



2016

# Annual Report

Aqua America, Inc.





# Fulfilling Our Mission With Dedication.

Aqua America continued to fulfill its mission to protect and provide Earth's most essential resource by making meaningful advancements in the areas of service delivery, growth opportunities, stakeholder education, community outreach and workforce diversity in 2016.

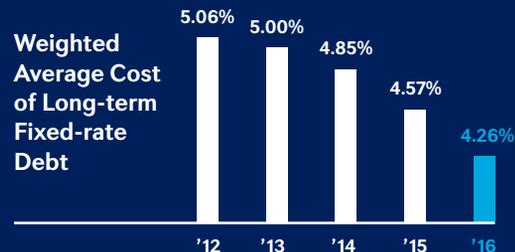
Aqua America's customers continued to see improvements in water and service reliability delivered by the company. Progressive legislation in Pennsylvania set the stage for additional opportunities for Aqua America to bring its expertise to new communities. The company worked cooperatively with environmental regulators to maintain water quality compliance, using its engineering, operations and technical expertise to address challenges in troubled systems.

Aqua America continued its environmental stewardship by volunteering and financially supporting various activities, like stream cleanups, to ensure clean water for everyone. All of these efforts are being accomplished with a professional workforce, which Aqua America is continuing to develop and grow, with the goal of sustaining excellent quality and service, and achieving a level of diversity that reflects the customers we serve.

# Financial Highlights

in thousands of dollars, except per-share amounts

|   | 2016        | 2015        | % Change |
|---|-------------|-------------|----------|
| <b>Operating revenues</b>   | \$819,875   | \$814,204   | 0.7%     |
| <b>Regulated segment</b>  |             |             |          |
| Operating revenues  | \$800,107   | \$779,613   | 2.6%     |
| Operating and maintenance expense   | \$285,347   | \$282,866   | 0.9%     |
| <b>Net Income</b>   | \$234,182   | \$201,790   | 16.1%    |
| <b>Diluted net income per common share</b>  | \$1.32      | \$1.14      | 15.8%    |
| Exclude:  |             |             |          |
| Joint venture impairment charge   | -           | \$32,975    |          |
| Tax effect  | -           | (\$11,542)  |          |
| <b>Adjusted income<sup>(a)</sup></b><br>(Non-GAAP financial measure)                  | \$234,182   | \$223,223   | 4.9%     |
| <b>Adjusted income per common share<sup>(a)</sup></b><br>(Non-GAAP financial measure) | \$1.32      | \$1.26      | 4.8%     |
| <b>Annualized dividend rate</b><br>per common share (12/31)                           | \$0.77      | \$0.71      | 7.8%     |
| <b>Total assets</b>   | \$6,158,991 | \$5,717,873 | 7.7%     |
| <b>Number of utility customers served<sup>(c)</sup></b>                               | 972,265     | 956,983     | 1.6%     |



(a) The GAAP financial measures are net income and net income per share. Please see our investor relations page of AquaAmerica.com for a reconciliation of the GAAP to non-GAAP financial measures.

(b) 2015 Income from Continuing Operations adjusted for Joint Venture Impairment Charge (a Non-GAAP Financial Measure). 2015 Income from Continuing Operations per Share was \$1.14.

(c) 2015 excludes 883 customers associated with utility systems disposed of during 2016.



# A Letter From the Chairman and the President & CEO.

*Nicholas DeBenedictis  
Chairman*

*Christopher H. Franklin  
President and  
Chief Executive Officer*

We celebrated Aqua America's rich history in 2016 when the company reached the important milestone of becoming 130 years old. The company was founded in 1886 in Springfield, Pennsylvania and has since grown into the second largest publicly traded water utility in the nation. In 2016, we also celebrated the formation of the company's strong new leadership team that is responsible for the future success of the company. Our founders laid the strong foundation on which we are building the future by investing record levels of capital to replace aging infrastructure. This investment will be key to providing sustainable quality water and wastewater service to our customers.

Throughout the year, our operating team continued to uphold our well-known standard of operational excellence. Additionally, we focused on growing our customer base and bringing our quality service to an even larger group of customers. In fact, we developed

a revised and more focused approach to growth, which yielded strong customer growth. Focusing our efforts on the right initiatives is critical and that's the reason we exited some non-core businesses that were not scalable and had become distractions to our management team.

Corporate culture development was also at the center of our activity as we continued to make safety, integrity and respect central threads in the fabric of our culture. We spend valuable time to select and retain employees who share our values and engage in our important mission.

Our nation faced real challenges in water treatment in 2016. The incident in Flint, Michigan was the most prominent, but it seems that similar stories are in the news almost daily.

Our mission is clear at Aqua America: protecting and providing Earth's most essential resource. In 2016 alone, we invested a record level (nearly \$400 million) in infrastructure rehabilitation to support this mission and we are committed to investing \$1.2 billion over the next three years. Aqua America's nearly 1,600 dedicated utility professionals come to work every day to ensure that we provide quality water and wastewater service to the 3 million people who rely on us for these life sustaining services.

Growing our customer base is important for shareholders and our existing customers. Economies of scale are critical in the utility business as we work to spread the large fixed cost of plants and water pipes over a growing base of customers – to keep costs and rates down while improving returns for shareholders. Last year, we invested more than \$22 million to acquire 13 water and six wastewater systems. Coupled with organic growth, the company increased its customer base by 1.6 percent for the year. We think it is important to note that the majority of these acquisitions do not yet reflect the new size range that we have strategically targeted -- 2,500 to 25,000 customers. The majority of the 2016 acquisitions were initiated before we refocused our strategy on larger opportunities, but the work that we began in 2015 and continues today, will focus our efforts on larger opportunities. We believe this refocused strategy is already making a difference.

One of the efforts that really started to generate momentum in 2016 was legislation that has now passed in Illinois and Pennsylvania, which allows companies like ours to acquire municipal water and wastewater systems at their fair market value, rather than the system's depreciated original cost. We see this as an opportunity to provide a solution for some of the municipal utilities that are struggling to meet regulatory standards and cannot raise the capital associated with infrastructure replacement.

To put the increased activity in perspective -- we currently have agreements in place to acquire the assets of four municipal systems in 2017. Collectively, these agreements are valued at more than \$100 million. While the opportunities are exciting, we want to assure you that our investment committee maintains strict discipline based on a framework that we believe provides value to both customers and shareholders.

As we look to the future, we are as optimistic as ever about this company. The opportunities we see in front of

us in the water and wastewater space are more numerous than either of us has seen during our long tenures at the company. While as a nation we might struggle with aging infrastructure, rebuilding is at the core of what we do and we continue to believe that we can play an increasing role in helping to solve the country's water and wastewater problems.

While we are committed to growing this great company, we understand and believe in the importance of our quarterly cash dividends to our shareholders. In August 2016, Aqua America's board of directors increased the quarterly cash dividend for the 26th time in the past 25 years. The dividend was raised 7.5 percent to \$0.1913 per-share, effective September 1, 2016. To date, Aqua

In 2016 alone, we invested at a record level (nearly \$400 million) in infrastructure to support this mission and we are committed to investing **\$1.2 billion over the next three years.**

America has paid consecutive quarterly dividends to its shareholders for 72 years. The board's decision to increase the quarterly dividend reflects our confidence in the company's ability to continue delivering strong results based on its strategy for future performance.

The success we achieved in 2016 was a result of our employees who remain customer-focused as they fulfill our mission to protect and provide Earth's most essential resource every day. On behalf of the board and the entire senior leadership team, we thank each and every one of them for all they have done to ensure another great year for our company. We also thank you, our shareholders, for their confidence and support, which enables us to execute our mission successfully.

Lastly, I invite you to visit [AquaAmerica.com](http://AquaAmerica.com) to learn more about our great company and stay abreast of the latest news about the company.

Sincerely,



**Christopher H. Franklin**  
President and CEO

**Nicholas DeBenedictis**  
Chairman of the Board

# Improving Infrastructure Improves Quality of Life.

## Rick Fox

Executive Vice President and Chief Operating Officer

Our nation's water and wastewater infrastructure requires significant investment for rehabilitation and expansion. Aqua America's operating subsidiaries are uniquely qualified to provide solutions. The most recent surveys from the U.S. Environmental Protection Agency (EPA) show that \$271 billion is needed within five years (of January 2016) to maintain and improve the nation's

wastewater infrastructure, including the pipes that carry wastewater to treatment plants and the technology that treats the wastewater. In 2013, it was estimated that \$384 billion in improvements was needed for the nation's drinking water infrastructure through 2030, to address countless miles of transmission and distribution pipes and thousands of treatment plants and storage tanks, which are all vital to public health and the economy. Often, municipalities are faced with competing priorities. When Aqua America purchases these systems, it brings to bear the capital, engineering, and technical expertise to address municipal water and wastewater challenges, so that finite tax dollars can be used for other local government needs.



Iron and manganese are naturally occurring metals found in the ground in several areas of the U.S. Neither is considered a public health issue in drinking water, but left unaddressed, each can cause drinking water to be discolored and affect its taste and odor, making it unpalatable to customers.

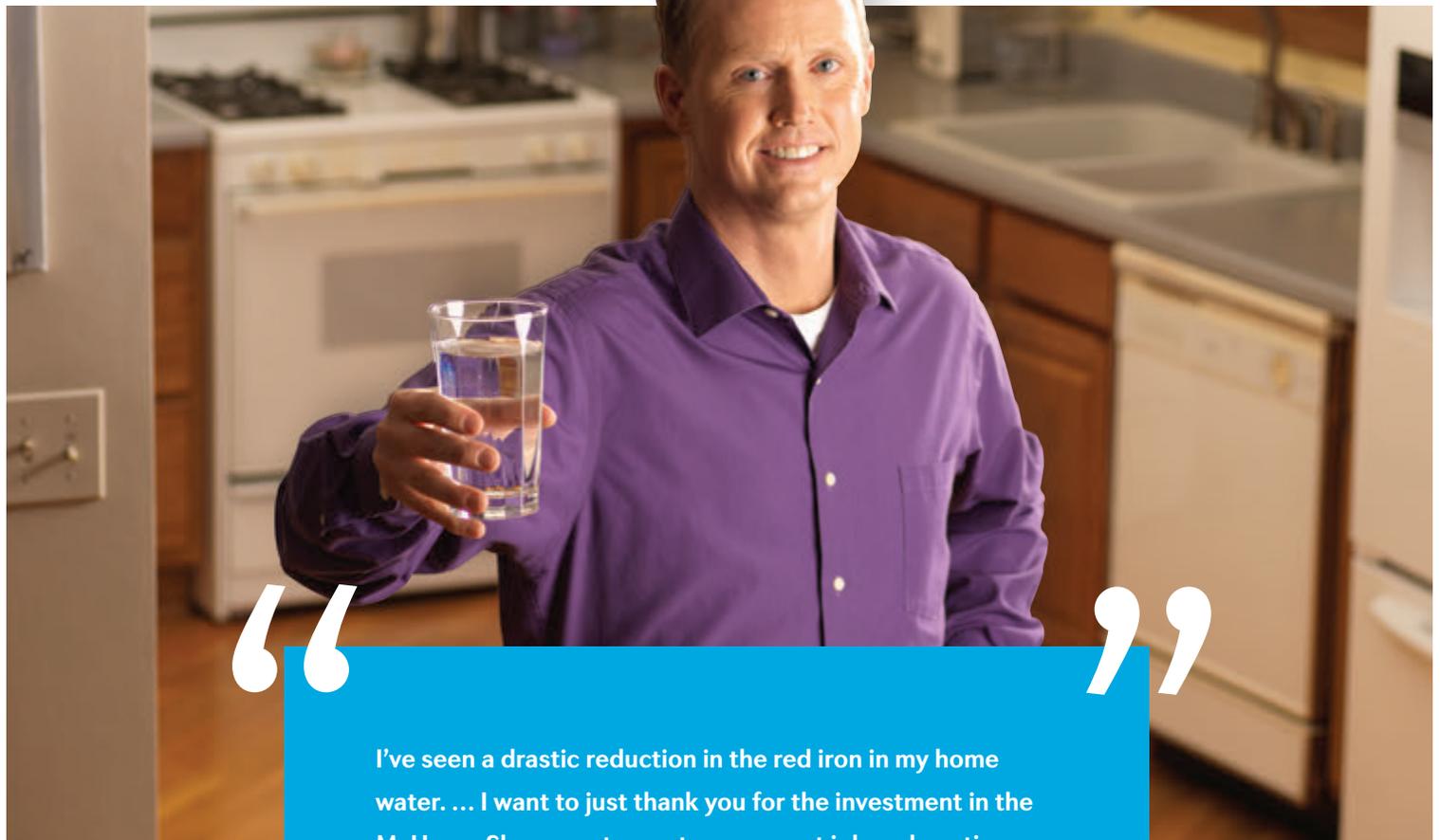
Without a treatment removal system, water companies generally use a chemical process that reduces the ability for the metals to move freely in the pipes, reducing the potential for discoloration. When coupled with routine flushing, this option can be effective in some situations. In many areas, however, treatment removal systems are required.

Aqua North Carolina is in the second year of a multi-year program to install such systems in communities with the most persistent iron and manganese problems, significantly improving water quality for approximately 8,500 homes (25,000 residents) in Wake, Surry, Catawba, and Gaston counties.

Similarly, Aqua Illinois installed a new iron pressure filter as part of a major overhaul of the McHenry Shores water system that reduced iron levels in that community by 75 percent.

## Chris Johnson

Customer, McHenry Shores, IL



“ ”

I've seen a drastic reduction in the red iron in my home water. ... I want to just thank you for the investment in the McHenry Shores water system. ... great job and continue doing what you guys have been doing to improve our water.

# Working With Community Leaders to Benefit the Environment.

“

Our water and wastewater operations are directly impacted by local, state and federal regulations and legislation. We maintain consistent, open and transparent communications with regulators and legislators. This approach ensures these key stakeholders are educated and prepared to make informed, solution-oriented decisions about our operations that complement our charge to provide safe and reliable service to more customers.

”

## **Kimberly Joyce**

Vice President, Regulatory,  
Government and External Affairs





In each case, the municipalities received a fair price for their assets, and customers have enjoyed the benefits of more than **\$4 million in needed infrastructure improvements...**

In April 2016, Pennsylvania became the fourth state in the Aqua America footprint to have water and wastewater fair market valuation legislation when Governor Tom Wolf signed Act 12, “fair market legislation,” into law. As municipalities and authorities face looming infrastructure upgrades to comply with environmental regulations and other financial challenges, many are looking to divest their water and wastewater assets. The legislation sets streamlined guidelines for these governmental entities to sell their systems to regulated water and wastewater companies if they choose. Customers benefit from having a professional water or wastewater provider with the capital and industry expertise to address infrastructure needs and environmental compliance, the latter of which is becoming more of a challenge with increasingly stringent regulations. The municipality or authority is able to refocus its attention—and proceeds if necessary—on other community priorities like schools, public safety and economic development.

A similar law was passed in Illinois in 2013, enabling Aqua Illinois to acquire four municipal systems—North Maine Utilities in 2015 and Crystal Clear Water Company, Eastwood Manor Water Company and Nunda Utilities in 2016. In each case, the municipalities received a fair price for their assets, and customers have enjoyed the benefits of more than \$4 million in needed infrastructure improvements, including the replacement of aging water mains, service lines, hydrants and meters. These improvements enable Aqua America subsidiaries to provide better service for customers and conserve water by replacing aged, and often leaking, water mains.

Fair market valuation legislation is a new tool in the toolbox of local governments. For those who choose to use it, this mechanism can provide a direct benefit for their communities, creating a win-win for customers, the environment and Aqua America.

# Collaborating to Ensure Our Water Is Protected.

## Chris Crockett

Vice President and Chief Environmental Officer



Routine communications with environmental regulators and public interest organizations is crucial to ensuring that we understand their expectations and that our

counterparts

understand our perspectives.

We collaborate with stakeholders

on a variety of local, regional and national regulatory policies and environmental issues, and share scientific information with them to augment their body of knowledge about drinking water and wastewater.

These relationships often result in partnerships that benefit both customers and the environment.



The U.S. Environmental Protection Agency's (EPA) Partnership for Safe Water is a voluntary cooperative effort between the EPA, the American Water Works Association and other drinking water organizations, representing more than 200 surface water utilities throughout the United States. The objective of the organization is to encourage water suppliers to minimize the risk to their consumers through continuous improvement in surface water treatment plant performance. There are four levels of distinction to be reached via a process that the EPA describes as "an arduous and difficult self-assessment." Aqua America has a total of 17 plants participating throughout its four states with surface water: Pennsylvania, Ohio, Illinois and Virginia. The highest level of distinction earns the participant the prestigious Excellence in Water Treatment Award. Aqua Pennsylvania's Roaring Creek plant is just one level away, having achieved the organization's second-highest award—the Phase IV President's Award in November 2016.

**Roaring Creek Plant wins the Phase IV President's Award in November 2016.**

Aqua Pennsylvania is also a partner to the Schuylkill Action Network, a source water protection organization dedicated to the protection of the Schuylkill River—a primary

source of supply for its Pickering treatment plant, the company's largest surface water facility. Employees also participate in watershed protection efforts such as tree planting, watershed monitoring, educational events, and cleanups along regional waterways that provide water to three of its large surface water treatment plants.



**From left to right:** Gary Hampton, Dan Ogden, Terry Weidner, Rich Kotwica. **Not pictured:** Jeremy Nicodemus, Bryan Yagel, Aaron Tom and Mike Budwash.

Aqua Illinois has been as a member of the Kankakee River Basin Commission for decades and now has permanent representation on its board. Aqua Illinois Regional Environmental Compliance Manager Kevin Culver is currently board secretary for the organization. He also serves as vice chairman of the Illinois State American Water Works Association source water protection committee and was appointed vice chairman of the Northeastern Illinois Regional Groundwater

**Kevin Culver - Aqua Illinois Regional Environmental Compliance Manager**

Protection and Planning Committee by the Illinois EPA. Aqua Illinois is also a

member of the statewide Nutrient Loss Reduction Strategy Workgroup, which plays a significant role in reducing the impact of farming activity on Illinois' rivers among other things. In addition, Aqua Illinois employees are active participants in the Northern Illinois Anglers Association's adopt-the-river cleanups.



# Forging A Stronger, More Diverse Workforce.



Aqua America nearly quadrupled its customer base in the last 25 years, bringing our services to larger, more diverse populations throughout eight states. Maintaining this growth trend requires continued excellence from a workforce that reflects the diversity of the communities we serve. Our aspirational goal is to be an industry leader in workforce diversity and inclusion by attracting, engaging, developing and retaining high-potential diverse talent across all levels of the organization.



**Karen Heisler**

Senior Vice President and Chief Human Resources Officer

## Carolyn Stout

Facility Operator I

“ When I first started four years ago, I worked as if I had something to prove. I didn't want the men to believe I got the job because I was female. I wanted to be sure they knew I was as qualified as they were. I could tell they were not used to working with women. It actually took about two years for them to loosen up and realize that they could be themselves around me. I've never been mistreated and no one has ever said anything to make me feel uncomfortable. Honestly, I don't think they needed to behave any differently for me. I have the pleasure of working with a group of very nice and polite men.

”



## Tori Murry

Facility Operator I

“ I have a great role model in my mother who still works in the male-dominated gas sector of a major energy company. It took her five years to become comfortable working in a predominantly male workplace. I've always been treated fairly and have learned a lot from my male coworkers. But working in industries that are traditionally dominated by the opposite gender inherently leads to some level of discomfort for men and women alike. I don't believe that's always a bad thing—it helps us learn about one another. Women bring a different and valuable perspective to the traditionally male workplace. I'm glad that Aqua understands that benefit and is working to increase diversity throughout the organization.

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2016

# Financial Data

AQUA<sup>SM</sup>

## 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)*

#### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements in this Annual Report (the "Annual Report") are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are made based upon, among other things, our current assumptions, expectations, plans, and beliefs concerning future events and their potential effect on us. These forward-looking statements involve risks, uncertainties and other factors, many of which are outside our control 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," "probably," "predictions," "intends," "will," "continue" "in the event" or the negative of such terms or similar expressions.

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;
- changes to the rules or our assumptions underlying our determination of what qualifies for an income tax deduction for qualifying utility asset improvements;
- 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;
- changes in, or unanticipated, capital requirements;
- changes in our credit rating or the market price of our common stock;
- changes in valuation of strategic ventures;
- 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 attacks or other cyber-related events;
- changes in accounting pronouncements;
- litigation and claims; and
- changes in environmental conditions, including the effects of climate change.

## 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)*

Given these risks and uncertainties, you should not place undue reliance on any forward-looking statements. You should read this Annual Report completely and with the understanding that our actual future results, performance and achievements may be materially different from what we expect. These forward-looking statements represent assumptions, expectations, plans, and beliefs only as of the date of this Annual Report. Except for our ongoing obligations to disclose certain information under the federal securities laws, we are not obligated, and assume no obligation, to update these forward-looking statements, even though our situation may change in the future. For further information or other factors which could affect our financial results and such forward-looking statements, see *Risk Factors* included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

## 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 included in this Annual Report. This discussion contains forward-looking statements that are based on management's current expectations, estimates and projections about our business, operations and financial performance. All dollar amounts are in thousands of dollars, except per share amounts.

### **The Company**

Aqua America, Inc., (referred to as "Aqua America", the "Company", "we", "us", or "our"), a Pennsylvania corporation, is the holding company for regulated utilities providing water or wastewater services to what we estimate to be almost three million people in Pennsylvania, Ohio, Texas, Illinois, North Carolina, New Jersey, Indiana, and Virginia. Our largest operating subsidiary is Aqua Pennsylvania, Inc., which accounted for approximately 52% of our operating revenues and approximately 74% of our net income for 2016. As of December 31, 2016, Aqua Pennsylvania provided water or wastewater services to approximately one-half of the total number of people we serve. Aqua Pennsylvania's service territory is located in the suburban areas in counties north and west of the City of Philadelphia and in 27 other counties in Pennsylvania. Our other regulated utility subsidiaries provide similar services in seven other states. In addition, the Company's market-based activities are conducted through Aqua Resources, Inc. and Aqua Infrastructure, LLC. Aqua Resources provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to our utility companies' service territories; and offers, through a third party, water and sewer line repair service and protection solutions to households.

In 2016, the Company sold the following business units of Aqua Resources, which were reported as assets held for sale in the Company's consolidated balance sheets:

- a business unit which provided liquid waste hauling and disposal services; and
- a business unit which inspected, cleaned and repaired storm and sanitary wastewater lines.

Additionally, in 2016, the Company decided to market for sale a business unit within Aqua Resources, which installs and tests devices that prevent the contamination of potable water, for which the sale was completed in January 2017, and a business unit that repairs and performs maintenance on water and wastewater systems. These business units are reported as assets held for sale in the Company's consolidated balance sheets. Aqua Infrastructure provides non-utility raw water supply services for 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

## 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 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 utility commissions, which have broad administrative power and authority to regulate billing rates, determine franchise areas and conditions of service, approve acquisitions, and authorize the issuance of securities. The utility commissions also generally establish uniform systems of accounts and approve the terms of contracts with affiliates and customers, business combinations with other utility systems, and loans and other financings. The policies of the utility 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 was the case for our Texas operations where, in 2014, economic regulation changed from the Texas Commission on Environmental Quality to the Texas Public Utility Commission. The profitability of our utility operations is influenced to a great extent by the timeliness and adequacy of rate allowances in the various states in which we operate. One consideration we may undertake in evaluating which states to focus our growth and investment strategy is whether a state provides for consolidated rates, a surcharge for replacing and rehabilitating infrastructure and other systems, 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 creates assets that are 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, 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 utility 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. As of December 31, 2016, the Company's rate base is estimated to be \$3,750,000, which is comprised of:

- \$2,873,000 filed with respective state utility commissions or local regulatory authorities; and
- \$877,000 not yet filed with respective state utility commissions or local regulatory authorities.

Our water and wastewater operations are composed of 53 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 have sought approval from the applicable state utility commission to consolidate rate divisions to achieve a more even distribution of costs over a larger customer base. All of the eight states in which we operate currently permit us to file a revenue requirement using some form of consolidated rates for some or all of the rate divisions in that state.

***Revenue Surcharges*** – Six states in which we operate water utilities, and five 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. This surcharge is intended to substantially reduce regulatory lag, which

## 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)*

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, which require us to wait for a period of time to file the next base rate increase request. These agreements 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, 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 market-based 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. Another element of our growth strategy is the consideration of opportunities to expand by acquiring other utilities, including those that may be in a new state if they provide promising economic growth opportunities and a return on equity that we consider acceptable. The ability to successfully execute this strategy and meet the industry challenges is largely due to our core competencies, 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 2016, we completed 19 acquisitions, which along with the organic growth in our existing systems, represents 15,282 new customers. During 2015, we completed 16 acquisitions, which along with the organic growth in our existing systems, represents 17,747 new customers. During 2014, we completed 16 acquisitions, which along with the organic growth in our existing systems, represents 12,120 new customers.

In addition to acquisitions, from time to time, we sell utility systems or relinquish ownership in systems through condemnation. Consistent with our strategy to evaluate future growth opportunities and the financial performance of our individual utility systems, we divested our wastewater treatment facility in Georgia in March 2014. In addition, in December 2014, we sold our water utility systems in Fort Wayne, Indiana.

The operating results, cash flows, and financial position of the Company's water utility systems in Fort Wayne, Indiana and Georgia were presented in the Company's consolidated financial statements as discontinued operations.

