In August 2016, the FASB issued updated accounting guidance on the classification of certain cash receipts and cash payments in the statement of cash flows, which is intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, and early adoption is permitted. The Company is currently evaluating the impact of this new standard on its consolidated cash flow statement.

In March 2016, the FASB issued updated accounting guidance on simplifying the accounting for share-based payments, which includes several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The updated guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with early adoption available. The Company has evaluated the requirements of the updated guidance and has determined that upon adoption, on January 1, 2017, the Company will recognize a previously unrecognized windfall tax benefit for stock-based compensation of \$2,805 (\$1,823 after-tax), associated with the Company's 2012 Federal net operating loss, which will be recorded as an adjustment to retained earnings.

Additionally, once adopted, income tax benefits in excess of compensation costs or tax deficiencies for share-based compensation will be recorded to our income tax provision, instead of historically to stockholder's equity, which will impact our effective tax rate. Lastly, all tax-related cash flows resulting from share-based payments will be reported as operating activities on the statement of cash flows, a change from the historical requirement to present tax benefits as an inflow from financing activities and an outflow from operating activities.

In February 2016, the FASB issued updated accounting guidance on accounting for leases, which requires lessees to establish a right-of-use asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. For income statement purposes, leases will be classified as either operating or finance. Operating leases will result in straight-line expense while finance leases will result in a front-loaded expense pattern. The updated

accounting guidance is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption available. The Company is evaluating the requirements of the updated guidance to determine the impact of adoption.

In September 2015, the FASB issued updated accounting guidance on simplifying measurement-period adjustment in business combinations, which eliminates the requirement that an acquirer in a business combination account for measurement-period adjustments retrospectively. Instead, an acquirer will recognize a measurement-period adjustment during the period in which it determines the amount of the adjustment. The Company adopted the provisions of this accounting standard, as required on January 1, 2016, and it did not have an impact on its results of operations or financial position.

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(In thousands of dollars, except per share amounts)

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In April 2015, the FASB issued updated accounting guidance on simplifying the presentation of debt issuance costs, which requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability. Previously, debt issuance costs were presented in the balance sheet as a deferred charge. The Company adopted the provisions of this accounting standard as required on January 1, 2016. The adoption of this standard was applied retrospectively and resulted in the reclassification of \$23,165 from deferred charges and other assets, net to debt issuance costs, which is reported as a reduction to long-term debt, in the December 31, 2015 consolidated balance sheet.

In August 2014, the FASB issued an accounting standard that will require management to assess an entity's ability to continue as a going concern for each annual and interim reporting period and to provide related footnote disclosures in circumstances in which substantial doubt exists. The accounting standard is effective in the first annual reporting period ending after December 15, 2016. The Company does not expect the provisions of this accounting standard to have an impact on its results of operations or financial position.

In May 2014, the FASB issued updated accounting guidance on recognizing revenue from contracts with customers, which outlines a single comprehensive model that an entity will apply to determine the measurement of revenue and timing of when it is recognized. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. The updated guidance also requires additional disclosure about the nature, amount, timing, and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to fulfill a contract. In July 2015, the FASB approved a one year deferral to the original effective date of this guidance. The updated guidance is effective for reporting periods beginning after December 15, 2017, and will be applied retrospectively. The Company is evaluating the requirements of the updated guidance to determine the impact of adoption.

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AQUA AMERICA, INC. AND SUBSIDIARIES

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

(In thousands of dollars, except per share amounts)

Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Quarterly Report contain, in addition to historical information, forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements address, among other things: the projected impact of various legal proceedings; the projected effects of recent accounting pronouncements; prospects, plans, objectives, expectations and beliefs of management, as well as information contained in this report where statements are preceded by, followed by or include the words "believes," "expects," "anticipates," "plans," "future," "potential," "probably," "predictions," "intends," "will," "continue," "in the event" or the negative of such terms or similar expressions. Forward-looking statements are based on a number of assumptions concerning future events, and are subject to a number of risks, uncertainties and other factors, many of which are outside our control, which could cause actual results to differ materially from those expressed or implied by such statements. These risks and uncertainties include, among others: the effects of regulation, abnormal weather, changes in capital requirements and funding, acquisitions, changes to the capital markets, and our ability to assimilate acquired operations, as well as those risks, uncertainties and other factors discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 under the captions "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in such report. As a result, readers are cautioned not to place undue reliance on any forward-looking statements. We undertake no obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.

