

March 11, 2014



Nicholas DeBenedictis  
Chairman, President and CEO

## Chairman's Message

*We are pleased to announce another successful year for Aqua America. Our continued focus on customer satisfaction and shareholder value allowed us to achieve a 14th straight year of increased net income, further growth in the value of our asset base and the 23rd dividend increase in 22 years. Net income for the full year 2013 rose to \$221.3 million from \$196.6 million in 2012, an increase of 13 percent. The company continued to set industry-leading margins, grew stronger financially, enhanced shareholder value 19 percent, issued a 5-for-4 stock split, and increased the dividend by 9 percent. The company also eclipsed the \$200 million level for net income just 5 years after passing the \$100 million level, which took nearly 125 years to accomplish.*

In 2013, the company invested more than \$300 million for the fourth straight year to improve infrastructure across all of its regulated operations as part of its capital investment program. Over the next three years, the company projects investing an additional \$1 billion in pipe replacement to improve its distribution network; upgrade plants to enhance water quality; and make service reliability improvements for our customers.

Aqua America's well-acknowledged growth-through-acquisition program yielded 15 acquisitions in 2013. Acquisitions and organic growth led to customer growth of 1.3 percent, the most growth since 2008.

2013 was one of the strongest years operationally in my 22 years as chairman. Thanks to the diligence of our employees, our base utility operations expense growth was maintained at the rate of inflation as a result of Aqua's industry-leading cost and efficiency practices.

Aqua won multiple awards for innovative programs including the Energy Solutions Center Partnership Award for Innovative Energy Solutions recognizing the implementation of compressed natural gas (CNG) technology used in company vehicles and fueling stations throughout Southeastern Pennsylvania. Aqua was also awarded the National Association of Water Companies' (NAWC) 2013 Management Innovation Award for its pursuit of maximizing performance in electricity load response programs.

Aqua America's weighted average cost of fixed-rate long-term debt is now less than 5 percent, and the company had \$239 million available on its credit lines as of February 25, 2014. In 2013, Standard & Poor's reiterated its A+ credit rating for Aqua Pennsylvania, our largest subsidiary. Of the 217 electric, gas and water utilities rated by S&P, only one has a higher rating than Aqua Pennsylvania.

During 2013, Aqua received base rate awards in Ohio, Texas and Virginia, and infrastructure surcharges in various states increasing annualized revenues by approximately \$12.5 million. To date in 2014, the company has received rate awards and infrastructure surcharges in Illinois, Indiana, New Jersey, Ohio and Pennsylvania (wastewater) estimated to increase annualized revenues by approximately \$2.8 million. The company has \$21.0 million of rate cases pending before state regulatory bodies in Ohio, New Jersey, North Carolina, Texas and Virginia. The timing and extent to which rate increases might be granted by the applicable regulatory agencies will vary by state.

As I begin my 23rd year as the CEO of Aqua America, I continue to be optimistic about the company's ability to deliver strong results for

our shareholders. The company is well positioned to internally fund needed investments for our customers, and to acquire both municipal and private water and wastewater utilities that can benefit from our professional expertise, ability to control costs and financial capacity to fund needed infrastructure improvements. We are also prepared to continue investments in strategic ventures and deliver strong results for our shareholders through our record of growth and 69 consecutive years of paying quarterly dividends.

Thank you for your confidence in Aqua.



Nicholas DeBenedictis  
Chairman, President and CEO

## FAST FACTS



Provides drinking  
water to

**2.75M**  
people



**1,447**

Public water  
systems owned  
and operated



Provides wastewater  
service to

**250K**  
people



**187**

Wastewater treatment  
plants and collection sys-  
tems owned and operated



## Who We Are

Aqua has come a long way since our “founding fathers”—a few Swarthmore College professors concerned about water quality in their Southeastern Pennsylvania community—were granted a charter to supply water to area residents in 1886. We refreshed our brand in 2013 with a more contemporary look and feel, but our core values have remained the same.

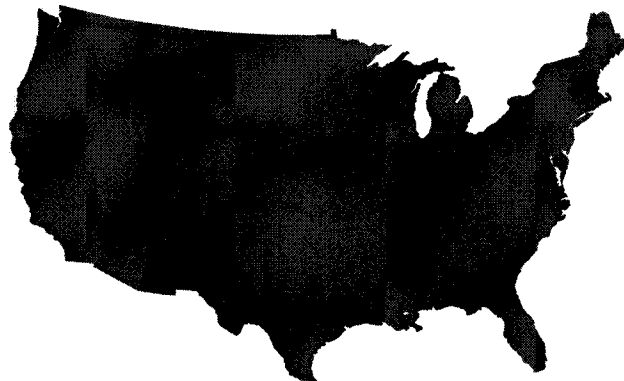
Since the first pipe was laid in 1886, we have been dedicated to improving infrastructure and supply, whether through building reservoirs and treatment plants to service a growing community, or by replacing pipe to strengthen aging systems.

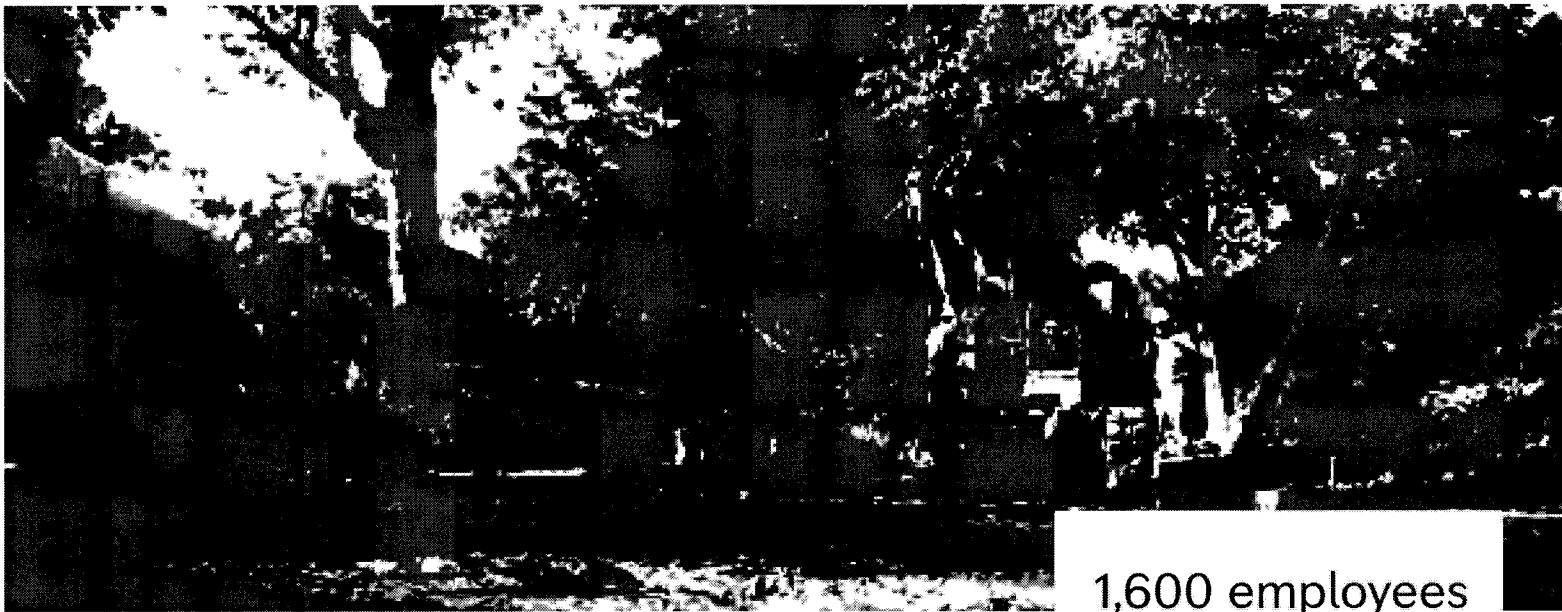
As our nation has grown, so has our company. As early as the 1900s, the company established a growth strategy that still serves as its foundation today, responsible for developing Aqua into one of the nation's largest U.S.-based water and wastewater utilities serving close to 3 million people in several states.

Aqua is an industry leader, setting the standards for water quality, infrastructure, customer service and community involvement. Aqua's dedicated staff consists of highly skilled scientists, engineers, treatment operators and a host of other professionals. With our technical expertise and resources, Aqua has become the “go to” company for officials who continually rely upon us to solve problems with troubled water and wastewater utilities in their states.

## States we serve

Pennsylvania, Ohio, North Carolina,  
Texas, Illinois, New Jersey, Indiana, Virginia





**1,600 employees**

work daily to ensure quality water  
and reliable water and wastewater  
service for people in eight states.

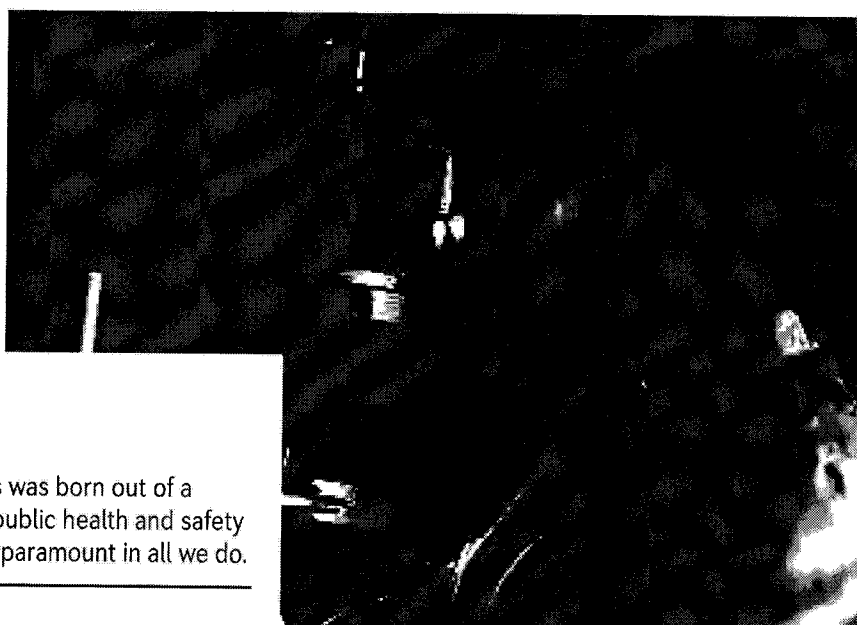
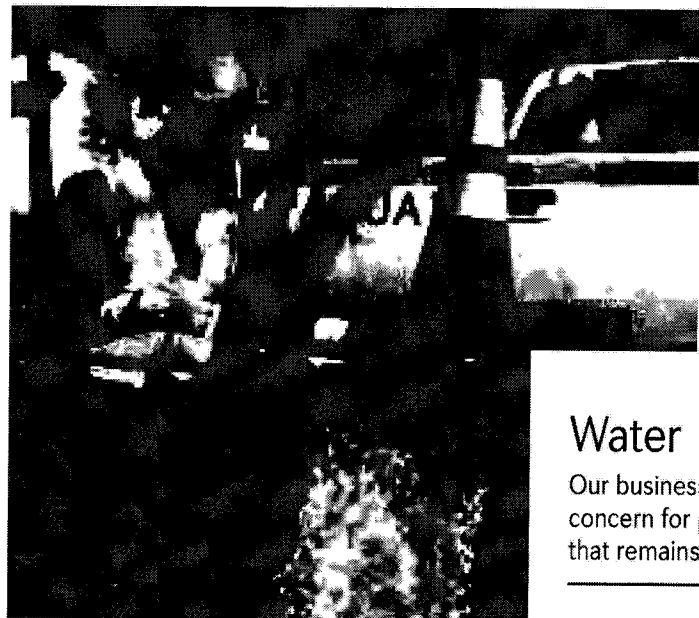
---



## What We Do

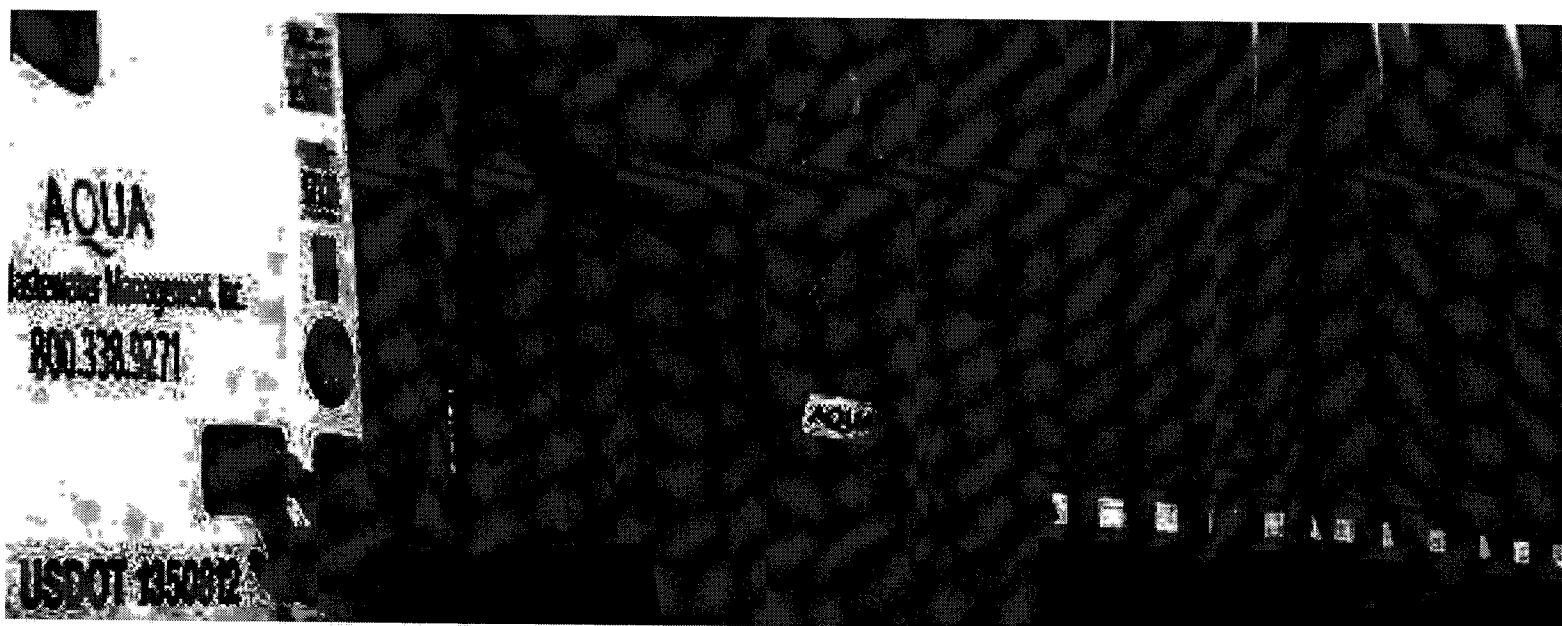
Aqua cleans billions of gallons of fresh water each year for delivery directly to customers' taps via thousands of miles of pipe. Its wastewater operations treat millions of gallons of wastewater annually, restoring its quality so it can be safely returned to the environment.

Water and wastewater operations are actually the most capital intensive of all utilities, requiring investment of more capital per dollar of revenue earned than any other utility. Aqua's unique ability to continue the reliable delivery of quality water that meets or outperforms state and federal regulations requires strong and stable infrastructure. The same is true of its wastewater operations. The U.S. Environmental Protection Agency estimates that investments of \$384 billion and \$202.5 billion will be necessary to adequately maintain the nation's water and wastewater systems, respectively, over the next 20 years. That is why Aqua singularly has invested \$2.8 billion in water and wastewater infrastructure over the last 10 years (2004 through 2013), including \$308 million in 2013 alone.



## Water

Our business was born out of a concern for public health and safety that remains paramount in all we do.



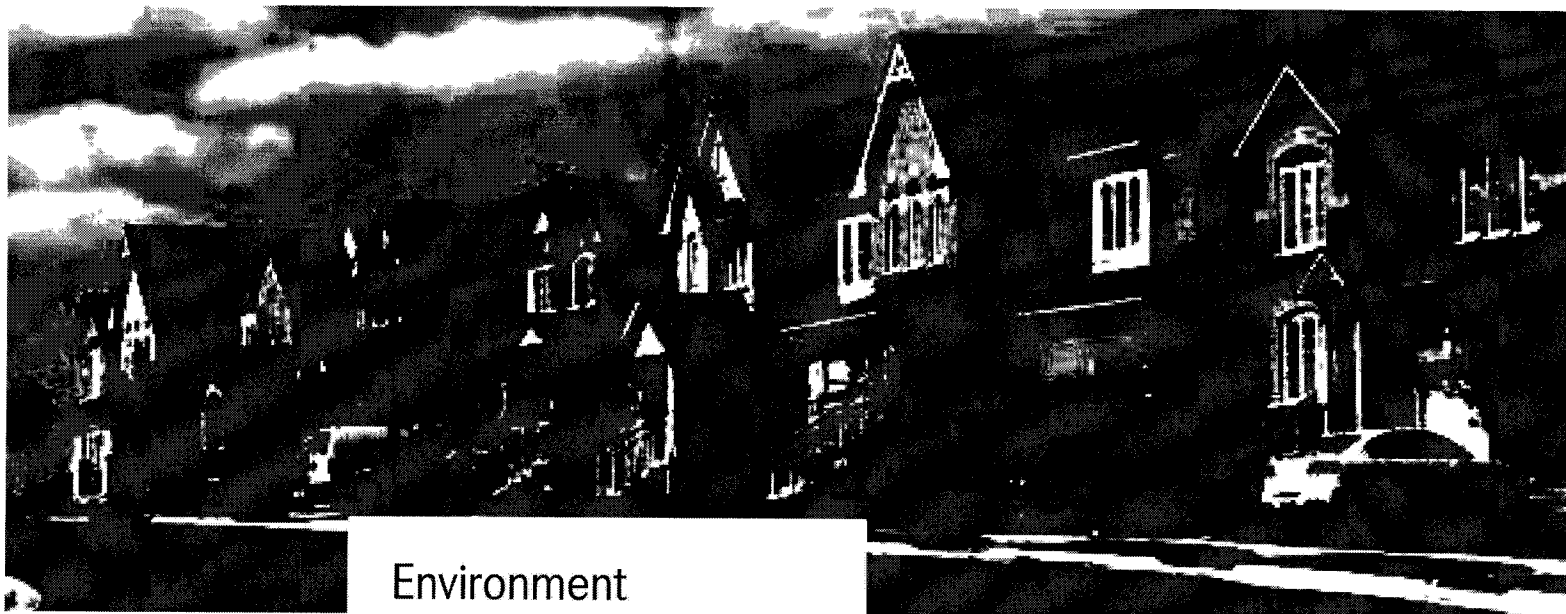
## Why We Do It

Aqua employees are driven by the same concern our founders had for access to clean drinking water. Although it is seemingly ubiquitous, surface water—the primary source of drinking water—makes up just 0.007 percent of Earth's total water according to the United States Geological Survey. That is why water is Earth's most recycled—and valuable—natural resource.

