

AQUA AMERICA INC
Form 10-Q
August 03, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

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

For the transition period from _____ to _____

Commission File Number 1-6659

AQUA AMERICA, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction of
incorporation or organization)

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

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

19010 -3489
(Zip Code)

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth 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
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

July 24, 2018: 177,913,909

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AQUA AMERICA, INC. AND SUBSIDIARIES

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands of dollars, except per share amounts)

(UNAUDITED)

| | June 30, 2018 | December 31, 2017 |
|--|------------------|-------------------------|
| Assets | | |
| Property, plant and equipment, at cost | \$ 7,191,574 | \$ 7,003,993 |
| Less: accumulated depreciation | 1,649,601 | 1,604,133 |
| Net property, plant and equipment | 5,541,973 | 5,399,860 |
| Current assets: | | |
| Cash and cash equivalents | 52,948 | 4,204 |
| Accounts receivable and unbilled revenues, net | 103,931 | 98,596 |
| Inventory, materials and supplies | 16,046 | 14,361 |
| Prepayments and other current assets | 14,891 | 12,542 |
| Assets held for sale | 1,558 | 1,543 |
| Total current assets | 189,374 | 131,246 |
| Regulatory assets | 750,826 | 713,971 |
| Deferred charges and other assets, net | 38,648 | 38,485 |
| Investment in joint venture | 7,474 | 6,671 |
| Goodwill | 42,050 | 42,230 |
| Total assets | \$ 6,570,345 | \$ 6,332,463 |
| Liabilities and Equity | | |
| Stockholders' equity: | | |
| Common stock at \$.50 par value, authorized 300,000,000 shares, issued 180,971,159 and 180,700,251 as of June 30, 2018 and December 31, 2017 | \$ 90,486 | \$ 90,350 |
| Capital in excess of par value | 811,763 | 807,135 |
| Retained earnings | 1,177,874 | 1,132,556 |
| Treasury stock, at cost, 3,058,248 and 2,986,308 shares as of June 30, 2018 and December 31, 2017 | (75,771) | (73,280) |
| Accumulated other comprehensive income | - | 860 |
| Total stockholders' equity | 2,004,352 | 1,957,621 |
| Long-term debt, excluding current portion | 2,202,363 | 2,029,358 |
| Less: debt issuance costs | 21,002 | 21,605 |
| Long-term debt, excluding current portion, net of debt issuance costs | 2,181,361 | 2,007,753 |
| Commitments and contingencies (See Note 14) | | |

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| | | |
|--|--------------|--------------|
| Current liabilities: | | |
| Current portion of long-term debt | 118,540 | 113,769 |
| Loans payable | - | 3,650 |
| Accounts payable | 42,450 | 59,165 |
| Book overdraft | 15,567 | 21,629 |
| Accrued interest | 22,283 | 21,359 |
| Accrued taxes | 17,373 | 23,764 |
| Other accrued liabilities | 37,769 | 41,152 |
| Total current liabilities | 253,982 | 284,488 |
| Deferred credits and other liabilities: | | |
| Deferred income taxes and investment tax credits | 808,711 | 769,073 |
| Customers' advances for construction | 93,342 | 93,186 |
| Regulatory liabilities | 542,525 | 541,910 |
| Other | 104,325 | 107,341 |
| Total deferred credits and other liabilities | 1,548,903 | 1,511,510 |
| Contributions in aid of construction | 581,747 | 571,091 |
| Total liabilities and equity | \$ 6,570,345 | \$ 6,332,463 |

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

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF NET INCOME

(In thousands, except per share amounts)

(UNAUDITED)

| | Three Months Ended June 30, | |
|--|--------------------------------|------------|
| | 2018 | 2017 |
| Operating revenues | \$ 211,860 | \$ 203,418 |
| Operating expenses: | | |
| Operations and maintenance | 73,515 | 69,615 |
| Depreciation | 36,613 | 33,407 |
| Amortization | 149 | 127 |
| Taxes other than income taxes | 14,829 | 14,419 |
| Total operating expenses | 125,106 | 117,568 |
| Operating income | 86,754 | 85,850 |
| Other expense (income): | | |
| Interest expense, net | 23,723 | 21,387 |
| Allowance for funds used during construction | (2,577) | (3,463) |
| Gain on sale of other assets | (141) | (10) |
| Equity (earnings) loss in joint venture | (911) | 161 |
| Other | 437 | 1,238 |
| Income before income taxes | 66,223 | 66,537 |
| Provision for income tax (benefit) expense | (367) | 5,569 |
| Net income | \$ 66,590 | \$ 60,968 |
| Net income per common share: | | |
| Basic | \$ 0.37 | \$ 0.34 |
| Diluted | \$ 0.37 | \$ 0.34 |
| Average common shares outstanding during the period: | | |
| Basic | 177,901 | 177,609 |
| Diluted | 178,273 | 178,045 |
| Cash dividends declared per common share | \$ 0.2047 | \$ 0.1913 |