General Information

Aqua America, Inc. ("we", "us", "our" or the "Company"), a Pennsylvania corporation, is the holding company for regulated utilities providing water or wastewater services to what we estimate to be almost three million people in Pennsylvania, Ohio, Texas, Illinois, North Carolina, New Jersey, Indiana, and Virginia. Our largest operating subsidiary, Aqua

Pennsylvania, provides water or wastewater services to approximately one-half of the total number of people we serve, who are located in the suburban areas in counties north and west of the City of Philadelphia and in 27 other counties in Pennsylvania. Our other regulated utility subsidiaries provide similar services in seven other states. In addition, the Company's market-based activities are conducted through Aqua Resources, Inc. and Aqua Infrastructure, LLC. Aqua Resources provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to our utility companies' service territories; and offers, through a third party, water and wastewater line repair service and protection solutions to households. In addition, Aqua Resources provided liquid waste hauling and disposal services in a business unit that the Company sold in the second quarter of 2016, and that was reported as assets held for sale in the Company's consolidated balance sheets included in this report. Additionally, a business unit of Aqua Resources installs and tests

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AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

(In thousands of dollars, except per share amounts)

devices that prevent the contamination of potable water and repairs water and wastewater systems, which in the second quarter of 2016, the Company decided to market for sale. Further, in the third quarter of 2016, the Company decided to market for sale a business unit within Aqua Resources, which inspects, cleans and repairs storm and sanitary wastewater lines. These business units are reported as assets held for sale in the Company's consolidated balance sheets included in this report. Aqua Infrastructure provides non-utility raw water supply services for firms in the natural gas drilling industry.

Aqua America, Inc., which prior to its name change in 2004 was known as Philadelphia Suburban Corporation, was formed in 1968 as a holding company for its primary subsidiary, Aqua Pennsylvania, formerly known as Philadelphia Suburban Water Company. In the early 1990s, we embarked on a growth-through-acquisition strategy focused on water and wastewater operations. Our most significant transactions to date have been the merger with Consumers Water Company in 1999, the acquisition of the regulated water and wastewater operations of AquaSource, Inc. in 2003, the acquisition of Heater Utilities, Inc. in 2004, and the acquisition of American Water Works Company, Inc.'s regulated operations in Ohio in 2012. Since the early 1990s, our business strategy has been primarily directed toward the regulated water and wastewater utility industry, where we have more than quadrupled the number of regulated customers we serve, and has extended our regulated operations from southeastern Pennsylvania to include operations in seven other states. Currently, the Company seeks to acquire businesses in the U.S. regulated sector, which includes water and wastewater utilities and other regulated utilities, and to pursue growth ventures in market-based activities, such as infrastructure opportunities that are supplementary and complementary to our regulated businesses.

The following discussion and analysis of our financial condition and results of operations should be read together with our consolidated financial statements and related notes.

Financial Condition

During the first nine months of 2016, we had \$270,019 of capital expenditures, expended \$5,626 for the acquisition of water and wastewater utility systems, issued \$234,288 of long-term debt, and repaid debt and made sinking fund

contributions and other loan repayments of \$181,359. The capital expenditures were related to new and replacement water mains, improvements to treatment plants, tanks, hydrants, and service lines, well and booster improvements, and other enhancements and improvements. The issuance of long-term debt was comprised principally of the funds borrowed under our revolving credit facility. In addition, we issued 439,943 shares of the Company's common stock, and paid \$3,905 in cash for the acquisition of Superior Water Company, Inc. as described in Note 3 – Acquisitions.

At September 30, 2016, we had \$3,712 of cash and cash equivalents compared to \$3,229 at December 31, 2015. During the first nine months of 2016, we used the proceeds from the issuance of long-term debt and internally generated funds to fund the cash requirements discussed above and to pay dividends.

At September 30, 2016, our \$250,000 unsecured revolving credit facility, which was amended and now expires in February 2021, had \$72,034 available for borrowing. At September 30, 2016, we had short-term lines of credit of \$135,500, of which \$87,510 was available for borrowing. One of our short-term

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AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

(In thousands of dollars, except per share amounts)

lines of credit is an Aqua Pennsylvania \$100,000 364-day unsecured revolving credit facility with four banks, which is used to provide working capital, and as of September 30, 2016, \$53,000 was available for borrowing.