We take seriously our role as environmental stewards and understand that the cleaner our fresh water resources are, the less treatment is required at our plants. That is one of the reasons our wastewater operations strive to assure that treated wastewater is returned to the environment in full compliance with all environmental laws.

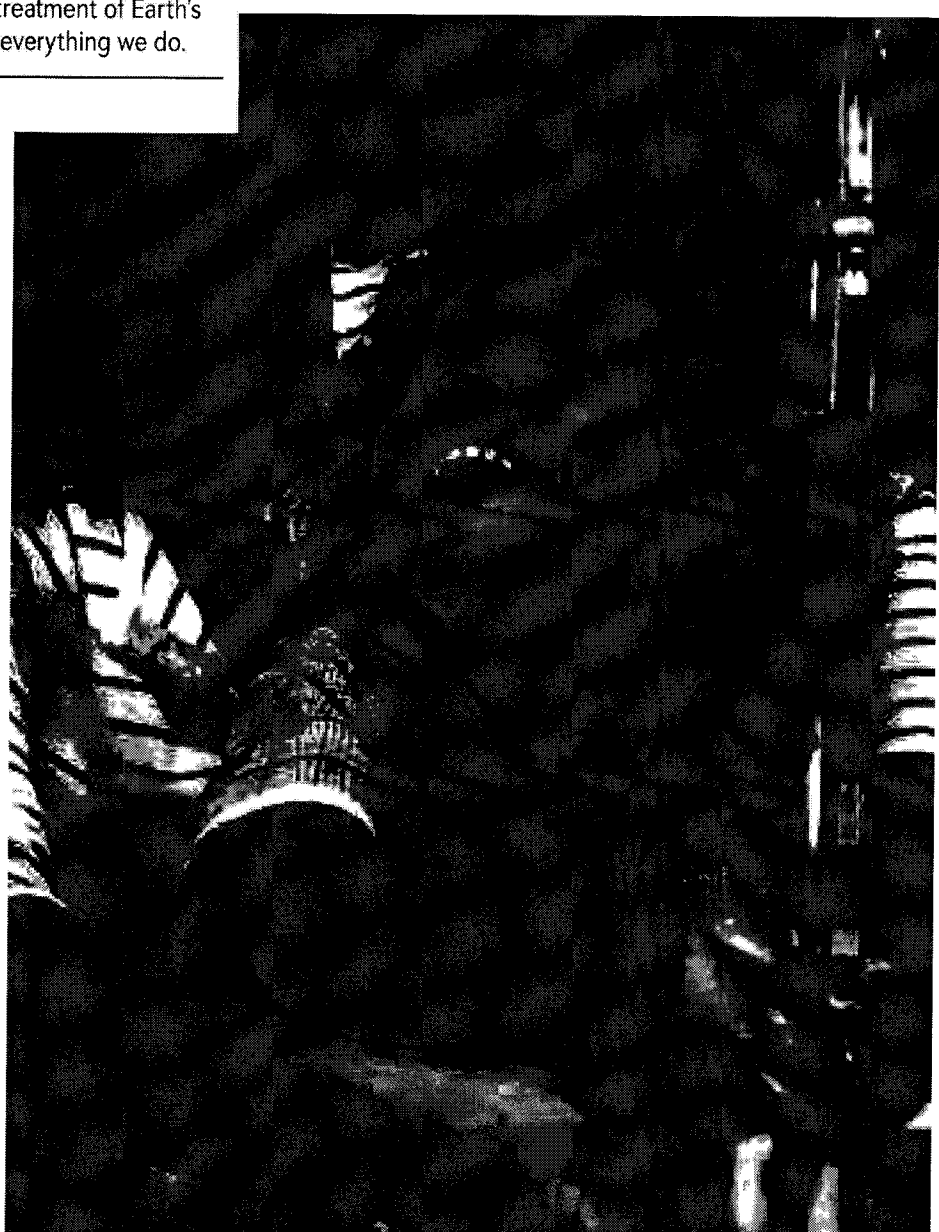
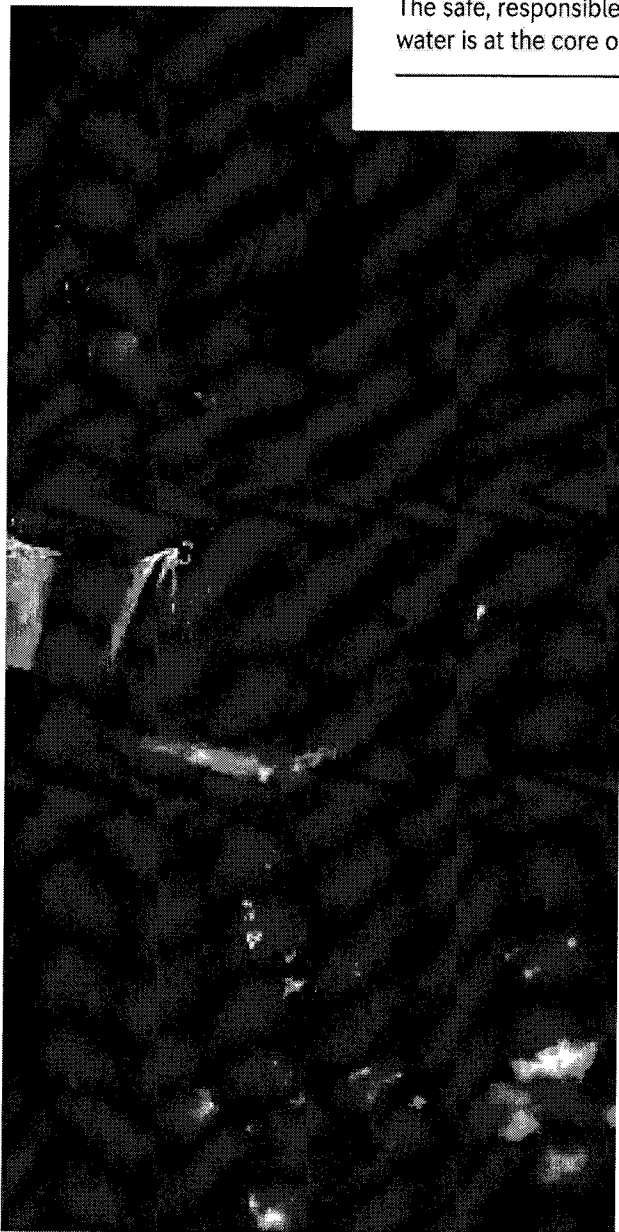
In addition to the primary environmental and public health benefits of our business, we also understand the impact that reliable water and wastewater service has on the economy. Businesses of all sizes require reliable water and wastewater service to operate. In recent years, we have seen increasing evidence of the need for a significant infusion of capital to restore our nation's utility infrastructure. Such an investment, spearheaded by companies like Aqua, renews crucial infrastructure while positively impacting the nation's economy by creating living-wage jobs.

Aqua continues to be a leader in this regard, and plans to invest more than \$1 billion in capital improvements over the next three years, demonstrating the role that the private sector can play in the nation's infrastructure renewal and limiting the burden on tax requirements. Aqua's ongoing investment helps us achieve regulatory compliance and continues to provide customers with the quality water and reliable service they deserve.



## Environment

The safe, responsible treatment of Earth's water is at the core of everything we do.






## Connecting With Customers


“Around the water cooler” took on new meaning for Aqua in 2013, as customers were able to learn about and engage with the company for the first time via social media when it launched Facebook and Twitter pages.

Using Facebook and Twitter to offer customers an alternative to the company’s website for useful information, Aqua’s social media presence has also served to leverage Aqua employee news and profiles, providing information about interesting hobbies and activities in which employees are engaged outside of work. We have also increased the exposure of our various company-sponsored community relations activities through social media, expanding the reach of good news, and further allowing the company to be involved, engaged and approachable. Customers have become the beneficiaries of frequent, useful and timely tips through the Aqua Facebook page and have begun to embrace Twitter as an alternative to contacting the call center for quick information about everything from service appointments to questions about specific infrastructure projects.

Aqua’s recently refreshed website is infused with many new features including “WaterSmart,” an interactive program to help customers conserve water in their homes and learn about the water treatment process. The interactive program is rooted in an illustration of a home, with clickable elements in each room that provide practical tips for water conservation. Aqua website visitors can learn how water travels from a source to the tap, with downloadable diagrams that explain the processes to treat surface water, groundwater and wastewater.

 [AquaAmerica.com](http://AquaAmerica.com)

 [@MyAquaAmerica](https://twitter.com/MyAquaAmerica)

 [/MyAquaAmerica](https://www.facebook.com/MyAquaAmerica)



**AQUA** Aqua America  
Only the Best Water

If bottle and tap water meet the same federal and state drinking water standards, why waste money on bottled water?  
[aqua.us/1aBkdw](http://aqua.us)

Like · Comment · Retweet · Share

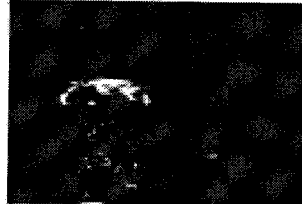


1 month · 1 day · 1 hour

**AQUA** Aqua America  
Only the Best Water

Did you know? Your bottle and faucet are composed of nearly 100% plastic. > [aqua.us/plasticwaterfromplastic](http://aqua.us/plasticwaterfromplastic)

Like · Comment · Retweet · Share



Working to make sure you have the best water possible. > [aqua.us](http://aqua.us)

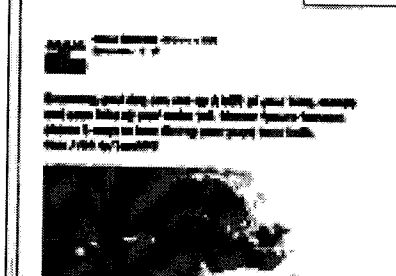
Now everyone in your area is guaranteed to get the best water. > [aqua.us](http://aqua.us)

Like · Comment · Retweet · Share

1 month · 1 day · 1 hour

**AQUA** Aqua America  
Only the Best Water

The Philadelphia Phillies game is going to be up to us. > [aqua.us](http://aqua.us)



**AQUA** Aqua America  
Only the Best Water

An aging LEF Waterbury has nearly 5 BILLION gallons of water each day. > [aqua.us](http://aqua.us)

Like · Comment · Retweet · Share

1 month · 1 day · 1 hour

**AQUA** Aqua America  
Only the Best Water

Working to make sure you have the best water possible. > [aqua.us](http://aqua.us)

Now everyone in your area is guaranteed to get the best water. > [aqua.us](http://aqua.us)

Like · Comment · Retweet · Share

1 month · 1 day · 1 hour

**AQUA** Aqua America  
Only the Best Water

The Groundwork for a Better Tomorrow

Did you know? Your bottle and faucet are composed of nearly 100% plastic. > [aqua.us/plasticwaterfromplastic](http://aqua.us/plasticwaterfromplastic)

Like · Comment · Retweet · Share

1 month · 1 day · 1 hour

**AQUA** Aqua America  
Only the Best Water

Agree's Tips On Preventing Freezing Pipes | NBC10

Don't baby it's cold outside! Aqua's Dave McWayne was on NBC10 Philadelphia last night to share some helpful tips on how to prevent your pipes from freezing and avoid a water main break. After all, it's the season for freezein' — with Doug Shireff.

Like · Comment · Retweet · Share

1 month · 1 day · 1 hour

**AQUA** Aqua America  
Only the Best Water

The Story Always Had to End This Way

Like · Comment · Retweet · Share

1 month · 1 day · 1 hour

**AQUA** Aqua America  
Only the Best Water

Water is always there when it rains. > [aqua.us](http://aqua.us)

Now everyone in your area is guaranteed to get the best water. > [aqua.us](http://aqua.us)

Like · Comment · Retweet · Share

1 month · 1 day · 1 hour

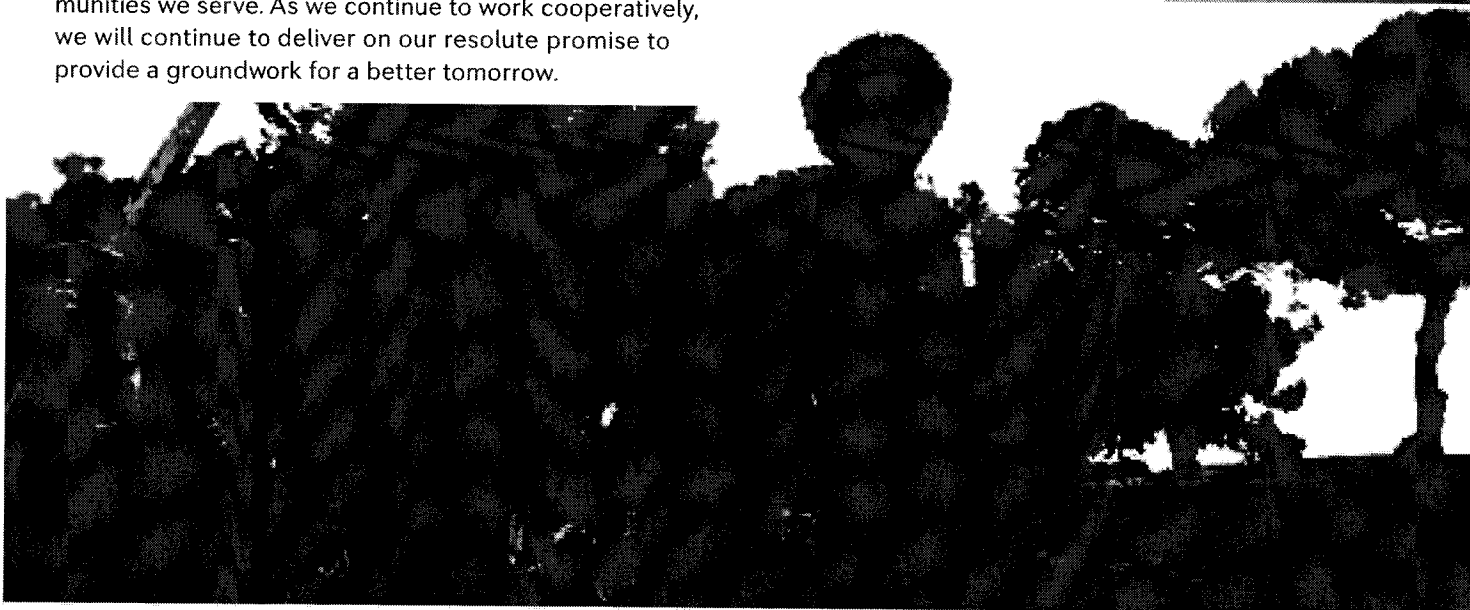


## Connecting With Communities

With assets that are literally part of the community, here at Aqua, we take our role as a corporate citizen very seriously.

Aqua has a long history of strengthening and enriching the communities we serve. We continue to identify and support worthy organizations that have a positive impact on the communities in our service areas. Additionally, we ardently support Pennsylvania's Tree Vitalize, an important environmental initiative created in 2005 to reverse the loss of tree cover. Through our involvement, nearly 40,000 trees have been planted along river and stream banks to protect drinking water sources. Aqua has sponsored and actively participated in myriad charitable events including the construction of a Habitat for Humanity home in Texas and the construction and donation of playground equipment to a Virginia school.

Fostering positive relationships by working closely with local and municipal officials has created partnerships that continue to be mutually beneficial to Aqua and the communities we serve. As we continue to work cooperatively, we will continue to deliver on our resolute promise to provide a groundwork for a better tomorrow.





# AQUA<sup>SM</sup>

Aqua America, Inc.  
2013 FINANCIAL DATA

The Groundwork  
for a Better Tomorrow.

This page intentionally left blank.