We believe that utility acquisitions, organic growth, and expansion of our market-based business will continue to be the primary sources of 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 14,500 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 2012, there are

## 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)*

approximately 15,000 such facilities in the nation serving approximately 76% 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 there are approximately 4,000 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 utility acquisitions or otherwise, including 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 utility systems 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 reduce the size of future rate increases. Currently, the Company seeks to acquire businesses in the U.S. regulated sector, which includes water and wastewater utilities and other regulated utilities, and to pursue growth ventures in market-based activities, such as infrastructure opportunities that are supplementary and complementary to our regulated businesses.

#### **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 utility 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. Currently, portions of our Pennsylvania (four counties), New Jersey, and Texas service areas are under drought warnings. The entire Pennsylvania and New Jersey service areas are under drought watch.

## 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)

Portions of our northern and central Texas service areas have conservation water restrictions. Drought warnings and watches result in the public being asked to voluntarily reduce water consumption.

The geographic diversity of our utility customer base reduces the effect of our exposure to extreme or unusual weather conditions in any one area of the country. During the year ended December 31, 2016, our operating revenues were derived principally from the following states: approximately 52% in Pennsylvania, 13% in Ohio, 9% in Texas, 8% in Illinois, and 7% 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;
- earnings before interest, taxes, and depreciation (“EBITD”);
- earnings before income taxes as compared to our operating budget;
- net income; 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”);
- return on revenues (income from continuing operations divided by operating revenues);
- rate base growth;
- return on equity (net income divided by stockholders' equity); and
- the ratio of capital expenditures to depreciation expense.

Furthermore, we review the measure of earnings before unusual items that are noncash and not directly related to our core business, such as the measure of adjusted earnings to remove the joint venture impairment charge, which was recognized in the fourth quarter of 2015. Refer to Note 1 – *Summary of Significant Accounting Policies – Investment in Joint Venture* in this Annual Report for information regarding the impairment charge. 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 operating expense ratio can be impacted by the timeliness of recovery of, and the return on capital investments. The operating expense 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). The operating expense ratio is also influenced by 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 qualifying utility asset improvements for tax purposes that are capitalized for book purposes in Aqua Pennsylvania and consequently forgoing operating revenue increases.

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)*

During periods of inflation, our operations and maintenance expenses may increase, impacting the operating expense ratio, as a result of regulatory lag, since our rate cases may not be filed timely and are not 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 our 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 market-based subsidiary companies, Aqua Resources and Aqua Infrastructure. The cost-structure of these market-based companies differs from our utility companies in that, although they may generate free cash flow, these companies have a much higher ratio of operations and maintenance expenses to operating revenues 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 operating expense ratio is not comparable between the businesses. These market-based subsidiary companies are not a component of our Regulated segment.

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

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 Selected Financial and Operating Statistics**

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

| Years ended December 31,                              | 2016              | 2015              | 2014              | 2013              | 2012              |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|
| Utility customers:                                    |                   |                   |                   |                   |                   |
| Residential water                                     | 801,190           | 791,404           | 779,665           | 771,660           | 766,121           |
| Commercial water                                      | 40,582            | 40,151            | 39,614            | 39,237            | 38,805            |
| Industrial water                                      | 1,349             | 1,353             | 1,357             | 1,368             | 1,373             |
| Other water   | 19,036            | 17,420            | 17,412            | 17,230            | 16,643            |
| Wastewater  | 110,108           | 107,538           | 102,071           | 98,705            | 95,044            |
| Total utility customers                               | <u>972,265</u>    | <u>957,866</u>    | <u>940,119</u>    | <u>928,200</u>    | <u>917,986</u>    |
| Operating revenues:                                   |                   |                   |                   |                   |                   |
| Residential water                                     | \$ 484,901        | \$ 477,773        | \$ 460,013        | \$ 457,404        | \$ 441,240        |
| Commercial water                                      | 131,170           | 126,677           | 122,795           | 121,178           | 117,559           |
| Industrial water                                      | 27,916            | 28,021            | 27,369            | 25,263            | 24,822            |
| Other water   | 62,983            | 56,997            | 59,474            | 57,446            | 70,693            |
| Wastewater  | 82,780            | 79,399            | 76,472            | 73,062            | 68,225            |
| Other utility   | 10,357            | 10,746            | 9,934             | 10,174            | 10,416            |
| Regulated segment total                               | <u>800,107</u>    | <u>779,613</u>    | <u>756,057</u>    | <u>744,527</u>    | <u>732,955</u>    |
| Other and eliminations                                | 19,768            | 34,591            | 23,846            | 17,366            | 17,730            |
| Consolidated operating revenues                       | <u>\$ 819,875</u> | <u>\$ 814,204</u> | <u>\$ 779,903</u> | <u>\$ 761,893</u> | <u>\$ 750,685</u> |
| Operations and maintenance expense                    | <u>\$ 304,897</u> | <u>\$ 309,310</u> | <u>\$ 288,556</u> | <u>\$ 283,561</u> | <u>\$ 270,042</u> |
| Joint venture impairment charge (1)                   | <u>\$ -</u>       | <u>\$ 21,433</u>  | <u>\$ -</u>       | <u>\$ -</u>       | <u>\$ -</u>       |
| Income from continuing operations                     | <u>\$ 234,182</u> | <u>\$ 201,790</u> | <u>\$ 213,884</u> | <u>\$ 202,871</u> | <u>\$ 181,837</u> |
| Net income  | <u>\$ 234,182</u> | <u>\$ 201,790</u> | <u>\$ 233,239</u> | <u>\$ 221,300</u> | <u>\$ 196,563</u> |
| Capital expenditures                                  | <u>\$ 382,996</u> | <u>\$ 364,689</u> | <u>\$ 328,605</u> | <u>\$ 307,908</u> | <u>\$ 347,098</u> |
| <b>Operating Statistics</b>                           |                   |                   |                   |                   |                   |
| Selected operating results as a                       |                   |                   |                   |                   |                   |
| percentage of operating revenues:                     |                   |                   |                   |                   |                   |
| Operations and maintenance                            | 37.2%             | 38.0%             | 37.0%             | 37.2%             | 36.0%             |
| Depreciation and amortization                         | 16.2%             | 15.8%             | 16.2%             | 16.3%             | 15.5%             |
| Taxes other than income taxes                         | 6.9%              | 6.8%              | 6.5%              | 6.9%              | 6.2%              |
| Interest expense, net                                 | 9.8%              | 9.4%              | 9.8%              | 10.1%             | 10.4%             |
| Income from continuing operations                     | <u>28.6%</u>      | <u>24.8%</u>      | <u>27.4%</u>      | <u>26.6%</u>      | <u>24.2%</u>      |
| Return on Aqua America stockholders' equity           | <u>12.7%</u>      | <u>11.7%</u>      | <u>14.1%</u>      | <u>14.4%</u>      | <u>14.2%</u>      |
| Ratio of capital expenditures to depreciation expense | <u>2.9</u>        | <u>2.9</u>        | <u>2.7</u>        | <u>2.6</u>        | <u>3.1</u>        |
| Effective tax rate (2)                                | <u>8.2%</u>       | <u>6.9%</u>       | <u>10.5%</u>      | <u>9.5%</u>       | <u>26.4%</u>      |

(1) Represents a \$21,433 (\$32,975 pre-tax) joint venture impairment charge. This amount represents our share of the impairment charge recognized by our joint venture that operates a private pipeline to supply raw water to firms with natural gas well drilling operations.

(2) See Results of Operations – *Income Taxes* for a discussion of the effective tax rate change that commenced in 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 10.9% and our net income has grown at an annual compound rate of approximately 10.4% during the five-year period ended December 31, 2016. During the past five years, operating revenues grew at a compound rate of 3.8% and operating expenses grew at a compound rate of 4.2%.

**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 Aqua Resources and Aqua Infrastructure. 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)*

### **Consolidated Results**

**Operating Revenues** – Operating revenues totaled \$819,875 in 2016, \$814,204 in 2015, and \$779,903 in 2014. The growth in revenues over the past three years is a result of increases in our customer base and our water and wastewater rates. The number of customers increased at an annual compound rate of 1.4% over the past three years due to acquisitions and organic growth, adjusted to exclude customers associated with utility system dispositions. Acquisitions in our Regulated segment have provided additional water and wastewater revenues of \$8,201 in 2016, \$8,900, in 2015, and \$2,732 in 2014. Rate increases implemented during the past three years have provided additional operating revenues of \$4,319 in 2016, \$8,503 in 2015, and \$5,250 in 2014.

On June 7, 2012, Aqua Pennsylvania reached a settlement agreement in its last rate filing with the Pennsylvania Public Utility Commission, which in addition to a water rate increase, provided for a reduction in current income tax expense as a result of the recognition of qualifying income tax benefits upon Aqua Pennsylvania changing its tax accounting method to permit the expensing of qualifying utility asset improvement costs that historically had been capitalized and depreciated for book and tax purposes. In December 2012, Aqua Pennsylvania implemented this change which provides for the flow-through of income tax benefits that resulted in a substantial reduction in income tax expense and greater net income and cash flow. As a result, Aqua Pennsylvania was able to suspend its water Distribution System Improvement Charges in 2013 and lengthen the amount of time until the next Aqua Pennsylvania rate case is filed. During 2016, 2015, and 2014, the income tax accounting change resulted in income tax benefits of \$78,530, \$72,944, and \$69,048 that reduced the Company's current income tax expense and increased net income. 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 these expenditures, or \$38,000 annually, which reduced income tax expense and increased the Company's net income by \$16,734, which is included in the income tax benefits noted in the previous sentence. In accordance with the settlement agreement, this amortization is expected to reduce income tax expense during periods when qualifying parameters are met. Aqua Pennsylvania expects to file an infrastructure investment surcharge in 2017 and expects to file a rate case in 2018, with resolution of the rate case expected in 2019.

Our operating subsidiaries received rate increases representing estimated annualized revenues of \$3,589 in 2016 resulting from seven rate decisions, \$3,347 in 2015 resulting from four rate decisions, and \$9,886 in 2014 resulting from twelve rate decisions. Revenues from these increases realized in the year of grant were \$1,801 in 2016, \$2,887 in 2015, and \$5,375 in 2014. As of December 31, 2016, our operating subsidiaries have filed two rate requests, which are being reviewed by the state utility commissions, proposing an aggregate increase of \$7,976 in annual revenues. During 2017, we intend to file three additional rate requests proposing an aggregate of approximately \$13,425 of increased annual revenues; the timing and extent to which our rate increase requests may be granted will vary by state.

Currently, Pennsylvania, Illinois, Ohio, Indiana, New Jersey, and North Carolina allow for the use of a surcharge for replacing and rehabilitating infrastructure systems. The rate increases under this surcharge typically adjust periodically based on additional qualified capital expenditures completed or anticipated in a future period. This surcharge is capped as a percentage of base rates, generally at 5% to 12.75% of base rates, and is 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. These surcharges provided revenues of \$7,379 in 2016, \$3,261 in 2015, and \$4,598 in 2014.

Our Regulated segment also includes operating revenues of \$10,357 in 2016, \$10,746 in 2015, and \$9,934 in 2014 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 recognized market-based revenues that are associated with Aqua Resources and Aqua Infrastructure of \$20,091 in 2016, \$34,909 in 2015, and \$24,189 in 2014. The decrease in revenues in 2016 is due to the disposition of business units within Aqua Resources.

**Operations and Maintenance Expenses** – Operations and maintenance expenses totaled \$304,897 in 2016, \$309,310 in 2015, and \$288,556 in 2014. Most elements of operating costs are subject to the effects of inflation and changes in 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)

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, insurance and claims costs, and costs to comply with environmental regulations. 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 decreased in 2016 as compared to 2015 by \$4,413 or 1.4%, primarily due to:

- decreases in market-based activities expenses of \$10,393;
- a decrease in water production costs of \$3,156;
- the effects of the recognition in 2015 of leadership transition expenses of \$2,510, the recording of a reserve of \$1,862 for water rights held for future use, and the recording of a legal contingency reserve of \$1,580;
- the reversal of a reserve for a legal contingency of \$1,580;
- offset by an increase in postretirement benefits of \$5,554; and
- additional operating costs associated with acquisitions of \$4,538.

Operations and maintenance expenses increased in 2015 as compared to 2014 by \$20,754 or 7.2%, primarily due to:

- additional operating costs associated with acquisitions, consisting of market-based activities of \$8,313 and utility systems of \$6,823;
- an increase in water productions costs of \$3,401;
- leadership transition expenses of \$2,510;
- the recording of a reserve of \$1,862 for water rights held for future use;
- the recording of a legal contingency reserve of \$1,580;
- the effect of the favorable recognition of a regulatory asset in 2014 of \$1,575;
- an increase in legal fees of \$1,420; and
- offset by a decrease in postretirement benefits expense of \$4,447.

The increase in water production costs of \$3,401 was impacted by an increase in energy costs resulting from the extreme cold temperatures experienced in many of our service territories in the first quarter of 2015.

**Depreciation and Amortization Expenses** – Depreciation expense was \$130,987 in 2016, \$125,290 in 2015, and \$123,054 in 2014, 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. The increase for 2015 was impacted by the absence of a credit recognized in 2014 for the effect of decreased depreciation rates implemented in our Texas operating subsidiary, offset by a decrease in depreciation rates, implemented in 2015, for Aqua Pennsylvania.

Amortization expense was \$2,021 in 2016, \$3,447 in 2015, and \$3,481 in 2014, and has decreased primarily due to the completion of the recovery of our costs associated with 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 \$56,385 in 2016, \$55,057 in 2015, and \$50,453 in 2014. The increase in 2016 was primarily due to an increase of \$578 for pumping fees in Texas due to higher water production, a rate increase, and the addition of two water systems, and an increase in gross receipts, excise and franchise taxes of \$502. The increase in 2015 was primarily due to an increase in property taxes of \$2,412 largely due to the effect of a non-recurring credit realized in 2014 that resulted in a reduction in property taxes for our Ohio operating subsidiary.

**Interest Expense, net** – Net interest expense was \$80,594 in 2016, \$76,536 in 2015, and \$76,397 in 2014. Interest income of \$217 in 2016, \$272 in 2015, and \$316 in 2014 was netted against interest expense. Net interest expense increased in 2016 due to an increase in average short-term borrowings of \$9,808 at higher short-term interest rates and an increase in average outstanding fixed rate long-term debt of \$98,006 partially offset by a decline in long-term interest rates. Net

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)

interest expense increased in 2015 due to an increase in average short-term borrowings of \$13,977 and an increase in average outstanding fixed rate long-term debt of \$91,785, partially offset by a decline in long-term interest rates. Interest income decreased in 2015 due to lower investment rates. The weighted average cost of fixed rate long-term debt was 4.26% at December 31, 2016, 4.57% at December 31, 2015, and 4.85% at December 31, 2014. The weighted average cost of fixed and variable rate long-term debt was 4.23% at December 31, 2016, 4.44% at December 31, 2015, and 4.65% at December 31, 2014.

**Allowance for Funds Used During Construction** – The allowance for funds used during construction (“AFUDC”) was \$8,815 in 2016, \$6,219 in 2015, and \$5,134 in 2014, and varies as a result of changes in the average balance of utility plant construction work in progress, to which AFUDC is applied, changes in the AFUDC rate which is based predominantly on short-term interest rates, changes in the balance of short-debt, changes in the amount of AFUDC related to equity, and changes in the average balance of the proceeds held from tax-exempt bond issuances that are restricted to funding specific capital projects. The increase in 2016 and 2015 is primarily due to an increase in the AFUDC rate as a result of an increase in the amount of AFUDC related to equity and in 2016 and 2015 an increase in the average balance of utility plant construction work in progress, to which AFUDC is applied. The amount of AFUDC related to equity was \$6,561 in 2016, \$4,621 in 2015, and \$3,640 in 2014.

**(Gain) Loss on Sale of Other Assets** – (Gain) loss on sale of other assets totaled \$(378) in 2016, \$(468) in 2015, and \$4 in 2014, and consists of the sales of property, plant and equipment and marketable securities.

**Gain on Extinguishment of Debt** – The gain on extinguishment of debt of \$678 in 2015 results from the recognition of the unamortized issuance premium for the early redemption of \$95,985 of tax-exempt bonds at 5.00% that were originally maturing between 2035 and 2038.

**Equity (Earnings) Loss in Joint Venture** – Equity (earnings) loss in joint venture totaled \$(976) in 2016, \$35,177 in 2015, and \$3,989 in 2014. The equity earnings in 2016 resulted from the recognition of a connection fee earned by the joint venture in 2016 for which our share was \$1,831 and a reduction in depreciation expense resulting from the noncash impairment charge recognized by the joint venture on its long-lived assets in 2015. The increase in equity loss in joint venture in 2015 of \$31,188 is primarily due to a noncash impairment charge recognized by the joint venture on its long-lived assets for which our share was \$32,975, partially offset by a decrease in depreciation expense resulting from the 2015 increase in depreciable life for the joint venture's pipeline assets. The impairment charge was recognized in the fourth quarter of 2015 as a result of a determination that the long-lived assets, primarily consisting of a pipeline and pump station, had become impaired due to a marked decline in natural gas prices in 2015, and in particular a further decline in the fourth quarter of 2015, a distinguishable reduction in the volume of water sales by the joint venture which led to a lowered forecast in the fourth quarter of 2015 on future water sales volumes by the joint venture, as well as changes in the natural gas industry and market conditions. These market conditions were largely associated with natural gas prices, which sharply declined in the fourth quarter and this downturn no longer appeared to be temporary and instead may be a long-term condition.

**Income Taxes** – Our effective income tax rate was 8.2% in 2016, 6.9% in 2015, and 10.5% in 2014. The effective income tax rate for 2016, 2015, and 2014 was affected by the 2012 income tax accounting change for qualifying utility asset improvements at Aqua Pennsylvania which resulted in a \$78,530, \$72,944, and \$69,048 net reduction to the Company's 2016, 2015, and 2014 Federal and state income tax expense, respectively. As of December 31, 2016, the Company has an unrecognized tax benefit related to the Company's change in its tax accounting method for qualifying utility asset improvement costs, of which \$20,674 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.

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)

**Summary –**

|   | Years ended December 31, |                   |                   |
|---|--------------------------|-------------------|-------------------|
|   | 2016                     | 2015              | 2014              |
| Operating income                                      | \$ 325,585               | \$ 321,100        | \$ 314,359        |
| Income from continuing operations                     | \$ 234,182               | \$ 201,790        | \$ 213,884        |
| Income from discontinued operations                   | -                        | -                 | 19,355            |
| Net income  | <u>\$ 234,182</u>        | <u>\$ 201,790</u> | <u>\$ 233,239</u> |
| Diluted income from continuing operations per share   | \$ 1.32                  | \$ 1.14           | \$ 1.20           |
| Diluted income from discontinued operations per share | -                        | -                 | 0.11              |
| Diluted net income per share                          | 1.32                     | 1.14              | 1.31              |

The changes in the per share income from continuing operations in 2016 and 2015 over the previous years were due to the aforementioned changes.

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 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<br>December 31, |            |
|--|------------------------------------|------------|
|  | 2016                               | 2015       |
| Operating revenues                           | \$ 196,799                         | \$ 197,067 |
| Operations and maintenance                   | 77,550                             | 77,856     |
| Depreciation                                 | 33,342                             | 31,760     |
| Amortization                                 | 654                                | 858        |
| Taxes other than income taxes                | 13,291                             | 11,978     |
|  | 124,837                            | 122,452    |
| Operating income                             | 71,962                             | 74,615     |
| Other expense (income):                      |                                    |            |
| Interest expense, net                        | 20,458                             | 19,732     |
| Allowance for funds used during construction | (2,369)                            | (2,289)    |
| Loss (gain) on sale of other assets          | 12                                 | (130)      |
| Gain on extinguishment of debt               | -                                  | (678)      |
| Equity loss in joint venture                 | 167                                | 33,681     |
| Income before income taxes                   | 53,694                             | 24,299     |
| Provision for income taxes                   | 4,045                              | (4,135)    |
| Net income                                   | \$ 49,649                          | \$ 28,434  |

The decrease in operating revenues of \$268 was primarily due to a decrease in market-based activities revenue of \$4,945 due to dispositions, offset by an increase in customer water consumption, additional revenues of \$1,235 associated with a larger customer base due to utility acquisitions, and an increase in water and wastewater rates of \$1,124.

The decrease in operations and maintenance expense of \$306 is due primarily to a decrease in market-based activities expenses of \$4,169, and a decrease in the Company's self-insured employee medical benefit program expense of \$1,229, partially offset by an increase in postretirement benefits expense of \$1,533, and additional operating costs associated with acquisitions of \$500.

Depreciation expense increased by \$1,582 primarily due to the utility plant placed in service since December 31, 2015.

The increase in other taxes of \$1,313 is primarily due to an increase in property taxes of \$900.

Interest expense increased by \$726 due to an increase in the average outstanding debt balance.

The gain on extinguishment of debt recognized in 2015 is due to the recognition of the unamortized premium associated with the early redemption of long-term debt.

The decrease in equity loss in joint venture of \$33,514 is primarily due to the effect of the noncash impairment charge recognized in 2015 by the joint venture (discussed below under "Management's Discussion and Analysis of Financial Condition and Results of Operations – Consolidated Cash Flow and Capital Expenditures – Joint Venture") for which our share was \$32,975.

The provision for income taxes increased by \$8,180 primarily as a result of the change in income before income taxes.

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)

**LIQUIDITY AND CAPITAL RESOURCES**

**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, 2016 were as follows:

|      | Net Operating Cash<br>Flows | Dividends         | Capital Expenditures | Acquisitions      |
|------|-----------------------------|-------------------|----------------------|-------------------|
| 2012 | 375,823                     | 93,423            | 347,098              | 121,248           |
| 2013 | 365,409                     | 102,889           | 307,908              | 14,997            |
| 2014 | 364,888                     | 112,106           | 328,605              | 14,616            |
| 2015 | 370,794                     | 121,248           | 364,689              | 28,989            |
| 2016 | 395,788                     | 130,923           | 382,996              | 9,423             |
|      | <u>\$ 1,872,702</u>         | <u>\$ 560,589</u> | <u>\$ 1,731,296</u>  | <u>\$ 189,273</u> |

Included in capital expenditures for the five-year period are: expenditures for the rehabilitation of existing water and wastewater systems, the expansion of our water and wastewater systems, modernization and replacement of existing treatment facilities, water meters, office facilities, information technology, vehicles, and equipment. During this five-year period, we received \$31,166 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 repayments of debt of \$914,684, and have refunded \$22,029 of customers' advances for construction. Dividends increased during the past five years as a result of annual increases in the dividends declared and paid and increases in the number of shares outstanding.

Our planned 2017 capital program, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to be more than \$450,000 in infrastructure improvements for the communities we serve. The 2017 capital program is expected to include \$206,900 for infrastructure rehabilitation surcharge qualified projects, of which \$175,800 is for Aqua Pennsylvania. On January 1, 2013, Aqua Pennsylvania reset its water infrastructure rehabilitation surcharge to zero resulting from the change in its tax method of accounting for qualifying utility asset improvements as described below. Although we were not eligible to use an infrastructure rehabilitation surcharge with our Aqua Pennsylvania water customers since 2012, we were able to use the income tax savings derived from the qualifying utility asset improvements to continue to maintain a similar capital investment program as 2012. Our planned 2017 capital program in Pennsylvania is estimated to be approximately \$304,000 a portion of which is expected to be eligible as a deduction for qualifying utility asset improvements for Federal income tax purposes. Our overall 2017 capital program, along with \$150,671 of debt repayments, and \$200,395 of other contractual cash obligations, as reported in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations – 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 2018 through 2019, 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 \$826,000. We anticipate that less than one-half of these expenditures will require external financing. We expect to refinance \$193,532 of long-term debt during this period as they become due with new issues of long-term debt, internally-generated funds, and our 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.

## 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 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 typical acquisitions through internally-generated funds, supplemented by short-term lines of credit. Over time, we partially repay or pay-down our short-term lines of credit with long-term debt. 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.

On June 7, 2012, Aqua Pennsylvania reached a settlement agreement in its rate filing with the Pennsylvania Public Utility Commission, which in addition to a water rate increase, provided for a reduction in current income tax expense as a result of the recognition of qualifying income tax benefits upon Aqua Pennsylvania changing 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. In December 2012, Aqua Pennsylvania implemented this change, which resulted in a substantial reduction in income tax expense and greater net income and cash flow, and as a result allowed Aqua Pennsylvania to suspend its water Distribution System Improvement Charges in 2013 and lengthen the amount of time until the next Aqua Pennsylvania rate case is filed. As a result of the Pennsylvania rate order, income tax benefits reduced the Company's current income tax expense and increased net income by \$69,048 in 2014, \$72,944 in 2015, and \$78,530 in 2016. 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 these expenditures or \$38,000 annually, which reduced income tax expense and increased the Company's net income by \$16,734. In accordance with the settlement agreement, this amortization is expected to reduce income tax expense during periods when qualifying parameters are met. During 2013, our Ohio and North Carolina operating divisions implemented this change in tax accounting method. These divisions currently do not employ a method of accounting that provides for a reduction in current income taxes as a result of the recognition of income tax benefits, and as such the change in the Company's tax method of accounting in these operating divisions has no impact on our effective income tax rate.

The deduction for qualifying utility asset improvements is anticipated to continue in 2017 and beyond. Our 2017 earnings will be impacted by the following factors in Aqua Pennsylvania: the deduction for qualifying utility asset improvements in 2017 is expected to reduce current income tax expense and the ten year amortization of the qualifying capital expenditures made prior to 2012 is also expected to reduce current income tax expense; offset by the effect of regulatory lag.