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

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF NET INCOME

(In thousands, except per share amounts)

(UNAUDITED)

| | Six Months Ended | |
|--|------------------|------------|
| | June 30, | |
| | 2018 | 2017 |
| Operating revenues | \$ 406,207 | \$ 391,205 |
| Operating expenses: | | |
| Operations and maintenance | 147,461 | 137,505 |
| Depreciation | 72,580 | 67,244 |
| Amortization | 279 | 316 |
| Taxes other than income taxes | 29,796 | 29,156 |
| Total operating expenses | 250,116 | 234,221 |
| Operating income | 156,091 | 156,984 |
| Other expense (income): | | |
| Interest expense, net | 47,194 | 42,713 |
| Allowance for funds used during construction | (5,444) | (6,656) |
| Gain on sale of other assets | (337) | (279) |
| Equity (earnings) loss in joint venture | (1,293) | 191 |
| Other | 1,040 | 2,476 |
| Income before income taxes | 114,931 | 118,539 |
| Provision for income tax (benefit) expense | (2,498) | 8,499 |
| Net income | \$ 117,429 | \$ 110,040 |
| Net income per common share: | | |
| Basic | \$ 0.66 | \$ 0.62 |
| Diluted | \$ 0.66 | \$ 0.62 |
| Average common shares outstanding during the period: | | |
| Basic | 177,852 | 177,545 |
| Diluted | 178,299 | 178,042 |

Cash dividends declared per common share \$ 0.4094 \$ 0.3826

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

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands of dollars)

(UNAUDITED)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|-----------|------------------|------------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Net income | \$ 66,590 | \$ 60,968 | \$ 117,429 | \$ 110,040 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized holding gain on investments, net of tax expense of \$20 for the three months, and \$51 for the six months ended June 30, 2017, respectively | - | 37 | - | 95 |
| Comprehensive income | \$ 66,590 | \$ 61,005 | \$ 117,429 | \$ 110,135 |

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

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CAPITALIZATION

(In thousands of dollars, except per share amounts)

(UNAUDITED)

| | June 30, 2018 | December 31, 2017 |
|---|---------------------|-------------------------|
| Stockholders' equity: | | |
| Common stock, \$.50 par value | \$ 90,486 | \$ 90,350 |
| Capital in excess of par value | 811,763 | 807,135 |
| Retained earnings | 1,177,874 | 1,132,556 |
| Treasury stock, at cost | (75,771) | (73,280) |
| Accumulated other comprehensive income | - | 860 |
| Total stockholders' equity | 2,004,352 | 1,957,621 |
| Long-term debt of subsidiaries (substantially collateralized by utility plant): | | |
| Interest Rate Range | Maturity Date Range | |
| 0.00% to 0.99% | 2023 to 2033 | 3,876 |
| 1.00% to 1.99% | 2019 to 2035 | 12,343 |
| 2.00% to 2.99% | 2019 to 2033 | 18,377 |
| 3.00% to 3.99% | 2019 to 2056 | 498,841 |
| 4.00% to 4.99% | 2020 to 2057 | 706,431 |
| 5.00% to 5.99% | 2019 to 2043 | 205,311 |
| 6.00% to 6.99% | 2018 to 2036 | 44,000 |
| 7.00% to 7.99% | 2022 to 2027 | 31,955 |
| 8.00% to 8.99% | 2021 to 2025 | 5,842 |
| 9.00% to 9.99% | 2018 to 2026 | 20,700 |
| 10.00% to 10.99% | 2018 | 6,000 |
| | | 1,553,676 |
| Notes payable to bank under revolving credit agreement, variable rate, due 2021 | 157,000 | 60,000 |
| Unsecured notes payable: | | |
| Bank notes at 2.48% and 3.5% due 2019 and 2020 | 100,000 | 100,000 |
| Notes at 3.01% and 3.59% due 2027 and 2041 | 245,000 | 245,000 |
| | 122,800 | 122,800 |