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)*

**FORWARD-LOOKING STATEMENTS**

This report by Aqua America, Inc. ("Aqua America," "we" or "us") contains, in addition to historical information, forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements involve risks, uncertainties and other factors, that may be outside our control and that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by these forward-looking statements. In some cases, you can identify forward-looking statements where statements are preceded by, followed by or include the words "believes," "expects," "anticipates," "plans," "future," "potential," "in the event" or the negative of such terms or similar expressions. Forward-looking statements in this report, include, but are not limited to, statements regarding:

- recovery of capital expenditures and expenses in rates;
- projected capital expenditures and related financing requirements;
- the availability and cost of capital financing;
- dividend payment projections;
- future financing plans;
- future pension contributions;
- the impact of changes in income tax laws regarding tax-basis depreciation on capital additions, and repair tax deductions;
- our determination of what qualifies as a capital cost versus a repair expense tax deduction;
- opportunities for future acquisitions, the success of pending acquisitions and the impact of future acquisitions;
- acquisition-related costs and synergies;
- the sale of water and wastewater divisions;
- the capacity of our water supplies, water facilities and wastewater facilities;
- the impact of geographic diversity on our exposure to unusual weather;
- the impact of conservation awareness of customers and more efficient plumbing fixtures and appliances on water usage;
- the availability and cost of key production necessities, including power, chemicals and purchased water or wastewater services;
- the availability of qualified personnel;
- the return performance of our defined benefit pension plan assets;
- general economic conditions;
- the impact of federal and/or state tax policies and the regulatory treatment of the effects of those policies; and
- the impact of accounting pronouncements and income taxation policies.

Because forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements, including but not limited to:

- changes in general economic, business, credit and financial market conditions;
- changes in governmental laws, regulations and policies, including those dealing with taxation, the environment, health and water quality, and public utility regulation;
- our determination of what qualifies for a repair expense tax deduction;
- the decisions of governmental and regulatory bodies, including decisions on rate increase requests;
- our ability to file rate cases on a timely basis to minimize regulatory lag;
- abnormal weather conditions, including those that result in water use restrictions;

## 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)

- changes in, or unanticipated, capital requirements;
- changes in our credit rating or the market price of our common stock;
- our ability to integrate businesses, technologies or services which we may acquire;
- our ability to manage the expansion of our business;
- our ability to treat and supply water or collect and treat wastewater;
- the extent to which we are able to develop and market new and improved services;
- the effect of the loss of major customers;
- our ability to retain the services of key personnel and to hire qualified personnel as we expand;
- labor disputes;
- increasing difficulties in obtaining insurance and increased cost of insurance;
- cost overruns relating to improvements to, or the expansion of, our operations;
- increases in the costs of goods and services;
- civil disturbance or terroristic threats or acts;
- the continuous and reliable operation of our information technology systems, including the impact of cyber security or other events;
- changes in accounting pronouncements;
- litigation and claims; and
- changes in environmental conditions, including the effects of climate change.

Given these uncertainties, you should not place undue reliance on these forward-looking statements. You should read this report with the understanding that our actual future results, performance and achievements may be materially different from what we expect. These forward-looking statements represent our estimates and assumptions only as of the date of this report. Except for our ongoing obligations to disclose material information under the federal securities laws, we are not obligated to update these forward-looking statements, even though our situation may change in the future. We qualify all of our forward-looking statements by these cautionary statements. As you read this report, you should pay particular attention to the "Risk Factors" included in our Annual Report on Form 10-K.

## OVERVIEW

*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.*

### **The Company**

Aqua America, Inc. is the holding company for regulated utilities providing water or wastewater services to what we estimate to be almost 3 million people concentrated in Pennsylvania, Ohio, Texas, Illinois, North Carolina, New Jersey, Indiana, and Virginia. Our largest operating subsidiary is Aqua Pennsylvania, Inc. ("Aqua Pennsylvania"), which accounted for approximately 54% of our operating revenues and a larger percentage of our net income for 2013, and, as of December 31, 2013, provided water or wastewater services to approximately one-half of the total number of people we serve located in the suburban areas in counties north and west of the City of Philadelphia and in 26 other counties in Pennsylvania. Our other regulated utility subsidiaries provide similar services in seven other states. In addition, the Company's non-regulated subsidiary, Aqua Resources, provides liquid waste hauling and disposal, water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to our utility companies' service territories, offers, through a third party, water and sewer line repair service and protection solutions to households, backflow prevention, construction, and other non-regulated water and wastewater services, and the Company's non-regulated subsidiary, Aqua Infrastructure, provides non-utility raw water supply services for firms, with which we enter into a water supply contract, in the natural gas drilling industry.

Aqua America, 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

## 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)*

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 ("American Water") regulated water and wastewater 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 utility operations from southeastern Pennsylvania to include our current operations in seven other states.

Beginning in 2010, and substantially completed in 2013, we pursued a portfolio rationalization strategy to focus our operations in areas where we have critical mass and economic growth potential, and to divest operations where limited customer growth opportunities exist, or where we are unable to achieve favorable operating results or a return on equity that we consider acceptable. In 2012, we sold our utility operations in Maine and New York, in 2011, we sold our utility operations in Missouri and in 2010 we sold our utility operations in South Carolina. In connection with the sale of our New York and Missouri utility operations, we acquired additional utility systems (and customers) in Ohio and Texas, two of the larger states in Aqua America's portfolio. In 2012, we began to market for sale our Florida utility operations and our wastewater treatment facility in Georgia. The sale of our regulated utility operations in Florida concluded in 2013, and the Company continues to pursue a sale of its Georgia operations.

The operating results, cash flows, and financial position of the Company's Maine, New York, Florida, and Georgia subsidiaries have been presented in the Company's consolidated financial statements as discontinued operations.

In 2011, one of our subsidiaries entered into a joint venture with a firm that operates natural gas pipelines and processing plants for the construction and operation of a private pipeline system to supply raw water to natural gas well drilling operations in Pennsylvania. The operation of the private pipeline system commenced in the second quarter of 2012 and marks an expansion of our growth venture in serving the raw water needs of firms in the natural gas drilling industry.

#### **Industry Mission**

The mission of the investor-owned water utility industry is to provide quality and reliable water service at reasonable rates to customers, while earning a fair return for shareholders. A number of challenges face the industry, including:

- strict environmental, health and safety standards;
- aging utility infrastructure and the need for substantial capital investment;
- economic regulation by state, and/or, in some cases, local government;
- declining consumption per customer as a result of conservation;
- lawsuits and the need for insurance; and
- the impact of weather and sporadic drought conditions on water sales demand.

#### **Economic Regulation**

Most of our water and wastewater utility operations are subject to regulation by their respective state regulatory commissions, which have broad administrative power and authority to regulate rates and charges, determine franchise areas and conditions of service, approve acquisitions and authorize the issuance of securities. The regulatory commissions also generally establish uniform systems of accounts and approve the terms of contracts with affiliates and customers, business combinations with other utility systems, loans and other financings, and the franchise areas that we serve. The policies of the regulatory commissions often differ from state to state, and may change over time. A small number of our operations are subject to rate regulation by county or city government. Over time, the regulatory party in a particular state may change, as is the case for our Texas operations, in 2014, where economic regulation changes from the Texas Commission on Environmental Quality to the Texas Public Utility Commission. The profitability of our



## 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)

utility operations is influenced to a great extent by the timeliness and adequacy of rate allowances in the various states in which we operate. A consideration in evaluating which states to focus our growth and investment strategy is whether a state provides for consolidated rates, infrastructure rehabilitation surcharge mechanisms, and other regulatory policies, that promote infrastructure investment and efficiency in processing rate cases.

**Rate Case Management Capability** – We strive to achieve the industry's mission by effective planning, efficient investments, and productive use of our resources. We maintain a rate case management capability to pursue timely and adequate returns on the capital investments that we make in improving our distribution system, treatment plants, information technology systems, and other infrastructure. This capital investment represents our assets used and useful in providing utility service, and is commonly referred to as rate base. Timely, adequate rate relief is important to our continued profitability and in providing a fair return to our shareholders, and thus providing access to capital markets to help fund these investments. Accordingly, the objective of our rate case management strategy is to provide that the rates of our utility operations reflect, to the extent practicable, the timely recovery of increases in costs of operations (primarily labor and employee benefits, electricity, chemicals, transportation, communication costs, maintenance expenses, insurance and claims costs, and costs to comply with environmental regulations), capital, and taxes. In pursuing our rate case strategy, we consider the amount of net utility plant additions and replacements made since the previous rate decision, the changes in the cost of capital, changes in our capital structure and changes in operating and other costs. Based on these assessments, our utility operations periodically file rate increase requests with their respective state regulatory commissions or local regulatory authorities. In general, as a regulated enterprise, our water and wastewater rates are established to provide full recovery of utility operating costs, taxes, interest on debt used to finance capital investments and a return on equity used to finance capital investments. Our ability to recover our expenses in a timely manner and earn a return on equity employed in the business helps determine the profitability of the Company.

Our water and wastewater operations are composed of 61 rate divisions, each of which requires a separate rate filing for the evaluation of the cost of service and recovery of investments in connection with the establishment of tariff rates for that rate division. When feasible and beneficial to our utility customers, we will seek approval from the applicable state regulatory commission to consolidate rate divisions to achieve a more even distribution of costs over a larger customer base. Seven of the states in which we operate permit us to file a revenue requirement using some form of consolidated rates for some or all of the rate divisions in that state. As of December 31, 2013, we have five active rate proceedings in five of our eight states proposing an aggregate annualized rate increase of \$16,976.

**Revenue Surcharges** – Five states in which we operate water utilities, and three states in which we operate wastewater utilities, permit us to add a surcharge to water or wastewater bills to offset the additional depreciation and capital costs associated with capital expenditures related to replacing and rehabilitating infrastructure systems. In all other states, water and wastewater utilities absorb all of the depreciation and capital costs of these projects between base rate increases without the benefit of additional revenues. The gap between the time that a capital project is completed and the recovery of its costs in rates is known as regulatory lag. The infrastructure rehabilitation surcharge mechanism is intended to substantially reduce regulatory lag, which often acts as a disincentive to water and wastewater utilities to rehabilitate their infrastructure. In addition, some states permit our subsidiaries to use a surcharge or credit on their bills to reflect allowable changes in costs, such as changes in state tax rates, other taxes and purchased water costs, until such time as the new costs are fully incorporated in base rates.

**Effects of Inflation** – Recovery of the effects of inflation through higher water and wastewater rates is dependent upon receiving adequate and timely rate increases. However, rate increases are not retroactive and often lag increases in costs caused by inflation. On occasion, our regulated utility companies may enter into rate settlement agreements that provide specific stay-out provisions which require us to wait for a period of time to file the next base rate increase request. These stay-out provisions may result in regulatory lag whereby inflationary increases in expenses may not yet be reflected in rates, or a gap may exist between when a capital project is completed and the start of its recovery in rates. Even during periods of moderate inflation, as has

## 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)

been experienced in 2013, 2012, and 2011, the effects of inflation can have a negative impact on our operating results.

#### **Growth-Through-Acquisition Strategy**

Part of our strategy to meet the industry challenges is to actively explore opportunities to expand our utility operations through acquisitions of water and wastewater utilities either in areas adjacent to our existing service areas or in new service areas, and to explore acquiring non-regulated businesses that are complementary to our regulated water and wastewater operations. To complement our growth strategy, we routinely evaluate the operating performance of our individual utility systems, and in instances where limited economic growth opportunities exist or where we are unable to achieve favorable operating results or a return on equity that we consider acceptable, we will seek to sell the utility system and reinvest the proceeds in other utility systems. Consistent with this strategy, we are focusing our acquisitions and resources in states where we have critical mass of operations in an effort to achieve economies of scale and increased efficiency. Our growth-through-acquisition strategy allows us to operate more efficiently by sharing operating expenses over more utility customers and provides new locations for possible future growth. The ability to successfully execute this strategy and meet the industry challenges is largely due to our financial position and our qualified and trained workforce, which we strive to retain by treating employees fairly and providing our employees with development and growth opportunities.

During 2013, we completed 15 acquisitions and other growth ventures, which along with the organic growth in our existing systems, represent 12,341 new customers. In May 2012, we completed our acquisition of American Water's water and wastewater operations in Ohio serving approximately 59,000 customers. In addition to our Ohio acquisition, during 2012, we completed 16 acquisitions and other growth ventures, which along with the organic growth in our existing system represent 11,070 new customers. In June 2011, we completed our acquisition of approximately 51 water and five wastewater systems in Texas serving approximately 5,300 customers. In addition to our Texas acquisition, during 2011, we completed eight acquisitions and other growth ventures, which along with the organic growth in our existing systems represent 3,962 new customers.

In addition to acquisitions, from time to time, we sell utility systems or relinquish ownership in systems through condemnation. In 2011, 2012, and 2013 consistent with our strategy to evaluate our individual utility systems, we divested our operations in four states: Missouri in May 2011, Maine in January 2012, New York in May 2012, and Florida in separate transactions in March, April, and December of 2013. In related transactions, with respect to the sale of our Missouri operations, and with respect to the sale of our New York operations, we acquired additional utility systems (and additional customers) in Texas and in Ohio, which resulted in a net increase in customers of approximately 10,000. In addition to the dispositions mentioned above, we sold the following utility systems: in 2013 we sold three utility systems representing 1,763 customers, in 2012 we sold two utility systems representing 1,139 customers, and in 2011 we sold three utility systems representing 2,179 customers.

We believe that utility acquisitions, organic growth, and expansion of our non-regulated business will continue to be the primary sources of customer growth for us. With approximately 53,000 community water systems in the U.S., 82% of which serve less than 3,300 customers, the water industry is the most fragmented of the major utility industries (telephone, natural gas, electric, water and wastewater). In the states where we operate regulated utilities, we believe there are approximately 14,000 community water systems of widely-varying size, with the majority of the population being served by government-owned water systems.

Although not as fragmented as the water industry, the wastewater industry in the U.S. also presents opportunities for consolidation. According to the U.S. Environmental Protection Agency's ("EPA") most recent survey of wastewater treatment facilities (which includes both government-owned and privately-owned facilities) in 2008, there are approximately 15,000 such facilities in the nation serving approximately 74% of the U.S. population. The remaining population represents individual homeowners with their own treatment facilities; for example, community on-lot disposal systems and septic tank systems. The vast majority of wastewater facilities are government-owned rather than privately-owned. The EPA survey also indicated that

## 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)*

there are approximately 5,000 wastewater facilities in operation in the states where we operate regulated utilities.

Because of the fragmented nature of the water and wastewater utility industries, we believe that there are many potential water and wastewater system acquisition candidates throughout the United States. We believe the factors driving the consolidation of these systems are:

- the benefits of economies of scale;
- the increasing cost and complexity of environmental regulations;
- the need for substantial capital investment;
- the need for technological and managerial expertise;
- the desire to improve water quality and service;
- limited access to cost-effective financing;
- the monetizing of public assets to support, in some cases, the declining financial condition of municipalities; and
- the use of system sale proceeds by a municipality to accomplish other public purposes.

We are actively exploring opportunities to expand our water and wastewater utility operations through regulated acquisitions or otherwise, such as the management of publicly-owned facilities in a public-private partnership. We intend to continue to pursue acquisitions of government-owned and privately-owned water and wastewater systems of all sizes that provide services in areas near our existing service territories or in new service areas. It is our intention to focus on growth opportunities in states where we have critical mass, which allows us to improve economies of scale through spreading our fixed costs over more customers – this cost efficiency should enable us to lessen the size of future rate increases. Periodically, we consider opportunities for the acquisition of non-regulated water and wastewater service businesses. We are also seeking other potential business opportunities, including partnering with public and private utilities to invest in water and wastewater infrastructure improvements, and growth opportunities provided by both meeting the needs of industrial facilities and the natural gas drilling industry, with a current focus on serving the raw water needs of drillers.

#### **Sendout**

“Sendout” represents the quantity of treated water delivered to our distribution systems. We use sendout as an indicator of customer demand. Weather conditions tend to impact water consumption, particularly during the late spring, summer, and early fall when discretionary and recreational use of water is at its highest. Consequently, a higher proportion of annual operating revenues are realized in the second and third quarters. In general during this period, an extended period of hot and dry weather increases water consumption, while above-average rainfall and cool weather decreases water consumption. Conservation efforts, construction codes that require the use of low-flow plumbing fixtures, as well as mandated water use restrictions in response to drought conditions can reduce water consumption. We believe an increase in conservation awareness by our customers, including the increased use of more efficient plumbing fixtures and appliances, may continue to result in a long-term structural trend of declining water usage per customer. These gradual long-term changes are normally taken into account by the regulatory commissions in setting rates, whereas significant short-term changes in water usage, resulting from drought warnings, water use restrictions, or extreme weather conditions, may not be fully reflected in the rates we charge between rate proceedings.

On occasion, drought warnings and water use restrictions are issued by governmental authorities for portions of our service territories in response to extended periods of dry weather conditions, regardless of our ability to meet unrestricted customer water demands. The timing and duration of the warnings and restrictions can have an impact on our water revenues and net income. In general, water consumption in the summer months is affected by drought warnings and restrictions to a higher degree because discretionary and recreational use of water is highest during the summer months, particularly in our northern service territories. At other times of the year, warnings and restrictions generally have less of an effect on water consumption.

## 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)*

The geographic diversity of our utility customer base reduces the effect on Aqua America of our exposure to extreme or unusual weather conditions in any one area of our service territory. During the year ended December 31, 2013, our operating revenues were derived principally from the following states: approximately 54% in Pennsylvania, 12% in Ohio, 9% in Texas, 7%, in Illinois, and 6% in North Carolina.

#### **Performance Measures Considered by Management**

We consider the following financial measures (and the period to period changes in these financial measures) to be the fundamental basis by which we evaluate our operating results: earnings per share, operating revenues, income from continuing operations, net income attributable to common shareholders and the dividend rate on common stock. In addition, we consider other key measures in evaluating our utility business performance within our Regulated segment: our number of utility customers, the ratio of operations and maintenance expense compared to operating revenues (this percentage is termed "operating expense ratio" or "efficiency ratio"); return on revenues (income from continuing operations divided by operating revenues); return on equity (net income attributable to common shareholders divided by stockholders' equity); and the ratio of capital expenditures to depreciation expense. We also review the measure of earnings before interest, taxes, and depreciation ("EBITD") and the measure of earnings before income taxes as compared to our operating budget. We review these measurements regularly and compare them to historical periods, to our operating budget as approved by our Board of Directors, and to other publicly-traded water utilities.