#### **Acquisitions**

During the past five years, we have expended cash of \$189,273 and issued 439,943 shares of common stock, valued at \$12,845 at the time of acquisition, related to the acquisition of utility systems, both water and wastewater utilities, as well as investments in supplying raw water to the natural gas drilling industry.

In January 2016, we acquired the water and wastewater utility system assets of Superior Water Company, Inc., which provided public water service to approximately 3,900 customers in portions of Berks, Chester, and Montgomery counties in Pennsylvania. The total purchase price for the utility system was \$16,750, which consisted of the issuance of 439,943 shares of the Company's common stock and \$3,905 in cash. Additionally, during 2016, we completed 18 acquisitions of water and wastewater utility systems for \$5,518 in cash in eight of the states in which we operate in.

In April 2015, we acquired the water and wastewater utility system assets of North Maine Utilities, located in the Village of Glenview, Illinois. The total purchase price consisted of \$23,079 in cash. Additionally, during 2015, we completed 14 acquisitions of water and wastewater utility systems for \$5,210 in cash in six of the states in which we operate.

## 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)*

During 2014, we completed 16 acquisitions of water and wastewater utility systems for \$10,530 in cash in seven of the states in which we operate. Further, in 2014, we acquired two market-based businesses that specialized in inspecting, cleaning and repairing storm and sanitary sewer lines, as well as providing water distribution system services and training to waterworks operators. The total purchase price in aggregate was \$4,810 and both these businesses were subsequently sold in November 2016 and January 2017.

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

We continue to pursue the acquisition of water and wastewater utility systems, and explore other utility acquisitions that may be in a new state. 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.

#### **Joint Venture**

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 "Joint Venture"). We own 49% of the Joint Venture. The initial 18-mile pipeline commenced operations in 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. The Joint Venture has entered into water supply contracts with natural gas drilling companies. As of December 31, 2016, our capital contributions since inception totaled \$53,643 in cash. This investment has been financed through the issuance of long-term debt. Our 49% investment in the 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. In the fourth quarter of 2015 an impairment charge was recognized by the joint venture on its long-lived assets, of which the Company's share totaled \$32,975 (\$21,433 after-tax), representing our share of the noncash impairment charge as further described in Note 1 – *Summary of Significant Accounting Policies – Investment in Joint Venture* in this Annual Report.

#### **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 2016, the Company sold two business units within Aqua Resources, which resulted in total proceeds of \$4,459, and recognized a net loss of \$543. In 2013 and 2012, 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 the following states: Florida, New York, and Maine. With respect to the sale of our systems in New York and the sale of our systems in Missouri to American Water, we acquired additional utility systems from American Water in Ohio and in Texas. Additionally, in March, 2014, we completed the sale of our wastewater treatment facility in Georgia.

## 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)*

In December 2014, we completed the sale of our water utility system in southwest Allen County Indiana to the City of Fort Wayne, Indiana for \$67,011, which is comprised of \$50,100 in addition to \$16,911 the city initially paid the Company towards its water and wastewater system assets in the northern part of Fort Wayne in 2008. We recognized a gain on sale of \$29,210 (\$17,611 after-tax) in the fourth quarter of 2014. In addition, as a result of this transaction, Aqua Indiana will expand its sewer customer base by accepting new wastewater flows from the City. Refer to Note 3 – *Discontinued Operations and Other Disposition* in this Annual Report for further information on this sale.

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). In June 2013, the Company sold a water and wastewater utility system in Texas 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 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 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.

Despite these transactions, one of our primary strategies continues to be to acquire additional utility 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.

#### **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 \$1,335,239 of long-term debt and obtained other short-term borrowings during the past five years. At December 31, 2016, we have a \$250,000 long-term revolving credit facility that expires in February 2021, of which \$17,561 was designated for letter of credit usage, \$207,439 was available for borrowing and \$25,000 of borrowings were outstanding at December 31, 2016. In addition, we have short-term lines of credit of \$135,500, of which \$128,965 was available as of December 31, 2016. 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.

Our loan and debt agreements require us to comply with certain financial covenants, which among other things, subject to specific exceptions, limit the Company's ratio of consolidated total indebtedness to consolidated total capitalization, and require a minimum level of earnings coverage over interest expense. During 2016, 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

## 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)*

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.

The Company has a universal shelf registration statement, which was filed with the Securities and Exchange Commission, ("SEC") on February 27, 2015, 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. The Company has not issued any securities to date under this universal shelf registration statement.

In addition, we have a shelf registration statement, which was filed with the SEC on February 27, 2015, to permit the offering from time to time of an aggregate of \$500,000 of our common stock and shares of preferred stock in connection with acquisitions. During 2016, we issued 439,943 shares of common stock totaling \$12,845 to acquire a water system. The balance remaining available for use under the acquisition shelf registration as of December 31, 2016 is \$487,155.

We will determine the form and terms of any securities issued under the universal shelf registration statement and the acquisition shelf registration statement 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 issued throughout the year. The dividend reinvestment portion of the Plan offers a five percent discount on the purchase of shares of common stock with reinvested dividends. As of the December 2016 dividend payment, holders of 10.7% 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 1,218,407 original issue shares of common stock for net proceeds of \$25,093 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 2016, 2015, and 2014, 484,645, 535,439, and 558,317 shares of common stock were purchased under the dividend reinvestment portion of the Plan by the Company's transfer agent in the open-market for \$14,916, \$14,380, and \$14,148, respectively.

The Company's Board of Directors has authorized us to repurchase our common stock, from time to time, in the open market or through privately negotiated transactions. In 2014, we repurchased 560,000 shares of our common stock in the open market for \$13,280. In December 2014, the Company's Board of Directors authorized a share buyback program of up to 1,000,000 shares to minimize share dilution through timely and orderly share repurchases. In December 2015, the Company's Board of Directors added 400,000 shares to this program. In 2016, we did not repurchase any shares of our common stock in the open market under this program. In 2015, we repurchased 805,000 shares of our common stock in the open market for \$20,502. This program expired on December 31, 2016.

#### **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, 2016:

|  | Payments Due By Period |                     |                   |                   |                      |
|--|------------------------|---------------------|-------------------|-------------------|----------------------|
|  | Total                  | Less than 1<br>year | 1 - 3 years       | 3 - 5 years       | More than 5<br>years |
| Long-term debt                             | \$ 1,910,633           | \$ 150,671          | \$ 193,532        | \$ 111,263        | \$ 1,455,167         |
| Interest on fixed-rate, long-term debt (1) | 1,392,112              | 80,878              | 149,103           | 132,477           | 1,029,654            |
| Operating leases (2)                       | 20,610                 | 1,713               | 2,922             | 2,460             | 13,515               |
| Unconditional purchase obligations (3)     | 38,964                 | 7,658               | 9,693             | 8,026             | 13,587               |
| Other purchase obligations (4)             | 72,572                 | 72,572              | -                 | -                 | -                    |
| Pension plan obligation (5)                | 15,421                 | 15,421              | -                 | -                 | -                    |
| Other obligations (6)                      | 33,880                 | 22,153              | 2,201             | 2,199             | 7,327                |
| <b>Total</b>                               | <b>\$ 3,484,192</b>    | <b>\$ 351,066</b>   | <b>\$ 357,451</b> | <b>\$ 256,425</b> | <b>\$ 2,519,250</b>  |

- (1) Represents interest payable on fixed rate, long-term debt. Amounts reported may differ from actual due to future refinancing of debt.
- (2) Represents operating leases that are noncancelable, before expiration, for the lease of motor vehicles, buildings, land and other equipment.
- (3) 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.
- (4) Represents an approximation of the open purchase orders for goods and services purchased in the ordinary course of business.
- (5) Represents contributions to be made to pension plan.
- (6) 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 2026 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 \$28,099. 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. See Note 7 – *Income Taxes* in this Annual Report for further information on our uncertain tax positions.

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)

The Company is routinely involved in legal matters, including both asserted and unasserted legal claims, during the ordinary course of business. See Note 9 – *Commitments and Contingencies* in this Annual Report 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.

**Capitalization**

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

| December 31,                      | 2016   | 2015   | 2014   | 2013   | 2012   |
|-----------------------------------|--------|--------|--------|--------|--------|
| Long-term debt (1)                | 50.8%  | 50.8%  | 49.4%  | 50.3%  | 53.4%  |
| Aqua America stockholders' equity | 49.2%  | 49.2%  | 50.6%  | 49.7%  | 46.6%  |
|                                   | 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 \$25,000 at December 31, 2016, \$60,000 at December 31, 2015, \$72,000 at December 31, 2014, \$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.

**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 Virginia, we commence the billing of our utility customers, under new rates, upon authorization from the respective utility 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.

## 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)

**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 Financial Accounting Standards Board's ("FASB") accounting guidance for regulated operations. Our review determines whether there have been changes in circumstances or events, such as regulatory disallowances, or abandonments, 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. For utility plant in service, we would recognize an impairment loss for any amount disallowed by the respective utility commission. For our equity method investment in joint venture, the Company evaluates whether it has experienced a decline in the value of its investment that is other than temporary in nature. We would recognize an impairment loss if the fair value of our investment is less than the carrying amount of the investment, and the decline in value is considered other than temporary. Additionally, the Company would recognize its share of an impairment loss if the joint venture determines that the carrying amount of the joint venture's assets exceeds the sum of the joint venture's undiscounted estimated cash flows.

Our long-lived assets, which consist primarily of utility plant in service, regulatory assets and investment in joint venture, are reviewed for impairment when changes in circumstances or events occur. These circumstances or events could include a decline in the market value or physical condition of a long-lived asset, an adverse change in the manner in which long-lived assets are used or planned to be used, a change in historical trends, operating cash flows associated with the long-lived assets, changes in macroeconomic conditions, industry and market conditions, or overall financial performance. When these circumstances or events occur, we determine whether it is more likely than not that the fair value of those assets is less than their carrying amount. If we determine that it is more likely than not (that is, the likelihood of more than 50 percent), we would recognize an impairment charge if it is determined that the carrying amount of an asset exceeds the sum of the undiscounted estimated cash flows. In this circumstance, we would recognize an impairment charge equal to the difference between the carrying amount and the fair value of the asset. Fair value is estimated to be the present value of future net cash flows associated with the asset, discounted using a discount rate commensurate with the risk and remaining life of the asset. This assessment requires significant management judgment and estimates that are based on budgets, general strategic business plans, historical trends and other data and relevant factors. These estimates include significant inherent uncertainties, since they involve forecasting future events. If changes in circumstances or events occur, or estimates and assumptions that were used in this review are changed, we may be required to record an impairment charge on our long-lived assets.

We have an investment in a joint venture, for which we own 49%, and use the equity method of accounting to account for this joint venture. The joint venture operates a private pipeline system to supply raw water to natural gas well drilling operations in the Marcellus Shale in north central Pennsylvania. In the fourth quarter of 2015, the joint venture recognized an impairment charge on its long-lived assets, of which the Company's share totaled \$32,975 (\$21,433 after-tax), representing our share of the noncash impairment charge. Refer to Note 1 – *Summary of Significant Accounting Policies – Property, Plant and Equipment and Depreciation*, and *Investment in Joint Venture* in this Annual Report for additional information regarding the review of long-lived assets for impairment. See also *Consolidated Results – Equity (Earnings) Loss in Joint Venture* above in this Annual Report.

We test the goodwill attributable for 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, including macroeconomic conditions, industry and market considerations, cost factors, overall financial performance, and entity specific events, 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 a quantitative goodwill impairment test by determining the fair value of a reporting unit based on a discounted cash flow analysis. If we perform a quantitative test and determine that the fair value of a reporting unit is less than its carrying amount, we would determine the reporting unit's implied fair value of its goodwill and compare it with the carrying amount of its goodwill 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

## 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)*

assumptions that were used in our impairment test change, we may be required to record an impairment charge for goodwill. Refer to Note 1 – *Summary of Significant Accounting Policies – Goodwill* in this Annual Report for information regarding the results of our annual impairment test.

**Accounting for Post-Retirement Benefits** — We maintain a qualified defined benefit pension plan and plans that provide for post-retirement benefits other than pensions. Accounting for pension 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 benefits expense that we recognize.

Our discount rate assumption, which is used to calculate the present value of the projected benefit payments of our post-retirement benefits, was determined by selecting a hypothetical portfolio of high quality corporate bonds appropriate to match the projected benefit payments of the plans. 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 rate that equates the market value of the bonds purchased to the discounted value of the projected benefit payments of the plans. A decrease in the discount rate would increase our post-retirement benefits expense and benefit obligation. After reviewing the hypothetical portfolio of bonds, we selected a discount rate of 4.13% for our pension plan and 4.25% for our other post-retirement benefit plans as of December 31, 2016, which represent a 35 basis-point decrease as compared to the discount rates selected at December 31, 2015, respectively. Our post-retirement benefits expense under these plans is determined using the discount rate as of the beginning of the year, which was 4.48% for our pension plan and 4.60% for our other-postretirement benefit plans for 2016, and will be 4.13% for our pension plan and 4.25% for our other post-retirement benefit plans for 2017.

Our expected return on plan 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 plans' assets as of the last day of its fiscal year, and is a determinant for the expected return on plan assets, which is a component of post-retirement benefits expense. The allocation of our plans' assets impacts our expected return on plan assets. The expected return on plan 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. Our post-retirement benefits expense increases as the expected return on plan assets decreases. We believe that our actual long-term asset allocations on average will approximate our targeted allocations. Our targeted allocations are driven by our 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. For 2016, we used a 7.25% expected return on plan assets assumption which will decrease to 7.00% for 2017.

In October 2014, the Society of Actuaries issued an updated set of mortality tables and a mortality improvement scale. The updated mortality tables extend the assumed life expectancy of participants in defined benefit plans, and the updated mortality improvement scale projects how mortality rates will improve into the future based on anticipated medical innovations and a reduction in unhealthy behaviors. We considered the mortality data at the December 31, 2014 measurement of our post-retirement benefit obligations in relation to our plans' participant population experience and adopted the updated mortality table and mortality improvement scale. Because mortality is a key assumption in developing actuarial estimates, the impact of adopting the mortality data was, an increase in our post-retirement benefit obligation as of December 31, 2014 of \$14,400 and an increase in our 2015 net periodic benefit costs of \$2,500, of which approximately \$900 had an impact on our 2015 post-retirement benefits expense, due to the regulatory treatment of our net periodic benefit costs.

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 2017 our pension contribution is expected to be \$15,421. Future years' contributions will be subject to economic conditions, plan

## 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)*

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.

**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.

Our determination of what qualifies as a capital cost versus a tax deduction, for qualifying utility asset improvements, as it relates to our income tax accounting method change beginning in 2012, is subject to subsequent adjustment as well as IRS audits, changes in income tax laws, including regulations regarding tax-basis depreciation as it applies to our capital expenditures, or qualifying utility asset improvements, the expiration of a statute of limitations, or other unforeseen matters 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* in this Annual Report.

**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.

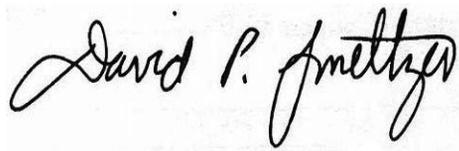
Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree 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* (2013). As a result of management's assessment and based on the criteria in the framework, management has concluded that, as of December 31, 2016, the Company's internal control over financial reporting was effective.

The effectiveness of our internal control over financial reporting as of December 31, 2016 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.



Christopher H. Franklin  
*President and Chief Executive Officer*



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

February 24, 2017

## 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, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016 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, 2016 based on criteria established in *Internal Control - Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (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 considered 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.



Philadelphia, Pennsylvania  
February 24, 2017

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(In thousands of dollars, except per share amounts)  
December 31, 2016 and 2015

|   | 2016         | 2015         |
|---|--------------|--------------|
| Assets  |              |              |
| Property, plant and equipment, at cost  | \$ 6,509,117 | \$ 6,088,011 |
| Less: accumulated depreciation  | 1,507,502    | 1,399,086    |
| Net property, plant and equipment   | 5,001,615    | 4,688,925    |
| Current assets:   |              |              |
| Cash and cash equivalents   | 3,763        | 3,229        |
| Accounts receivable and unbilled revenues, net  | 97,394       | 99,146       |
| Inventory, materials and supplies   | 12,961       | 12,414       |
| Prepayments and other current assets  | 12,804       | 11,802       |
| Assets held for sale  | 1,728        | 1,779        |
| Total current assets  | 128,650      | 128,370      |
| Regulatory assets   | 948,647      | 830,118      |
| Deferred charges and other assets, net  | 30,845       | 28,878       |
| Investment in joint venture   | 7,026        | 7,716        |
| Goodwill  | 42,208       | 33,866       |
| Total assets  | \$ 6,158,991 | \$ 5,717,873 |
| Liabilities and Equity  |              |              |
| Aqua America stockholders' equity:  |              |              |
| Common stock at \$.50 par value, authorized 300,000,000 shares, issued 180,311,345 and 179,363,660 in 2016 and 2015 | \$ 90,155    | \$ 89,682    |
| Capital in excess of par value  | 797,513      | 773,585      |
| Retained earnings   | 1,032,844    | 930,061      |
| Treasury stock, at cost, 2,916,969 and 2,819,569 shares in 2016 and 2015  | (71,113)     | (68,085)     |
| Accumulated other comprehensive income  | 669          | 687          |
| Total stockholders' equity  | 1,850,068    | 1,725,930    |
| Long-term debt, excluding current portion   | 1,759,962    | 1,743,612    |
| Less: debt issuance costs   | 22,357       | 23,165       |
| Long-term debt, excluding current portion, net of debt issuance costs   | 1,737,605    | 1,720,447    |
| Commitments and contingencies (See Note 9)  | -            | -            |
| Current liabilities:  |              |              |
| Current portion of long-term debt   | 150,671      | 35,593       |
| Loans payable   | 6,535        | 16,721       |
| Accounts payable  | 59,872       | 56,452       |
| Accrued interest  | 18,367       | 12,651       |
| Accrued taxes   | 25,607       | 21,887       |
| Other accrued liabilities   | 40,484       | 49,895       |
| Total current liabilities   | 301,536      | 193,199      |
| Deferred credits and other liabilities:   |              |              |
| Deferred income taxes and investment tax credits  | 1,269,253    | 1,118,923    |
| Customers' advances for construction  | 91,843       | 86,934       |
| Regulatory liabilities  | 250,635      | 259,507      |
| Other   | 115,583      | 100,498      |
| Total deferred credits and other liabilities  | 1,727,314    | 1,565,862    |
| Contributions in aid of construction  | 542,468      | 512,435      |
| Total liabilities and equity  | \$ 6,158,991 | \$ 5,717,873 |

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF NET INCOME

(In thousands, except per share amounts)

Years ended December 31, 2016, 2015, and 2014

|   | 2016              | 2015              | 2014              |
|---|-------------------|-------------------|-------------------|
| Operating revenues                                      | \$ 819,875        | \$ 814,204        | \$ 779,903        |
| Operating costs and expenses:                           |                   |                   |                   |
| Operations and maintenance                              | 304,897           | 309,310           | 288,556           |
| Depreciation  | 130,987           | 125,290           | 123,054           |
| Amortization  | 2,021             | 3,447             | 3,481             |
| Taxes other than income taxes                           | 56,385            | 55,057            | 50,453            |
| Total operating expenses                                | <u>494,290</u>    | <u>493,104</u>    | <u>465,544</u>    |
| Operating income  | 325,585           | 321,100           | 314,359           |
| Other expense (income):                                 |                   |                   |                   |
| Interest expense, net                                   | 80,594            | 76,536            | 76,397            |
| Allowance for funds used during construction            | (8,815)           | (6,219)           | (5,134)           |
| (Gain) loss on sale of other assets                     | (378)             | (468)             | 4                 |
| Gain on extinguishment of debt                          | -                 | (678)             | -                 |
| Equity (earnings) loss in joint venture                 | (976)             | 35,177            | 3,989             |
| Income from continuing operations before income taxes   | <u>255,160</u>    | <u>216,752</u>    | <u>239,103</u>    |
| Provision for income taxes                              | 20,978            | 14,962            | 25,219            |
| Income from continuing operations                       | <u>234,182</u>    | <u>201,790</u>    | <u>213,884</u>    |
| Discontinued operations:                                |                   |                   |                   |
| Income from discontinued operations before income taxes | -                 | -                 | 32,155            |
| Provision for income taxes                              | -                 | -                 | 12,800            |
| Income from discontinued operations                     | <u>-</u>          | <u>-</u>          | <u>19,355</u>     |
| Net income  | <u>\$ 234,182</u> | <u>\$ 201,790</u> | <u>\$ 233,239</u> |
| Income from continuing operations per share:            |                   |                   |                   |
| Basic   | <u>\$ 1.32</u>    | <u>\$ 1.14</u>    | <u>\$ 1.21</u>    |
| Diluted   | <u>\$ 1.32</u>    | <u>\$ 1.14</u>    | <u>\$ 1.20</u>    |
| Income from discontinued operations per share:          |                   |                   |                   |
| Basic   | <u>\$ -</u>       | <u>\$ -</u>       | <u>\$ 0.11</u>    |
| Diluted   | <u>\$ -</u>       | <u>\$ -</u>       | <u>\$ 0.11</u>    |
| Net income per common share:                            |                   |                   |                   |
| Basic   | <u>\$ 1.32</u>    | <u>\$ 1.14</u>    | <u>\$ 1.32</u>    |
| Diluted   | <u>\$ 1.32</u>    | <u>\$ 1.14</u>    | <u>\$ 1.31</u>    |
| Average common shares outstanding during the period:    |                   |                   |                   |
| Basic   | <u>177,273</u>    | <u>176,788</u>    | <u>176,864</u>    |
| Diluted   | <u>177,846</u>    | <u>177,517</u>    | <u>177,763</u>    |
| Cash dividends declared per common share                | <u>\$ 0.7386</u>  | <u>\$ 0.686</u>   | <u>\$ 0.634</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, 2016, 2015, and 2014

|   | 2016       | 2015       | 2014       |
|---|------------|------------|------------|
| Net income  | \$ 234,182 | \$ 201,790 | \$ 233,239 |
| Other comprehensive income, net of tax:   |            |            |            |
| Unrealized holding (loss) gain on investments, net of tax (benefit) expense of \$21, \$(53), and \$104 for the years ended December 31, 2016, 2015, and 2014, respectively                    | 39         | (101)      | 193        |
| Reclassification adjustment for loss (gain) reported in net income, net of tax (benefit) expense of \$30 and \$(134) for the twelve months ended December 31, 2016 and 2014, respectively (1) | (57)       | -          | 249        |
| Comprehensive income  | \$ 234,164 | \$ 201,689 | \$ 233,681 |

See accompanying notes to consolidated financial statements.

(1) Amount of pre-tax loss (gain) of \$(87) and \$383 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, 2016 and 2014, respectively.

AQUA AMERICA, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CAPITALIZATION

(In thousands of dollars, except per share amounts)

December 31, 2016 and 2015

|   | 2016                       | 2015         |
|---|----------------------------|--------------|
| Aqua America stockholders' equity:  |                            |              |
| Common stock, \$.50 par value   | \$ 90,155                  | \$ 89,682    |
| Capital in excess of par value  | 797,513                    | 773,585      |
| Retained earnings   | 1,032,844                  | 930,061      |
| Treasury stock, at cost   | (71,113)                   | (68,085)     |
| Accumulated other comprehensive income  | 669                        | 687          |
| Total stockholders' equity  | 1,850,068                  | 1,725,930    |
| 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               | 4,661        |
| 1.00% to 1.99%  | 2019 to 2035               | 15,539       |
| 2.00% to 2.99%  | 2024 to 2031               | 19,668       |
| 3.00% to 3.99%  | 2019 to 2056               | 381,944      |
| 4.00% to 4.99%  | 2020 to 2054               | 487,318      |
| 5.00% to 5.99%  | 2017 to 2043               | 213,078      |
| 6.00% to 6.99%  | 2017 to 2036               | 52,985       |
| 7.00% to 7.99%  | 2022 to 2027               | 33,066       |
| 8.00% to 8.99%  | 2021 to 2025               | 6,565        |
| 9.00% to 9.99%  | 2018 to 2026               | 26,400       |
| 10.00% to 10.99%  | 2018                       | 6,000        |
|   | 1,247,224                  | 1,185,257    |
| Notes payable to bank under revolving credit agreement, variable rate, due 2021 | 25,000                     | 60,000       |
| Unsecured notes payable:  |                            |              |
| Bank notes at 1.921% and 1.975% due 2017 and 2018                               | 100,000                    | 100,000      |
| Notes at 3.57% and 3.59% due 2027 and 2041                                      | 245,000                    | 120,000      |
| Notes ranging from 4.62% to 4.87%, due 2017 through 2024                        | 133,600                    | 144,400      |
| Notes ranging from 5.20% to 5.95%, due 2017 through 2037                        | 159,809                    | 169,548      |
| Total long-term debt  | 1,910,633                  | 1,779,205    |
| Current portion of long-term debt   | 150,671                    | 35,593       |
| Long-term debt, excluding current portion                                       | 1,759,962                  | 1,743,612    |
| Less: debt issuance costs   | 22,357                     | 23,165       |
| Long-term debt, excluding current portion,                                      | 1,737,605                  | 1,720,447    |
| Total capitalization  | \$ 3,587,673               | \$ 3,446,377 |

See accompanying notes to consolidated financial statements.