Our short-term lines of credit of \$135,500 are subject to renewal on an annual basis. Although we believe we will be able to renew these facilities, there is no assurance that they will be renewed, or what the terms of any such renewal will be.

The Company's consolidated balance sheet historically has had a negative working capital position whereby routinely our current liabilities exceed our current assets. Management believes that internally generated funds along with existing credit facilities and the proceeds from the issuance of long-term debt will be adequate to provide sufficient working capital to maintain normal operations and to meet our financing requirements for at least the next twelve months.

Results of Operations

Analysis of Third Quarter of 2016 Compared to Third Quarter of 2015

Revenues increased by \$5,542 or 2.5%, primarily due to an increase in customer water consumption, additional water and wastewater revenues of \$1,337 associated with a larger customer base due to utility acquisitions, an increase in water rates of \$1,234, and an increase in infrastructure rehabilitation surcharges of \$1,120, offset by a decrease in market-based activities revenue of \$3,668. The market-based activities revenues decreased due to a reduction in revenues associated with the inspection, cleaning and repairing of storm and sanitary wastewater lines, and the second quarter of 2016 sale of a business unit that provided liquid waste hauling and disposal services.

Operations and maintenance expenses increased by \$1,293 or 1.6%, primarily due to an increase in postretirement benefits expense of \$1,491, an asset impairment of \$970 associated with the planned disposition of a business unit within Aqua Resources, and additional operating costs associated with acquired utility systems of \$413, offset by the effect of the recording of a legal contingency reserve of \$1,580 in the third quarter of 2015, and a reduction in operating expenses for Aqua Resources of \$602 associated with the disposition of business units.

Depreciation expense increased by \$1,900 or 5.9%, primarily due to the utility plant placed in service since September 30, 2015.

Interest expense increased by \$929 or 4.8%, primarily due to an increase in average borrowings, offset by a decrease in our effective interest rate.

Allowance for funds used during construction (“AFUDC”) increased by \$559, due to an increase in the average balance of utility plant construction work in progress, to which AFUDC is applied.

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AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

(In thousands of dollars, except per share amounts)

Equity earnings in joint venture increased by \$2,319 primarily due to the recognition of a connection fee earned by the joint venture in the third quarter of 2016 for which our share was \$1,831 and a reduction in depreciation expense resulting from the noncash impairment charge recognized by the joint venture on its long-lived assets in the fourth quarter of 2015.

Our effective income tax rate was 10.3% in the third quarter of 2016 and 12.4% in the third quarter of 2015. The effective income tax rate decreased due to the effect of additional tax deductions recognized in the third quarter of 2016 for certain qualifying infrastructure improvements for Aqua Pennsylvania.

Net income increased by \$5,741 or 8.5%, primarily as a result of the factors described above.

Analysis of First Nine Months of 2016 Compared to First Nine Months of 2015

Revenues increased by \$5,939 or 1.0%, primarily due to additional water and wastewater revenues of \$6,966 associated with a larger customer base due to utility acquisitions, an increase in infrastructure rehabilitation surcharges of \$3,536, and an increase in water and wastewater rates of \$3,195, offset by a decrease in market-based activities revenues of \$9,873. The market-based activities revenues decreased due to a reduction in revenues associated with the inspection, cleaning and repairing of storm and sanitary wastewater lines, and the second quarter of 2016 sale of a business unit that provided liquid waste hauling and disposal services.

Operations and maintenance expenses decreased by \$4,107 or 1.8%, primarily due to the effects of the recognition in 2015 of the following three events: \$2,329 for leadership transition expenses; operating costs of \$1,862 for the recording of a reserve for water rights held for future use; and the recording of a legal contingency reserve of \$1,580, as well as decreases in market-based activities expenses of \$3,810, a decrease in water production costs of \$2,182, a reversal of a reserve for a legal contingency of \$1,580, a gain of \$1,135 that was recognized for the buyout of an

operating contract, and lower fuel costs of \$1,016, offset by increases in operating costs associated with acquired utility systems of \$4,038, postretirement benefits expense of \$4,021, the Company's self-insured employee medical benefit program expense of \$1,271, and an asset impairment of \$970 associated with the disposition of a business unit within Aqua Resources.

Depreciation expense increased by \$4,115 or 4.4%, primarily due to the utility plant placed in service since September 30, 2015.