Our operating expense ratio is one measure that we use to evaluate our operating efficiency and management effectiveness of our regulated operations. Our operating expense ratio is affected by a number of factors, including the following:

- ***Regulatory lag*** – Our rate filings are designed to provide for the recovery of increases in costs of operations (primarily labor and employee benefits, electricity, chemicals, transportation, maintenance expenses, insurance and claim costs, and costs to comply with environmental regulations), capital, and taxes. The revenue portion of the efficiency ratio can be impacted by the timeliness of recovery of, and the return on capital investments. The efficiency ratio is further influenced by regulatory lag (increases in operations and maintenance expenses not yet recovered in rates or a gap between the time that a capital project is completed and the start of its cost recovery in rates), or decreases in operating revenues without a commensurate decrease in operations and maintenance expense, such as changes in customer water consumption as impacted by adverse weather conditions, conservation trends, or as a result of utility rates incorporating the effects of income tax benefits derived from deducting repair expenses for tax purposes that are capitalized for book purposes in Aqua Pennsylvania and forgoing operating revenue increases. During periods of inflation, our operations and maintenance expenses may increase, impacting the efficiency ratio, as a result of regulatory lag since our rate cases may not be filed timely nor are they retroactive.
- ***Acquisitions*** – In general, acquisitions of smaller undercapitalized utility systems in some areas may initially increase our operating expense ratio if the operating revenues generated by these operations are accompanied by a higher ratio of operations and maintenance expenses as compared to other operational areas of the company that are more densely populated and have integrated operations. In these cases, the acquired operations are characterized as having relatively higher operating costs to fixed capital costs, in contrast to the majority of the Aqua America operations, which generally consist of larger, interconnected systems, with higher fixed capital costs (utility plant investment) and lower operating costs per customer. In addition, we operate non-regulated subsidiary companies that provide liquid waste hauling and disposal, water and wastewater service through operating and maintenance contracts with municipal authorities and other parties in close proximity to our utility companies' service territories, offers, through a third party, water and sewer line repair service and protection solutions to households, backflow prevention, construction, and other non-regulated water and wastewater services, and non-utility raw water supply services for firms, with which we enter into a water supply contract, in the natural gas drilling industry. The cost-structure of these non-regulated businesses differs from our utility companies in that, although they may generate free cash flow, these businesses have a much higher ratio of operations and maintenance expenses to operating revenues

# 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)

and a lower capital investment and, consequently, a lower ratio of fixed capital costs versus operating revenues in contrast to our regulated operations. As a result, the ratio of operating income compared to operating revenues is not comparable between the businesses. These non-regulated subsidiary companies are not a component of our Regulated segment.

We continue to evaluate initiatives to help control operating costs and improve efficiencies.

### **Consolidated Selected Financial and Operating Statistics**

Our selected five-year consolidated financial and operating statistics follow:

Years ended December 31,	2013 (1)	2012 (2)	2011 (3)	2010	2009 (4)
Utility customers:					
Residential water	784,100	778,350	723,649	719,812	712,619
Commercial water	39,513	39,079	35,078	34,649	34,261
Industrial water	1,369	1,374	1,213	1,226	1,222
Other water	17,320	16,730	15,762	15,376	16,242
Wastewater	98,705	95,044	84,978	86,108	84,041
Total utility customers	941,007	930,577	860,680	857,171	848,385
Operating revenues:					
Residential water	\$ 463,156	\$ 447,338	\$ 408,904	\$ 391,922	\$ 356,265
Commercial water	121,615	117,992	105,837	99,632	89,520
Industrial water	25,442	25,015	21,576	20,716	18,723
Other water	57,699	70,922	65,118	63,369	64,039
Wastewater	73,062	68,225	62,780	62,156	58,577
Other utility	10,303	10,538	10,712	10,973	11,139
Regulated segment total	751,277	740,030	674,927	648,768	598,263
Other and eliminations	17,366	17,730	12,364	11,418	11,634
Consolidated	\$ 768,643	\$ 757,760	\$ 687,291	\$ 660,186	\$ 609,897
Operations and maintenance expense	\$ 285,340	\$ 271,843	\$ 256,743	\$ 250,989	\$ 239,905
Income from continuing operations	\$ 204,993	\$ 184,087	\$ 141,683	\$ 116,379	\$ 98,440
Net income attributable to common shareholders	\$ 221,300	\$ 196,563	\$ 143,069	\$ 123,975	\$ 104,353
Capital expenditures	\$ 308,171	\$ 347,985	\$ 325,808	\$ 308,134	\$ 266,190
<b>Operating Statistics</b>					
Selected operating results as a percentage of operating revenues:					
Operations and maintenance	37.1%	35.9%	37.4%	38.0%	39.3%
Depreciation and amortization	16.2%	15.4%	15.8%	16.9%	17.6%
Taxes other than income taxes	6.9%	6.3%	6.0%	6.1%	6.1%
Interest expense, net	10.1%	10.3%	11.3%	11.1%	10.9%
Income from continuing operations	26.7%	24.3%	20.6%	17.6%	16.1%
Return on Aqua America stockholders' equity	14.4%	14.2%	11.4%	10.6%	9.4%
Ratio of capital expenditures to depreciation expense	2.6	3.1	3.2	3.1	2.8
Effective tax rate (5)	10.0%	26.6%	32.8%	39.2%	39.3%

- (1) Net income attributable to common shareholders includes the gain of \$615 (\$1,025 pre-tax) realized on the sale of a utility system. The gain is reported in the 2013 consolidated statement of net income as a reduction to operations and maintenance expense.
- (2) 2012 utility customers were impacted by the addition of 65,577 utility customers associated with utility systems acquired.
- (3) Net income attributable to common shareholders includes the gain of \$3,035 (\$5,058 pre-tax) realized on the sale of utility systems. The gain is reported in the 2011 consolidated statement of net income as a reduction to operations and maintenance expense.
- (4) Net income attributable to common shareholders includes the gain of \$605 (\$1,009 pre-tax) realized on the sale of a utility system. The gain is reported in the 2009 consolidated statement of net income as a reduction to operations and maintenance expense.
- (5) See Results of Operations – Income Taxes for a discussion of the effective tax rate change for 2013 and 2012.

## 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)*

### RESULTS OF OPERATIONS

Our income from continuing operations has grown at an annual compound rate of approximately 16.4% and our net income has grown at an annual compound rate of approximately 17.7% during the five-year period ended December 31, 2013. During the past five years, operating revenues grew at a compound rate of 6.0% and total expenses, exclusive of income taxes, grew at a compound rate of 5.5%. In addition, as a result of the implementation of the repair tax accounting change in 2012, the Company's provision for income taxes decreased by \$40,936 or 64.3% for the five-year period ended December 31, 2013.

#### Operating Segments

We have identified ten operating segments and we have one reportable segment based on the following:

- Eight segments are composed of our water and wastewater regulated utility operations in the eight states where we provide these services. These operating segments are aggregated into one reportable segment since each of these operating segments has the following similarities: economic characteristics, nature of services, production processes, customers, water distribution and/or wastewater collection methods, and the nature of the regulatory environment. Our single reportable segment is named the Regulated segment.
- Two segments are not quantitatively significant to be reportable and are composed of the businesses that provide liquid waste hauling and disposal, water and wastewater service through operating and maintenance contracts with municipal authorities and other parties in close proximity to our utility companies' service territories, offer, through a third party, water and sewer line repair service and protection solutions to households, backflow prevention, other non-regulated water and wastewater services, and non-utility raw water supply services for firms, with which we enter into a water supply contract, in the natural gas drilling industry. These segments are included as a component of "other," in addition to corporate costs that have not been allocated to the Regulated segment and intersegment eliminations. Corporate costs include general and administrative expenses, and interest expense.

# 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)*

Unless specifically noted, the following discussion and analysis provides information on our consolidated results of continuing operations. The following table provides the Regulated segment and consolidated information for the years ended December 31, 2013, 2012, and 2011:

	2013			2012		
	Regulated	Other and Eliminations	Consolidated	Regulated	Other and Eliminations	Consolidated
Operating revenues	\$ 751,277	\$ 17,366	\$ 768,643	\$ 740,030	\$ 17,730	\$ 757,760
Operations and maintenance expense	272,758	12,582	285,340	259,847	11,996	271,843
Taxes other than income taxes	51,106	2,162	53,268	45,450	1,954	47,404
Earnings before interest, taxes, depreciation and amortization	<u>\$ 427,413</u>	<u>\$ 2,622</u>	430,035	<u>\$ 434,733</u>	<u>\$ 3,780</u>	438,513
Depreciation and amortization			124,793			116,996
Operating income			305,242			321,517
Interest expense, net of AFUDC			75,042			73,615
Gain on sale of other assets			(148)			(1,090)
Equity losses (earnings) in joint venture			2,665			(1,976)
Provision for income taxes			22,690			66,881
Income from continuing operations			204,993			184,087
Income from discontinued operations, net of income taxes of \$8,425 and \$8,017, respectively			16,307			12,476
Net income			<u>\$ 221,300</u>			<u>\$ 196,563</u>

	2011		
	Regulated	Other and Eliminations	Consolidated
Operating revenues	\$ 674,927	\$ 12,364	\$ 687,291
Operations and maintenance expense	243,137	13,606	256,743
Taxes other than income taxes	39,677	1,772	41,449
Earnings (losses) before interest, taxes, depreciation and amortization	<u>\$ 392,113</u>	<u>\$ (3,014)</u>	389,099
Depreciation and amortization			108,300
Operating income			280,799
Interest expense, net of AFUDC			70,654
Gain on sale of other assets			(649)
Provision for income taxes			69,111
Income from continuing operations			141,683
Income from discontinued operations, net of income taxes of \$12,893			1,386
Net income			<u>\$ 143,069</u>

## 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)

#### **Consolidated Results**

**Operating Revenues** – The growth in revenues over the past three years is a result of increases in water and wastewater rates and in our customer base. Rate increases implemented during the past three years have provided additional operating revenues of approximately \$25,676 in 2013, \$39,987 in 2012, and \$37,988 in 2011. Negatively impacting our revenue growth in 2013 was a decrease in customer water consumption and a decrease in infrastructure rehabilitation surcharges of \$12,725 primarily in Pennsylvania, and in 2012 was a slight decline in water consumption as compared to the prior year. The decrease in customer water consumption in 2013 is largely due to unfavorable weather conditions in many of our service territories during the second and third quarters of 2013 and what we believe is an increase in water conservation awareness by our customers. The number of customers increased at an annual compound rate of 3.1% over the past three years, adjusted to exclude customers associated with utility system dispositions, due to acquisitions and organic growth. Acquisitions in our Regulated segment have provided additional water and wastewater revenues of approximately \$16,200 in 2013, \$28,296 in 2012, and \$3,960 in 2011.

On June 7, 2012, the Pennsylvania Public Utility Commission (“PAPUC”) granted Aqua Pennsylvania a water rate increase designed to increase water rates by \$16,700 on an annual basis. The rates in effect at the time of the filing included \$27,449 in Distribution System Improvement Charges (“DSIC”) or 7.5% above prior base rates. Consequently, the total base rates increased by \$44,149 since the last base rate increase, and the DSIC was reset to zero. In addition, the rate case settlement provided for the flow-through accounting treatment of qualifying income tax benefits should Aqua Pennsylvania change its tax accounting method to permit the expensing of qualifying utility asset improvement costs that have historically been capitalized and depreciated for book and tax purposes (the “Repair Change”). In December 2012, Aqua Pennsylvania implemented the Repair Change which resulted in the net recognition of 2012 income tax benefits of \$33,565, which reduced the Company’s Federal and state income tax expense and flowed-through to net income in the fourth quarter of 2012. In 2013, the Company recorded additional income tax benefits of \$14,908, as adjusted for the 2012 tax return. Similar to 2012, the Company recorded \$45,647 of income tax benefits in 2013. The Company recognized a tax deduction on its 2012 Federal tax return of \$380,000 for qualifying capital expenditures made prior to 2012 (the “catch-up adjustment”), and based on the settlement agreement, beginning in 2013, the Company began to amortize 1/10<sup>th</sup> of the catch-up adjustment. In accordance with the settlement agreement, the amortization is expected to reduce income tax expense during periods when qualifying parameters are met. During 2013, the Company amortized its catch-up adjustment and recognized \$15,766 of deferred income tax benefits, which reduced income tax expense and increased the Company’s net income. Also, as a result of the Repair Change, the fourth quarter 2012 DSIC of 2.82% for Aqua Pennsylvania’s water customers was reset to zero beginning January 1, 2013, and Aqua Pennsylvania did not file a water base rate case or for a DSIC in 2013.

In August 2013, the Company’s operating subsidiary in North Carolina filed an application with the North Carolina Utilities Commission designed to increase water and wastewater rates by \$8,611 or 19.2% on an annual basis. The amount of the final rate award that might be granted by the North Carolina Utilities Commission can vary significantly from the amount requested. The Company anticipates a final order to be issued in May 2014.

In February 2012, two of the Company’s operating divisions in Texas began to bill interim rates in accordance with authorization from the Texas Commission on Environmental Quality (the “TCEQ”). The additional revenue billed and collected prior to the TCEQ’s final ruling was subject to refund based on the outcome of the rate case. The rate case concluded with the issuance of an order on June 3, 2013, and no refunds of revenue previously billed and collected were required.

Our operating subsidiaries, excluding the 2012 Pennsylvania water rate award, discussed above, received rate increases representing estimated annualized revenues of \$9,431 in 2013 resulting from six rate decisions, \$17,923 in 2012 resulting from nine rate decisions, and \$6,311 in 2011 resulting from twelve rate decisions. Revenues from these increases realized in the year of grant were \$8,169 in 2013, \$13,754 in 2012, and \$3,312 in 2011. As of December 31, 2013, excluding the North Carolina rate request discussed above, our operating subsidiaries currently have filed four rate requests, which are being reviewed by the state regulatory commissions, proposing an aggregate increase of \$8,425 in annual revenues. During 2014, we intend to file



## 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)

three additional rate requests proposing an aggregate of approximately \$3,425 of increased annual revenues; the timing and extent to which our rate increase requests may be granted will vary by state.

Currently, Pennsylvania, Ohio, Illinois, Indiana, and New Jersey allow for the use of infrastructure rehabilitation surcharges. In Pennsylvania, this mechanism is referred to as a DSIC. The rate increases under these surcharge mechanisms typically adjust periodically based on additional qualified capital expenditures completed or anticipated in a future period. Infrastructure rehabilitation surcharges are capped as a percentage of base rates, generally at 5% to 12.75% of base rates, and are reset to zero when new base rates that reflect the costs of those additions become effective or when a utility's earnings exceed a regulatory benchmark. Infrastructure rehabilitation surcharges provided revenues of \$3,205 in 2013, \$15,911 in 2012, and \$15,937 in 2011. The decrease in infrastructure rehabilitation surcharges for 2013 resulted primarily from the January 1, 2013 suspension of Aqua Pennsylvania's DSIC as a result of the implementation of the Repair Change.

In 2012, Aqua Pennsylvania decided to adopt the repair tax accounting change on Aqua America's 2012 federal income tax return to be filed in September 2013. The change, which was contemplated under our subsidiary's June 2012 rate order, allows a tax deduction for qualifying utility asset improvements that were formerly capitalized and depreciated for book and tax purposes. As a result of Aqua Pennsylvania's implementing this tax accounting change, the DSIC was suspended for 2013 for Aqua Pennsylvania due to the anticipated earnings level to be achieved. This tax accounting change and its flow-through treatment under the Pennsylvania rate order offset the impact of the 2013 DSIC suspension through a substantial reduction in income tax expense and greater net income and cash flow.

Our Regulated segment also includes non-regulated operating revenues of \$10,303 in 2013, \$10,538 in 2012, and \$10,712 in 2011. These operating revenues are associated with contract operations that are integrated into the regulated utility business and operations. These amounts vary over time according to the level of activity associated with the utility contract operations.

In addition to the Regulated segment operating revenues, we had other non-regulated revenues that were primarily associated with providing liquid waste hauling and disposal, water and wastewater service through operating and maintenance contracts with municipal authorities and other parties in close proximity to our utility companies' service territories, offering, through a third party, water and sewer line repair service and protection solutions to households, backflow prevention, construction, other non-regulated water and wastewater services, and non-utility raw water supply services for firms, with which we enter into a water supply contract, in the natural gas drilling industry of \$17,712 in 2013, \$18,247 in 2012, and \$12,604 in 2011.

**Operations and Maintenance Expenses** – Operations and maintenance expenses totaled \$285,340 in 2013, \$271,843 in 2012, and \$256,743 in 2011. Most elements of operating costs are subject to the effects of inflation and changes in the number of customers served. Several elements are subject to the effects of changes in water consumption, weather and the degree of water treatment required due to variations in the quality of the raw water. The principal elements of operating costs are labor and employee benefits, electricity, chemicals, transportation, maintenance expenses, and insurance and claims costs. Electricity and chemical expenses vary in relationship to water consumption, raw water quality, and price changes. Maintenance expenses are sensitive to extremely cold weather, which can cause water mains to rupture, resulting in additional costs to repair the affected main.