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| | | |
|---|--------------|--------------|
| Notes ranging from 4.62% to 4.87%, due 2018 through 2024 | | |
| Notes ranging from 5.20% to 5.95%, due 2018 through 2037 | 142,427 | 152,427 |
| Total long-term debt | 2,320,903 | 2,143,127 |
| Current portion of long-term debt | 118,540 | 113,769 |
| Long-term debt, excluding current portion | 2,202,363 | 2,029,358 |
| Less: debt issuance costs | 21,002 | 21,605 |
| Long-term debt, excluding current portion, net of debt issuance costs | 2,181,361 | 2,007,753 |
| Total capitalization | \$ 4,185,713 | \$ 3,965,374 |

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

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EQUITY

(In thousands of dollars)

(UNAUDITED)

| | Common Stock | Capital in Excess of Par Value | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income | Total |
|---|-----------------|--------------------------------------|----------------------|-------------------|---|--------------|
| Balance at December 31, 2017 | \$ 90,350 | \$ 807,135 | \$ 1,132,556 | \$ (73,280) | \$ 860 | \$ 1,957,621 |
| Net income | - | - | 117,429 | - | - | 117,429 |
| Dividends | - | - | (72,802) | - | - | (72,802) |
| Issuance of common stock under dividend reinvestment plan (22,170 shares) | 11 | 709 | - | - | - | 720 |
| Repurchase of stock (71,940 shares) | - | - | - | (2,491) | - | (2,491) |
| Equity compensation plan (185,639 shares) | 93 | (93) | - | - | - | - |
| Exercise of stock options (63,099 shares) | 32 | 987 | - | - | - | 1,019 |
| Stock-based compensation | - | 3,428 | (169) | - | - | 3,259 |
| Cumulative effect of change in accounting principle - financial instruments | - | - | 860 | - | (860) | - |
| Other | - | (403) | - | - | - | (403) |
| Balance at June 30, 2018 | \$ 90,486 | \$ 811,763 | \$ 1,177,874 | \$ (75,771) | \$ - | \$ 2,004,352 |

Refer to Note 16 - Recent Accounting Pronouncements for a discussion of the cumulative effect of change in accounting principle - financial instruments

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

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOW

(In thousands of dollars)

(UNAUDITED)

| | Six Months Ended | |
|--|------------------|------------|
| | June 30, | |
| | 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net income | \$ 117,429 | \$ 110,040 |
| Adjustments to reconcile net income to net cash flows from operating activities: | | |
| Depreciation and amortization | 72,859 | 67,560 |
| Deferred income taxes | (4,602) | 6,299 |
| Provision for doubtful accounts | 2,213 | 2,052 |
| Stock-based compensation | 3,432 | 2,810 |
| Loss on sale of market-based business unit | - | 324 |
| Gain on sale of other assets | (337) | (279) |
| Net change in receivables, inventory and prepayments | (11,110) | (7,417) |
| Net change in payables, accrued interest, accrued taxes and other accrued liabilities | (6,165) | (10,969) |
| Pension and other postretirement benefits contributions | (8,692) | (15,421) |
| Other | 4,658 | 2,262 |
| Net cash flows from operating activities | 169,685 | 157,261 |
| Cash flows from investing activities: | | |
| Property, plant and equipment additions, including the debt component of allowance for funds used during construction of \$1,613 and \$1,543 | (216,614) | (208,472) |
| Acquisitions of utility systems and other, net | (190) | (5,765) |
| Net proceeds from the sale of market-based business unit and other assets | 398 | 1,102 |
| Other | (152) | (144) |
| Net cash flows used in investing activities | (216,558) | (213,279) |
| Cash flows from financing activities: | | |
| Customers' advances and contributions in aid of construction | 4,068 | 3,629 |
| Repayments of customers' advances | (1,818) | (1,774) |
| Net (repayments) proceeds of short-term debt | (3,650) | 60,921 |
| Proceeds from long-term debt | 218,037 | 222,780 |
| Repayments of long-term debt | (41,001) | (145,499) |
| Change in cash overdraft position | (6,062) | (12,616) |
| Proceeds from issuing common stock | 720 | 715 |
| Proceeds from exercised stock options | 1,019 | 2,327 |
| Repurchase of common stock | (2,491) | (2,093) |

