AQUA AMERICA INC
Form 10-Q
November 02, 2016
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

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

For the transition period from_______________ to _______________

Commission File Number 1-6659

AQUA AMERICA, INC.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Pennsylvania<br>(State or other jurisdiction of<br>incorporation or organization) | 23-1702594<br>(I.R.S. Employer<br>Identification No.) |
| 762 W. Lancaster Avenue, Bryn Mawr, Pennsylvania<br>(Address of principal executive offices) | 19010 -3489<br>(Zip Code) |
| (610) 527-8000<br>(Registrant's telephone number, including area code) | |

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

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of

October 20, 2016: 177,358,257

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

TABLE OF CONTENTS

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands of dollars, except per share amounts)

(UNAUDITED)

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

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

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

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF NET INCOME

(In thousands, except per share amounts)

(UNAUDITED)

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

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

3

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF NET INCOME

(In thousands, except per share amounts)

(UNAUDITED)

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

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

4

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands of dollars)

(UNAUDITED)

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

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

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

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CAPITALIZATION

(In thousands of dollars, except per share amounts)

(UNAUDITED)

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

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

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

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EQUITY

(In thousands of dollars)

(UNAUDITED)

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

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

7

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOW

(In thousands of dollars)

(UNAUDITED)

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

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

See notes to consolidated financial statements beginning on page 9 of this report.
See note 3 - Acquisitions for a description of non-cash activities.

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 1 – Basis of Presentation

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

Note 2 – Goodwill

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

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

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

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

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

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

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

Note 3 – Acquisitions

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

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

Note 4 – Assets Held for Sale

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

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

]

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 5 – Capitalization

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

Note 6 – Fair Value of Financial Instruments

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

- Level 1: unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access;

- Level 2: inputs other than Level 1 that are observable, either directly or indirectly, such as quoted market prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in non-active markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; or

- Level 3: inputs that are unobservable and significant to the fair value measurement.

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

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

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

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

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

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

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

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

Note 7 – Net Income per Common Share

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

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

For the three and nine months ended September 30, 2016 and 2015, all of the Company's employee stock options were included in the calculations of diluted net income per share as the calculated cost to exercise the stock options was less than the average market price of the Company's common stock during these periods.

Note 8 – Stock-based Compensation

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

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

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

13

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

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

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

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

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

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

14

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

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

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

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

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

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

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

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

1

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

15

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

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

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

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

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

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

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 9 – Pension Plans and Other Postretirement Benefits

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

| | Pension Benefits | | | |
|---|---|---|---|---|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | $ 784 | $ 750 | $ 2,394 | $ 2,600 |
| Interest cost | 3,251 | 3,255 | 9,787 | 9,699 |
| Expected return on plan assets | (4,215) | (4,677) | (12,696) | (14,025) |
| Amortization of prior service cost | 145 | 44 | 435 | 130 |
| Amortization of actuarial loss | 1,797 | 1,465 | 5,354 | 4,529 |
| Settlement charge | - | - | 3,028 | - |
| Special termination benefit charge | - | - | 302 | - |
| Net periodic benefit cost | $ 1,762 | $ 837 | $ 8,604 | $ 2,933 |

| | Other Postretirement Benefits | | | |
|---|---|---|---|---|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | $ 253 | $ 273 | $ 761 | $ 952 |
| Interest cost | 726 | 681 | 2,202 | 2,120 |
| Expected return on plan assets | (645) | (731) | (2,001) | (2,192) |
| Amortization of prior service cost | (137) | (211) | (411) | (476) |
| Amortization of actuarial loss | 220 | 309 | 707 | 972 |
| Net periodic benefit cost | $ 417 | $ 321 | $ 1,258 | $ 1,376 |

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

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

## Note 10 – Water and Wastewater Rates

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

## Note 11 – Taxes Other than Income Taxes

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

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

Note 12 – Segment Information

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

Table of Contents

AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

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

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