Operations and maintenance expenses increased in 2013 as compared to 2012 by \$13,497 or 5.0%, primarily due to increases in operating costs associated with acquired utility systems and other growth ventures of \$7,386, the effect of the recognition in 2012 of a regulatory asset resulting from a completed rate case which when compared to 2013 resulted in an increase to operations and maintenance expense by \$3,356, an increase in post-retirement benefits expense of \$1,175, and normal increases in other operating costs, offset by a decrease in water production costs of \$4,396 attributed to decreased water consumption in 2013 and a gain on sale of a utility system recognized in 2013 of \$1,025. The gain on sale of utility system is reported in the consolidated statement of net income as a component of operations and maintenance expense.

Operations and maintenance expenses increased in 2012 as compared to 2011 by \$15,100 or 5.9%, primarily due to increases in operating costs associated with acquired utility systems and other growth ventures of

## 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)*

\$13,080, the effect of the gains on the sales of our utility system recognized during 2011 of \$5,058, an increase in insurance expense of \$2,677, an increase in post-retirement benefits expenses of \$2,217, an increase in stock-based compensation of \$1,684, and normal increases in other operating costs. Offsetting these increases were decreases in water production costs of \$5,732, and the effect of the recognition of a regulatory asset resulting from a completed rate case which reduced operations and maintenance expense by \$3,356. The decrease in water production costs results primarily from a decrease in the contractual rate of one of our purchased water contracts, and the non-renewal of another purchased water contract.

***Depreciation and Amortization Expenses*** – Depreciation expense was \$119,258 in 2013, \$111,767 in 2012, and \$103,412 in 2011, and has increased principally as a result of the significant capital expenditures made to expand and improve our utility facilities, and our acquisitions of new utility systems.

Amortization expense was \$5,535 in 2013, \$5,229 in 2012, and \$4,888 in 2011, and increased in 2013 and 2012 primarily due to the amortization of costs associated with, and other costs being recovered in, various rate filings. Expenses associated with filing rate cases are deferred and amortized over periods that generally range from one to three years.

***Taxes Other than Income Taxes*** – Taxes other than income taxes totaled \$53,268 in 2013, \$47,404 in 2012, and \$41,449 in 2011. The increase in 2013 is primarily due to an increase in property taxes of \$4,214 associated with our Ohio acquisition, an increase in gross receipt, excise and franchise taxes of \$1,797 due primarily to our Ohio acquisition, as well as the effect of a favorable adjustment recorded in 2012 related to gross receipts, excise and franchise taxes for one of our operating subsidiaries of \$824 which had the effect of increasing 2013's taxes other than income taxes, offset by a decrease in capital stock taxes of \$1,069 associated with a decrease in capital stock taxes assessed for Aqua Pennsylvania. The increase in 2012 is primarily due to an increase in property taxes of \$4,932, gross receipts, excise and franchise taxes of \$652, and payroll taxes of \$526 resulting primarily from the partial year effect of our Ohio acquisition, offset by a decrease in capital stock taxes of \$363 for Aqua Pennsylvania.

***Interest Expense, net*** – Net interest expense was \$77,316 in 2013, \$77,757 in 2012, and \$77,804 in 2011. Interest income of \$438 in 2013, \$372 in 2012, and \$757 in 2011 was netted against interest expense. Net interest expense decreased in 2013 primarily due to a decline in average short-term borrowings of \$43,666, offset by an increase in average outstanding fixed rate long-term debt of \$40,926, as well as a decline in long and short term interest rates. Net interest expense decreased in 2012 primarily due to a decline in short-term interest rates and the refinancing of existing debt at lower interest rates. Interest income decreased in 2012 due to lower investment rates and lower balances on the proceeds from the issuance of tax-exempt bonds held by trustees pending the draw-down for projects financed with the issuances. The interest income earned on the proceeds from the issuance of tax-exempt bonds is capitalized through our allowance for funds used during construction, a reduction to net interest expense. The weighted average cost of fixed rate long-term debt was 5.00% at December 31, 2013, 5.06% at December 31, 2012, and 5.30% at December 31, 2011. The weighted average cost of fixed and variable rate long-term debt was 5.00% at December 31, 2013, 4.81% at December 31, 2012, and 5.17% at December 31, 2011.

***Allowance for Funds Used During Construction*** – The allowance for funds used during construction ("AFUDC") was \$2,274 in 2013, \$4,142 in 2012, and \$7,150 in 2011, and has varied over the years as a result of changes in the average balance of utility plant construction work in progress ("CWIP"), to which AFUDC is applied, changes in the AFUDC rate which is based predominantly on short-term interest rates, and changes in the average balance of the proceeds held from tax-exempt bond issuances that are restricted to funding specific capital projects. The decreases in 2013 and 2012 are due to decreases of \$43,561 and \$63,178, respectively, in the average balance of proceeds held from tax-exempt bond issuances that are restricted to funding specific capital projects.

***Gain on Sale of Other Assets*** – Gain on sale of other assets totaled \$148 in 2013, \$1,090 in 2012, and \$649 in 2011, and consists of the sales of properties and marketable securities.

***Equity Loss (Earnings) in Joint Venture*** – Equity loss (earnings) in joint venture totaled \$2,665 in 2013 and \$(1,976) in 2012. The decrease in 2013 reflects a decline in water sales, due to sluggish well drilling

# 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)

activity, in connection with serving the raw water needs of firms, with which we enter into a water supply contract, in the natural gas drilling industry.

**Income Taxes** – Our effective income tax rate was 10.0% in 2013, 26.6% in 2012, and 32.8% in 2011. The decrease in the effective tax rate for 2013 and 2012 was primarily due to the 2012 change in the Company's repair tax accounting method for repair expenditures at Aqua Pennsylvania which resulted in a \$67,918 and \$33,565 net reduction to the Company's 2013 and 2012 Federal and state income tax expense. As of December 31, 2013, the Company has an unrecognized tax benefit related to the Company's Repair Change, of which \$9,795 of these tax benefits would further reduce the Company's effective income tax rate in the event the Company does sustain all, or a portion, of its tax position in the period this information is determined.

### Summary –

	Years ended December 31,		
	2013	2012	2011
Operating income	\$ 305,242	\$ 321,517	\$ 280,799
Income from continuing operations	\$ 204,993	\$ 184,087	\$ 141,683
Income from discontinuing operations	16,307	12,476	1,386
Net income attributable to common shareholders	\$ 221,300	\$ 196,563	\$ 143,069
Diluted income from continuing operations per share	\$ 1.16	\$ 1.05	\$ 0.82
Diluted income from discontinued operations per share	0.09	0.07	0.01
Diluted net income per share	1.25	1.12	0.83

The changes in the per share income from continuing operations in 2013 and 2012 over the previous years were due to the aforementioned changes and impacted by a 1.1% increase in the average number of common shares outstanding during 2013 and a 0.9% increase in the average number of common shares outstanding during 2012. The increase in the number of shares outstanding in 2013 and 2012 is primarily a result of the additional shares sold or issued through our equity compensation plan and dividend reinvestment plan.

Income from discontinued operations for 2013 increased by \$3,831 or \$0.02 per diluted share, in comparison to 2012 primarily as a result of the net gain on sale recognized on the sales of our Florida operations in 2013, net of income taxes, of \$13,766 and the effects of the 2012 recognition of charges incurred from the disposal of our New York subsidiary of \$2,090, and an asset impairment recognized in 2012, net of tax, of \$852, offset by the effect of the prior year recognition of the gain on sale of our Maine operating subsidiary net of income taxes of \$10,821. Income from discontinued operations for 2012 increased by \$11,090 or \$0.06 per diluted share, in comparison to 2011 primarily as a result of the recognition in 2012 of the gain on sale of our Maine operating subsidiary, of \$17,699 (\$10,821 after-tax), the effect of the income tax expense recognized in 2011 of \$7,253 for the additional deferred tax liability that arose from the difference between the stock and tax basis of the Company's investment in its New York and Maine operating subsidiaries, a reduction in interest expense, net of tax, of \$1,120 as a result of debt assumed in 2012 by the acquirers in the sale of our New York and Maine operating subsidiaries, offset by charges incurred from the disposal of our New York subsidiary of \$2,090, and an asset impairment recognized in 2012, net of tax, of \$852.

Although we have experienced increased income in the recent past, continued adequate rate increases reflecting increased operating costs and new capital investments, as well as a continuation of income tax benefits related to repair tax eligible utility asset improvement costs are important to the future realization of improved profitability.

# 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)

**Fourth Quarter Results** – The following table provides our fourth quarter results:

	Three Months Ended December 31,	
	2013	2012
Operating revenues	\$ 188,608	\$ 187,481
Operations and maintenance	74,106	72,179
Depreciation	30,287	29,031
Amortization	1,632	1,456
Taxes other than income taxes	12,947	12,704
	<u>118,972</u>	<u>115,370</u>
Operating income	69,636	72,111
Interest expense, net	19,482	19,373
Allowance for funds used during construction	(806)	(658)
Gain on sale of other assets	(27)	(264)
Equity loss (earnings) in joint venture	933	(1,045)
Income before income taxes	<u>50,054</u>	<u>54,705</u>
Provision for income taxes	3,324	(10,429)
Income from continuing operations	<u>46,730</u>	<u>65,134</u>
Income from discontinued operations, net of income taxes of \$5,406 and \$259	10,802	1,421
Net income	<u>\$ 57,532</u>	<u>\$ 66,555</u>

The increase in operating revenues of \$1,127 was primarily a result of additional revenues of \$972 associated with a larger customer base due to acquisitions, an increase in customer water consumption, an increase in water and wastewater rates of \$616 from water and wastewater rates implemented in various operating subsidiaries, offset by a decrease in infrastructure rehabilitation surcharges of \$1,921. The increase in operations and maintenance expense of \$1,927 is due primarily to an increase in post-retirement benefits expenses of \$412, the recording of a reserve of \$412 for a long-lived asset, \$224 of additional operating costs associated with acquisitions, and normal increases in other operating expenses, offset by a decrease in water production costs of \$313. Depreciation expense increased by \$1,256 primarily due to the utility plant placed in service since December 31, 2012. Amortization expense increased by \$176 primarily due to the amortization of costs associated with, and other costs being recovered in, various rate filings. The increase in other taxes of \$243 is primarily due to an increase in property taxes of \$523, offset by a decrease in capital stock taxes of \$274 associated with a decrease in capital stock taxes assessed for Aqua Pennsylvania. Interest expense increased by \$109 due to an increase in our effective interest rate offset by a decrease in the average outstanding debt balance. Allowance for funds used during construction increased by \$148 primarily due to an increase in the average balance of utility plant construction work in process, to which AFUDC is applied. Gain on sale of other assets decreased by \$237 principally due to the timing of sales of land and other property. The decrease in equity loss (earnings) in joint venture of \$1,978 reflects a decline in water sales, due to sluggish well drilling activity, in connection with serving the raw water needs of firms, with which we enter into a water supply contract, in the natural gas drilling industry. The provision for income taxes increased by \$13,753 as a result of the effect of the adoption in the fourth quarter of 2012 of the full year 2012 net tax benefits recognized of \$33,565 resulting from our change in tax method of accounting associated with the Repair Change. Income from discontinued operations increased by \$9,381 primarily due to the gain on sale, net of taxes, of \$10,211 for our water and wastewater utility system in Sarasota, Florida in December 2013.

# 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)

## FINANCIAL CONDITION

### Consolidated Cash Flow and Capital Expenditures

Net operating cash flows from continuing operations, dividends paid on common stock, capital expenditures used in continuing operations, including allowances for funds used during construction, and expenditures for acquiring water and wastewater systems for our continuing operations for the five years ended December 31, 2013 were as follows:

	Net Operating Cash Flows	Common Dividends	Capital Expenditures	Acquisitions
2009	\$ 244,318	\$ 74,729	\$ 266,190	\$ 3,373
2010	244,717	80,907	308,134	8,625
2011	352,041	87,133	325,808	8,515
2012	377,485	93,423	347,985	121,248
2013	366,720	102,889	308,171	14,997
	<u>\$ 1,585,281</u>	<u>\$ 439,081</u>	<u>\$ 1,556,288</u>	<u>\$ 156,758</u>

Included in capital expenditures for the five-year period are: expenditures for the rehabilitation of existing water distribution systems, new water distribution systems, modernization and replacement of existing treatment plants, and water meters. During this five-year period, we received \$25,135 of customer advances and contributions in aid of construction to finance new water mains and related facilities that are not included in the capital expenditures presented in the above table. In addition, during this period, we have made sinking fund contributions and repaid debt in the amount of \$520,402, and have refunded \$24,271 of customers' advances for construction. Common dividends increased during the past five years as a result of annual increases in the common dividends declared and paid and increases in the number of shares outstanding during the period.

Our planned 2014 capital program, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to continue at similar levels as 2013. The 2014 capital program is expected to include \$180,600 for infrastructure rehabilitation surcharge-qualified projects. Our planned capital program includes spending for infrastructure rehabilitation that may qualify for infrastructure rehabilitation surcharge mechanisms, and should these regulatory mechanisms be discontinued for any reason, which is not anticipated, we may re-evaluate the magnitude of this portion of our capital program. Beginning January 1, 2013, Aqua Pennsylvania reset its water DSIC to zero resulting from the change in its tax method of accounting for repair tax deductions as described below. Although we were not eligible to use a DSIC with our Aqua Pennsylvania water customers in 2013, we were able to use the income tax savings derived from the Repair Change to continue to maintain a similar capital investment program as 2012. Our planned 2014 capital program in Pennsylvania is estimated to be \$231,000 a portion of which is expected to be eligible as a repair deduction for federal income tax purposes. Our overall 2014 capital program, along with \$86,288 of sinking fund obligations and debt maturities, and \$152,429 of other contractual cash obligations, as reported in the section captioned "Contractual Obligations", has been, or is expected to be, financed through internally-generated funds, our revolving credit facilities, and the issuance of long-term debt.

Future utility construction in the period 2015 through 2016, including recurring programs, such as the ongoing replacement or rehabilitation of water meters, water mains, water treatment plant upgrades, storage facility renovations, and additional transmission mains to meet customer demands, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to require aggregate expenditures of approximately \$641,000. We anticipate that less than one-half of these expenditures will require external financing. We expect to refinance \$94,545 of sinking fund obligations and debt maturities during this period as they become due with new issues of long-term debt, internally-generated funds, and our

## 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)

revolving credit facilities. The estimates discussed above do not include any amounts for possible future acquisitions of water and wastewater systems or the financing necessary to support them.

Our primary sources of liquidity are cash flows from operations (including the allowed deferral of federal income tax payments), borrowings under various short-term lines of credit and other credit facilities, and customer advances and contributions in aid of construction. Our cash flow from operations, or internally-generated funds, is impacted by the timing of rate relief, water consumption, and changes in federal tax laws with respect to accelerated tax depreciation or deductions for utility construction projects. We fund our capital and acquisition programs through internally-generated funds, supplemented by short-term borrowings. Over time, we partially repay or pay-down our short-term borrowings with long-term debt and when necessary proceeds from the issuance of common stock. The ability to finance our future construction programs, as well as our acquisition activities, depends on our ability to attract the necessary external financing and maintain internally-generated funds. Rate orders permitting compensatory rates of return on invested capital and timely rate adjustments will be required by our operating subsidiaries to achieve an adequate level of earnings and cash flow to enable them to secure the capital they will need to operate and to maintain satisfactory debt coverage ratios.

In December 2012, we changed our tax method of accounting as permitted under Internal Revenue Service ("IRS") regulations for qualifying utility system repairs in Aqua Pennsylvania effective with the tax year ended December 31, 2012 and for prior tax years. The repair tax accounting method was changed to permit the expensing of qualifying utility asset improvement costs that were previously being capitalized and depreciated for book and tax purposes (the "Repair Change"). The Repair Change was implemented in response to a June 2012 rate order issued by the Pennsylvania Public Utility Commission to Aqua Pennsylvania ("settlement agreement") which provides for flow-through accounting treatment of qualifying income tax benefits resulting from the Repair Change. As a result of this settlement agreement, the net 2012 income tax benefits of \$33,565 reduced the Company's Federal and state income tax expense and increased net income in the fourth quarter of 2012. In 2013, the Company recorded additional income tax benefits, as adjusted for the 2012 tax return, of \$14,908. Similar to 2012, the Company recorded \$45,647 of income tax benefits in 2013. The Company recognized a tax deduction on its 2012 Federal tax return of \$380,000 for qualifying capital expenditures made prior to 2012, and based on the settlement agreement, beginning in 2013, the Company began to amortize 1/10<sup>th</sup> of the catch-up adjustment. In accordance with the settlement agreement, the amortization is expected to reduce income tax expense during periods when qualifying parameters are met. During 2013, the Company amortized its catch-up adjustment and recognized \$15,766 of deferred income tax benefits, which reduced income tax expense and increased the Company's net income.