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

|  | Common<br>stock | Capital in<br>excess of<br>par value | Retained<br>earnings | Treasury<br>stock | Accumulated<br>Other<br>Comprehensive<br>Income | Noncontrolling<br>Interest | Total        |
|--|-----------------|--------------------------------------|----------------------|-------------------|---|----------------------------|--------------|
| Balance at December 31, 2013                                   | \$ 88,964       | \$ 743,335                           | \$ 729,272           | \$ (27,082)       | \$ 346  | \$ 208                     | \$ 1,535,043 |
| Net income   | -               | -                                    | 233,239              | -                 | -   | 40                         | 233,279      |
| Purchase of subsidiary shares from<br>noncontrolling interest  | -               | -                                    | -                    | -                 | -   | (208)                      | (208)        |
| Other comprehensive income, net of income<br>tax of \$238      | -               | -                                    | -                    | -                 | 442   | -                          | 442          |
| Dividends  | -               | -                                    | (112,106)            | -                 | -   | -                          | (112,106)    |
| Repurchase of stock (659,666 shares)                           | -               | -                                    | -                    | (15,756)          | -   | -                          | (15,756)     |
| Equity compensation plan (212,920 shares)                      | 107             | (107)                                | -                    | -                 | -   | -                          | -            |
| Exercise of stock options (449,412 shares)                     | 225             | 7,071                                | -                    | -                 | -   | -                          | 7,296        |
| Stock-based compensation                                       | -               | 6,811                                | (453)                | -                 | -   | -                          | 6,358        |
| Employee stock plan tax benefits                               | -               | 1,828                                | -                    | -                 | -   | -                          | 1,828        |
| Other  | -               | (793)                                | -                    | -                 | -   | -                          | (793)        |
| Balance at December 31, 2014                                   | 89,296          | 758,145                              | 849,952              | (42,838)          | 788   | 40                         | 1,655,383    |
| Net income   | -               | -                                    | 201,790              | -                 | -   | -                          | 201,790      |
| Other comprehensive loss, net of income tax<br>benefit of \$53 | -               | -                                    | -                    | -                 | (101)   | -                          | (101)        |
| Dividends  | -               | -                                    | (121,248)            | -                 | -   | -                          | (121,248)    |
| Sale of stock (26,295 shares)                                  | 13              | 664                                  | -                    | -                 | -   | -                          | 677          |
| Repurchase of stock (981,585 shares)                           | -               | -                                    | -                    | (25,247)          | -   | -                          | (25,247)     |
| Equity compensation plan (321,402 shares)                      | 161             | (161)                                | -                    | -                 | -   | -                          | -            |
| Exercise of stock options (424,709 shares)                     | 212             | 7,328                                | -                    | -                 | -   | -                          | 7,540        |
| Stock-based compensation                                       | -               | 5,860                                | (433)                | -                 | -   | -                          | 5,427        |
| Employee stock plan tax benefits                               | -               | 2,602                                | -                    | -                 | -   | -                          | 2,602        |
| Other  | -               | (853)                                | -                    | -                 | -   | (40)                       | (893)        |
| Balance at December 31, 2015                                   | 89,682          | 773,585                              | 930,061              | (68,085)          | 687   | -                          | 1,725,930    |
| Net income   | -               | -                                    | 234,182              | -                 | -   | -                          | 234,182      |
| Other comprehensive loss, net of income tax<br>benefit of \$9  | -               | -                                    | -                    | -                 | (18)  | -                          | (18)         |
| Dividends  | -               | -                                    | (130,923)            | -                 | -   | -                          | (130,923)    |
| Stock issued for acquisition (439,943 shares)                  | 220             | 12,625                               | -                    | -                 | -   | -                          | 12,845       |
| Sale of stock (47,478 shares)                                  | 24              | 1,364                                | -                    | -                 | -   | -                          | 1,388        |
| Repurchase of stock (97,400 shares)                            | -               | -                                    | -                    | (3,028)           | -   | -                          | (3,028)      |
| Equity compensation plan (231,502 shares)                      | 115             | (115)                                | -                    | -                 | -   | -                          | -            |
| Exercise of stock options (228,762 shares)                     | 114             | 4,146                                | -                    | -                 | -   | -                          | 4,260        |
| Stock-based compensation                                       | -               | 5,390                                | (476)                | -                 | -   | -                          | 4,914        |
| Employee stock plan tax benefits                               | -               | 1,329                                | -                    | -                 | -   | -                          | 1,329        |
| Other  | -               | (811)                                | -                    | -                 | -   | -                          | (811)        |
| Balance at December 31, 2016                                   | \$ 90,155       | \$ 797,513                           | \$ 1,032,844         | \$ (71,113)       | \$ 669  | \$ -                       | \$ 1,850,068 |

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, 2016, 2015, and 2014

|  | 2016             | 2015             | 2014             |
|--|------------------|------------------|------------------|
| Cash flows from operating activities:  |                  |                  |                  |
| Net income   | \$ 234,182       | \$ 201,790       | \$ 233,239       |
| Income from discontinued operations  | -                | -                | 19,355           |
| Income from continuing operations  | <u>234,182</u>   | <u>201,790</u>   | <u>213,884</u>   |
| Adjustments to reconcile income from continuing operations to net cash flows from operating activities:  |                  |                  |                  |
| Depreciation and amortization  | 133,008          | 128,737          | 126,535          |
| Deferred income taxes  | 17,250           | 16,506           | 31,477           |
| Provision for doubtful accounts  | 5,505            | 5,765            | 5,838            |
| Share-based compensation   | 5,390            | 5,860            | 6,819            |
| Gain on sale of utility system and market-based business unit  | (744)            | -                | -                |
| (Gain) loss on sale of other assets  | (378)            | (468)            | 4                |
| Gain on extinguishment of debt   | -                | (678)            | -                |
| Equity (earnings) loss in joint venture  | (976)            | 35,177           | 3,989            |
| Net change in receivables, inventory and prepayments   | (3,974)          | (6,520)          | (20,299)         |
| Net change in payables, accrued interest, accrued taxes and other accrued liabilities  | 4,756            | (3,469)          | 470              |
| Change in income tax receivable  | -                | -                | 7,873            |
| Other  | 1,769            | (11,906)         | (11,702)         |
| Operating cash flows from continuing operations  | <u>395,788</u>   | <u>370,794</u>   | <u>364,888</u>   |
| Operating cash flows used in discontinued operations, net  | -                | -                | (1,100)          |
| Net cash flows from operating activities   | <u>395,788</u>   | <u>370,794</u>   | <u>363,788</u>   |
| Cash flows from investing activities:  |                  |                  |                  |
| Property, plant and equipment additions, including the debt component of allowance for funds used during construction of \$2,220, \$1,598, and \$1,494 | (382,996)        | (364,689)        | (328,605)        |
| Acquisitions of utility systems and other, net   | (9,423)          | (28,989)         | (14,616)         |
| Release of funds previously restricted for construction activity   | -                | 47               | -                |
| Net proceeds from the sale of utility systems and other assets   | 7,746            | 648              | 558              |
| Other  | 1,464            | (1,079)          | 279              |
| Investing cash flows used in continuing operations   | <u>(383,209)</u> | <u>(394,062)</u> | <u>(342,384)</u> |
| Investing cash flows from discontinued operations, net   | -                | -                | 49,883           |
| Net cash flows used in investing activities  | <u>(383,209)</u> | <u>(394,062)</u> | <u>(292,501)</u> |
| Cash flows from financing activities:  |                  |                  |                  |
| Customers' advances and contributions in aid of construction   | 7,263            | 5,904            | 6,064            |
| Repayments of customers' advances  | (3,763)          | (3,977)          | (4,028)          |
| Net repayments of short-term debt  | (10,186)         | (1,677)          | (18,342)         |
| Proceeds from long-term debt   | 503,586          | 560,544          | 317,699          |
| Repayments of long-term debt   | (373,087)        | (400,407)        | (253,192)        |
| Change in cash overdraft position  | (8,076)          | (739)            | (322)            |
| Proceeds from issuing common stock   | 1,388            | 677              | -                |
| Proceeds from exercised stock options  | 4,260            | 7,540            | 7,296            |
| Share-based compensation windfall tax benefits   | 1,332            | 1,842            | 1,422            |
| Repurchase of common stock   | (3,028)          | (25,247)         | (15,756)         |
| Dividends paid on common stock   | (130,923)        | (121,248)        | (112,106)        |
| Other  | (811)            | (853)            | (793)            |
| Financing cash flows (used in) from continuing operations  | <u>(12,045)</u>  | <u>22,359</u>    | <u>(72,058)</u>  |
| Financing cash flows used in discontinued operations, net  | -                | -                | (149)            |
| Net cash flows (used in) from financing activities   | <u>(12,045)</u>  | <u>22,359</u>    | <u>(72,207)</u>  |
| Net increase (decrease) in cash and cash equivalents   | 534              | (909)            | (920)            |
| Cash and cash equivalents at beginning of year   | 3,229            | 4,138            | 5,058            |
| Cash and cash equivalents at end of year   | <u>\$ 3,763</u>  | <u>\$ 3,229</u>  | <u>\$ 4,138</u>  |
| Cash paid during the year for:   |                  |                  |                  |
| Interest, net of amounts capitalized   | \$ 66,067        | \$ 70,103        | \$ 72,441        |
| Income taxes   | 2,739            | 6,902            | 4,348            |
| Non-cash investing activities:   |                  |                  |                  |
| Property, plant and equipment additions purchased at the period end, but not yet paid  | \$ 35,145        | \$ 25,612        | \$ 31,050        |
| Non-cash customer advances for construction  | 26,234           | 27,992           | 43,642           |

See accompanying notes to consolidated financial statements.

See Note 2 – *Acquisitions*, Note 10 – *Long-term Debt and Loans Payable*, and Note 14 – *Employee Stock and Incentive Plan* for a description of non-cash activities.

**Note 1 – Summary of Significant Accounting Policies**

**Nature of Operations** — Aqua America, Inc. (“Aqua America,” the “Company,” “we,” “our”, 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 is Aqua Pennsylvania, Inc., which accounted for approximately 52% of our operating revenues and approximately 74% of our net income for 2016. As of December 31, 2016, Aqua Pennsylvania provided water or wastewater services to approximately one-half of the total number of people we serve. Aqua Pennsylvania’s service territory is located in the suburban areas north and west of the City of Philadelphia and in 27 other counties in Pennsylvania. The Company’s other regulated utility subsidiaries provide similar services in seven other states. In addition, the Company’s market-based activities are conducted through Aqua Resources, Inc. and Aqua Infrastructure LLC. Aqua Resources provides water and wastewater services through operating and maintenance contracts with municipal authorities and other parties in close proximity to our utility companies’ service territories; and offers, through a third party, water and wastewater line repair service and protection solutions to households. In addition, in 2016, the Company sold the following business units of Aqua Resources, which were reported as assets held for sale in the Company’s consolidated balance sheets:

- a business unit which provided liquid waste hauling and disposal services; and
- a business unit which inspected, cleaned and repaired storm and sanitary wastewater lines.

Additionally, in 2016, the Company decided to market for sale a business unit within Aqua Resources, which installs and tests devices that prevent the contamination of potable water, for which the sale was completed in January 2017, and a business unit that repairs and performs maintenance on water and wastewater systems. These business units are reported as assets held for sale in the Company’s consolidated balance sheets. Aqua Infrastructure provides non-utility raw water supply services for firms in the natural gas drilling industry.

In December 2014, we completed the sale of our water utility system in southwest Allen County, Indiana, which served approximately 13,000 customers, to the City of Fort Wayne, Indiana. The completion of this sale settled the dispute concerning the February 2008 acquisition, by eminent domain, by the City of Fort Wayne, of the northern portion of our water and wastewater utility systems. The operating results, cash flows, and financial position of the Company’s water utility system in Fort Wayne, Indiana has 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. Refer to Note 3 – *Discontinued Operations and Other Disposition* for further information on this sale.

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, Aqua Resources and Aqua Infrastructure are not quantitatively significant to be reportable and are included as a component of “Other,” in addition to corporate costs that have not been allocated to the Regulated segment and intersegment eliminations.

**Regulation** — Most of the operating companies that are regulated public utilities are subject to regulation by the utility commissions of the states in which they operate. The respective utility 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

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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. Certain prior period amounts have been reclassified to conform to the current period presentation of equity (earnings) loss in joint venture in the operating cash flows section of the consolidated statements of cash flows, and the presentation of debt issuance costs on the consolidated balance sheets.

***Recognition of Revenues*** — Revenues in our Regulated segment principally 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's market-based subsidiary Aqua Resources recognizes revenues when services are performed or, for construction of water and wastewater systems, based on the percentage of completion of the project and Aqua Infrastructure recognizes revenues when services are performed. The Company's market-based subsidiaries recognized revenues of \$20,091 in 2016, \$34,909 in 2015, and \$24,189 in 2014.

***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 additions meeting certain criteria, allowance for funds used during construction. Water systems acquired are typically 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 goodwill, or as an acquisition adjustment within utility plant as permitted by the applicable regulatory jurisdiction. At December 31, 2016, utility plant includes a net credit acquisition adjustment of \$25,683, which is generally being amortized from 2 to 59 years. Amortization of the acquisition adjustments totaled \$2,223 in 2016, \$2,556 in 2015, and \$2,648 in 2014.

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 utility 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, 2016, \$16,239 of these costs have been incurred since the last respective 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, data conversion and business process reengineering costs, are deferred as a regulatory asset if the Company expects to recover these costs in future rates. If these costs are not deferred, then these costs are charged to operating expenses when incurred. As of December 31, 2016, \$31,686 of these costs have been deferred since the last respective rate proceeding as a regulatory asset, and the deferral is reported as a component of net property, plant and equipment.

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When units of utility property are replaced, retired or abandoned, the recorded value thereof is credited to the asset account and such value, together with the net cost of removal, is charged to accumulated depreciation. To the extent the Company anticipates recovery of the cost of removal or other retirement costs through rates after the retirement costs are incurred, a regulatory asset is recorded as those costs are incurred. In some cases, the Company recovers retirement costs through rates during the life of the associated asset and before the costs are incurred. These amounts, which are not yet utilized, result in a regulatory liability being reported based on the amounts previously recovered through customer rates.

The straight-line remaining life method is used to compute depreciation on utility plant. Generally, the straight-line method is used with respect to transportation and mechanical equipment, office equipment and laboratory equipment.

Long-lived assets of the Company, which consist primarily of utility plant in service, regulatory assets, and investment in joint venture, are reviewed for impairment when changes in circumstances or events occur. These circumstances or events could include a disallowance of utility plant in service or regulatory assets by the respective utility commission, a decline in the market value or physical condition of a long-lived asset, an adverse change in the manner in which long-lived assets are used or planned to be used, a change in historical trends, operating cash flows associated with the long-lived assets, changes in macroeconomic conditions, industry and market conditions, or overall financial performance. When these circumstances or events occur, the Company determines whether it is more likely than not that the fair value of those assets is less than their carrying amount. If the Company determines that it is more likely than not (that is, the likelihood of more than 50 percent), the Company would recognize an impairment charge if it is determined that the carrying amount of an asset exceeds the sum of the undiscounted estimated cash flows. In this circumstance, the Company would recognize an impairment charge equal to the difference between the carrying amount and the fair value of the asset. Fair value is estimated to be the present value of future net cash flows associated with the asset, discounted using a discount rate commensurate with the risk and remaining life of the asset. There has been no change in circumstances or events that have occurred that require adjustments to the carrying values of the Company's long-lived assets, except for an impairment charge recognized by the joint venture on its long-lived assets in 2015.

***Allowance for Funds Used During Construction*** — The allowance for funds used during construction ("AFUDC") represents the capitalized cost of funds used to finance the construction of utility plant. In general, AFUDC is applied to construction projects requiring more than one month to complete. No AFUDC is applied to projects funded by customer advances for construction, contributions in aid of construction, or applicable state-revolving fund loans. AFUDC includes the net cost of borrowed funds and a rate of return on other funds when used, and is recovered through water rates as the utility plant is depreciated. The amount of AFUDC related to equity funds in 2016 was \$6,561, 2015 was \$4,621, and 2014 was \$3,640. No interest was capitalized by our market-based businesses.

***Cash and Cash Equivalents*** — The Company considers all highly liquid investments with an original maturity of three months or less, which are not restricted for construction activity, to be cash equivalents.

The Company had a book overdraft, which represents transactions that have not cleared the bank accounts at the end of the period, for specific disbursement cash accounts of \$12,616 and \$20,693 at December 31, 2016 and 2015, respectively. The Company transfers cash on an as-needed basis to fund these items as they clear the bank in subsequent periods. The balance of the book overdraft is reported as accounts payable and the change in the book overdraft balance is reported as cash flows from financing activities, due to our ability to fund the overdraft with the Company's credit facility.

***Funds Restricted for Construction Activity*** — The proceeds received from specific financings for construction and capital improvement of utility facilities are held in escrow until the designated expenditures are incurred. These amounts are reported as funds restricted for construction activity and are expected to be released over time

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as the capital projects are funded. As of December 31, 2016 and 2015, the Company did not have any funds restricted for construction activity.

**Accounts Receivable** — Accounts receivable are recorded at the invoiced amounts, which consists of billed and unbilled revenues. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in our existing accounts receivable, and is determined based on historical write-off experience and the aging of account balances. The Company reviews the allowance for doubtful accounts quarterly. Account balances are written off against the allowance when it is probable the receivable will not be recovered. When utility customers request extended payment terms, credit is extended based on regulatory guidelines, and collateral is not required.

**Inventories, Materials and Supplies** — Inventories are stated at cost. Cost is determined using the first-in, first-out method.

**Regulatory Assets, Deferred Charges and Other Assets** — Deferred charges and other assets consist primarily of assets held to compensate employees in the future who participate in the Company's deferred compensation plan and other costs. Other costs, for which the Company has received or expects to receive prospective rate recovery, are deferred as a regulatory asset and amortized over the period of rate recovery in accordance with the FASB's accounting guidance for regulated operations. See Note – 6 *Regulatory Assets and Liabilities* for further information regarding the Company's regulatory assets.

Marketable equity securities are carried on the balance sheet at fair market value, and changes in fair value are included in other comprehensive income.

**Investment in Joint Venture** — The Company uses the equity method of accounting to account for our 49% investment in a joint venture with a firm in the natural gas industry 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, which commenced operations in 2012. Our initial investment is carried at cost. Subsequently, the carrying amount of our investment is adjusted to reflect capital contributions or distributions, and our equity in earnings or losses since the commencement of the system's operations, as well as a decline in the fair value of our investment. Our share of equity earnings or losses in the joint venture is reported in the consolidated statements of net income as equity (earnings) losses in joint venture. During 2016 and 2015 we received distributions of \$1,666 and \$441, respectively. For our equity method investment in joint venture, the Company evaluates whether it has experienced a decline in the value of its investment that is other than temporary in nature. We would recognize an impairment loss if the fair value of our investment is less than the carrying amount of the investment, and the decline in value is considered other than temporary. Additionally, the Company would recognize its share of an impairment loss if the joint venture determines that the carrying amount of the joint venture's assets exceeds the sum of the joint venture's undiscounted estimated cash flows.

During the fourth quarter of 2015, the joint venture experienced the following events: a marked decline in natural gas prices, particularly in the fourth quarter of 2015, following a period of steady decline in 2015, a distinguishable reduction in the volume of water sales by the joint venture which led to a lowered forecast in the fourth quarter of 2015 on future water sales volumes by the joint venture, as well as changes in the natural gas industry and market conditions. These market conditions were largely associated with natural gas prices, which sharply declined in the fourth quarter of 2015 and this downturn no longer appeared temporary and instead may be a long-term condition. It was then determined that the carrying amount of the joint venture's long-lived assets exceeded the sum of the joint venture's undiscounted estimated cash flows, which resulted in the recognition of a noncash impairment charge of \$32,975 (\$21,433 after-tax) in the fourth quarter of 2015, representing the Company's share of the impairment charge. The impairment charge, on a pre-tax basis, is reported as equity loss in joint venture on the Company's consolidated statements of income. The amount of the impairment charge recognized by the joint venture is equal to the difference between the carrying value and the fair value of the long-

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lived assets. Fair value is estimated to be the present value of the future net cash flows associated with the assets, discounted using a rate commensurate with the risk and remaining life of the assets.

**Goodwill** — Goodwill represents the excess cost over the fair value of net tangible and identifiable intangible assets acquired through acquisitions. Goodwill is not amortized but is tested for impairment annually, or more often, if circumstances indicate a possible impairment may exist. When testing goodwill for impairment, we may assess qualitative factors, including macroeconomic conditions, industry and market considerations, cost factors, overall financial performance, and entity specific events, 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 a quantitative goodwill impairment test by determining the fair value of a reporting unit based on a discounted cash flow analysis. If we perform a quantitative test and determine that the fair value of a reporting unit is less than its carrying amount, we would determine the reporting unit's implied fair value of its goodwill and compare it with the carrying amount of its goodwill to measure such impairment. The Company tested the goodwill attributable for each of our reporting units for impairment as of July 31, 2016, and concluded that the estimated fair value of each reporting unit, which has goodwill recorded, exceeded the reporting unit's carrying amount, indicating that none of the Company's goodwill was impaired. The following table summarizes the changes in the Company's goodwill:

|   | Regulated<br>Segment | Other    | Consolidated |
|---|----------------------|----------|--------------|
| Balance at December 31, 2014  | \$ 24,564            | \$ 6,620 | \$ 31,184    |
| Goodwill acquired during year   | -                    | 12       | 12           |
| Reclassifications from (to) utility plant acquisition adjustment, net | 2,682                | -        | 2,682        |
| Other   | -                    | (12)     | (12)         |
| Balance at December 31, 2015  | 27,246               | 6,620    | 33,866       |
| Goodwill acquired during year   | 10,378               |          | 10,378       |
| Reclassifications to utility plant acquisition adjustment             | (98)                 |          | (98)         |
| Disposition   | (159)                | (1,232)  | (1,391)      |
| Classified as assets held for sale                                    |                      | (547)    | (547)        |
| Balance at December 31, 2016  | \$ 37,367            | \$ 4,841 | \$ 42,208    |

The reclassification of goodwill to utility plant acquisition adjustment results from a mechanism approved by the applicable utility commission. The mechanism provides for the transfer over time, and the recovery through customer rates, of goodwill associated with some acquisitions upon achieving specific objectives. The reclassification from utility plant acquisition adjustment to goodwill represents the purchase price in excess of the fair market value of the net assets acquired, from a prior acquisition, which was originally accounted for as utility plant acquisition adjustment.

The goodwill allocated to a disposition or classified as assets held for sale results from the allocation of goodwill for market-based business units based on their relative fair value as compared to Aqua Resource's fair value.

**Income Taxes** — The Company accounts for some income and expense items in different time periods for financial and tax reporting purposes. Deferred income taxes are provided on specific temporary differences between the tax basis of the assets and liabilities, and the amounts at which they are carried in the consolidated financial statements. The income tax effect of temporary differences not currently recovered in rates is recorded as deferred taxes with an offsetting regulatory asset or liability. These deferred income taxes are based on the enacted tax rates expected to be in effect when such temporary differences are projected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount more likely than not to be

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realized. Investment tax credits are deferred and amortized over the estimated useful lives of the related properties. Judgment is required in evaluating the Company's Federal and state tax positions. Despite management's belief that the Company's tax return positions are fully supportable, the Company establishes reserves when it believes that its tax positions are likely to be challenged and it may not fully prevail in these challenges. The Company's provision for income taxes includes interest, penalties and reserves for uncertain tax positions.

In 2012, the Company changed its tax method of accounting for qualifying utility asset improvement costs in Aqua Pennsylvania effective with the tax year ended December 31, 2012 and for prior tax years. The 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. This change was implemented in response to a June 2012 rate order issued by the Pennsylvania Public Utility Commission to Aqua Pennsylvania, which provides for a reduction in current income tax expense as a result of the recognition of income tax benefits for qualifying utility asset improvements. This change results in a significant reduction in the effective income tax rate, a reduction in current income tax expense, and reduces the amount of taxes currently payable. For qualifying capital expenditures made prior to 2012, the resulting tax benefits have been deferred as of December 31, 2012 and, in accordance with the rate order, a ten year amortization of the income tax benefits, which reduces future income tax expense, commenced in 2013. During 2013, our Ohio and North Carolina operating divisions implemented this change. These divisions currently do not employ a method of accounting that provides for a reduction in current income taxes as a result of the recognition of income tax benefits, and as such the change in the Company's tax method of accounting in these operating divisions had no impact on the Company's effective income tax rate.

***Customers' Advances for Construction and Contributions in Aid of Construction*** — Water mains, other utility property or, in some instances, cash advances to reimburse the Company for its costs to construct water mains or other utility property, are contributed to the Company by customers, real estate developers and builders in order to extend utility service to their properties. The value of these contributions is recorded as customers' advances for construction. Over time, the amount of non-cash contributed property will vary based on the timing of the contribution of the non-cash property and the volume of non-cash contributed property received in connection with development in our service territories. The Company makes refunds on these advances over a specific period of time based on operating revenues related to the property, or as new customers are connected to and take service from the applicable water main. After all refunds are made, any remaining balance is transferred to contributions in aid of construction. Contributions in aid of construction include direct non-refundable contributions and the portion of customers' advances for construction that become non-refundable.

Based on regulatory conventions in states where the Company operates, generally our subsidiaries depreciate contributed property and amortize contributions in aid of construction at the composite rate of the related property. Contributions in aid of construction and customers' advances for construction are deducted from the Company's rate base for rate-making purposes, and therefore, no return is earned on contributed property.