Interest expense increased by \$3,332 or 5.9%, primarily due to an increase in average borrowings, offset by a decrease in our effective interest rate.

AFUDC increased by \$2,516, due to an increase in the average balance of utility plant construction work in progress, to which AFUDC is applied.

Equity earnings in joint venture increased by \$2,639 primarily due to the recognition of a connection fee earned by the joint venture in the third quarter of 2016 for which our share was \$1,831 and a reduction in

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AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

(In thousands of dollars, except per share amounts)

depreciation expense resulting from the noncash impairment charge recognized by the joint venture on its long-lived assets in the fourth quarter of 2015.

Our effective income tax rate was 8.4% in the first nine months of 2016 and 9.9% in the first nine months of 2015. The effective income tax rate decreased due to the effect of additional tax deductions recognized in 2016 for certain qualifying infrastructure improvements for Aqua Pennsylvania.

Net income increased by \$11,177 or 6.4%, primarily as a result of the factors described above.

Impact of Recent Accounting Pronouncements

We describe the impact of recent accounting pronouncements in Note 15, Recent Accounting Pronouncements, of the consolidated financial statements in this report.

Recent Events

In October 2016, a subset of our customer base in North Carolina experienced a loss of water service for approximately two days as a result of Hurricane Matthew. We incurred additional operations and maintenance expenses and capital expenditures, for which the amount is still being determined, to restore water service or provide alternative services until restoration was completed to these customers. This event is not expected to have a material impact on the Company's fourth quarter 2016 results of operations or financial position. Additionally, a portion of the capital expenditures and lost revenue may be covered by the Company's insurance.

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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. There have been no significant changes in our exposure to market risks since December 31, 2015. Refer to Item 7A of the Company’s Annual Report on Form 10-K for the year ended December 31, 2015 for additional information.

Item 4 – Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this report are effective such that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

(b) Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1 – Legal Proceedings

We are party to various legal proceedings. Although the results of legal proceedings cannot be predicted with certainty, there are no pending legal proceedings to which we or any of our subsidiaries is a party or to which any of

our properties is the subject that we believe are material or are expected to have a material adverse effect on our financial position, results of operations or cash flows.

Item 1A – Risk Factors

There have been no material changes to the risks disclosed in our Annual Report on Form 10-K for the year ended December 31, 2015 under “Part 1, Item 1A – Risk Factors.”

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Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

The following table summarizes the Company's purchases of its common stock for the quarter ended September 30, 2016:

| Period | Issuer Purchases of Equity Securities | | | |
|----------------------|---|---------------------------------------|--|---|
| | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs (2) |
| July 1-31, 2016 | 1,314 | \$ 35.48 | - | 720,348 |
| August 1-31, 2016 | - | - | - | 720,348 |
| September 1-30, 2016 | - | - | - | 720,348 |
| Total | 1,314 | \$ 35.48 | - | 720,348 |

(1) These amounts include shares we acquired from our employees who elected to pay the exercise price of their stock options (and then hold shares of the stock), upon exercise, by delivering to us shares of our common stock in accordance with the terms of our equity compensation plan that were previously approved by our shareholders and disclosed in our proxy statements. This feature of our equity compensation plan is available to all employees who receive stock-based compensation under the plan. We purchased these shares at their fair market value, as determined by reference to the closing price of our common stock on the day prior to the option exercise.

(2) In December 2014, our Board of Directors authorized a share buyback program of up to 1,000,000 shares to minimize share dilution through timely and orderly share repurchases. In December 2015, our Board of Directors added 400,000 shares to this program. This program expires on the earliest of December 31, 2016 or when all authorized repurchases have been made.

Item 6 – Exhibits

The information required by this Item is set forth in the Exhibit Index hereto which is incorporated herein by reference.

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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 executed on its behalf by the undersigned thereunto duly authorized.

November 2, 2016

Aqua America,
Inc.
Registrant

/s/ Christopher
H. Franklin
Christopher H.
Franklin
President and
Chief
Executive
Officer

/s/ David P.
Smeltzer
David P.
Smeltzer
Executive Vice
President and
Chief Financial
Officer

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EXHIBIT INDEX

Exhibit No. Description

| | |
|----------|---|
| 31.1 | Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934. |
| 31.2 | Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934. |
| 32.1 | Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350. |
| 32.2 | Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRES | XBRL Taxonomy Extension Presentation Linkbase Document |