Our planned 2014 capital program is projected to continue at a similar level compared to 2013, and the repair tax deduction is anticipated to continue in 2014 and beyond. Our 2014 earnings will be impacted by the following factors in Aqua Pennsylvania: the repair tax deduction in 2014 is expected to decrease income tax expense by a similar amount as 2013, and the ten year amortization of the catch-up adjustment is also expected to reduce income tax expense; offset by the effect on operating revenue as a result of the DSIC being reset to zero beginning January 1, 2013 and remaining at that level in 2014, and the effect of regulatory lag as we will likely not be filing a request for a base rate increase in Pennsylvania until after 2014. In addition, during 2013, additional income tax benefits were recognized of \$17,736, related to a change in the Company's tax method of accounting for qualifying utility system repairs in some non-Pennsylvania operating divisions, and we are continuing to evaluate the use of a Repair Change in other states where we operate, although the rate treatment afforded in operating divisions outside of Pennsylvania is not expected to have a direct impact on income tax expense.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act") was enacted on December 17, 2010 and provided for an extension of 50% bonus depreciation for qualifying capital additions through 2012 and a 100% expensing allowance for qualifying capital additions placed in service after September 8, 2010 through 2011. A substantial portion of our capital expenditures qualified for 50% bonus depreciation or the 100% expensing allowance. As a result of the Tax Relief Act, the Company's Federal income tax payments were eliminated for tax year 2011 and our net operating cash flows were favorably impacted. In addition, we received a Federal income tax refund in the amount of \$33,600 in

## 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)

October 2011 relating to our 2010 tax return. In the first quarter of 2011, one of our state tax jurisdictions announced that it would recognize the 100% expensing allowance beginning after September 8, 2010 and in 2011. As a result of this guidance and the flow-through treatment afforded by that state's regulatory commission, the net state tax benefit reduced our state income tax expense in 2011 by \$14,800, reduced our effective income tax rate, and increased our earnings by \$0.085 per share. The American Tax Relief Act of 2012 was enacted on January 2, 2013 and provided for an extension of the 50% bonus depreciation for qualifying capital additions for tax year 2013.

#### Acquisitions

During the past five years, we have expended cash of \$156,758 and issued 205,065 shares of common stock, valued at \$2,909 at the time of the acquisition, related to the acquisition of utility systems, both water and wastewater utilities, as well as investments in the natural gas drilling industry. During 2013, we completed 15 acquisitions of water and wastewater utility systems for \$14,997 in cash in four of the states in which we operate.

As part of the Company's growth-through-acquisition strategy, in July 2011, the Company entered into a definitive agreement with American Water to purchase all of the stock of the subsidiary that held American Water's regulated water and wastewater operations in Ohio. American Water's Ohio operations served approximately 59,000 customers. On May 1, 2012, the Company completed its acquisition of American Water's water and wastewater operations in Ohio. The total purchase price at closing consisted of \$102,154 in cash plus specific assumed liabilities, including debt of \$14,281, as adjusted pursuant to the purchase agreement based on book value at closing. The transaction has been accounted for as a business combination. The Ohio acquisition was financed primarily from the proceeds from the January 1, 2012 sale of our Maine subsidiary, the May 1, 2012 sale of our New York subsidiary, and by the issuance of long-term and/or short-term debt. In addition to our Ohio acquisition, during 2012, we completed 16 acquisitions of water and wastewater utility systems for \$19,094 in cash in six of the states in which we operate.

In June 2011, the Company completed its acquisition of approximately 51 water and five wastewater systems in Texas serving approximately 5,300 customers. The total purchase price consisted of \$6,245 in cash. The Company's acquisitions in Ohio and Texas were accretive to the Company's results of operations, however, the pro forma effect of the businesses acquired are not material to the Company's results of operations. In addition to our Texas acquisition, during 2011, we completed eight acquisitions of water and wastewater utility systems for \$2,270 in cash in three of the states in which we operate. During 2010, we completed 23 acquisitions of water and wastewater utility systems in six of the states in which we operate. The 2010 acquisitions were completed for \$8,625 in cash. During 2009, we completed 18 acquisitions of water and wastewater systems in five of the states in which we operate, including expanding our operations into one new state. The 2009 acquisitions were completed for \$3,373 in cash and the issuance of 205,065 shares of common stock valued at \$2,909 at the time of the acquisition.

We included the operating results of these acquisitions in our consolidated financial statements beginning on the respective acquisition dates.

We continue to hold acquisition discussions with several water and wastewater systems. Our typical acquisitions are expected to be financed with short-term debt with subsequent repayment from the proceeds of long-term debt, retained earnings, or equity issuances.

In September 2011, one of our subsidiaries entered into a joint venture with a firm that operates natural gas pipelines and processing plants for the construction and operation of a private pipeline system to supply raw water to natural gas well drilling operations in the Marcellus Shale in north-central Pennsylvania. The initial 18-mile pipeline commenced operations in the second quarter of 2012. The initial pipeline system was expanded for an additional 38 miles with a permitted intake on the Susquehanna River, which extended the pipeline to additional drillers. The total cost of this pipeline was \$109,000. This project marks an expansion of our growth venture in serving the raw water needs of firms in the natural gas drilling industry. The joint venture has entered into water supply contract with natural gas drilling companies and negotiations continue with other area drilling companies. As of December 31, 2013, our capital contributions since inception totaled \$53,643 in cash. This investment has been financed through the issuance of long-term debt. Our

## 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)*

49% investment in this joint venture is as an unconsolidated affiliate and is accounted for under the equity method of accounting. Our investment is carried at cost, including capital contributions or distributions and our equity in earnings and losses since the commencement of the system's operations. Since some practices for natural gas drilling require a large quantity of raw water in order to extract gas, we are continuing to hold exploratory discussions with other natural gas drilling companies about their needs for raw water supply.

#### **Dispositions**

We routinely review and evaluate areas of our business and operating divisions and, over time, may sell utility systems or portions of systems. In 2010, 2011, 2012, and 2013, in accordance with our strategy to focus our resources on states where we have critical mass to improve our economies of scale and expect future economic growth, we sold water and wastewater systems in five states: South Carolina, Missouri, Maine, New York, and Florida. With respect to the sale of our systems in Missouri and the sale of our systems in New York, we acquired additional utility systems in Texas and in Ohio.

In March, April, and December 2013, through five separate sales transactions, we completed the sale of our water and wastewater utility systems in Florida, which concluded our regulated operations in Florida. The Company received total net proceeds from these sales of \$88,934, and recognized a gain on sale of \$21,178 (\$13,766 after-tax). One of our sales in Florida, which was completed in March 2013, and represented approximately 8% of our customers served in Florida, remains subject to customary regulatory review, for which we expect to receive the regulator's decision by midyear 2014. If the regulator does not approve this sale, the purchase price would be refunded and the assets sold would revert back to the Company.

In June 2013, the Company sold a water and wastewater utility system for net proceeds of \$3,400. The sale resulted in the recognition of a gain on sale of these assets, net of expenses, of \$1,025 (\$615 after-tax). The utility system represented approximately 0.04% of the Company's total assets.

In July 2011, the Company entered into a definitive agreement with Connecticut Water Service, Inc. to sell its operations in Maine, which served approximately 16,000 customers, for cash at closing plus specific assumed liabilities, including debt of \$17,364. On January 1, 2012, we completed the sale for net proceeds of \$36,870, and recognized a gain on sale of \$17,699 (\$10,821 after-tax). The sale of our Maine operations concluded our regulated operations in Maine. The proceeds were used to finance a portion of our acquisition of American Water's Ohio subsidiary, pay-down a portion of our short-term debt, and other general corporate purposes.

In July 2011, the Company entered into a definitive agreement with American Water to sell its operations in New York for its book value at closing plus specific assumed liabilities, including debt of approximately \$23,000. On May 1, 2012, the Company completed the sale for net proceeds of \$36,688 in cash as adjusted pursuant to the sale agreement based on book value at closing. The Company's New York operations served approximately 51,000 customers. The sale of our New York operations concluded our regulated operations in New York. The proceeds were used to finance a portion of our acquisition of American Water's Ohio subsidiary, pay-down a portion of our short-term debt, and other general corporate purposes.

In June 2011, we sold a water and wastewater utility system for net proceeds of \$4,106. The sale resulted in the recognition of a gain on the sale, net of expenses, of \$2,692 (\$1,615 after-tax), and is reported in the consolidated statement of net income as a reduction to operations and maintenance expense. The utility system represented approximately 0.03% of Aqua America's total assets. In May 2011, we sold our regulated water and wastewater operations in Missouri for net proceeds of \$3,225, resulting in a small gain on sale. The sale of our utility operations in Missouri represented approximately 0.07% of Aqua America's total assets. In January 2011, we sold a water and wastewater utility system for net proceeds of \$3,118. The sale resulted in the recognition of a gain on the sale, net of expenses, of \$2,452 (\$1,471 after-tax). The utility system represented approximately 0.01% of Aqua America's total assets. The gain is reported in the consolidated statement of net income as a reduction to operations and maintenance expense.

In June 2009, we sold a water and wastewater utility system for net proceeds of \$1,601, which was in excess of the book value for these assets. The proceeds were used to pay-down short-term debt and the sale resulted in the recognition in 2009 of a gain on the sale of these assets, net of expenses of \$1,009 (\$605 after-



## 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)*

tax). The gain is reported in the 2009 consolidated statement of net income as a reduction to operations and maintenance expense. These utility systems represented approximately 0.02% of Aqua America's total assets.

The City of Fort Wayne, Indiana (the "City") has authorized the acquisition by eminent domain of the northern portion of the utility system of one of the Company's operating subsidiaries in Indiana, Utility Center, Inc., (the "Northern Assets"). In January 2008, the Company reached a settlement with the City to transition the Northern Assets in February 2008 upon receipt of the City's initial valuation payment of \$16,911. The settlement agreement specifically stated that the final valuation of the Northern Assets will be determined through a continuation of the legal proceedings that were filed challenging the City's valuation. On February 12, 2008, the Company turned over the Northern Assets to the City upon receipt of the initial valuation payment. The proceeds received by the Company are in excess of the book value of the assets relinquished. No gain has been recognized due to the contingency over the final valuation of the assets. The net book value of the Northern Assets has been removed from the consolidated balance sheet and the difference between the net book value and the initial payment received has been deferred and is recorded in other accrued liabilities on the Company's consolidated balance sheet. Once the contingency is resolved and the asset valuation is finalized, through the finalization of the litigation between the Company and the City, the amounts deferred will be recognized in the Company's consolidated statement of net income. On March 16, 2009, oral argument was held on procedural aspects with respect to the valuation evidence that may be presented and whether the Company is entitled to a jury trial. On October 12, 2010, the Wells County Indiana Circuit Court ruled that the Company is not entitled to a jury trial, and that the Wells County judge should review the City of Fort Wayne Board of Public Works' assessment based upon a "capricious, arbitrary or an abuse of discretion" standard. The Company disagreed with the Court's decision and appealed the Wells County Indiana Circuit Court's decision to the Indiana Court of Appeals. On January 13, 2012, the Indiana Court of Appeals reached a decision upholding the Wells County Indiana Circuit Court decision. On February 10, 2012, the Company filed a petition for transfer requesting that the Indiana Supreme Court review the matter. On April 11, 2013, the Supreme Court of Indiana ruled that the statute at issue gives the Company the right to a full evidentiary hearing before a jury regarding the value of the assets and remanded the case to the trial court for a proceeding consistent with that ruling. The Company continues to evaluate its legal options with respect to this decision. Depending upon the outcome of all of the legal proceedings, including the planned transaction below, which would resolve this litigation, the Company may be required to refund a portion of the initial valuation payment, or may receive additional proceeds. The Northern Assets relinquished represents approximately 0.4% of the Company's total assets.

In addition, in December 2012, the Fort Wayne City Council considered an ordinance that sought to declare it a "public convenience and necessity" to acquire some of the Company's water utility system assets located in the southwest section of the City and in Allen County (the "Southern Assets"), and if negotiations with Fort Wayne officials were to fail, to condemn the Southern Assets. The first public hearing on the ordinance was held on January 22, 2013 and a subsequent hearing scheduled for February 5, 2013 was not held due to ongoing settlement discussions between the parties. On July 2, 2013, the Company's operating subsidiary and the City signed a letter of intent, which among other items, addresses many of the terms by which the City would purchase the Company's Southern Assets, will resolve the litigation between the Company and the City with respect to the Northern Assets, and will establish the terms by which the Company's remaining operating subsidiary will treat wastewater sent to it by the City. The letter of intent states that the City agrees to pay the Company \$50,100 for the Northern Assets and Southern Assets in addition to the \$16,911 paid to the Company by the City in 2008 as an initial valuation payment for the Northern Assets (for a total payment of \$67,011). The letter of intent is conditioned on the Company's Board of Directors and City Council approving the final terms of the proposed transaction, and the Company and the City entering into several definitive agreements that detail the subject matter of the letter of intent. On February 27, 2014, the Company's Board of Directors authorized management to enter into agreements with the City on terms and conditions that are consistent with the July 2, 2013 letter of intent, for among other items, the sale of the Company's Northern Assets and Southern Assets to the City. Further, the completion of the transaction is subject to regulatory requirements and approval. If this transaction is consummated, the Company will relinquish its water utility system yet expand its sewer customer base in the City. The completion of the

## 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)

transaction is not expected to close until the third quarter of 2014. The Company continues to evaluate its legal and operational options on an ongoing basis.

Despite these transactions, our primary strategy continues to be to acquire additional water and wastewater systems, to maintain our existing systems where there is a strategic business benefit, and to actively oppose unilateral efforts by municipal governments to acquire any of our operations.

The Company is routinely involved in other legal matters, including both asserted and unasserted legal claims, during the ordinary course of business. See Note 9 – Commitments and Contingencies of the consolidated financial statements for a discussion of the Company's legal matters. It is not always possible for management to make a meaningful estimate of the potential loss or range of loss associated with such litigation. Also, unanticipated changes in circumstances and/or revisions to the assessed probability of the outcomes of legal matters could result in expenses being incurred in future periods as well as an increase in actual cash required to resolve the legal matter.

#### Sources of Capital

Since net operating cash flow plus advances and contributions in aid of construction have not been sufficient to fully fund cash requirements, we issued approximately \$745,112 of long-term debt and obtained other short-term borrowings during the past five years. At December 31, 2013, we have a \$150,000 long-term revolving credit facility that expires in March 2017, of which \$24,428 was designated for letter of credit usage, \$125,572 was available for borrowing and no borrowings were outstanding at December 31, 2013. In addition, we have short-term lines of credit of \$160,500, of which \$123,760 was available. These short-term lines of credit 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.

Our 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.

We are obligated to comply with covenants under some of our loan and debt agreements. These covenants contain a number of restrictive financial covenants, which among other things limit, subject to specific exceptions, the Company's ratio of consolidated total indebtedness to consolidated total capitalization, and require a minimum level of earnings coverage over interest expense. During 2013, we were in compliance with our debt covenants under our credit facilities. Failure to comply with our debt covenants could result in an event of default, which could result in us being required to repay or finance our borrowings before their due date, possibly limiting our future borrowings, and increasing our borrowing costs.

In February 2012, we renewed our universal shelf registration, which expired in December 2011, through a filing with the Securities and Exchange Commission ("SEC") which allows for the potential future offer and sale by us, from time to time, in one or more public offerings, of an indeterminate amount of our common stock, preferred stock, debt securities, and other securities specified therein at indeterminate prices. The Company's Board of Directors has authorized the Company to issue up to \$500,000 of our common stock, preferred stock, debt securities, and other securities specified therein under this universal shelf registration statement. No issues have been completed to date under this shelf registration statement.

In addition, we have a shelf registration statement filed with the SEC to permit the offering from time to time of shares of common stock and shares of preferred stock in connection with acquisitions. During 2013, 2012, 2011, and 2010, we did not issue any shares under the acquisition shelf registration. During 2009, we issued 205,065 shares of common stock totaling \$2,909 to acquire a water system. The balance remaining available for use under the acquisition shelf registration as of December 31, 2013 is 1,904,487 shares. We will determine the form and terms of any securities issued under these shelf registrations at the time of issuance.

We offer a Dividend Reinvestment and Direct Stock Purchase Plan (the "Plan") that provides a convenient and economical way to purchase shares of the Company. Under the direct stock purchase portion of the Plan, shares are sold throughout the year. The dividend reinvestment portion of the Plan offers a 5%

## 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)*

discount on the purchase of shares of common stock with reinvested dividends. As of the December 2013 dividend payment, holders of 13.1% of the common shares outstanding participated in the dividend reinvestment portion of the Plan. The shares issued under the Plan are either original issue shares or shares purchased by the Company's transfer agent in the open-market. During the past five years, we have sold 3,588,168 original issue shares of common stock for net proceeds of \$58,635 through the dividend reinvestment portion of the Plan, and we used the proceeds to invest in our operating subsidiaries, to repay short-term debt, and for general corporate purposes. In 2013, 154,900 shares of the Company were purchased under the dividend reinvestment portion of the Plan by the Company's transfer agent in the open-market for \$3,693.

The Board of Directors has authorized us to purchase our common stock, from time to time, in the open market or through privately negotiated transactions. As of December 31, 2013, 685,348 shares remain available for repurchase. Funding for future stock purchases, if any, is not expected to have a material impact on our financial position.

In May 2013 the Board of Directors approved a five-for-four stock split to be effected in the form of a 25% stock distribution to shareholders of record on August 16, 2013. Common shares outstanding do not include shares held by the Company in treasury. The new shares were distributed on September 1, 2013. Aqua America's par value of \$0.50 per share did not change as a result of the common stock distribution, and \$17,655 was transferred from capital in excess of par value to common stock to record the stock split.

#### **Off-Balance Sheet Financing Arrangements**

We do not engage in any off-balance sheet financing arrangements. We do not have any interest in entities referred to as variable interest entities, which includes special purpose entities and other structured finance entities.