***Stock-Based Compensation*** — The Company records compensation expense in the financial statements for stock-based awards based on the grant date fair value of those awards. Stock-based compensation expense includes an estimate for pre-vesting forfeitures and is recognized over the requisite service periods of the awards on a straight-line basis, which is generally commensurate with the vesting term.

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

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

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs. There have been no changes in the valuation techniques used to measure fair value or asset or liability transfers between the levels of the fair value hierarchy for the years ended December 31, 2016 and 2015.

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

In March 2016, the FASB issued updated accounting guidance on simplifying the accounting for share-based payments, which includes several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The updated guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with early adoption available. The Company has evaluated the requirements of the updated guidance and has determined that upon adoption, on January 1, 2017, the Company will recognize a previously unrecognized windfall tax benefit for stock-based compensation of \$2,805 (\$1,823 after-tax), associated with the Company's 2012 Federal net operating loss, which will be recorded as an adjustment to retained earnings. Additionally, once adopted, income tax benefits in excess of compensation costs or tax deficiencies for share-based compensation will be recorded to our income tax provision, instead of, as was done historically, to stockholder's equity, which will impact our effective tax rate. Lastly, all tax-related cash flows resulting from share-based payments will be reported as operating activities on the statement of cash flows, a change from the historical requirement to present tax benefits as an inflow from financing activities and an outflow from operating activities.

In February 2016, the FASB issued updated accounting guidance on accounting for leases, which requires lessees to establish a right-of-use asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. For income statement purposes, leases will be classified as either operating or finance. Operating leases will result in straight-line expense while finance leases will result in a front-loaded expense pattern. The updated accounting guidance is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption available. The Company is evaluating the requirements of the updated guidance to determine the impact of adoption. Refer to Note 9 – *Commitments and Contingencies* for further information on the Company's leases.

In September 2015, the FASB issued updated accounting guidance on simplifying measurement-period adjustments in business combinations, which eliminates the requirement that an acquirer in a business combination account for measurement-period adjustments retrospectively. Instead, an acquirer will recognize a

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measurement-period adjustment during the period in which it determines the amount of the adjustment. The updated guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years, with early adoption available. The Company adopted the provisions of this accounting standard, as required on January 1, 2016, and it did not have an impact on its results of operations or financial position.

In April 2015, the FASB issued updated accounting guidance on simplifying the presentation of debt issuance costs, which requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability. Previously, debt issuance costs were presented in the balance sheet as a deferred charge. The accounting standard is effective for reporting periods beginning after December 15, 2015, and will be applied retrospectively. The Company adopted the provisions of this accounting standard as required on January 1, 2016. The adoption of this standard was applied retrospectively and resulted in the reclassification as of December 31, 2015 of \$23,165 from deferred charges and other assets, net to debt issuance costs, which is reported as a reduction to long-term debt.

In August 2014, the FASB issued an accounting standard that will require management to assess an entity's ability to continue as a going concern for each annual and interim reporting period and to provide related footnote disclosures in circumstances in which substantial doubt exists. The accounting standard is effective in the first annual reporting period ending after December 15, 2016. The Company adopted the provisions of this accounting standard for its year ended December 31, 2016, which did not have an impact on its results of operations or financial position.

In May 2014, the FASB issued updated accounting guidance on recognizing revenue from contracts with customers, which outlines a single comprehensive model that an entity will apply to determine the measurement of revenue and timing of recognition. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. The updated guidance also requires additional disclosure about the nature, amount, timing, and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to fulfill a contract. Additionally, the accounting for contributions in aid of construction may be impacted by the updated accounting guidance if the contributions are determined to be in scope. In July 2015, the FASB approved a one year deferral to the original effective date of this guidance. The updated guidance is effective for annual periods beginning after December 15, 2017, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the updated guidance in each prior reporting period, or (ii) a modified retrospective approach with the cumulative effect of initially adopting the updated guidance recognized through retained earnings at the date of adoption. In 2016, the Company performed an evaluation of the requirements of the updated guidance and based on current interpretations of the updated guidance believes that the impact of adoption may not result in a material change in our measurement of revenue and timing of recognition if contributions in aid of construction is determined to not be in scope. The Company continues to evaluate the impact of adoption if contributions in aid of construction are determined to be in scope. Additionally, we plan to implement the updated guidance using the modified retrospective approach.

## **Note 2 – Acquisitions**

Pursuant to the Company's growth-through-acquisition strategy, the Company completed the following acquisitions. In January 2016, the Company acquired Superior Water Company, Inc., which provides public water service to approximately 3,900 customers in portions of Berks, Chester, and Montgomery counties in Pennsylvania. The total purchase price for the utility system was \$16,750, which consisted of the issuance of 439,943 shares of the Company's common stock and \$3,905 in cash. The purchase price allocation for this acquisition consisted primarily of acquired property, plant and equipment of \$25,167, contributions in aid of construction of \$16,565, and goodwill of \$8,622. Additionally, during 2016 the Company completed 18 acquisitions of water and wastewater utility systems in various states. The total purchase price of these utility

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systems consisted of \$5,518 in cash. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company for the utility systems acquired in 2016 are \$3,809. The pro forma effect of the businesses acquired is not material either individually or collectively to the Company's results of operations.

In April 2015, the Company acquired the water and wastewater utility system assets of North Maine Utilities, located in the Village of Glenview, Illinois serving approximately 7,400 customers. The total purchase price consisted of \$23,079 in cash. The purchase price allocation for this acquisition consists primarily of acquired property, plant and equipment. Additionally, in 2015, the Company completed 14 acquisitions of water and wastewater utility systems in various states. The total purchase price of these utility systems consisted of \$5,210 in cash. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company for the utility systems acquired were \$10,708 in 2016 and \$6,662 in 2015. The pro forma effect of the businesses acquired is not material either individually or collectively to the Company's results of operations.

In 2014, the Company completed 16 acquisitions of water and wastewater utility systems in various states. The total purchase price of these utility systems consisted of \$10,530 in cash. Further, in August 2014, the Company acquired a market-based business that specializes in the inspection, cleaning and repair of storm and sanitary sewer lines. The total purchase price consisted of \$3,010, of which a total of \$810 is contingent upon satisfying certain annual performance targets over a three-year period for which \$270 has been paid for completion of the performance targets for year one. Additionally, in December 2014, the Company acquired a market-based business that specializes in providing water distribution system services to prevent the contamination of potable water, including training to waterworks operators. The total purchase price consisted of \$1,800, of which \$700 was paid in the first quarter of 2015. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company for these utility systems and market-based businesses were \$13,493 in 2016, \$19,154 in 2015, and \$4,403 in 2014. The decrease in operating revenues is due to the sale of a market-based business unit in 2016. The pro forma effect of the businesses acquired is not material either individually or collectively to the Company's results of operations.

**Note 3 – Discontinued Operations and Other Dispositions**

*Discontinued Operations* – In December 2014, we completed the sale of our water utility system in southwest Allen County, Indiana to the City of Fort Wayne, Indiana (the "City") for \$67,011, which included a payment received in December 2014 of \$50,100 in addition to \$16,911 the City already paid the Company for the northern portion of our water and wastewater utility systems, which were acquired by the City in February 2008, by eminent domain. We recognized a gain on sale of \$29,210 (\$17,611 after-tax) in the fourth quarter of 2014. As a result of this transaction, Aqua Indiana will expand its sewer customer base by accepting new wastewater flows from the City.

In September 2012, the Company began to market for sale its non-regulated wastewater treatment facility in Georgia. In March 2014, we completed the sale of our wastewater treatment facility in Georgia, which concluded our operations in this state.

The operating results, cash flows, and financial position of the Company's subsidiaries named above have been presented in the Company's consolidated statements of net income, consolidated statements of cash flow, and consolidated balance sheets as discontinued operations.

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A summary of discontinued operations presented in the consolidated statements of net income includes the following:

|   | Year Ended<br>December 31, |
|---|----------------------------|
|   | 2014                       |
| Operating revenues                                      | \$ 6,324                   |
| Total operating expenses                                | 3,262                      |
| Operating income  | 3,062                      |
| Other (income) expense:                                 |                            |
| Gain on sale  | (29,093)                   |
| Other, net  | -                          |
| Income from discontinued operations before income taxes | 32,155                     |
| Provision for income taxes                              | 12,800                     |
| Income from discontinued operations                     | \$ 19,355                  |

As of December 31, 2016 and 2015 the Company does not have any assets or liabilities of discontinued operations held for sale.

**Other Dispositions** – The following dispositions have not been presented as discontinued operations in the Company’s consolidated financial statements as they do not qualify as discontinued operations, since their disposal does not represent a strategic shift that has a major effect on our operations or financial results. The gains or loss disclosed below are reported in the consolidated statements of net income as a component of operations and maintenance expense. These business units were reported within the Company’s market-based subsidiary, Aqua Resources, and were included in “Other” in the Company’s segment information.

*Dispositions Completed in 2016*

In the third quarter of 2016, the Company marketed for sale a business unit which inspects, cleans and repairs storm and sanitary wastewater lines. In November 2016, this business unit was sold for \$1,059 in cash and resulted in a loss on sale of \$1,081. Further, in December 2015, the Company decided to sell a business unit which provides liquid waste hauling and disposal services. This business unit was reported as assets held for sale in the Company’s December 31, 2015 consolidated balance sheet included in this Annual Report. During the second quarter of 2016, this business unit was sold for \$3,400 in cash and resulted in a gain on sale of \$537.

*Dispositions Reported as Assets Held for Sale at December 31, 2016*

In the second quarter of 2016, the Company decided to market for sale business units, which install and test devices that prevent the contamination of potable water and repair water and wastewater systems, for which the sale was completed in January 2017, and a business unit that repairs and performs maintenance on water and wastewater systems. These business units are reported within the Company’s market-based subsidiary, Aqua Resources. These business units are reported as assets held for sale in the Company’s consolidated balance sheets included in this Annual Report.

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**Note 4 – Property, Plant and Equipment**

|   | December 31,        |                     | Approximate Range<br>of Useful Lives | Weighted Average<br>Useful Life |
|---|---------------------|---------------------|--------------------------------------|---------------------------------|
|   | 2016                | 2015                |                                      |                                 |
| Utility plant and equipment:                          |                     |                     |                                      |                                 |
| Mains and accessories                                 | \$ 2,898,560        | \$ 2,696,194        | 30 - 93 years                        | 77 years                        |
| Services, hydrants, treatment plants and reservoirs   | 1,621,972           | 1,531,052           | 5 - 85 years                         | 49 years                        |
| Operations structures and water tanks                 | 283,635             | 263,722             | 14 - 85 years                        | 47 years                        |
| Miscellaneous pumping and purification equipment      | 733,074             | 687,472             | 7 - 90 years                         | 40 years                        |
| Meters, data processing, transportation and operating | 733,837             | 684,335             | 4 - 63 years                         | 25 years                        |
| Land and other non-depreciable assets                 | 98,529              | 98,575              | -                                    | -                               |
| Utility plant and equipment                           | 6,369,607           | 5,961,350           |                                      |                                 |
| Utility construction work in progress                 | 163,565             | 144,448             | -                                    | -                               |
| Net utility plant acquisition adjustment              | (25,683)            | (24,428)            | 2 - 59 years                         | 28 years                        |
| Non-utility plant and equipment                       | 1,628               | 6,641               | 3 - 15 years                         | 6 years                         |
| Total property, plant and equipment                   | <u>\$ 6,509,117</u> | <u>\$ 6,088,011</u> |                                      |                                 |

**Note 5 – Accounts Receivable**

|                                      | December 31,     |                  |
|--------------------------------------|------------------|------------------|
|                                      | 2016             | 2015             |
| Billed utility revenue               | \$ 63,518        | \$ 56,876        |
| Unbilled revenue                     | 34,635           | 37,276           |
| Other                                | 6,336            | 10,867           |
|                                      | 104,489          | 105,019          |
| Less allowance for doubtful accounts | 7,095            | 5,873            |
| Net accounts receivable              | <u>\$ 97,394</u> | <u>\$ 99,146</u> |

The Company's utility customers are located principally in the following states: 47% in Pennsylvania, 16% in Ohio, 10% in North Carolina, 8% in Texas, and 8% in Illinois. No single customer accounted for more than one percent of the Company's regulated operating revenues during the years ended December 31, 2016, 2015, and 2014. The following table summarizes the changes in the Company's allowance for doubtful accounts:

|                                    | 2016            | 2015            | 2014            |
|------------------------------------|-----------------|-----------------|-----------------|
| Balance at January 1,              | \$ 5,873        | \$ 5,365        | \$ 4,413        |
| Amounts charged to expense         | 5,500           | 5,762           | 5,838           |
| Accounts written off               | (5,410)         | (6,513)         | (6,120)         |
| Recoveries of accounts written off | 1,132           | 1,259           | 1,234           |
| Balance at December 31,            | <u>\$ 7,095</u> | <u>\$ 5,873</u> | <u>\$ 5,365</u> |

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**Note 6 – Regulatory Assets and Liabilities**

The regulatory assets represent costs that are probable to be fully recovered from customers in future rates while regulatory liabilities represent amounts that are expected to be refunded to customers in future rates or amounts recovered from customers in advance of incurring the costs. Except for income taxes, regulatory assets and regulatory liabilities are excluded from the Company’s rate base and do not earn a return. The components of regulatory assets and regulatory liabilities are as follows:

|  | December 31, 2016    |                           | December 31, 2015    |                           |
|--|----------------------|---------------------------|----------------------|---------------------------|
|  | Regulatory<br>Assets | Regulatory<br>Liabilities | Regulatory<br>Assets | Regulatory<br>Liabilities |
| Income taxes   | \$ 807,952           | \$ 157,266                | \$ 699,247           | \$ 181,067                |
| Utility plant retirement costs                                 | 4,986                | 31,288                    | 6,052                | 27,604                    |
| Post-retirement benefits                                       | 119,519              | 59,882                    | 112,626              | 50,775                    |
| Accrued vacation   | 1,984                | -                         | 1,744                | -                         |
| Water tank painting  | 2,111                | 2,143                     | 303                  | -                         |
| Fair value adjustment of long-term debt assumed in acquisition | 3,268                | -                         | 3,636                | -                         |
| Rate case filing expenses and other                            | 8,827                | 56                        | 6,510                | 61                        |
|  | <u>\$ 948,647</u>    | <u>\$ 250,635</u>         | <u>\$ 830,118</u>    | <u>\$ 259,507</u>         |

Items giving rise to deferred state income taxes, as well as a portion of deferred Federal income taxes related to specific differences between tax and book depreciation expense, are recognized in the rate setting process on a cash basis or as a reduction in current income tax expense and will be recovered as they reverse. Amounts include differences that arise between specific utility asset improvement costs capitalized for book and deducted as an expense for tax purposes.

A portion of the regulatory liability for income taxes is related to Aqua Pennsylvania’s income tax accounting change for the tax benefits realized on the Company’s 2012 tax return, which have not yet reduced current income tax expense due to the ten year amortization period which began in 2013. This amortization was stipulated in a June 2012 rate order issued to Aqua Pennsylvania and is subject to specific parameters being met each year. Beginning in 2013, the Company amortized \$38,000, annually, of its deferred income tax benefits, which reduced current income tax expense and increased the Company’s net income by \$16,734.

The regulatory asset for utility plant retirement costs, including cost of removal, represents costs already incurred that are expected to be recovered in future rates over a five year recovery period. The regulatory liability for utility plant retirement costs represents amounts recovered through rates during the life of the associated asset and before the costs are incurred.

The regulatory asset for accrued vacation represents costs that would otherwise be charged to operations and maintenance expense for vacation that is earned by employees, which is recovered as a cost of service.

The regulatory asset for Post-retirement benefits, which includes pension and other post-retirement benefits, primarily reflects a regulatory asset that has been recorded for the costs that would otherwise be charged to stockholders’ equity for the underfunded status of the Company’s pension and other post-retirement benefit plans. The Company also has a regulatory asset related to post-retirement benefits costs that represent costs already incurred which are now being recovered in rates over 10 years. The regulatory liability for post-retirement benefits represents costs recovered in rates in excess of post-retirement benefits expense.

Expenses associated with water tank painting are deferred and amortized over a period of time as approved in the regulatory process. Water tank painting costs are generally being amortized over a period ranging from 1 to 20

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years. The regulatory liability for water tank painting costs represents amounts recovered through rates and before the costs are incurred.

The Company recorded a fair value adjustment for fixed rate, long-term debt assumed in acquisitions that matures in various years ranging from 2022 to 2029. The regulatory asset or liability results from the rate setting process continuing to recognize the historical interest cost of the assumed debt.

The regulatory asset related to rate case filing expenses and other represents the costs associated with filing for rate increases that are deferred and amortized over periods that generally range from one to five years, and costs incurred by the Company for which it has received or expects to receive rate recovery.

The regulatory asset related to the costs incurred for information technology software projects and water main cleaning and relining projects are described in Note 1 – *Summary of Significant Accounting Policies – Property, Plant and Equipment and Depreciation*.

**Note 7 – Income Taxes**

The provision for income taxes for the Company’s continuing operations consists of:

|                   | Years Ended December 31, |           |             |
|-------------------|--------------------------|-----------|-------------|
|                   | 2016                     | 2015      | 2014        |
| Current:          |                          |           |             |
| Federal           | \$ 2,046                 | \$ 2,624  | \$ (11,296) |
| State             | 1,682                    | (4,168)   | 5,038       |
|                   | 3,728                    | (1,544)   | (6,258)     |
| Deferred:         |                          |           |             |
| Federal           | 21,489                   | 12,649    | 37,500      |
| State             | (4,239)                  | 3,857     | (6,023)     |
|                   | 17,250                   | 16,506    | 31,477      |
| Total tax expense | \$ 20,978                | \$ 14,962 | \$ 25,219   |

The statutory Federal tax rate is 35% and for states with a corporate net income tax, the state corporate net income tax rates range from 4% to 9.99% for all years presented.

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The reasons for the differences between amounts computed by applying the statutory Federal income tax rate to income before income tax expense for the Company's continuing operations are as follows:

|   | Years Ended December 31, |                  |                  |
|---|--------------------------|------------------|------------------|
|   | 2016                     | 2015             | 2014             |
| Computed Federal tax expense at statutory rate  | \$ 89,306                | \$ 75,863        | \$ 83,686        |
| Decrease in Federal tax expense related to an income tax accounting change for qualifying utility asset improvement costs | (62,831)                 | (59,488)         | (57,015)         |
| State income taxes, net of Federal tax benefit  | (1,662)                  | (202)            | (640)            |
| Increase in tax expense for depreciation expense to be recovered in future rates  | 199                      | 199              | 317              |
| Stock-based compensation  | (227)                    | (174)            | (168)            |
| Deduction for Aqua America common dividends paid under employee benefit plan  | (455)                    | (456)            | (350)            |
| Amortization of deferred investment tax credits   | (405)                    | (421)            | (416)            |
| Other, net  | (2,947)                  | (359)            | (195)            |
| Actual income tax expense   | <u>\$ 20,978</u>         | <u>\$ 14,962</u> | <u>\$ 25,219</u> |

In December 2012, the Company changed its tax method of accounting for qualifying utility system repairs in Aqua Pennsylvania effective with the tax year ended December 31, 2012 and for prior tax years. The 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. This change was implemented in response to a June 2012 rate order issued by the Pennsylvania Public Utility Commission to Aqua Pennsylvania which provides for a reduction in current income tax expense as a result of the flow-through recognition of some income tax benefits due to the income tax accounting change. In 2014, the Company recorded \$69,048 of income tax benefits. In 2015, the Company recorded \$72,944 of income tax benefits. In 2016, the Company recorded \$78,530 of income tax benefits. 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 rate order, in 2013, the Company began to amortize 1/10<sup>th</sup> of these expenditures. In accordance with the rate order, the amortization is expected to reduce current income tax expense during periods when qualifying parameters are met. Beginning in 2013, the Company amortized the qualifying capital expenditures made prior to 2012 and recognized \$38,000, annually, of deferred income tax benefits, which reduced current income tax expense and increased the Company's net income by \$16,734. The Company's effective income tax rate for 2016, 2015, and 2014, for its continuing operations, was 8.2%, 6.9%, and 10.5%, respectively.

In September 2013, the Department of Treasury and the Internal Revenue Service issued "Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property" which contains standards for determining whether and when a taxpayer must capitalize costs incurred in acquiring, maintaining or improving tangible property. These regulations were effective for the Company's 2014 fiscal year, and the adoption of these regulations did not have a material impact on the Company's consolidated results of operations or consolidated financial position.

The Company establishes 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. The Company believes its tax positions comply with applicable law and that it has adequately recorded reserves as required. However, to the extent the final tax outcome of these matters is different than the estimates recorded, the Company would then adjust its tax reserves or unrecognized tax benefits in the period that this information becomes known. The Company has elected to recognize accrued interest and penalties related to uncertain tax positions as income tax expense.

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The following table provides the changes in the Company's unrecognized tax benefits:

|   | 2016             | 2015             |
|---|------------------|------------------|
| Balance at January 1,                                       | \$ 28,016        | \$ 25,292        |
| Additions based on tax position related to the current year | 83               | 2,724            |
| Balance at December 31,                                     | <u>\$ 28,099</u> | <u>\$ 28,016</u> |

The unrecognized tax benefits relate to the income tax accounting change, and the tax position is attributable to a temporary difference. The Company does not anticipate material changes to its unrecognized tax benefits within the next year. As a result of the regulatory treatment afforded by the income tax accounting change in Pennsylvania and despite this position being a temporary difference, as of December 31, 2016 and 2015, \$20,674 and \$17,777 and, respectively, of these tax benefits would have an impact on the Company's effective income tax rate in the event the Company does sustain all, or a portion, of its tax position.

The following table provides the components of the net deferred tax liability from continuing operations:

|   | December 31,        |                  |
|---|---------------------|------------------|
|   | 2016                | 2015             |
| Deferred tax assets:  |                     |                  |
| Customers' advances for construction  | \$ 21,738           | \$ 27,675        |
| Costs expensed for book not deducted for tax, principally accrued expenses  | 15,751              | 15,612           |
| Utility plant acquisition adjustment basis differences  | 3,114               | 3,489            |
| Post-retirement benefits  | 38,269              | 36,362           |
| Tax loss carryforward   | 77,911              | 93,263           |
| Other   | 2,137               | 1,102            |
|   | <u>158,920</u>      | <u>177,503</u>   |
| Less valuation allowance  | 9,486               | 10,982           |
|   | <u>149,434</u>      | <u>166,521</u>   |
| Deferred tax liabilities:   |                     |                  |
| Utility plant, principally due to depreciation and differences in the basis of fixed assets due to variation in tax and book accounting | 1,104,032           | 1,027,406        |
| Deferred taxes associated with the gross-up of revenues necessary to recover, in rates, the effect of temporary differences             | 269,773             | 214,861          |
| Tax effect of regulatory asset for post-retirement benefits   | 38,269              | 36,362           |
| Deferred investment tax credit  | 6,613               | 6,815            |
|   | <u>1,418,687</u>    | <u>1,285,444</u> |
| Net deferred tax liability  | <u>\$ 1,269,253</u> | <u>1,118,923</u> |

At December 31, 2016, the Company has a cumulative Federal net operating loss ("NOL") of \$113,144. The Company believes the Federal NOLs are more likely than not to be recovered and require no valuation allowance. The Company's Federal NOLs do not begin to expire until 2032.

In 2012 and 2011, as a result of the Company's Federal cumulative NOLs the Company ceased recognizing the windfall tax benefit associated with stock-based compensation, because the deduction did not reduce income taxes payable. As of December 31, 2015, the Company utilized all of the 2011 NOL and recognized a windfall tax benefit of \$1,680. As a result of the adoption on January 1, 2017 of the FASB's updated accounting guidance on simplifying the accounting for share-based payments, the Company will recognize a windfall tax benefit of

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\$2,805 associated with the Company's 2012 Federal NOL, which will be recorded as an adjustment to retained earnings.

At December 31, 2016 the Company has a cumulative state NOL of \$575,330, a portion of which is offset by a valuation allowance because the Company does not believe these NOLs are more likely than not to be realized. The state NOLs do not begin to expire until 2023.

The Company has unrecognized tax positions that result in the associated tax benefit being unrecognized. The Company's Federal and state NOL carryforwards are reduced by an unrecognized tax position, on a gross basis, of \$62,747 and \$85,044, respectively, which results from the Company's adoption in 2013 of the FASB's accounting guidance on the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The amounts of the Company's Federal and state NOL carryforwards prior to being reduced by the unrecognized tax positions are \$175,891 and \$660,373, respectively. The Company records its unrecognized tax benefit as a reduction to its deferred income tax liability.

As of December 31, 2016, the Company's Federal income tax returns for all years through 2011 have been closed. Tax years 2012 through 2016 remain open to Federal examination. The statute remains open for the Company's state income tax returns for tax years 2013 through 2016 in the various states in which the Company's conducts business.

**Note 8 – Taxes Other than Income Taxes**

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

|                                      | Years Ended December 31, |                  |                  |
|--------------------------------------|--------------------------|------------------|------------------|
|                                      | 2016                     | 2015             | 2014             |
| Property                             | \$ 26,788                | \$ 26,545        | \$ 24,133        |
| Capital Stock                        | 1,442                    | 1,644            | 1,315            |
| Gross receipts, excise and franchise | 10,864                   | 10,362           | 10,945           |
| Payroll                              | 9,772                    | 9,539            | 7,583            |
| Regulatory assessments               | 2,630                    | 2,689            | 2,538            |
| Pumping fees                         | 4,571                    | 3,993            | 3,618            |
| Other                                | 318                      | 285              | 321              |
| Total taxes other than income taxes  | <u>\$ 56,385</u>         | <u>\$ 55,057</u> | <u>\$ 50,453</u> |

**Note 9 – Commitments and Contingencies**

The following disclosures reflect commitments and contingencies for the Company's continuing operations.

**Commitments** – The Company leases motor vehicles, buildings and other equipment under operating leases that are noncancelable. The future annual minimum lease payments due are as follows:

| 2017     | 2018   | 2019   | 2020   | 2021   | Thereafter |
|----------|--------|--------|--------|--------|------------|
| \$ 1,122 | \$ 962 | \$ 789 | \$ 750 | \$ 559 | \$ 588     |

The Company leases parcels of land on which treatment plants and other facilities are situated and adjacent parcels that are used for watershed protection. The operating leases are noncancelable, expire between 2017 and 2052 and contain renewal provisions. Some leases are subject to an adjustment every five years based on changes

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in the Consumer Price Index. Subject to the aforesaid adjustment, during each of the next five years, an average of \$582 of annual lease payments for land is due, and the aggregate of the years remaining approximates \$12,927.

The Company maintains agreements with other water purveyors for the purchase of water to supplement its water supply, particularly during periods of peak demand. The agreements stipulate purchases of minimum quantities of water to the year 2026. The estimated annual commitments related to such purchases through 2021 are expected to average \$5,075 and the aggregate of the years remaining approximates \$13,587.

The Company has entered into purchase obligations, in the ordinary course of business, that include agreements for water treatment processes at some of its wells in a small number of its divisions. The 20 year term agreement provides for the use of treatment equipment and media used in the treatment process and are subject to adjustment based on changes in the Consumer Price Index. The future contractual cash obligations related to these agreements are as follows:

|    | 2017   | 2018     | 2019     | 2020     | 2021     | Thereafter |
|----|--------|----------|----------|----------|----------|------------|
| \$ | 22,153 | \$ 1,101 | \$ 1,101 | \$ 1,100 | \$ 1,099 | \$ 7,326   |

Rent expense under operating leases, purchased water expense, and water treatment expenses under these agreements were as follows:

|   | Years Ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2016                     | 2015     | 2014     |
| Operating lease expense                             | \$ 2,440                 | \$ 2,440 | \$ 2,820 |
| Purchased water under long-term agreements          | 13,955                   | 13,718   | 13,139   |
| Water treatment expense under contractual agreement | 940                      | 972      | 892      |

**Contingencies** – The Company is routinely involved in various disputes, claims, lawsuits and other regulatory and legal matters, including both asserted and unasserted legal claims, in the ordinary course of business. The status of each such matter, referred to herein as a loss contingency, is reviewed and assessed in accordance with applicable accounting rules regarding the nature of the matter, the likelihood that a loss will be incurred, and the amounts involved. As of December 31, 2016, the aggregate amount of \$13,892 is accrued for loss contingencies and is reported in the Company’s consolidated balance sheet as other accrued liabilities and other liabilities. These accruals represent management’s best estimate of probable loss (as defined in the accounting guidance) for loss contingencies or the low end of a range of losses if no single probable loss can be estimated. For some loss contingencies, the Company is unable to estimate the amount of the probable loss or range of probable losses. While the final outcome of these loss contingencies cannot be predicted with certainty, and unfavorable outcomes could negatively impact the Company, at this time in the opinion of management, the final resolution of these matters are not expected to have a material adverse effect on the Company’s financial position, results of operations or cash flows. Further, Aqua America has insurance coverage for a number of these loss contingencies, and as of December 31, 2016, estimates that approximately \$1,242 of the amount accrued for these matters are probable of recovery through insurance, which amount is also reported in the Company’s consolidated balance sheet as deferred charges and other assets, net.

Although the results of legal proceedings cannot be predicted with certainty, there are no pending legal proceedings to which the Company or any of its subsidiaries is a party or to which any of its properties is the subject that are material or are expected to have a material effect on the Company’s financial position, results of operations or cash flows.

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Additionally, the Company self-insures its employee medical benefit program, and maintains stop-loss coverage to limit the exposure arising from these claims. The Company's reserve for these claims totaled \$1,770 and \$1,496 at December 31, 2016 and 2015 and represents a reserve for unpaid claim costs, including an estimate for the cost of incurred but not reported claims.

**Note 10 – Long-term Debt and Loans Payable**

**Long-term Debt** – The consolidated statements of capitalization provide a summary of long-term debt as of December 31, 2016 and 2015. The supplemental indentures with respect to specific issues of the first mortgage bonds restrict the ability of Aqua Pennsylvania and other operating subsidiaries of the Company to declare dividends, in cash or property, or repurchase or otherwise acquire the stock of these companies. Loan agreements for Aqua Pennsylvania and other operating subsidiaries of the Company have restrictions on minimum net assets. As of December 31, 2016, restrictions on the net assets of the Company were \$1,324,679 of the total \$1,850,068 in net assets. Included in this amount were restrictions on Aqua Pennsylvania's net assets of \$999,061 of their total net assets of \$1,419,703. As of December 31, 2016, approximately \$1,268,494 of Aqua Pennsylvania's retained earnings of approximately \$1,288,494 and approximately \$118,400 of the retained earnings of approximately \$171,800 of other subsidiaries were free of these restrictions. Some supplemental indentures also prohibit Aqua Pennsylvania and some other subsidiaries of the Company from making loans to, or purchasing the stock of, the Company.

Sinking fund payments are required by the terms of specific issues of long-term debt. Excluding amounts due under the Company's revolving credit agreement, the future sinking fund payments and debt maturities of the Company's long-term debt are as follows:

| Interest Rate Range | 2017       | 2018       | 2019      | 2020      | 2021      | Thereafter   |
|---------------------|------------|------------|-----------|-----------|-----------|--------------|
| 0.00% to 0.99%      | \$ 487     | \$ 483     | \$ 486    | \$ 486    | \$ 484    | \$ 2,235     |
| 1.00% to 1.99%      | 51,389     | 51,398     | 1,287     | 1,232     | 1,003     | 9,230        |
| 2.00% to 2.99%      | 1,649      | 1,693      | 1,739     | 1,786     | 1,835     | 10,966       |
| 3.00% to 3.99%      | 2,712      | 2,808      | 2,760     | 2,557     | 2,595     | 613,512      |
| 4.00% to 4.99%      | 58,952     | 11,195     | 50,404    | 16,617    | 15,298    | 468,452      |
| 5.00% to 5.99%      | 24,945     | 10,596     | 31,125    | 23,120    | 8,402     | 274,699      |
| 6.00% to 6.99%      | 9,000      | 12,985     | -         | -         | -         | 31,000       |
| 7.00% to 7.99%      | 445        | 523        | 566       | 612       | 663       | 30,257       |
| 8.00% to 8.99%      | 392        | 521        | 563       | 611       | 1,662     | 2,816        |
| 9.00% to 9.99%      | 700        | 5,700      | 700       | 2,400     | 4,900     | 12,000       |
| 10.00% to 10.99%    | -          | 6,000      | -         | -         | -         | -            |
| Total               | \$ 150,671 | \$ 103,902 | \$ 89,630 | \$ 49,421 | \$ 36,842 | \$ 1,455,167 |

In December 2016, Aqua Pennsylvania issued \$85,000 of first mortgage bonds, of which \$25,000 is due in 2051 and \$60,000 is due in 2056 with interest rates of 3.85% and 3.95%, respectively. In January 2017, Aqua Pennsylvania issued \$50,000 of first mortgage bonds, of which \$10,000 is due in 2042 and \$40,000 is due in 2044 with interest rates of 3.65% and 3.69%, respectively. The proceeds from these bonds were used to repay existing indebtedness and for general corporate purposes.

In November 2016, the Company issued \$125,000 of senior notes, of which \$35,000 is due in 2031, \$30,000 is due in 2034, \$25,000 is due in 2035, \$10,000 is due in 2038, and \$25,000 is due in 2041 with interest rates of 3.01%, 3.19%, 3.25%, 3.41%, and 3.57%, respectively. The proceeds from these bonds were used to repay existing indebtedness and for general corporate purposes.

In December 2015, Aqua Pennsylvania issued \$210,000 of first mortgage bonds, of which \$65,000 is due in 2036, \$20,000 is due in 2037, \$25,000 is due in 2038, \$60,000 is due in 2046, \$20,000 is due in 2047, and \$20,000 is

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due in 2048 with interest rates of 3.77%, 3.82%, 3.85%, 4.16%, 4.18%, and 4.20%, respectively. The proceeds from these bonds were used to repay existing indebtedness and for general corporate purposes.

In October 2015, Aqua Pennsylvania provided notice for the early redemption of \$4,000 of first mortgage bonds at 8.14% that were originally maturing in 2025 and \$95,985 of tax-exempt bonds at 5.00% that were originally maturing between 2035 and 2038. Upon early redemption in December 2015 of the tax-exempt bonds, a gain of \$678 was recognized resulting from the recognition of the unamortized issuance premium.

In May 2015, the Company issued \$70,000 of senior unsecured notes due in 2030 with an interest rate of 3.59%. The proceeds were used to repay existing indebtedness and for general corporate purposes.

In May 2015, Aqua Pennsylvania entered into a \$50,000 three-year unsecured loan at an interest rate of 1.975%. The proceeds from this loan were used for refinancing existing indebtedness and general working capital purposes.

As of December 31, 2016 and 2015, the Company did not have any funds restricted for construction activity. The weighted average cost of long-term debt at December 31, 2016 and 2015 was 4.23% and 4.44%, respectively. The weighted average cost of fixed rate long-term debt at December 31, 2016 and 2015 was 4.26% and 4.57%, respectively.

The Company has a five-year unsecured revolving credit facility, which was amended in February 2016 to extend the expiration from March 2017 to February 2021, to increase the facility from \$200,000 to \$250,000, and added a fourth bank to the lending group. Included within this facility is a \$15,000 sublimit for daily demand loans. Funds borrowed under this facility are classified as long-term debt and are used to provide working capital as well as support for letters of credit for insurance policies and other financing arrangements. As of December 31, 2016, the Company has the following sublimits and available capacity under the credit facility: \$50,000 letter of credit sublimit, \$32,439 of letters of credit available capacity, \$0 borrowed under the swing-line commitment, and \$25,000 of funds borrowed under the agreement. Interest under this facility is based at the Company's option, on the prime rate, an adjusted Euro-Rate, an adjusted federal funds rate or at rates offered by the banks. A facility fee is charged on the total commitment amount of the agreement. Under this facility the average cost of borrowings was 1.54% and 0.87%, and the average borrowing was \$89,374 and \$82,880, during 2016 and 2015, respectively.

The Company is obligated to comply with covenants under some of its 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 2016, the Company was in compliance with its debt covenants under its credit facilities. Failure to comply with the Company's debt covenants could result in an event of default, which could result in the Company being required to repay or finance its borrowings before their due date, possibly limiting the Company's future borrowings, and increasing its borrowing costs.

**Loans Payable** – In November 2016, Aqua Pennsylvania renewed its \$100,000 364-day unsecured revolving credit facility with four banks. The funds borrowed under this agreement are classified as loans payable and used to provide working capital. As of December 31, 2016 and 2015, funds borrowed under the agreement were \$5,545 and \$7,281, respectively. Interest under this facility is based, at the borrower's option, on the prime rate, an adjusted federal funds rate, an adjusted London Interbank Offered Rate corresponding to the interest period selected, an adjusted Euro-Rate corresponding to the interest period selected or at rates offered by the banks. This agreement restricts short-term borrowings of Aqua Pennsylvania. A commitment fee of 0.05% is charged on the total commitment amount of Aqua Pennsylvania's revolving credit agreement. The average cost of borrowing under the facility was 1.18% and 0.86%, and the average borrowing was \$29,760 and \$25,486, during 2016 and

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2015, respectively. The maximum amount outstanding at the end of any one month was \$52,905 and \$40,000 in 2016 and 2015, respectively.

At December 31, 2016 and 2015, the Company had other combined short-term lines of credit of \$35,500. Funds borrowed under these lines are classified as loans payable and are used to provide working capital. As of December 31, 2016 and 2015, funds borrowed under the short-term lines of credit were \$990 and \$9,440, respectively. The average borrowing under the lines was \$2,944 and \$5,132 during 2016 and 2015, respectively. The maximum amount outstanding at the end of any one month was \$9,440 in 2016 and 2015, respectively. Interest under the lines is based at the Company's option, depending on the line, on the prime rate, an adjusted Euro-Rate, an adjusted federal funds rate or at rates offered by the banks. The average cost of borrowings under all lines during 2016 and 2015 was 1.24% and 0.99%, respectively.

**Interest Income and Expense**— Interest income of \$217, \$272, and \$316 was netted against interest expense on the consolidated statement of net income for the years ended December 31, 2016, 2015, and 2014, respectively. The total interest cost was \$80,811, \$76,808, and \$76,713 in 2016, 2015, and 2014, including amounts capitalized of \$8,815, \$6,219, and \$5,134, respectively.

**Note 11 – Fair Value of Financial Instruments**

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

The fair value of cash and cash equivalents, which is comprised of a money market fund, is determined based on the net asset value per unit utilizing level 2 methods and assumptions. As of December 31, 2016 and 2015, the carrying amounts of the Company's cash and cash equivalents were \$3,763 and \$3,229, which equates to their fair value. The fair value of "available-for-sale" securities to fund our deferred compensation plan liability, which represents mutual funds, is determined based on quoted market prices from active markets. As of December 31, 2016 and 2015, the carrying amount of these securities was \$17,072 and \$10,284. The fair value of funds restricted for construction activity and loans payable are determined based on their carrying amount and utilizing level 1 methods and assumptions. As of December 31, 2016 and 2015, the Company did not have any funds restricted for construction activity. As of December 31, 2016 and 2015, the carrying amount of the Company's loans payable was \$6,535 and \$16,721, respectively, which equates to their estimated fair value.

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

|                      | December 31, |              |
|----------------------|--------------|--------------|
|                      | 2016         | 2015         |
| Carrying amount      | \$ 1,910,633 | \$ 1,779,205 |
| Estimated fair value | 2,018,933    | 1,905,393    |

The fair value of long-term debt has been determined by discounting the future cash flows using current market interest rates for similar financial instruments of the same duration utilizing level 2 methods and assumptions. The Company's customers' advances for construction have a carrying value of \$91,843 and \$86,934 at December 31, 2016 and 2015, respectively. Their relative fair values cannot be accurately estimated because future refund payments depend on several variables, including new customer connections, customer consumption levels and future rate increases. Portions of these non-interest bearing instruments are payable annually through 2026 and amounts not paid by the contract expiration dates become non-refundable. The fair value of these amounts would, however, be less than their carrying value due to the non-interest bearing feature.

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**Note 12 – Stockholders’ Equity**

At December 31, 2016, the Company had 300,000,000 shares of common stock authorized; par value \$0.50. Shares outstanding and treasury shares held were as follows:

|                    | December 31, |             |             |
|--------------------|--------------|-------------|-------------|
|                    | 2016         | 2015        | 2014        |
| Shares outstanding | 177,394,376  | 176,544,091 | 176,753,270 |
| Treasury shares    | 2,916,969    | 2,819,569   | 1,837,984   |

At December 31, 2016, the Company had 1,770,819 shares of authorized but unissued Series Preferred Stock, \$1.00 par value.

In February 2015, the Company filed a universal shelf registration statement with the Securities and Exchange Commission (“SEC”) to allow for the potential future sale by the Company, 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.

In February 2015, the Company filed a registration statement with the SEC which permits the offering, from time to time, of an aggregate of \$500,000 in shares of common stock and shares of preferred stock in connection with acquisitions. During 2016, 439,943 shares of common stock totaling \$12,845 were issued by the Company to acquire a water utility system. The balance remaining available for use under the acquisition shelf registration as of December 31, 2016 is \$487,155.

The form and terms of any securities issued under the universal shelf registration statement and the acquisition shelf registration statement will be determined at the time of issuance.

The Company has a Dividend Reinvestment and Direct Stock Purchase Plan (“Plan”) that allows reinvested dividends to be used to purchase shares of common stock at a five percent discount from the current market value. Under the direct stock purchase program, shares are purchased by investors at a five percent discount from the market price. The shares issued under the Plan are either shares purchased by the Company’s transfer agent in the open-market or original issue shares. In 2016, 2015, and 2014, 484,645, 535,439, and 558,317 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 \$14,916, \$14,380, and \$14,148, respectively. During 2016 and 2015, under the dividend reinvestment portion of the Plan, 47,478 and 26,295 original issue shares of common stock were sold, providing the Company with proceeds of \$1,388 and \$677, respectively. During 2014 to minimize share dilution, the Company did not sell original issue shares of common stock under the Plan.

In October 2013, the Company’s Board of Directors approved a resolution authorizing the Company to purchase, from time to time, up to 685,348 shares of its common stock in the open market or through privately negotiated transactions. This authorization renewed the number of shares that had remained, when affected for stock splits, from an existing share buy-back authorization from 1997. The specific timing, amount and other terms of repurchases will depend on market conditions, regulatory requirements and other factors. In 2014, we repurchased 560,000 shares of our common stock in the open market for \$13,280. In December 2014, the Company’s Board of Directors authorized a share buyback program, commencing in 2015, of up to 1,000,000 shares to minimize share dilution through timely and orderly share repurchases. In December 2015, the Company’s Board of Directors added 400,000 shares to this program. In 2016, we did not repurchase any shares of our common stock in the open market. In 2015, we repurchased 805,000 shares of the Company’s common stock in the open market for \$20,502. This program expired on December 31, 2016.

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The Company's accumulated other comprehensive income is reported in the stockholders' equity section of the consolidated balance sheets, the consolidated statements of equity, and the related components of other comprehensive income are reported in the consolidated statements of comprehensive income. The Company reports its unrealized gains or losses on investments as other comprehensive income and accumulated other comprehensive income. The Company recorded a regulatory asset for its underfunded status of its pension and other post-retirement benefit plans that would otherwise be charged to other comprehensive income, as it anticipates recovery of its costs through customer rates.

**Note 13 – Net Income per Common Share and Equity per Common Share**

Basic net income per share is based on the weighted average number of common shares outstanding. Diluted net income per share is based on the weighted average number of common shares outstanding and potentially dilutive shares. The dilutive effect of employee stock-based compensation is included in the computation of diluted net income per share. The dilutive effect of stock-based compensation is calculated by using the treasury stock method and expected proceeds upon exercise or issuance of the stock-based compensation. The following table summarizes the shares, in thousands, used in computing basic and diluted net income per share:

|   | Years ended December 31, |         |         |
|---|--------------------------|---------|---------|
|   | 2016                     | 2015    | 2014    |
| Average common shares outstanding during the period for basic computation   | 177,273                  | 176,788 | 176,864 |
| Effect of dilutive securities:  |                          |         |         |
| Employee stock-based compensation   | 573                      | 729     | 899     |
| Average common shares outstanding during the period for diluted computation | 177,846                  | 177,517 | 177,763 |

For the years ended December 31, 2016, 2015, and 2014, all of the Company's employee stock options were included in the calculation of diluted net income per share as the calculated cost to exercise the stock options was less than the average market price of the Company's common stock during these periods.

Equity per common share was \$10.43 and \$9.78 at December 31, 2016 and 2015, respectively. These amounts were computed by dividing Aqua America stockholders' equity by the number of shares of common stock outstanding at the end of each year.

**Note 14 – Employee Stock and Incentive Plan**

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

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awards to non-employee directors, the Board of Directors makes such awards. At December 31, 2016, 3,952,869 shares underlying stock-based compensation awards were still available for grant under the 2009 Plan.

The recording of compensation expense for share-based compensation has no impact on net cash flows and results in the reclassification on the consolidated cash flow statements of related tax benefits from cash flows from operating activities to cash flows from financing activities to the extent these tax benefits exceed the associated compensation cost.

**Performance Share Units** – During 2016, 2015, and 2014, the Company granted performance share units. A performance share unit (“PSU”) represents the right to receive a share of the Company’s common stock if specified performance goals are met over the three year performance period specified in the grant, subject to exceptions through the respective vesting periods, generally three years. Each grantee is granted a target award of PSUs, and may earn between 0% and 200% of the target amount depending on the Company’s performance against the performance goals, which consisted of the following metrics for the 2016 grant:

- 27.5% of the PSUs could be earned based on the Company’s total shareholder return (“TSR”) compared to the TSR for a specific peer group of investor-owned water companies (a market-based condition);
- 27.5% of the PSUs could be earned based on the Company’s TSR compared to the TSR for the companies listed in the Standard and Poor’ Midcap Utilities Index (a market-based condition);
- 25% of the PSUs could be earned based on the achievement of a targeted cumulative level of rate base growth as a result of acquisitions (a performance-based condition); and
- And 20% of the PSUs could be earned based on the achievement of targets for maintaining consolidated operations and maintenance expenses over the three year measurement period (a performance-based condition).

The performance goals of the 2015 and 2014 grants consisted of the following metrics:

- 30% of the PSUs could be earned based on the Company’s TSR compared to the TSR for a specific peer group of investor-owned water companies (a market-based condition);
- 30% of the PSUs could be earned based on the Company’s TSR compared to the TSR for the companies listed in the Standard and Poor’s Midcap Utilities Index (a market-based condition);
- 20% of the PSUs could be earned based on maintaining an average ratio of operations and maintenance expenses as a percentage of revenues at Aqua Pennsylvania compared to a target average ratio for the three year performance period (a performance-based condition); and
- 20% of the PSUs could be earned based on earning a cumulative total earnings before taxes for the Company operations other than Aqua Pennsylvania for the three year performance period compared to a target (a performance-based condition).

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The following table provides compensation costs for PSUs:

|  | Years ended December 31, |       |          |
|--|--------------------------|-------|----------|
|  | 2016                     | 2015  | 2014     |
| Stock-based compensation within operations and maintenance expense | \$ 3,823                 | 4,419 | \$ 4,996 |
| Income tax benefit   | 1,552                    | 1,796 | 2,044    |

The following table summarizes nonvested PSU transactions for the year ended December 31, 2016:

|   | Number of<br>Share Units | Weighted<br>Average Fair<br>Value |
|---|--------------------------|-----------------------------------|
| Nonvested share units at beginning of period                    | 424,858                  | \$ 25.78                          |
| Granted   | 152,750                  | 28.89                             |
| Performance criteria adjustment                                 | 66,512                   | 26.65                             |
| Forfeited   | (21,964)                 | 26.85                             |
| Share units vested in prior period and issued in current period | 44,625                   | 26.88                             |
| Share units issued  | <u>(189,885)</u>         | 23.25                             |
| Nonvested share units at end of period                          | <u>476,896</u>           | \$ 27.96                          |

A portion of the fair value of PSUs was estimated at the grant date based on the probability of satisfying the market-based conditions associated with the PSUs using the Monte Carlo valuation method, which assesses the probabilities of various outcomes of market conditions. The other portion of the fair value of the PSUs associated with performance-based conditions was based on the fair market value of the Company's stock at the grant date, regardless of whether the market-based condition is satisfied. The fair value of each PSU grant is amortized into compensation expense on a straight-line basis over their respective vesting periods, generally 36 months. The accrual of compensation costs is based on an estimate of the final expected value of the award, and is adjusted as required for the portion based on the performance-based condition. The Company assumes that forfeitures will be minimal, and recognizes forfeitures as they occur, which results in a reduction in compensation expense. As the payout of the PSUs includes dividend equivalents, no separate dividend yield assumption is required in calculating the fair value of the PSUs. The recording of compensation expense for PSUs has no impact on net cash flows. The following table provides the assumptions used in the pricing model for the grant, the resulting grant date fair value of PSUs, and the intrinsic value and fair value of PSUs that vested during the year:

|   | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2016                     | 2015     | 2014     |
| Expected term (years)                       | 3.0                      | 3.0      | 3.0      |
| Risk-free interest rate                     | 0.91%                    | 1.03%    | 0.68%    |
| Expected volatility                         | 17.9%                    | 16.9%    | 19.8%    |
| Weighted average fair value of PSUs granted | \$ 28.89                 | \$ 26.46 | \$ 25.31 |
| Intrinsic value of vested PSUs              | \$ 5,912                 | \$ 7,964 | \$ 4,327 |
| Fair value of vested PSUs                   | \$ 5,104                 | \$ 6,416 | \$ 3,297 |

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As of December 31, 2016, \$5,444 of unrecognized compensation costs related to PSUs is expected to be recognized over a weighted average period of approximately 1.8 years. The aggregate intrinsic value of PSUs as of December 31, 2016 was \$15,582. The aggregate intrinsic value of PSUs is based on the number of nonvested share units and the market value of the Company's common stock as of the period end date.