# 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)

### Contractual Obligations

The following table summarizes our contractual cash obligations as of December 31, 2013:

	Total	Payments Due By Period			
		Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
Long-term debt (1)	\$ 1,554,871	\$ 86,288	\$ 94,545	\$ 107,013	\$ 1,267,025
Interest on fixed-rate, long-term debt (2)	1,218,782	77,512	143,861	137,360	860,049
Operating leases (3)	21,809	2,659	3,468	1,790	13,892
Unconditional purchase obligations (4)	79,911	12,637	26,147	12,579	28,548
Other purchase obligations (5)	38,038	38,038	-	-	-
Pension and other post-retirement benefit plans' obligations (6)	20,638	20,638	-	-	-
Other obligations (7)	20,534	945	1,951	6,236	11,402
<b>Total</b>	<b>\$ 2,954,583</b>	<b>\$ 238,717</b>	<b>\$ 269,972</b>	<b>\$ 264,978</b>	<b>\$ 2,180,916</b>

- (1) Represents sinking fund obligations and debt maturities.
- (2) Represents interest payable on fixed rate, long-term debt. Amounts reported may differ from actual due to future refinancing of debt.
- (3) Represents operating leases that are noncancelable, before expiration, for the lease of motor vehicles, buildings, land and other equipment.
- (4) Represents our commitment to purchase minimum quantities of water as stipulated in agreements with other water purveyors. We use purchased water to supplement our water supply, particularly during periods of peak customer demand. Our actual purchases may exceed the minimum required levels.
- (5) Represents an approximation of the open purchase orders for goods and services purchased in the ordinary course of business.
- (6) Represents contributions contractually obligated to be made to pension and other post-retirement benefit plans.
- (7) Represents expenditures estimated to be required under legal and binding contractual obligations.

In addition to these obligations, we pay refunds on customers' advances for construction over a specific period of time based on operating revenues related to developer-installed water mains or as new customers are connected to and take service from such mains. After all refunds are paid, any remaining balance is transferred to contributions in aid of construction. The refund amounts are not included in the above table because the refund amounts and timing are dependent upon several variables, including new customer connections, customer consumption levels and future rate increases, which cannot be accurately estimated. Portions of these refund amounts are payable annually through 2023 and amounts not paid by the contract expiration dates become non-refundable.

In addition to the obligations disclosed in the contractual obligations table above, we have uncertain tax positions of \$28,690. Although we believe our tax positions comply with applicable law, we have made judgments as to the sustainability of each uncertain tax position based on its technical merits. Due to the uncertainty of future cash outflows, if any, associated with our uncertain tax positions, we are unable to make a reasonable estimate of the timing or amounts that may be paid.

We will fund these contractual obligations with cash flows from operations and liquidity sources held by or available to us.

# 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)

### Market Risk

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. The exposure to changes in interest rates is a result of financings through the issuance of fixed rate, long-term debt. Such exposure is typically related to financings between utility rate increases, because generally our rate increases provide a revenue level to allow recovery of our current cost of capital. Interest rate risk is managed through the use of a combination of long-term debt, which is at fixed interest rates and short-term debt, which is at floating interest rates. As of December 31, 2013, the debt maturities by period and the weighted average interest rate for long-term debt are as follows:

	2014	2015	2016	2017	2018	Thereafter	Total	Fair Value
Long-term debt:								
Fixed rate	\$ 86,288	\$ 58,695	\$ 35,850	\$ 53,019	\$ 53,994	\$ 1,267,025	\$ 1,554,871	\$ 1,540,296
Variable rate	-	-	-	-	-	-	-	-
Total	\$ 86,288	\$ 58,695	\$ 35,850	\$ 53,019	\$ 53,994	\$ 1,267,025	\$ 1,554,871	\$ 1,540,296
Weighted average interest rate	5.18%	5.19%	4.81%	5.14%	6.32%	4.90%	5.00%	

From time to time, we make investments in marketable equity securities. As a result, we are exposed to the risk of changes in equity prices for the "available for sale" marketable equity securities. As of December 31, 2013, the carrying value of these investments, which reflects market value, was \$196.

### Capitalization

The following table summarizes our capitalization during the past five years:

December 31,	2013	2012	2011	2010	2009
Long-term debt (1)	50.3%	53.4%	54.8%	57.0%	56.6%
Aqua America stockholders' equity	49.7%	46.6%	45.2%	43.0%	43.4%
	100.0%	100.0%	100.0%	100.0%	100.0%

(1) Includes current portion, as well as our borrowings under a variable rate revolving credit agreement of \$0 at December 31, 2013 and \$100,000 at December 31, 2012.

Over the past five years, the changes in the capitalization ratios primarily resulted from the issuance of common stock, the issuance of debt to finance our acquisitions and capital program, growth in net income, and the declaration of dividends. It is our goal to maintain an equity ratio adequate to support the current Standard and Poor's corporate credit rating of "A+" and the senior secured debt rating of "AA-" for Aqua Pennsylvania, our largest operating subsidiary.

### Dividends on Common Stock

We have paid common dividends consecutively for 69 years. Effective May 8, 2013, our Board of Directors authorized an increase of 8.6% in the September 1, 2013 quarterly dividend over the dividend we paid in the previous quarter. As a result of this authorization, beginning with the dividend payment in September 2013, the annualized dividend rate increased to \$0.608 per share from \$0.560 per share. This is the 23<sup>rd</sup> dividend increase in the past 22 years and the 15<sup>th</sup> consecutive year that we have increased our dividend in excess of five percent. We presently intend to pay quarterly cash dividends in the future, on March 1, June 1, September 1, and December 1, subject to our earnings and financial condition, restrictions set forth in our debt instruments, regulatory requirements and such other factors as our Board of Directors may deem relevant. During the past five years, our common dividends paid have averaged 55.6% of net income attributable to common shareholders.

## 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)

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our financial condition and results of operations are impacted by the methods, assumptions, and estimates used in the application of critical accounting policies. The following accounting policies are particularly important to our financial condition or results of operations, and require estimates or other judgments of matters of uncertainty. Changes in the estimates or other judgments included within these accounting policies could result in a significant change to the financial statements. We believe our most critical accounting policies include revenue recognition, the use of regulatory assets and liabilities, the valuation of our long-lived assets, which consist primarily of utility plant in service, regulatory assets, and goodwill, our accounting for post-retirement benefits, and our accounting for income taxes. We have discussed the selection and development of our critical accounting policies and estimates with the Audit Committee of the Board of Directors.

**Revenue Recognition** — Our utility revenues recognized in an accounting period include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the last billing to the end of the accounting period. The estimated usage is based on our judgment and assumptions; our actual results could differ from these estimates, which would result in operating revenues being adjusted in the period that the revision to our estimates is determined.

In some operating divisions, we commence the billing of our utility customers, under new rates, upon authorization from the respective regulatory commission and before the final commission rate order is issued. The revenue recognized reflects an estimate based on our judgment of the final outcome of the commission's ruling. We monitor the applicable facts and circumstances regularly, and revise the estimate as required. The revenue billed and collected prior to the final ruling is subject to refund based on the commission's final ruling.

**Regulatory Assets and Liabilities** — We defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that these costs and credits will be recognized in the rate-making process in a period different from when the costs and credits were incurred. These deferred amounts, both assets and liabilities, are then recognized in the income statement in the same period that they are reflected in our rates charged for water or wastewater service. In the event that our assessment as to the probability of the inclusion in the rate-making process is incorrect, the associated regulatory asset or liability would be adjusted to reflect the change in our assessment or change in regulatory approval.

**Valuation of Long-Lived Assets, Goodwill and Intangible Assets** — We review our long-lived assets for impairment, including utility plant in service and investment in joint venture. We also review regulatory assets for the continued application of the FASB's accounting guidance for regulated operations. Our review determines whether there have been changes in circumstances or events that have occurred that require adjustments to the carrying value of these assets. Adjustments to the carrying value of these assets would be made in instances where their inclusion in the rate-making process is unlikely.

We test the goodwill attributable to each of our reporting units for impairment at least annually on July 31, or more often, if circumstances indicate a possible impairment may exist. When testing goodwill for impairment, we may assess qualitative factors for some or all of our reporting units to determine whether it's more likely than not that the fair value of a reporting unit is less than its carrying amount. Alternatively, we may bypass this qualitative assessment for some of our reporting units and perform step 1 of the quantitative two-step goodwill impairment test. If we perform step 1 and determine that the fair value of a reporting unit is less than its carrying amount, we would perform step 2 to measure such impairment. The assessment requires significant management judgment and estimates that are based on budgets, general strategic business plans, historical trends and other data and relevant factors. If changes in circumstances or events occur, or estimates and assumptions that were used in our impairment test change, we may be required to record an impairment charge for goodwill. Based on our comparison of the estimated fair value of each reporting unit to their respective carrying amounts, the impairment test performed in 2013 concluded that the estimated fair value of each reporting unit, which has goodwill recorded, exceeded the reporting unit's carrying amount by at least 55%, for reporting units that were tested quantitatively, indicating that none of our goodwill was impaired.

## 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)

**Accounting for Post-Retirement Benefits**— We maintain qualified defined benefit pension plans and plans that provide for post-retirement benefits other than pensions. Accounting for pensions and other post-retirement benefits requires an extensive use of assumptions about the discount rate, expected return on plan assets, the rate of future compensation increases received by our employees, mortality, turnover and medical costs. Each assumption is reviewed annually with assistance from our actuarial consultant, who provides guidance in establishing the assumptions. The assumptions are selected to represent the average expected experience over time and may differ in any one year from actual experience due to changes in capital markets and the overall economy. These differences will impact the amount of pension and other post-retirement benefit expense that we recognize.

Our discount rate assumption was determined by selecting a hypothetical portfolio of high quality corporate bonds appropriate to provide for the projected benefit payments of the plan. The selected bond portfolio was derived from a universe of Aa-graded corporate bonds, all of which were noncallable (or callable with make-whole provisions), and have at least \$50,000 in outstanding value. The discount rate was then developed as the single rate that equates the market value of the bonds purchased to the discounted value of the plan's benefit payments. Our pension expense and liability (benefit obligations) increases as the discount rate is reduced. A 25 basis-point reduction in this assumption would have increased 2013 pension expense by \$898 and the pension liabilities by \$10,270. The present values of Aqua America's future pension and other post-retirement obligations were determined using discount rates of 5.12% at December 31, 2013 and 4.17% at December 31, 2012. Our expense under these plans is determined using the discount rate as of the beginning of the year, which was 4.17% for 2013, and will be 5.12% for 2014. In 2012, our pension benefits were re-measured as of May 1, 2012 to reflect the pension benefits assumed in our Ohio acquisition. The expense for 2012 was determined using a 5.00% discount rate for the period January 1, 2012 – April 30, 2012 and 4.70% for the period May 1, 2012 – December 31, 2012.

Our expected return on assets is determined by evaluating the asset class return expectations with our advisors as well as actual, long-term, historical results of our asset returns. The Company's market-related value of plan assets is equal to the fair value of the plan assets as of the last day of its fiscal year, and is a determinant for the expected return on assets, which is a component of net pension expense. Our pension expense increases as the expected return on assets decreases. A 25-basis-point reduction in this assumption would have increased 2013 pension expense by \$492. For 2013, we used a 7.50% expected return on assets assumption which will remain unchanged for 2014. The expected return on assets is based on a targeted allocation of 25% to 75% domestic equities, 0% to 10% international equities, 25% to 50% fixed income, 0% to 5% alternative investments, and 0% to 20% cash and cash equivalents. We believe that our actual long-term asset allocation on average will approximate the targeted allocation. Our targeted allocation is driven by the investment strategy to earn a reasonable rate of return while maintaining risk at acceptable levels through the diversification of investments across and within various asset categories.

Funding requirements for qualified defined benefit pension plans are determined by government regulations and not by accounting pronouncements. In accordance with funding rules and our funding policy, during 2014 our pension contribution is expected to approximate \$17,875. Future years' contributions will be subject to economic conditions, plan participant data and the funding rules in effect at such time as the funding calculations are performed, though we expect future changes in the amount of contributions and expense recognized to be generally included in customer rates. During 2014, our funding of other post-retirement benefit plans are expected to approximate \$2,763.

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

## 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)*

Our determination of what qualifies as a capital cost versus a repair expense tax deduction as it relates to our repair tax accounting method change beginning in 2012 is subject to subsequent adjustment as well as IRS audits, changes in tax laws, the expiration of a statute of limitations, or other unforeseen matters, and could impact the tax benefits that have already been recognized. We establish reserves for uncertain tax positions based upon management's judgment as to the sustainability of these positions. These accounting estimates related to the uncertain tax position reserve require judgments to be made as to the sustainability of each uncertain tax position based on its technical merits. We believe our tax positions comply with applicable law and that we have adequately recorded reserves as required. However, to the extent the final tax outcome of these matters is different than our estimates recorded, we would then need to adjust our tax reserves which could result in additional income tax expense or benefits in the period that this information is known.

### **IMPACT OF RECENT ACCOUNTING PRONOUNCEMENTS**

We describe the impact of recent accounting pronouncements in Note 1 – Summary of Significant Accounting Policies, of the consolidated financial statements.



**AQUA AMERICA, INC. AND SUBSIDIARIES**  
**Management's Report On Internal Control Over Financial Reporting**

Management of Aqua America, Inc. (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. The Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

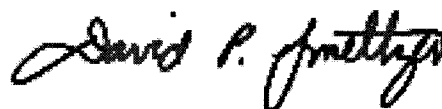
Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In assessing the effectiveness of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in *Internal Control-Integrated Framework* (1992). As a result of management's assessment and based on the criteria in the framework, management has concluded that, as of December 31, 2013, the Company's internal control over financial reporting was effective.

The effectiveness of our internal control over financial reporting as of December 31, 2013 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.



Nicholas DeBenedictis  
*Chairman, President and Chief Executive Officer*



David P. Smeltzer  
*Executive Vice President and Chief Financial Officer*

March 3, 2014

## Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders  
of Aqua America, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of net income, of comprehensive income, of capitalization, of equity and of cash flows present fairly, in all material respects, the financial position of Aqua America, Inc. and its subsidiaries at December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 Framework) (“COSO”). The Company’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control Over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company’s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we consider necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



PricewaterhouseCoopers LLP  
Philadelphia, Pennsylvania  
March 3, 2014

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF NET INCOME  
(In thousands of dollars, except per share amounts)  
Years ended December 31, 2013, 2012, and 2011

	2013	2012	2011
Operating revenues	\$ 768,643	\$ 757,760	\$ 687,291
Operating costs and expenses:			
Operations and maintenance	285,340	271,843	256,743
Depreciation	119,258	111,767	103,412
Amortization	5,535	5,229	4,888
Taxes other than income taxes	53,268	47,404	41,449
	<u>463,401</u>	<u>436,243</u>	<u>406,492</u>
Operating income	305,242	321,517	280,799
Other expense (income):			
Interest expense, net	77,316	77,757	77,804
Allowance for funds used during construction	(2,274)	(4,142)	(7,150)
Gain on sale of other assets	(148)	(1,090)	(649)
Equity loss (earnings) in joint venture	2,665	(1,976)	-
Income from continuing operations before income taxes	<u>227,683</u>	<u>250,968</u>	<u>210,794</u>
Provision for income taxes	22,690	66,881	69,111
Income from continuing operations	<u>204,993</u>	<u>184,087</u>	<u>141,683</u>
Discontinued operations:			
Income from discontinued operations before income taxes	24,732	20,493	14,279
Provision for income taxes	8,425	8,017	12,893
Income from discontinued operations	<u>16,307</u>	<u>12,476</u>	<u>1,386</u>
Net income attributable to common shareholders	<u>\$ 221,300</u>	<u>\$ 196,563</u>	<u>\$ 143,069</u>
Income from continuing operations per share:			
Basic	<u>\$ 1.16</u>	<u>\$ 1.06</u>	<u>\$ 0.82</u>
Diluted	<u>\$ 1.16</u>	<u>\$ 1.05</u>	<u>\$ 0.82</u>
Income from discontinued operations per share:			
Basic	<u>\$ 0.09</u>	<u>\$ 0.07</u>	<u>\$ 0.01</u>
Diluted	<u>\$ 0.09</u>	<u>\$ 0.07</u>	<u>\$ 0.01</u>
Net income per common share:			
Basic	<u>\$ 1.26</u>	<u>\$ 1.13</u>	<u>\$ 0.83</u>
Diluted	<u>\$ 1.25</u>	<u>\$ 1.12</u>	<u>\$ 0.83</u>
Average common shares outstanding during the period:			
Basic	<u>176,140</u>	<u>174,201</u>	<u>172,727</u>
Diluted	<u>176,814</u>	<u>174,918</u>	<u>173,361</u>
Cash dividends declared per common share	<u>\$ 0.584</u>	<u>\$ 0.536</u>	<u>\$ 0.504</u>

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(In thousands of dollars)  
Years ended December 31, 2013, 2012, and 2011

	2013	2012	2011
Net income attributable to common shareholders	\$ 221,300	\$ 196,563	\$ 143,069
Other comprehensive income, net of tax:			
Unrealized holding gain (loss) on investments, net of tax of \$76, \$106, and \$(5) for the years ended December 31, 2013, 2012, and 2011, respectively	141	198	(10)
Reclassification adjustment for loss (gain) reported in net income, net of tax (benefit) of \$(49), \$182, and \$125 for the twelve months ended December 31, 2013, 2012, and 2011, respectively (1)	90	(339)	(233)
Comprehensive income	<u>\$ 221,531</u>	<u>\$ 196,422</u>	<u>\$ 142,826</u>

See accompanying notes to consolidated financial statements.

(1) Amount of pre-tax loss (gain) of \$139, \$(521), and \$(358) reclassified from accumulated other comprehensive income to loss (gain) on sale of other assets on the consolidated statements of net income for the years ended December 31, 2013, 2012, and 2011, respectively.