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

|  | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2016                     | 2015     | 2014     |
| Stock-based compensation within operations and maintenance expense | \$ 1,061                 | \$ 1,076 | \$ 1,122 |
| Income tax benefit   | 438                      | 444      | 464      |

The following table summarizes nonvested RSU transactions for the year ended December 31, 2016:

|  | Number of<br>Stock Units | Weighted<br>Average Fair<br>Value |
|--|--------------------------|-----------------------------------|
| Nonvested stock units at beginning of period | 88,353                   | \$ 24.94                          |
| Granted                                      | 50,612                   | 32.08                             |
| Stock units vested and issued                | (25,740)                 | 23.51                             |
| Forfeited                                    | (3,952)                  | 27.81                             |
| Nonvested stock units at end of period       | 109,273                  | \$ 28.48                          |

The following table summarizes the value of RSUs:

|   | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2016                     | 2015     | 2014     |
| Weighted average fair value of RSUs granted | \$ 32.08                 | \$ 26.00 | \$ 24.80 |
| Intrinsic value of vested RSUs              | 805                      | 2,327    | 759      |
| Fair value of vested RSUs                   | 605                      | 1,904    | 544      |

As of December 31, 2016, \$1,498 of unrecognized compensation costs related to RSUs is expected to be recognized over a weighted average period of approximately 1.8 years. The aggregate intrinsic value of RSUs as of December 31, 2016 was \$3,283. The aggregate intrinsic value of RSUs is based on the number of nonvested stock units and the market value of the Company's common stock as of the period end date.

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**Stock Options** – The following table provides compensation costs for stock options:

|                    | Years ended December 31, |     |      |     |      |     |
|--------------------|--------------------------|-----|------|-----|------|-----|
|                    | 2016                     |     | 2015 |     | 2014 |     |
| Income tax benefit | \$                       | 260 | \$   | 193 | \$   | 189 |

There were no stock options granted during the years ended December 31, 2016, 2015, and 2014. Options under the plans were issued at the closing market price of the stock on the day of the grant. Options are exercisable in installments of 33% annually, starting one year from the date of the grant and expire 10 years from the date of the grant. The fair value of options was estimated at the grant date using the Black-Scholes option-pricing model, which relies on assumptions that require management's judgment.

The following table summarizes stock option transactions for the year ended December 31, 2016:

|  | Shares    | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Life (years) | Aggregate<br>Intrinsic<br>Value |
|--|-----------|--|--|---------------------------------|
| Outstanding, beginning of year             | 659,533   | \$ 16.62                                 |  |                                 |
| Forfeited                                  | -         | -  |  |                                 |
| Expired / Cancelled                        | (3,436)   | 16.15                                    |  |                                 |
| Exercised                                  | (228,762) | 18.62                                    |  |                                 |
| Outstanding and exercisable at end of year | 427,335   | \$ 15.55                                 | 1.9  | \$ 6,190                        |

The intrinsic value of stock options is the amount by which the market price of the stock on a given date, such as at the end of the period or on the day of exercise, exceeded the closing market price of stock on the date of grant. The following table summarizes the aggregate intrinsic value of stock options exercised and the fair value of stock options which became vested:

|                                      | Years ended December 31, |       |      |       |      |       |
|--------------------------------------|--------------------------|-------|------|-------|------|-------|
|                                      | 2016                     |       | 2015 |       | 2014 |       |
| Intrinsic value of options exercised | \$                       | 2,945 | \$   | 4,154 | \$   | 4,054 |

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The following table summarizes information about the options outstanding and options exercisable as of December 31, 2016:

| Options Outstanding and Exercisable |         |   |    |                                    |
|-------------------------------------|---------|---|----|------------------------------------|
|                                     | Shares  | Weighted Average<br>Remaining Life<br>(years) |    | Weighted Average Exercise<br>Price |
| Range of prices:                    |         |   |    |                                    |
| \$13.00 - 14.99                     | 121,707 | 3.1   | \$ | 13.72                              |
| \$15.00 - 15.99                     | 127,779 | 2.2   |    | 15.30                              |
| \$16.00 - 16.99                     | 117,025 | 1.2   |    | 16.15                              |
| \$17.00 - 19.99                     | 60,824  | 0.1   |    | 18.61                              |
|                                     | 427,335 | 1.9   | \$ | 15.55                              |

As of December 31, 2016, there were no unrecognized compensation costs related to nonvested stock options granted under the plans.

**Restricted Stock** – Restricted stock awards provide the grantee with the rights of a shareholder, including the right to receive dividends and to vote such shares, but not the right to sell or otherwise transfer the shares during the restriction period. Restricted stock awards result in compensation expense which is equal to the fair market value of the stock on the date of the grant and is amortized ratably over the restriction period. The Company expects forfeitures of restricted stock to be de minimis.

The following table provides compensation costs for restricted stock:

|  | Years ended December 31, |      |        |
|--|--------------------------|------|--------|
|  | 2016                     | 2015 | 2014   |
| Stock-based compensation within operations and maintenance expense | \$ -                     | \$ - | \$ 691 |
| Income tax benefit   | -                        | -    | 287    |

The following table summarizes the value of restricted stock awards:

|  | Years ended December 31, |        |          |
|--|--------------------------|--------|----------|
|  | 2016                     | 2015   | 2014     |
| Intrinsic value of restricted stock awards vested              | \$ -                     | \$ 860 | \$ 1,097 |
| Fair value of restricted stock awards vested                   | -                        | 553    | 906      |
| Weighted average fair value of restricted stock awards granted | -                        | -      | 25.19    |

As of December 31, 2016, there were no unrecognized compensation costs related to nonvested restricted stock as restricted stock was fully amortized in 2014. Additionally, there was no restricted stock granted during the years ended December 31, 2016 and 2015.

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

|  | Years ended December 31, |        |      |
|--|--------------------------|--------|------|
|  | 2016                     | 2015   | 2014 |
| Stock-based compensation within operations and maintenance expense | \$ 506                   | \$ 365 | \$ - |
| Income tax benefit   | 210                      | 151    | -    |

The following table summarizes stock award transactions for year ended December 31, 2016:

|   | Number of<br>Stock Units | Weighted<br>Average Fair<br>Value |
|---|--------------------------|-----------------------------------|
| Nonvested stock awards at beginning of period | -                        | \$ -                              |
| Granted                                       | 15,877                   | 31.87                             |
| Vested  | (15,877)                 | 31.87                             |
| Nonvested stock units at end of period        | -                        | \$ -                              |

The per unit weighted-average fair value at the date of grant for stock awards granted during the years ended December 31, 2016 and 2015 was \$31.87 and \$26.44, respectively.

**Note 15 – Pension Plans and Other Post-retirement Benefits**

The Company maintains a qualified, defined benefit pension plan that covers its full-time employees who were hired prior to April 1, 2003. Retirement benefits under the plan are generally based on the employee’s total years of service and compensation during the last five years of employment. The Company’s policy is to fund the plan annually at a level which is deductible for income tax purposes and which provides assets sufficient to meet its pension obligations over time. To offset some limitations imposed by the Internal Revenue Code with respect to payments under qualified plans, the Company has a non-qualified Supplemental Pension Benefit Plan for Salaried Employees in order to prevent some employees from being penalized by these limitations, and to provide certain retirement benefits based on employee’s years of service and compensation. The Company also has non-qualified Supplemental Executive Retirement Plans for some current and retired employees. The net pension costs and obligations of the qualified and non-qualified plans are included in the tables which follow. Employees hired after April 1, 2003 may participate in a defined contribution plan that provides a Company matching contribution on amounts contributed by participants and an annual profit-sharing contribution based upon a percentage of the eligible participants’ compensation.

In August 2014, the Company announced changes to the way it will provide future retirement benefits to employees acquired through a prior acquisition. Effective January 1, 2015, the Company began providing future retirement benefits for these employees through its defined contribution plan. As a result, no further service will be considered in future accruals in the qualified defined benefit pension plan after December 31, 2014, and as a result of this change, the Company recognized a curtailment loss of \$84 in 2014.

Effective July 1, 2015, the Company added a permanent lump sum option to the form of benefit payments offered to participants of the qualified defined benefit pension plan upon retirement or termination. The plan paid \$5,329 during the second half of 2015 to participants who elected this option and \$9,990 during 2016.

In addition to providing pension benefits, the Company offers post-retirement benefits other than pensions to employees hired before April 1, 2003 and retiring with a minimum level of service. These benefits include

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continuation of medical and prescription drug benefits, or a cash contribution toward such benefits, for eligible retirees and life insurance benefits for eligible retirees. The Company funds these benefits through various trust accounts. The benefits of retired officers and other eligible retirees are paid by the Company and not from plan assets due to limitations imposed by the Internal Revenue Code.

In 2016 the Company recognized a settlement loss of \$2,895, which results from lump sum payments from the non-qualified plans exceeding the threshold of service and interest cost for the period. A settlement loss is the recognition of unrecognized pension benefit costs that would have been incurred in subsequent periods. The Company recorded this settlement loss as a regulatory asset, as it is probable of recovery in future rates, which will be amortized into pension benefit costs.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years indicated:

| Years:    | Pension Benefits | Other Post-retirement Benefits |
|-----------|------------------|--------------------------------|
| 2017      | \$ 20,791        | \$ 2,025                       |
| 2018      | 20,640           | 2,296                          |
| 2019      | 20,240           | 2,570                          |
| 2020      | 21,369           | 2,815                          |
| 2021      | 20,824           | 2,974                          |
| 2022-2026 | 104,672          | 17,701                         |

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The changes in the benefit obligation and fair value of plan assets, the funded status of the plans and the assumptions used in the measurement of the company's benefit obligation are as follows:

|   | Pension Benefits |            | Other Post-retirement Benefits |           |
|---|------------------|------------|--------------------------------|-----------|
|   | 2016             | 2015       | 2016                           | 2015      |
| Change in benefit obligation:             |                  |            |                                |           |
| Benefit obligation at January 1,          | \$ 306,539       | \$ 311,609 | \$ 65,137                      | \$ 71,958 |
| Service cost                              | 3,179            | 3,349      | 1,014                          | 1,224     |
| Interest cost                             | 13,038           | 12,955     | 2,927                          | 2,802     |
| Actuarial (gain) loss                     | 15,321           | (7,778)    | 1,400                          | (6,527)   |
| Plan participants' contributions          | -                | -          | 170                            | 204       |
| Benefits paid                             | (21,861)         | (17,118)   | (1,336)                        | (1,270)   |
| Plan amendments                           | -                | 3,220      | -                              | (3,254)   |
| Settlements                               | (7,742)          | -          | -                              | -         |
| Special termination benefits              | (302)            | 302        | -                              | -         |
| Benefit obligation at December 31,        | 308,172          | 306,539    | 69,312                         | 65,137    |
| Change in plan assets:                    |                  |            |                                |           |
| Fair value of plan assets at January 1,   | 238,605          | 244,897    | 43,704                         | 43,326    |
| Actual return on plan assets              | 17,375           | (3,058)    | 2,149                          | (998)     |
| Employer contributions                    | 16,285           | 13,884     | 1,360                          | 2,428     |
| Benefits paid                             | (21,861)         | (17,118)   | (1,128)                        | (1,052)   |
| Settlements                               | (7,742)          | -          | -                              | -         |
| Special termination benefits              | (302)            | -          | -                              | -         |
| Fair value of plan assets at December 31, | 242,360          | 238,605    | 46,085                         | 43,704    |
| Funded status of plan:                    |                  |            |                                |           |
| Net amount recognized at December 31,     | \$ 65,812        | \$ 67,934  | \$ 23,227                      | \$ 21,433 |

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The following table provides the net liability recognized on the consolidated balance sheets at December 31,:

|                          | Pension Benefits |           | Other Post-retirement Benefits |        |
|--------------------------|------------------|-----------|--------------------------------|--------|
|                          | 2016             | 2015      | 2016                           | 2015   |
| Current liability        | \$ 613           | \$ 8,370  | \$ -                           | \$ -   |
| Noncurrent liability     | 65,199           | 59,564    | 23,226                         | 21,433 |
| Net liability recognized | \$ 65,812        | \$ 67,934 | \$ 23,226                      | 21,433 |

At December 31, 2016 and 2015, the Company's pension plans had benefit obligations in excess of its plan assets. The following tables provide the projected benefit obligation, the accumulated benefit obligation and fair market value of the plan assets as of December 31,:

|                              | Projected Benefit Obligation Exceeds the Fair Value of Plan Assets |         |      |         |
|------------------------------|--|---------|------|---------|
|                              | 2016   |         | 2015 |         |
| Projected benefit obligation | \$   | 308,172 | \$   | 306,539 |
| Fair value of plan assets    |  | 242,360 |      | 238,605 |

|                                | Accumulated Benefit Obligation Exceeds the Fair Value of Plan Assets |         |      |         |
|--------------------------------|--|---------|------|---------|
|                                | 2016   |         | 2015 |         |
| Accumulated benefit obligation | \$   | 291,889 | \$   | 291,132 |
| Fair value of plan assets      |  | 242,360 |      | 238,605 |

The following table provides the components of net periodic benefit costs for the years ended December 31,:

|   | Pension Benefits |          |          | Other Post-retirement Benefits |          |          |
|---|------------------|----------|----------|--------------------------------|----------|----------|
|   | 2016             | 2015     | 2014     | 2016                           | 2015     | 2014     |
| Service cost                                | \$ 3,179         | \$ 3,349 | \$ 4,295 | \$ 1,014                       | \$ 1,224 | \$ 1,161 |
| Interest cost                               | 13,038           | 12,955   | 14,153   | 2,927                          | 2,802    | 2,903    |
| Expected return on plan assets              | (16,910)         | (18,702) | (17,601) | (2,647)                        | (2,923)  | (2,742)  |
| Amortization of prior service cost (credit) | 578              | 174      | 277      | (549)                          | (687)    | (278)    |
| Amortization of actuarial loss              | 7,153            | 5,993    | 2,256    | 926                            | 1,282    | 260      |
| Settlement loss                             | 2,895            | -        | -        | -                              | -        | -        |
| Curtailement loss                           | -                | -        | 84       | -                              | -        | -        |
| Special termination benefits                | 302              | -        | -        | -                              | -        | -        |
| Net periodic benefit cost                   | \$ 10,235        | \$ 3,769 | \$ 3,464 | \$ 1,671                       | \$ 1,698 | \$ 1,304 |

The Company records the underfunded status of its pension and other post-retirement benefit plans on its consolidated balance sheets and records a regulatory asset for these costs that would otherwise be charged to stockholders' equity, as the Company anticipates recoverability of the costs through customer rates to be probable. The Company's pension and other post-retirement benefit plans were underfunded at December 31, 2016 and 2015. Changes in the plans' funded status will affect the assets and liabilities recorded on the balance sheet. Due to the Company's regulatory treatment, the recognition of the funded status is recorded as a regulatory asset pursuant to the FASB's accounting guidance for regulated operations.

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The following table provides the amounts recognized in regulatory assets that have not been recognized as components of net periodic benefit cost as of December 31,:

|                                       | Pension Benefits |           | Other Post-retirement Benefits |           |
|---------------------------------------|------------------|-----------|--------------------------------|-----------|
|                                       | 2016             | 2015      | 2016                           | 2015      |
| Net actuarial loss                    | \$ 92,436        | \$ 87,930 | \$ 15,441                      | \$ 14,469 |
| Prior service cost (credit)           | 3,841            | 4,419     | (2,378)                        | (2,926)   |
| Total recognized in regulatory assets | \$ 96,277        | \$ 92,349 | \$ 13,063                      | \$ 11,543 |

The following table provides the estimated net actuarial loss and prior service cost for the Company's pension plans that will be amortized from regulatory asset into net periodic benefit cost for the year ended December 31, 2017:

|                             | Pension Benefits |          | Other Post-retirement Benefits |          |
|-----------------------------|------------------|----------|--------------------------------|----------|
|                             | 2017             | 2016     | 2017                           | 2016     |
| Net actuarial loss          | \$ 8,023         | \$ 1,165 | \$ 1,165                       | \$ 1,165 |
| Prior service cost (credit) | 579              | (509)    | (509)                          | (509)    |

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 the Company's employees, mortality, turnover and medical costs. Each assumption is reviewed annually with assistance from the Company's 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 the Company recognizes.

The significant assumptions related to the Company's benefit obligations are as follows:

|   | Pension Benefits |          | Other Post-retirement Benefits |       |
|---|------------------|----------|--------------------------------|-------|
|   | 2016             | 2015     | 2016                           | 2015  |
| Weighted Average Assumptions Used to Determine Benefit Obligations as of December 31,         |                  |          |                                |       |
| Discount rate   | 4.13%            | 4.48%    | 4.25%                          | 4.60% |
| Rate of compensation increase   | 3.0-4.0%         | 3.0-4.0% | n/a                            | n/a   |
| Assumed Health Care Cost Trend Rates Used to Determine Benefit Obligations as of December 31, |                  |          |                                |       |
| Health care cost trend rate   | n/a              | n/a      | 6.6%                           | 7.0%  |
| Rate to which the cost trend is assumed to decline (the ultimate trend rate)                  | n/a              | n/a      | 5.0%                           | 5.0%  |
| Year that the rate reaches the ultimate trend rate  | n/a              | n/a      | 2020                           | 2021  |

*n/a – Assumption is not applicable.*

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The significant assumptions related to the Company's net periodic benefit costs are as follows:

|  | Pension Benefits |          |          | Other Post-retirement Benefits |            |            |
|--|------------------|----------|----------|--------------------------------|------------|------------|
|  | 2016             | 2015     | 2014     | 2016                           | 2015       | 2014       |
| Weighted Average Assumptions Used to Determine Net Periodic Benefit Costs for Years Ended December 31,         |                  |          |          |                                |            |            |
| Discount rate  | 4.48%            | 4.20%    | 5.12%    | 4.60%                          | 4.17%      | 5.12%      |
| Expected return on plan assets   | 7.25%            | 7.50%    | 7.50%    | 4.83-7.25%                     | 5.00-7.50% | 5.00-7.50% |
| Rate of compensation increase  | 3.0-4.0%         | 3.0-4.0% | 4.0-4.5% | n/a                            | n/a        | n/a        |
| Assumed Health Care Cost Trend Rates Used to Determine Net Periodic Benefit Costs for Years Ended December 31, |                  |          |          |                                |            |            |
| Health care cost trend rate  | n/a              | n/a      | n/a      | 7.0%                           | 7.0%       | 7.5%       |
| Rate to which the cost trend is assumed to decline (the ultimate trend rate)                                   | n/a              | n/a      | n/a      | 5.0%                           | 5.0%       | 5.0%       |
| Year that the rate reaches the ultimate trend rate   | n/a              | n/a      | n/a      | 2021                           | 2019       | 2019       |

*n/a – Assumption is not applicable.*

Assumed health-care trend rates have a significant effect on the expense and liabilities for other post-retirement benefit plans. The health care trend rate is based on historical rates and expected market conditions. A one-percentage point change in the assumed health-care cost trend rates would have the following effects:

|   | 1-Percentage-Point Increase | 1-Percentage-Point Decrease |
|---|-----------------------------|-----------------------------|
| Effect on the health-care component of the accrued other post-retirement benefit obligation                       | <u>\$ 4,456</u>             | <u>\$ (3,981)</u>           |
| Effect on aggregate service and interest cost components of net periodic post-retirement health-care benefit cost | <u>\$ 267</u>               | <u>\$ (243)</u>             |

The Company's discount rate assumption, which is utilized to calculate the present value of the projected benefit payments of our post-retirement benefits, was determined by selecting a hypothetical portfolio of high quality corporate bonds appropriate to match the projected benefit payments of the plans. 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 rate that equates the market value of the bonds purchased to the discounted value of the plan's benefit payments. The Company's pension expense and liability (benefit obligations) increases as the discount rate is reduced.

The Company's expected return on plan assets is determined by evaluating the asset class return expectations with its 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's assets as of the last day of its fiscal year, and is a determinant for the expected return on plan assets which is a component of post-retirement benefits expense. The Company's pension expense increases as the expected return on plan assets decreases. For 2016, the Company used a 7.25% expected return on plan assets assumption which will decrease to 7.00% for 2017. The Company believes its actual long-term asset allocation on average will approximate the targeted allocation. The Company's investment strategy is to earn a reasonable rate of return while maintaining risk at acceptable levels through the diversification of investments across and within various asset categories. Investment returns are compared to benchmarks that include the S&P 500 Index, the Barclays Capital Intermediate Government/Credit Index, and a

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combination of the two indices. The Pension Committee meets semi-annually to review plan investments and management monitors investment performance quarterly through a performance report prepared by an external consulting firm.

The Company's pension plan asset allocation and the target allocation by asset class are as follows:

|                           | Target Allocation | Percentage of Plan Assets at<br>December 31, |             |
|---------------------------|-------------------|--|-------------|
|                           |                   | 2016   | 2015        |
| Domestic equities         | 25 to 75%         | 65%  | 63%         |
| International equities    | 0 to 10%          | 6%   | 6%          |
| Fixed income              | 25 to 50%         | 19%  | 24%         |
| Alternative investments   | 0 to 5%           | 2%   | 3%          |
| Cash and cash equivalents | 0 to 20%          | 8%   | 4%          |
| <b>Total</b>              | <b>100%</b>       | <b>100%</b>                                  | <b>100%</b> |

The fair value of the Company's pension plans' assets at December 31, 2016 by asset class are as follows:

|   | Level 1           | Level 2          | Level 3     | Total             |
|---|-------------------|------------------|-------------|-------------------|
| Domestic equities: (1)                    |                   |                  |             |                   |
| Common stocks                             | \$ 152,740        | \$ -             | \$ -        | \$ 152,740        |
| Mutual funds                              | 3,668             | -                | -           | 3,668             |
| International equities (2)                | 13,813            | -                | -           | 13,813            |
| Fixed income: (3)                         |                   |                  |             |                   |
| U.S. Treasury and government agency bonds | -                 | 11,170           | -           | 11,170            |
| Corporate and foreign bonds               | -                 | 24,385           | -           | 24,385            |
| Mutual funds                              | 9,752             | -                | -           | 9,752             |
| Alternative investments: (4)              |                   |                  |             |                   |
| Real estate                               | 2,613             | -                | -           | 2,613             |
| Commodity funds                           | 1,279             | -                | -           | 1,279             |
| Cash and cash equivalents (5)             | 348               | 22,592           | -           | 22,940            |
| <b>Total pension assets</b>               | <b>\$ 184,213</b> | <b>\$ 58,147</b> | <b>\$ -</b> | <b>\$ 242,360</b> |

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The fair value of the Company's pension plans' assets at December 31, 2015 by asset class are as follows:

|   | Level 1           | Level 2          | Level 3     | Total             |
|---|-------------------|------------------|-------------|-------------------|
| Domestic equities: (1)                    |                   |                  |             |                   |
| Common stocks                             | \$ 146,970        | \$ -             | -           | \$ 146,970        |
| Mutual funds                              | 3,605             | -                | -           | 3,605             |
| International equities (2)                | 14,180            | -                | -           | 14,180            |
| Fixed income: (3)                         |                   |                  |             |                   |
| U.S. Treasury and government agency bonds | -                 | 22,953           | -           | 22,953            |
| Corporate and foreign bonds               | -                 | 13,579           | -           | 13,579            |
| Mutual funds                              | 21,523            | -                | -           | 21,523            |
| Alternative investments: (4)              |                   |                  |             |                   |
| Real estate                               | 5,981             | -                | -           | 5,981             |
| Commodity funds                           | 1,169             | -                | -           | 1,169             |
| Cash and cash equivalents (5)             | 50                | 8,595            | -           | 8,645             |
| Total pension assets                      | <u>\$ 193,478</u> | <u>\$ 45,127</u> | <u>\$ -</u> | <u>\$ 238,605</u> |

- (1) Investments in common stocks are valued using unadjusted quoted prices obtained from active markets. Investments in equity mutual funds, which invest in stocks, are valued using the net asset value per unit as obtained from quoted market prices from active markets.
- (2) Investments in international equities are valued using unadjusted quoted prices obtained from active markets.
- (3) Investments in U.S. Treasury and government agency bonds and corporate and foreign bonds are valued by a pricing service which utilizes pricing models that incorporate available trade, bid, and other market information to value the fixed income securities. Investments in fixed income mutual funds, which invest in bonds, are valued using the net asset value per unit as obtained from quoted market prices in active markets.
- (4) Alternative investments are comprised of real estate funds, real estate investment trusts, and commodity funds, and are valued using unadjusted quoted prices obtained from active markets.
- (5) Cash and cash equivalents are comprised of both uninvested cash and money market funds. The uninvested cash is valued based on its carrying value, and the money market funds are valued utilizing the net asset value per unit based on the fair value of the underlying assets as determined by the fund's investment managers.

Equity securities include our common stock in the amounts of \$20,632 or 8.5% and \$19,958 or 8.4% of total pension plans' assets as of December 31, 2016 and 2015, respectively.