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(In thousands of dollars, except per share amounts)  
December 31, 2013 and 2012

	2013	2012
Assets		
Property, plant and equipment, at cost	\$ 5,387,852	\$ 5,050,400
Less: accumulated depreciation	1,220,559	1,114,237
Net property, plant and equipment	4,167,293	3,936,163
Current assets:		
Cash and cash equivalents	5,058	5,521
Accounts receivable and unbilled revenues, net	95,356	92,921
Income tax receivable	7,873	16,082
Deferred income taxes	40,038	37,818
Inventory, materials and supplies	11,438	11,757
Prepayments and other current assets	11,112	10,372
Assets of discontinued operations held for sale	794	86,423
Total current assets	171,669	260,894
Regulatory assets	585,600	521,264
Deferred charges and other assets, net	50,290	49,852
Investment in joint venture	48,695	38,620
Funds restricted for construction activity	47	23,572
Goodwill	28,223	28,152
	\$ 5,051,817	\$ 4,858,517
Liabilities and Equity		
Aqua America stockholders' equity:		
Common stock at \$.50 par value, authorized 300,000,000 shares, issued 177,928,922 and 175,985,437 in 2013 and 2012	\$ 88,964	\$ 70,472
Capital in excess of par value	743,335	718,482
Retained earnings	729,272	611,303
Treasury stock, at cost, 1,178,323 and 776,355 shares in 2013 and 2012	(27,082)	(14,668)
Accumulated other comprehensive income	346	115
Total Aqua America stockholders' equity	1,534,835	1,385,704
Noncontrolling interest	208	188
Total Equity	1,535,043	1,385,892
Long-term debt, excluding current portion	1,468,583	1,543,954
Commitments and contingencies (See Note 9)	-	-
Current liabilities:		
Current portion of long-term debt	86,288	45,038
Loans payable	36,740	80,383
Accounts payable	65,816	55,506
Accrued interest	13,615	14,026
Accrued taxes	15,442	28,214
Other accrued liabilities	34,193	27,360
Liabilities of discontinued operations held for sale	14,816	23,637
Total current liabilities	266,910	274,164
Deferred credits and other liabilities:		
Deferred income taxes and investment tax credits	867,880	723,367
Customers' advances for construction	74,257	71,595
Regulatory liabilities	281,014	241,363
Other	81,552	157,978
Total deferred credits and other liabilities	1,304,703	1,194,303
Contributions in aid of construction	476,578	460,204
	\$ 5,051,817	\$ 4,858,517

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CAPITALIZATION  
(In thousands of dollars, except per share amounts)  
December 31, 2013 and 2012

	2013	2012
Aqua America stockholders' equity:		
Common stock, \$.50 par value	\$ 88,964	\$ 70,472
Capital in excess of par value	743,335	718,482
Retained earnings	729,272	611,303
Treasury stock, at cost	(27,082)	(14,668)
Accumulated other comprehensive income	346	115
Total Aqua America stockholders' equity	1,534,835	1,385,704
Noncontrolling interest	208	188
Total equity	1,535,043	1,385,892
Long-term debt of subsidiaries (substantially secured by utility plant):		
<u>Interest Rate Range</u>	<u>Maturity Date Range</u>	
0.00% to 0.99%	2023 to 2033	5,035
1.00% to 1.99%	2014 to 2035	28,615
2.00% to 2.99%	2024 to 2031	14,903
3.00% to 3.99%	2016 to 2047	167,365
4.00% to 4.99%	2020 to 2048	447,297
5.00% to 5.99%	2014 to 2043	284,362
6.00% to 6.99%	2015 to 2036	64,923
7.00% to 7.99%	2022 to 2027	35,056
8.00% to 8.99%	2021 to 2025	19,283
9.00% to 9.99%	2018 to 2026	28,500
10.00% to 10.99%	2018	6,000
	1,101,339	1,003,860
Notes payable to bank under revolving credit agreement, variable rate, due March 2017	-	100,000
Unsecured notes payable:		
Notes at 3.57% due 2027	50,000	50,000
Notes ranging from 4.62% to 4.87%, due 2014 through 2024	171,400	193,000
Notes ranging from 5.01% to 5.95%, due 2014 through 2037	232,132	242,132
	1,554,871	1,588,992
Current portion of long-term debt	86,288	45,038
Long-term debt, excluding current portion	1,468,583	1,543,954
Total capitalization	\$ 3,003,626	\$ 2,929,846

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF EQUITY  
(In thousands of dollars)

	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Accumulated Other Comprehensive Income	Noncontrolling Interest	Total
Balance at December 31, 2010	\$ 69,223	\$ 664,369	\$ 452,470	\$ (12,307)	\$ 499	\$ 572	\$ 1,174,826
Net income	-	-	143,069	-	-	14	143,083
Purchase of subsidiary shares from noncontrolling interest	-	-	-	-	-	(82)	(82)
Other comprehensive loss, net of income tax of \$130	-	-	-	-	(243)	-	(243)
Dividends	-	-	(87,133)	-	-	-	(87,133)
Sale of stock (753,958 shares)	295	11,987	-	325	-	-	12,607
Repurchase of stock (51,431 shares)	-	-	-	(1,163)	-	-	(1,163)
Equity Compensation Plan (79,133 shares)	32	(32)	-	-	-	-	-
Exercise of stock options (530,613 shares)	212	6,391	-	-	-	-	6,603
Stock-based compensation	-	3,964	(72)	-	-	-	3,892
Employee stock plan tax benefits	-	(573)	-	-	-	-	(573)
Balance at December 31, 2011	69,762	686,106	508,334	(13,145)	256	504	1,251,817
Net income	-	-	196,563	-	-	17	196,580
Purchase of subsidiary shares from noncontrolling interest	-	-	-	-	-	(333)	(333)
Other comprehensive loss, net of income tax of \$76	-	-	-	-	(141)	-	(141)
Dividends	-	-	(93,423)	-	-	-	(93,423)
Sale of stock (726,093 shares)	285	12,610	-	295	-	-	13,190
Repurchase of stock (77,355 shares)	-	-	-	(1,818)	-	-	(1,818)
Equity Compensation Plan (19,015 shares)	8	(8)	-	-	-	-	-
Exercise of stock options (1,041,796 shares)	417	14,181	-	-	-	-	14,598
Stock-based compensation	-	5,593	(171)	-	-	-	5,422
Balance at December 31, 2012	70,472	718,482	611,303	(14,668)	115	188	1,385,892
Net income	-	-	221,300	-	-	20	221,320
Other comprehensive gain, net of income tax of \$125	-	-	-	-	231	-	231
Dividends	-	-	(102,889)	-	-	-	(102,889)
Stock split	17,655	(17,655)	-	-	-	-	-
Sale of stock (449,129 shares)	188	9,693	-	409	-	-	10,290
Repurchase of stock (415,233 shares)	-	-	-	(12,823)	-	-	(12,823)
Equity Compensation Plan (43,500 shares)	17	(17)	-	-	-	-	-
Exercise of stock options (1,566,089 shares)	632	25,066	-	-	-	-	25,698
Stock-based compensation	-	5,066	(442)	-	-	-	4,624
Employee stock plan tax benefits	-	2,700	-	-	-	-	2,700
Balance at December 31, 2013	\$ 88,964	\$ 743,335	\$ 729,272	\$ (27,082)	\$ 346	\$ 208	\$ 1,535,043

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands of dollars)  
Years ended December 31, 2013, 2012, and 2011

	2013	2012	2011
Cash flows from operating activities			
Net income attributable to common shareholders	\$ 221,300	\$ 196,563	\$ 143,069
Income from discontinued operations	16,307	12,476	1,386
Income from continuing operations	204,993	184,087	141,683
Adjustments to reconcile income from continuing operations to net cash flows from operating activities			
Depreciation and amortization	124,793	116,996	108,300
Deferred income taxes	26,742	77,563	72,110
Provision for doubtful accounts	4,712	4,805	4,854
Share-based compensation	5,066	5,550	3,852
Gain on sale of utility system	(1,025)	-	(5,058)
Gain on sale of other assets	(148)	(1,090)	(649)
Net decrease (increase) in receivables, inventory and prepayments	2,238	(7,543)	(3,864)
Net increase (decrease) in payables, accrued interest, accrued taxes and other accrued liabilities	(12,870)	13,641	421
Decrease (increase) in income tax receivable	8,209	(16,082)	33,600
Other	4,010	(442)	(3,208)
Operating cash flows from continuing operations	366,720	377,485	352,041
Operating cash flows from (used in) discontinued operations, net	1,099	(9,078)	14,806
Net cash flows from operating activities	367,819	368,407	366,847
Cash flows from investing activities			
Property, plant and equipment additions, including the non-equity component of allowance for funds used during construction of \$1,741, \$3,954, and \$6,832	(308,171)	(347,985)	(325,808)
Acquisitions of utility systems and other, net	(14,997)	(121,248)	(8,515)
Release of funds previously restricted for construction activity	23,531	67,498	46,330
Additions to funds restricted for construction activity	(6)	(2,165)	(149)
Net proceeds from the sale of utility systems and other assets	5,315	3,819	13,404
Proceeds from note receivable	-	-	5,289
Investment in joint venture	(14,700)	(33,856)	(5,087)
Other	76	(1,512)	(946)
Investing cash flows used in continuing operations	(308,952)	(435,449)	(275,482)
Investing cash flows from (used in) discontinued operations, net	87,389	70,774	(9,422)
Net cash flows used in investing activities	(221,563)	(364,675)	(284,904)
Cash flows from financing activities			
Customers' advances and contributions in aid of construction	5,119	7,033	3,558
Repayments of customers' advances	(4,429)	(6,064)	(3,686)
Net (repayments) proceeds of short-term debt	(43,643)	(27,388)	18,103
Proceeds from long-term debt	263,834	300,109	52,513
Repayments of long-term debt	(300,323)	(202,203)	(96,072)
Change in cash overdraft position	9,872	(10,929)	14,503
Proceeds from issuing common stock	10,290	13,190	12,607
Proceeds from exercised stock options	25,698	14,598	6,603
Share-based compensation windfall tax benefits	2,420	-	-
Repurchase of common stock	(12,823)	(1,464)	(1,163)
Dividends paid on common stock	(102,889)	(93,423)	(87,133)
Financing cash flows used in continuing operations	(146,874)	(6,541)	(80,167)
Financing cash flows from discontinuing operations, net	155	126	494
Net cash flows used in financing activities	(146,719)	(6,415)	(79,673)
Net (decrease) increase in cash and cash equivalents	(463)	(2,683)	2,270
Cash and cash equivalents at beginning of year	5,521	8,204	5,934
Cash and cash equivalents at end of year	\$ 5,058	\$ 5,521	\$ 8,204
Cash paid during the year for			
Interest, net of amounts capitalized	\$ 75,453	\$ 74,152	\$ 71,640
Income taxes	\$ 6,995	\$ 9,319	\$ 5,431

See accompanying notes to consolidated financial statements.

See Note 1 – Summary of Significant Accounting Policies – Property, Plant and Equipment and Depreciation, Customers' Advances for Construction, Note 10 – Long-term Debt and Loans Payable, and Note 14 – Employee Stock and Incentive Plan for a description of non-cash activities.



## AQUA AMERICA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements  
(In thousands of dollars, except per share amounts)

### Note 1 – Summary of Significant Accounting Policies

**Nature of Operations** — Aqua America, Inc. (“Aqua America,” the “Company,” “we,” or “us”) is the holding company for regulated utilities providing water or wastewater services concentrated in Pennsylvania, Ohio, Texas, Illinois, North Carolina, New Jersey, Indiana, and Virginia. Our largest operating subsidiary, Aqua Pennsylvania, Inc. (“Aqua Pennsylvania”), which accounted for approximately 54% of our operating revenues and a larger percentage of our net income for 2013, and provided water or wastewater services to customers in the suburban areas north and west of the City of Philadelphia and in 26 other counties in Pennsylvania. The Company’s other regulated utility subsidiaries provide similar services in seven other states. In addition, the Company’s non-regulated subsidiary, Aqua Resources, provides liquid waste hauling and disposal, water and wastewater services through operating and maintenance contracts with municipal authorities and other parties in close proximity to our utility companies’ service territories, offers, through a third party, water and sewer line repair service and protection solutions to households, backflow prevention, construction, and other non-regulated water and wastewater services, and the Company’s non-regulated subsidiary, Aqua Infrastructure, provides non-utility raw water supply services for firms, with which we enter into a water supply contract, in the natural gas drilling industry.

In September 2012, we began to market for sale our water and wastewater operations in Florida, which served approximately 38,000 customers, and our non-regulated wastewater treatment facility in Georgia. In March, April, and December 2013, through five separate sales transactions, we completed the sale of our water and wastewater utility systems in Florida, which concluded our regulated operations in Florida. One of our sales in Florida which was completed in March 2013, and represented approximately 8% of our customers served in Florida, remains subject to customary regulatory review, for which we expect to receive the regulator’s decision by midyear 2014. If the regulator does not approve this sale, the purchase price would be refunded and the assets sold would revert back to the Company. In May 2012, we acquired all of American Water Works Company, Inc.’s (“American Water”) water and wastewater operations in Ohio, which serve approximately 59,000 customers, and simultaneously sold our water operations in New York, which served approximately 51,000 customers. In January 2012, we sold our regulated water operations in Maine, which served approximately 16,000 customers, to Connecticut Water Services, Inc. These transactions concluded our regulated operations in Maine and New York. During the second quarter of 2011, we acquired all of American Water’s water and wastewater operations in Texas, which serve approximately 5,300 customers, and sold our regulated water and wastewater operations in Missouri, which served approximately 3,900 customers and concluded our regulated utility operations in Missouri. The operating results, cash flows, and financial position of the Company’s Maine, New York, Florida, and Georgia subsidiaries have been presented in the Company’s consolidated financial statements as discontinued operations. Unless specifically noted, the financial information presented in the notes to consolidated financial statements reflects the Company’s continuing operations.

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 our water and wastewater regulated utility companies which are organized by the states where we provide these services. These operating segments are aggregated into one reportable segment since each of the Company’s operating segments has the following similarities: economic characteristics, nature of services, production processes, customers, water distribution or wastewater collection methods, and the nature of the regulatory environment. In addition, two operating segments are not quantitatively significant to be reportable and are comprised of the businesses that provide water and wastewater services through operating and maintenance contracts with municipal authorities and other parties in close proximity to our utility companies’ service territories as well as offers, through a third party, water and sewer line repair service and protection solutions to households, liquid waste hauling and disposal, backflow prevention, construction, and other non-regulated water and wastewater services, and non-utility raw water supply services for firms, with which we enter into a water supply contract, in the natural gas drilling industry. These segments are included as a component of “other,” in addition to corporate costs that have not been allocated to the Regulated segment and intersegment eliminations.

AQUA AMERICA, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements (continued)  
(In thousands of dollars, except per share amounts)

**Regulation** — Most of the operating companies that are regulated public utilities are subject to regulation by the regulatory commissions of the states in which they operate. The respective regulatory commissions have jurisdiction with respect to rates, service, accounting procedures, issuance of securities, acquisitions and other matters. Some of the operating companies that are regulated public utilities are subject to rate regulation by county or city government. Regulated public utilities follow the Financial Accounting Standards Board's ("FASB") accounting guidance for regulated operations, which provides for the recognition of regulatory assets and liabilities as allowed by regulators for costs or credits that are reflected in current rates or are considered probable of being included in future rates. The regulatory assets or liabilities are then relieved as the cost or credit is reflected in rates.

**Use of Estimates in Preparation of Consolidated Financial Statements** — The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Basis of Presentation** — The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany accounts and transactions have been eliminated. All common share, per common share, stock unit, and per stock unit data, for all periods presented, has been adjusted to give effect to the September 1, 2013 five-for-four stock split effected in the form of a 25% stock distribution (See Note 12). Certain prior period amounts have been reclassified, including reporting discontinued operations (see Note 3), to conform to the current period presentation.

**Recognition of Revenues** — Revenues in our Regulated segment include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the latest billing to the end of the accounting period. In addition, the Company has non-regulated revenues that are recognized when services are performed and are primarily associated with water and wastewater services through operating and maintenance contracts with municipal authorities and other parties in close proximity to our utility companies' service territories as well as offers, through a third party, water and sewer line repair service and protection solutions to households, liquid waste hauling and disposal, backflow prevention, construction, and other non-regulated water and wastewater services, and non-utility raw water supply services for firms in the natural gas industry of \$17,366 in 2013, \$17,730 in 2012, and \$12,364 in 2011.

**Property, Plant and Equipment and Depreciation** — Property, plant and equipment consist primarily of utility plant. The cost of additions includes contracted cost, direct labor and fringe benefits, materials, overheads and, for utility plant, allowance for funds used during construction. Water systems acquired are recorded at estimated original cost of utility plant when first devoted to utility service and the applicable depreciation is recorded to accumulated depreciation. The difference between the estimated original cost, less applicable accumulated depreciation, and the purchase price is recorded as an acquisition adjustment within utility plant as permitted by the applicable regulatory jurisdiction. At December 31, 2013, utility plant includes a net credit acquisition adjustment of \$27,466, which is generally being amortized from 2 to 53 years, except where not permitted or appropriate. Amortization of the acquisition adjustments totaled \$2,641 in 2013, \$2,858 in 2012, and \$2,741 in 2011.

Utility expenditures for maintenance and repairs, including major maintenance projects and minor renewals and betterments, are charged to operating expenses when incurred in accordance with the system of accounts prescribed by the regulatory commissions of the states in which the company operates. The cost of new units of property and betterments are capitalized. Utility expenditures for water main cleaning and relining of pipes are deferred and recorded in net property, plant and equipment in accordance with the FASB's accounting guidance for regulated operations. As of December 31, 2013, \$10,293 of these costs have been incurred since the last rate proceeding and the Company expects to recover these costs in future rates.

The cost of software upgrades and enhancements are capitalized if they result in added functionality which enable the software to perform tasks it was previously incapable of performing. Information technology costs associated with major system installations, conversions and improvements, such as software training,