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The asset allocation for the Company's other post-retirement benefit plans and the target allocation by asset class are as follows:

|                           | Target Allocation | Percentage of Plan Assets at<br>December 31, |      |
|---------------------------|-------------------|--|------|
|                           |                   | 2016   | 2015 |
| Domestic equities         | 25 to 75%         | 52%  | 54%  |
| International equities    | 0 to 10%          | 3%   | 2%   |
| Fixed income              | 25 to 50%         | 25%  | 26%  |
| Alternative investments   | 0 to 5%           | 0%   | 0%   |
| Cash and cash equivalents | 0 to 20%          | 20%  | 18%  |
| Total                     | 100%              | 100%   | 100% |

The fair value of the Company's other post-retirement benefit plans' assets at December 31, 2016 by asset class are as follows:

|   | Level 1   | Level 2   | Level 3 | Total     |
|---|-----------|-----------|---------|-----------|
| Domestic equities: (1)                    |           |           |         |           |
| Common stocks                             | \$ 10,667 | \$ -      | \$ -    | 10,667    |
| Mutual funds                              | 13,464    | -         | -       | 13,464    |
| International equities (2)                | 1,242     | -         | -       | 1,242     |
| Fixed income: (3)                         |           |           |         |           |
| U.S. Treasury and government agency bonds | -         | 4,968     | -       | 4,968     |
| Corporate and foreign bonds               | -         | 6,347     | -       | 6,347     |
| Alternative investments (4)               | 172       | -         | -       | 172       |
| Cash and cash equivalents (5)             | -         | 9,225     | -       | 9,225     |
| Total other post-retirement assets        | \$ 25,545 | \$ 20,540 | \$ -    | \$ 46,085 |

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The fair value of the Company's other post-retirement benefit plans' assets at December 31, 2015 by asset class are as follows:

|   | Level 1          | Level 2          | Level 3     | Total            |
|---|------------------|------------------|-------------|------------------|
| Domestic equities: (1)                    |                  |                  |             |                  |
| Common stocks                             | \$ 11,772        | \$ -             | \$ -        | \$ 11,772        |
| Mutual funds                              | 12,030           | -                | -           | 12,030           |
| International equities (2)                | 1,078            | -                | -           | 1,078            |
| Fixed income: (3)                         |                  |                  |             |                  |
| U.S. Treasury and government agency bonds | -                | 4,551            | -           | 4,551            |
| Corporate and foreign bonds               | -                | 4,476            | -           | 4,476            |
| Mutual funds                              | 2,177            | -                | -           | 2,177            |
| Cash and cash equivalents (5)             | -                | 7,620            | -           | 7,620            |
| Total other post-retirement assets        | <u>\$ 27,057</u> | <u>\$ 16,647</u> | <u>\$ -</u> | <u>\$ 43,704</u> |

- (1) Investments in common stocks are valued using unadjusted quoted prices obtained from active markets. Investments in equity mutual funds, which invest in stocks, are valued using the net asset value per unit as obtained from quoted market prices from active markets.
- (2) Investments in international equities are valued using unadjusted quoted prices obtained from active markets.
- (3) Investments in U.S. Treasury and government agency bonds and corporate and foreign bonds are valued by a pricing service which utilizes pricing models that incorporate available trade, bid, and other market information to value the fixed income securities. Investments in fixed income mutual funds, which invest in bonds, are valued using the net asset value per unit as obtained from quoted market prices in active markets.
- (4) Investments in alternative investments are comprised of investments in real estate funds and real estate investment trusts and are valued using unadjusted quoted prices obtained from active markets.
- (5) Cash and cash equivalents is comprised of money market funds, which are valued utilizing the net asset value per unit based on the fair value of the underlying assets as determined by the fund's investment managers.

Funding requirements for qualified defined benefit pension plans are determined by government regulations and not by accounting pronouncements. In accordance with funding rules and the Company's funding policy, during 2017 our pension contribution is expected to be \$15,421.

The Company has a 401(k) savings plan, which is a defined contribution plan and covers substantially all employees. The Company makes matching contributions that are initially invested in our common stock based on a percentage of an employee's contribution, subject to specific limitations. Participants may diversify their Company matching account balances into other investments offered under the 401(k) savings plan. The Company's contributions, which are recorded as compensation expense, were \$4,988, \$5,001, and \$3,051, for the years ended December 31, 2016, 2015, and 2014, respectively.

**Note 16 – Water and Wastewater Rates**

On June 7, 2012, Aqua Pennsylvania reached a settlement agreement in its rate filing with the Pennsylvania Public Utility Commission, which in addition to a water rate increase, provided for a reduction in current income tax expense as a result of the recognition of qualifying income tax benefits upon Aqua Pennsylvania changing its tax accounting method to permit the expensing of qualifying utility asset improvement costs that historically have

AQUA AMERICA, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except per share amounts)

been capitalized and depreciated for book and tax purposes. In December 2012, Aqua Pennsylvania implemented this change which provides for the flow-through of income tax benefits that resulted in a substantial reduction in income tax expense and greater net income and cash flow. This change allowed Aqua Pennsylvania to suspend its water Distribution System Improvement Charges in 2013 and lengthen the amount of time until the next Aqua Pennsylvania rate case is filed.

The Company's operating subsidiaries were allowed rate increases totaling \$3,589 in 2016, \$3,347 in 2015, and \$9,886 in 2014, represented by seven, four, and twelve rate decisions, respectively. Revenues from these increases realized in the year of grant were approximately \$1,801, \$2,887, and \$5,375 in 2016, 2015, and 2014, respectively.

Six states in which the Company operates permit water utilities, and in five states wastewater utilities, to add a surcharge to their water or wastewater bills to offset the additional depreciation and capital costs related to infrastructure system replacement and rehabilitation projects completed and placed into service between base rate filings. Currently, Pennsylvania, Illinois, Ohio, Indiana, New Jersey, and North Carolina allow for the use of this surcharge. The surcharge for infrastructure system replacements and rehabilitations is typically adjusted periodically based on additional qualified capital expenditures completed or anticipated in a future period, is capped as a percentage of base rates, generally at 5% to 12.75%, and is 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. The surcharge for infrastructure system replacements and rehabilitations provided revenues in 2016, 2015, and 2014 of \$7,379, \$3,261, and \$4,598, respectively.

**Note 17 – Segment Information**

The Company has ten operating segments and one reportable segment. The Regulated segment, the Company's single reportable segment, is comprised of eight operating segments representing our water and wastewater regulated utility companies which are organized by the states where we provide water and wastewater 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 or wastewater collection methods, and the nature of the regulatory environment.

Two operating segments are included within the Other category below. These segments are not quantitatively significant and are comprised of Aqua Resources and Aqua Infrastructure. In addition to these segments, Other is comprised of other business activities not included in the reportable segment, including corporate costs that have not been allocated to the Regulated segment and intersegment eliminations. Corporate costs include general and administrative expenses, and interest expense.



Selected Quarterly Financial Data (Unaudited)  
Aqua America, Inc. and Subsidiaries  
(In thousands of dollars, except per share amounts)

|                                     | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Year       |
|-------------------------------------|------------------|-------------------|------------------|-------------------|------------|
| <u>2016</u>                         |                  |                   |                  |                   |            |
| Operating revenues                  | \$ 192,607       | \$ 203,876        | \$ 226,593       | \$ 196,799        | \$ 819,875 |
| Operations and maintenance expense  | 73,541           | 73,994            | 79,812           | 77,550            | 304,897    |
| Operating income                    | 72,331           | 83,493            | 97,799           | 71,962            | 325,585    |
| Net income                          | 51,737           | 59,626            | 73,170           | 49,649            | 234,182    |
| Basic net income per common share   | 0.29             | 0.34              | 0.41             | 0.28              | 1.32       |
| Diluted net income per common share | 0.29             | 0.33              | 0.41             | 0.28              | 1.32       |
| Dividend paid per common share      | 0.178            | 0.178             | 0.1913           | 0.1913            | 0.7386     |
| Dividend declared per common share  | 0.178            | 0.178             | 0.1913           | 0.1913            | 0.7386     |
| Price range of common stock:        |                  |                   |                  |                   |            |
| - high                              | 32.44            | 35.66             | 35.83            | 31.29             | 35.83      |
| - low                               | 28.35            | 30.31             | 29.53            | 28.03             | 28.03      |
| <u>2015</u>                         |                  |                   |                  |                   |            |
| Operating revenues                  | \$ 190,326       | \$ 205,760        | \$ 221,051       | \$ 197,067        | \$ 814,204 |
| Operations and maintenance expense  | 73,189           | 79,746            | 78,519           | 77,856            | 309,310    |
| Operating income                    | 71,167           | 80,246            | 95,072           | 74,615            | 321,100    |
| Net income                          | 48,545           | 57,382            | 67,429           | 28,434            | 201,790    |
| Basic net income per common share   | 0.27             | 0.32              | 0.38             | 0.16              | 1.14       |
| Diluted net income per common share | 0.27             | 0.32              | 0.38             | 0.16              | 1.14       |
| Dividend paid per common share      | 0.165            | 0.165             | 0.178            | 0.178             | 0.686      |
| Dividend declared per common share  | 0.165            | 0.165             | 0.178            | 0.178             | 0.686      |
| Price range of common stock:        |                  |                   |                  |                   |            |
| - high                              | 28.13            | 27.53             | 27.10            | 31.09             | 31.09      |
| - low                               | 25.42            | 24.40             | 24.45            | 26.20             | 24.40      |

Fourth quarter of 2015 net income includes the Company's share of a joint venture impairment charge of \$21,433 (\$32,975 pre-tax).

High and low prices of the Company's common stock are as reported on the New York Stock Exchange.

**Summary of Selected Financial Data (Unaudited)**  
**Aqua America, Inc. and Subsidiaries**  
(In thousands of dollars, except per share amounts)

| Years ended December 31,   | 2016         | 2015         | 2014         | 2013         | 2012         |
|--|--------------|--------------|--------------|--------------|--------------|
| <b>PER COMMON SHARE:</b>   |              |              |              |              |              |
| Income from continuing operations:   |              |              |              |              |              |
| Basic  | \$ 1.32      | \$ 1.14      | \$ 1.21      | \$ 1.15      | \$ 1.04      |
| Diluted  | 1.32         | 1.14         | 1.20         | 1.15         | 1.04         |
| Income from discontinued operations:   |              |              |              |              |              |
| Basic  | -            | -            | 0.11         | 0.10         | 0.08         |
| Diluted  | -            | -            | 0.11         | 0.10         | 0.08         |
| Net income:  |              |              |              |              |              |
| Basic  | 1.32         | 1.14         | 1.32         | 1.26         | 1.13         |
| Diluted  | 1.32         | 1.14         | 1.31         | 1.25         | 1.12         |
| Cash dividends declared and paid   | 0.74         | 0.69         | 0.63         | 0.58         | 0.54         |
| Return on Aqua America stockholders' equity                                  | 12.7%        | 11.7%        | 14.1%        | 14.4%        | 14.2%        |
| Book value at year end   | \$ 10.43     | \$ 9.78      | \$ 9.37      | \$ 8.68      | \$ 7.91      |
| Market value at year end   | 30.04        | 29.80        | 26.70        | 23.59        | 20.34        |
| <b>INCOME STATEMENT HIGHLIGHTS:</b>  |              |              |              |              |              |
| Operating revenues   | \$ 819,875   | \$ 814,204   | \$ 779,903   | \$ 761,893   | \$ 750,685   |
| Depreciation and amortization  | 133,008      | 128,737      | 126,535      | 123,985      | 116,180      |
| Interest expense, net  | 80,594       | 76,536       | 76,397       | 77,316       | 77,757       |
| Income from continuing operations before income taxes (1)                    | 255,160      | 216,752      | 239,103      | 224,104      | 247,057      |
| Provision for income taxes   | 20,978       | 14,962       | 25,219       | 21,233       | 65,220       |
| Income from continuing operations (1)  | 234,182      | 201,790      | 213,884      | 202,871      | 181,837      |
| Income from discontinued operations  | -            | -            | 19,355       | 18,429       | 14,726       |
| Net income (1)   | 234,182      | 201,790      | 233,239      | 221,300      | 196,563      |
| <b>BALANCE SHEET HIGHLIGHTS:</b>   |              |              |              |              |              |
| Total assets   | \$ 6,158,991 | \$ 5,717,873 | \$ 5,383,243 | \$ 5,027,430 | \$ 4,834,165 |
| Property, plant and equipment, net   | 5,001,615    | 4,688,925    | 4,401,990    | 4,138,568    | 3,907,552    |
| Aqua America stockholders' equity  | 1,850,068    | 1,725,930    | 1,655,343    | 1,534,835    | 1,385,704    |
| Long-term debt, including current portion, excluding debt issuance costs (3) | 1,910,633    | 1,779,205    | 1,619,270    | 1,554,871    | 1,588,992    |
| Total debt, excluding debt issuance costs (3)                                | 1,917,168    | 1,795,926    | 1,637,668    | 1,591,611    | 1,669,375    |
| <b>ADDITIONAL INFORMATION:</b>   |              |              |              |              |              |
| Operating cash flows from continuing operations                              | \$ 395,788   | \$ 370,794   | \$ 364,888   | \$ 365,409   | \$ 375,823   |
| Capital additions  | 382,996      | 364,689      | 328,605      | 307,908      | 347,098      |
| Net cash expended for acquisitions of utility systems and other              | 9,423        | 28,989       | 14,616       | 14,997       | 121,248      |
| Dividends on common stock  | 130,923      | 121,248      | 112,106      | 102,889      | 93,423       |
| Number of utility customers served (2)                                       | 972,265      | 957,866      | 940,119      | 928,200      | 917,986      |
| Number of shareholders of common stock                                       | 24,750       | 25,269       | 25,780       | 25,833       | 26,216       |
| Common shares outstanding (000)  | 177,394      | 176,544      | 176,753      | 176,751      | 175,209      |
| Employees (full-time) (2)  | 1,551        | 1,617        | 1,617        | 1,542        | 1,556        |

(1) 2015 results includes Aqua America's share of a joint venture impairment charge of \$21,433 (\$32,975 pre-tax)

(2) Reflects continuing operations

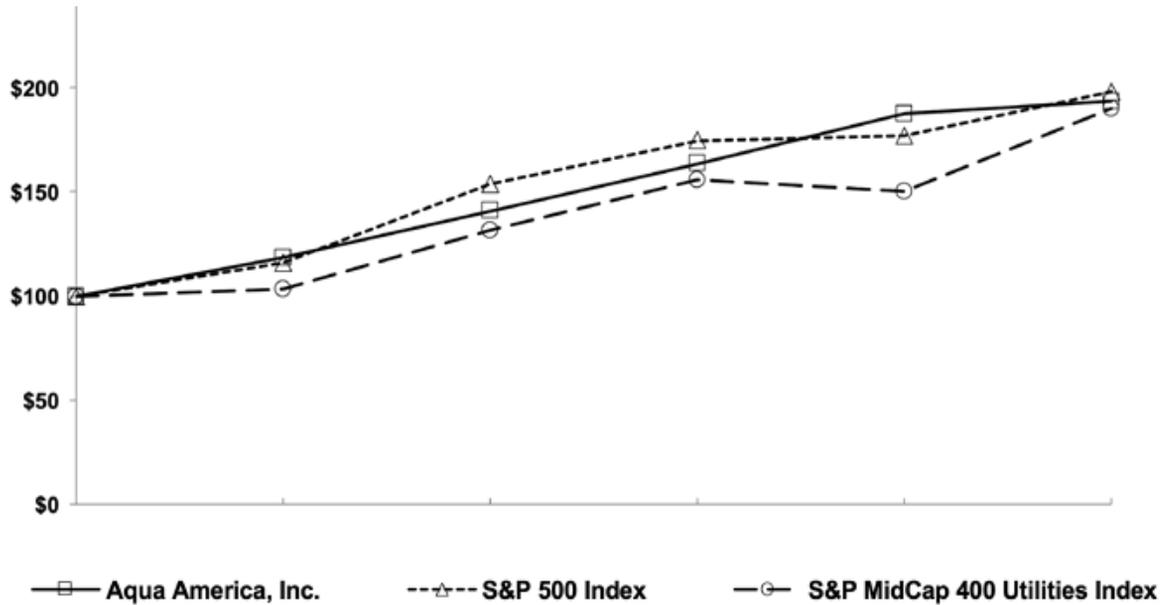
(3) Debt issuance costs for the years ended December 31, 2016, 2015, 2014, 2013, and 2012 were \$22,357, \$23,165, \$23,509, \$24,387, and \$24,352, respectively

## Stock Price Performance

The graph below matches Aqua America, Inc.'s cumulative 5-Year total shareholder return on common stock with the cumulative total returns of the S&P 500 index and the S&P MidCap 400 Utilities index. The graph tracks the performance of a \$100 investment in our common stock and in each index (with the reinvestment of all dividends) from 12/31/2011 to 12/31/2016.

### Comparison of Five Year Cumulative Total Return\*

Among Aqua America, Inc., the S&P 500 Index, and S&P MidCap 400 Utilities Index



\*\$100 invested on 12/31/11 in stock or index, including reinvestment of dividends Fiscal year ending December 31.

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#### Years as of December 31

|                                | 2011   | 2012   | 2013   | 2014   | 2015   | 2016   |
|--------------------------------|--------|--------|--------|--------|--------|--------|
| Aqua America, Inc.             | 100.00 | 118.60 | 140.85 | 163.52 | 187.23 | 193.25 |
| S&P 500 Index                  | 100.00 | 116.00 | 153.58 | 174.60 | 177.01 | 198.18 |
| S&P MidCap 400 Utilities Index | 100.00 | 103.14 | 131.73 | 155.87 | 150.35 | 189.93 |

*The stock price performance included in this graph is not necessarily indicative of future stock price performance.*

### **Financial Reports and Investor Relations**

Copies of the company's public financial reports, including annual reports and Forms 10-K and 10-Q, are available online and can be downloaded from the investor relations section of our Website at AquaAmerica.com. You may also obtain these reports by writing to us at:

Investor Relations Department  
Aqua America, Inc.  
762 W. Lancaster Avenue  
Bryn Mawr, PA 19010-3489

### **Corporate Governance**

We are committed to maintaining high standards of corporate governance and are in compliance with the corporate governance rules of the Securities and Exchange Commission (SEC) and the New York Stock Exchange. Copies of our key corporate governance documents, including our Corporate Governance Guidelines, Code of Ethical Business Conduct, and the charters of each committee of our Board of Directors can be obtained from the corporate governance portion of the investor relations section of our Website, AquaAmerica.com. Amendments to the Code, and in the event of any grant of waiver from a provision of the Code requiring disclosure under applicable SEC rules will be disclosed on our Website.

### **Annual Meeting**

8:30 a.m. Eastern Daylight Time  
Wednesday, May 3, 2017  
Drexelbrook Banquet Facility and Corporate Center  
4700 Drexelbrook Drive  
Drexel Hill, PA 19026

### **Transfer Agent and Registrar**

Computershare  
P.O. BOX 30170  
College Station, TX 77842  
800.205.8314 or  
[www.computershare.com/investor](http://www.computershare.com/investor)

### **Independent Registered Public Accounting Firm**

PricewaterhouseCoopers LLP  
Two Commerce Square  
Suite 1700  
2001 Market Street  
Philadelphia, PA 19103-7042

### **Stock Exchange**

The Common Stock of the company is listed on the New York Stock Exchange and under the ticker symbol **WTR**.

### **Dividend Reinvestment and Direct Stock Purchase Plan**

The company's Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") enables shareholders to reinvest all, or a designated portion of, dividends paid on up to 100,000 shares of Common Stock in additional shares of Common Stock at a discretionary discount from a price based on the market value of the stock. The discount between 0 and 5.0 percent on the shares purchased or issued to meet the dividend reinvestment requirement will be designated by us in our sole discretion prior to the purchase or issuance of such shares. We reserve the right to change, reduce or discontinue any discount at any time without notice. In addition, shareholders may purchase additional shares of Aqua America Common Stock at any time with a minimum investment of \$50, up to a maximum of \$250,000 annually. Individuals may become shareholders by making an initial investment of at least \$500. A Plan prospectus may be obtained by calling Computershare at 800.205.8314 or by visiting [www.computershare.com/investor](http://www.computershare.com/investor). Please read the prospectus carefully before you invest.

### **IRA, Roth IRA, Education IRA**

An IRA, Roth IRA or Coverdell Education Savings Account may be opened through the Plan to hold shares of Common Stock of the company and to make contributions to the IRA to purchase shares of Common Stock. Participants in the Plan may roll over an existing IRA or other qualified plan distribution in cash into an IRA under the Plan to purchase the company's Common Stock. Participants may also transfer the company's Common Stock from an existing IRA into an IRA under the Plan. A prospectus, IRA forms and a disclosure statement may be obtained by calling Computershare at 800.597.7736. Please read the prospectus carefully before you invest.

### **Direct Deposit**

With direct deposit, Aqua America cash dividends are deposited automatically on the dividend payment date of each quarter. Shareholders will receive confirmation of their deposit in the mail. Shareholders interested in direct deposit should call the company's transfer agent at 800.205.8314.

### **Delivery of voting materials to shareholders sharing an address**

The SEC's rules permit the Company to deliver a Notice of Internet Availability of Proxy Materials or a single set of proxy materials to one address shared by two or more of the Company's shareholders. This is intended to reduce the printing and postage expense of delivering duplicate voting materials to our shareholders who have more than one Aqua America stock account. A separate Notice of Internet Availability or proxy card is included for each of these shareholders. If you received a Notice of Internet Availability you will not receive a printed copy of the proxy materials unless you request it by following the instructions in the notice for requesting printed proxy material.

### **How to obtain a separate set of voting materials**

If you are a registered shareholder who shares an address with another registered shareholder and have received only one Notice of Internet Availability of Proxy Materials or set of proxy material and wish to receive a separate copy for each shareholder in your household for the 2016 annual meeting, you may write or call us to request a separate copy of this material at no cost to you at 610.645.1196 or write us at:

Attn: Investor Relations  
Aqua America, Inc.  
762 W. Lancaster Avenue  
Bryn Mawr, PA, 19010

For future annual meetings, you may request separate voting material by calling Broadridge at 800.542.1061, or by writing to Broadridge Financial Solutions, Inc., Householding Department, 51 Mercedes Way, Edgewood, New York 11717.

### **Account Access**

Aqua America shareholders may access their account by visiting [www.computershare.com/investor](http://www.computershare.com/investor). Shareholders may view their account, purchase additional shares, and make changes to their account. To learn more, visit [www.computershare.com/investor](http://www.computershare.com/investor) or call 800.205.8314.

## Dividends

Aqua America has paid dividends for 72 consecutive years. The normal Common Stock dividend dates for 2017 and the first six months of 2018 are:

| <b>Declaration Date</b> | <b>Ex-Dividend Date</b> | <b>Record Date</b> | <b>Payment Date</b> |
|-------------------------|-------------------------|--------------------|---------------------|
| February 3, 2017        | February 13, 2017       | February 15, 2017  | March 1, 2017       |
| May 5, 2017             | May 15, 2017            | May 17, 2017       | June 1, 2017        |
| August 4, 2017          | August 14, 2017         | August 16, 2017    | September 1, 2017   |
| November 6, 2017        | November 15, 2017       | November 17, 2017  | December 1, 2017    |
| February 5, 2018        | February 14, 2018       | February 16, 2018  | March 1, 2018       |
| May 7, 2018             | May 16, 2018            | May 18, 2018       | June 1, 2018        |

To be an owner of record, and therefore eligible to receive the quarterly dividend, shares must have been purchased before the ex-dividend date. Owners of any share(s) on or after the ex-dividend date will not receive the dividend for that quarter. The previous owner — the owner of record — will receive the dividend.

Only the Board of Directors may declare dividends and set record dates. Therefore, the payment of dividends and these dates may change at the discretion of the Board.

Dividends paid on the company's Common Stock are subject to Federal and State income tax.

### **Lost Dividend Checks, Stock Certificates and Escheatment**

Dividend checks lost by shareholders, or those that might be lost in the mail, will be replaced upon notification of the lost or missing check. All inquiries concerning lost or missing dividend checks should be made to the company's transfer agent at 800.205.8314. Shareholders should call or write the company's transfer agent to report a lost certificate. Appropriate documentation will be prepared and sent to the shareholder with instructions.

Escheatment is the act of reporting and transferring property to a state when the rightful owner has an invalid address or has not made contact or initiated a transaction during the state's designated dormancy period. Escheated assets are transferred to the state for safekeeping (and often liquidated) until the rightful owner makes a claim on the asset. To keep your shares of stock and uncashed dividends from being escheated, you must maintain contact (recommended at least once a year) with the company's transfer agent, especially if you recently changed your address, changed your marital status or are managing an estate following a death. Unclaimed property laws vary widely from state to state.

### **Safekeeping of Stock Certificates**

Under the Direct Stock Purchase Plan, shareholders may have their stock certificates deposited with the transfer agent for safekeeping free of charge. Stock certificates and written instructions should be forwarded to:

Computershare, N.A.  
P.O. Box 30170  
College Station, TX 77842.

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# Corporate Information

## Board Of Directors

### Nicholas DeBenedictis

Non-executive *Chairman and former Chief Executive Officer*  
*Aqua America, Inc.*  
Director since 1992

### Christopher H. Franklin

*President and Chief Executive Officer*  
*Aqua America, Inc.*  
Director since 2015

### Carolyn J. Burke

*Executive Vice President, Business Operations and Systems*  
*Dynegy, Inc.*  
Director since 2016

### Richard H. Glanton

Founder, Chairman and *Chief Executive Officer*  
*Elected Face, Inc.*  
Director since 1995

### Lon R. Greenberg

*Chairman Emeritus*  
*UGI Corporation*  
Director since 2005

### William P. Hankowsky

*Chairman, President and Chief Executive Officer*  
*Liberty Property Trust*  
Director since 2004

### Wendell F. Holland, Esq.

*Partner*  
*CFSD Group, LLC.*  
Director since 2011

### Ellen T. Ruff

*Partner*  
*McGuireWoods, LLP.*  
Director since 2006

## Officers

### Christopher H. Franklin

*President and Chief Executive Officer*

### Richard S. Fox

*Executive Vice President and Chief Operating Officer, Regulated Operations*

### Karen M. Heisler

*Senior Vice President and Chief Human Resources Officer*

### Christopher P. Luning

*Senior Vice President, General Counsel and Secretary*

### William C. Ross

*Senior Vice President*  
*Engineering and Environmental Affairs*

### Robert A. Rubin

*Senior Vice President*  
*Controller and Chief Accounting Officer*

### Daniel J. Schuller, PhD.

*Executive Vice President*  
*Corporate Development and Strategy*

### David P. Smeltzer

*Executive Vice President*  
*Chief Financial Officer*





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NYSE: WTR