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| | | |
|---|-----------|-----------|
| Dividends paid on common stock | (72,802) | (67,920) |
| Other | (403) | (404) |
| Net cash flows from financing activities | 95,617 | 60,066 |
| Net change in cash and cash equivalents | 48,744 | 4,048 |
| Cash and cash equivalents at beginning of period | 4,204 | 3,763 |
| Cash and cash equivalents at end of period | \$ 52,948 | \$ 7,811 |
| Non-cash investing activities: | | |
| Property, plant and equipment additions purchased at the period end, but not yet paid for | \$ 26,010 | \$ 32,770 |
| Non-cash customer advances and contributions in aid of construction | 10,468 | 11,488 |

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

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 1 – Basis of Presentation

The accompanying consolidated balance sheets and statements of capitalization of Aqua America, Inc. and subsidiaries (the “Company”) at June 30, 2018, the consolidated statements of net income and comprehensive income for the three and six months ended June 30, 2018 and 2017 the consolidated statements of cash flow for the six months ended June 30, 2018 and 2017, and the consolidated statement of equity for the six months ended June 30, 2018 are unaudited, but reflect all adjustments, consisting of only normal recurring accruals, which are, in the opinion of management, necessary to present a fair statement of its consolidated financial position, consolidated changes in equity, consolidated results of operations, and 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, 2017. 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, 2017 consolidated balance sheet data presented herein was derived from the Company’s December 31, 2017 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 in the consolidated statements of net income as a result of the adoption, in the first quarter of 2018, of the Financial Accounting Standards Board’s (“FASB”) accounting guidance on the presentation of net periodic pension and postretirement benefit cost (refer to Note 16 – Recent Accounting Pronouncements).

The preparation of financial statements often requires the selection of specific accounting methods and policies. Further, significant estimates and judgments may be required in selecting and applying those methods and policies in the recognition of the assets and liabilities in its consolidated balance sheets, the revenues and expenses in its consolidated statements of net income, and the information that is contained in its summary of significant accounting policies and notes to consolidated financial statements. Making these estimates and judgments requires the analysis of information concerning events that may not yet be complete and of facts and circumstances that may change over time. Accordingly, actual amounts or future results can differ materially from those estimates that the Company includes currently in its consolidated financial statements, summary of significant accounting policies, and notes.

There have been no changes to the summary of significant accounting policies, other than as described in Note 2 – Revenue Recognition as a result of the adoption of a new accounting pronouncement adopted on January 1, 2018, previously identified in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 2 – Revenue Recognition

The Company recognizes revenue as water and wastewater services are provided to our customers, which happens over time as the service is delivered and the performance obligation is satisfied. The Company's 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. Unbilled amounts are calculated by deriving estimates based on average usage of the prior month. The Company's 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. Unbilled amounts are included in accounts receivable and unbilled revenues, net on the consolidated balance sheet.

Generally, payment is due within 30 days once a bill is issued to a customer. Sales tax and other taxes we collect on behalf of government authorities, concurrent with our revenue-producing activities, are primarily excluded from revenue. The Company has determined that its revenue recognition is not materially different under the FASB's new accounting standard for revenue from contracts with customer, and has not made any changes to our accounting policy. The Company's revenues are being reported identical in the consolidated statements of net income to how they were reported under the FASB's former accounting standard for revenue recognition. The following table presents our revenues disaggregated by major source and customer class:

| | Three Months Ended | | | Six Months Ended | | |
|------------------|--------------------|------------|----------|------------------|------------|----------|
| | June 30, 2018 | | | June 30, 2018 | | |
| | Water | Wastewater | Other | Water | Wastewater | Other |
| | Revenues | Revenues | Revenues | Revenues | Revenues | Revenues |
| Regulated: | | | | | | |
| Residential | \$ 122,530 | \$ 17,583 | \$ - | \$ 236,367 | \$ 35,115 | \$ - |
| Commercial | 33,456 | 2,975 | - | 63,798 | 5,863 | - |
| Fire protection | 7,970 | - | - | 15,908 | - | - |
| Industrial | 7,309 | 498 | - | 13,669 | 961 | - |
| Other water | 14,220 | - | - | 25,241 | - | - |
| Other wastewater | - | 1,920 | - | - | 2,711 | - |

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|-----------------------------|------------|-----------|----------|------------|-----------|----------|
| Alternative revenue program | (120) | 164 | - | (120) | 164 | - |
| Other utility | - | - | 2,319 | - | - | 4,654 |
| Regulated segment total | 185,365 | 23,140 | 2,319 | 354,863 | 44,814 | 4,654 |
| Other and eliminations | - | - | 1,036 | - | - | 1,876 |
| Consolidated | \$ 185,365 | \$ 23,140 | \$ 3,355 | \$ 354,863 | \$ 44,814 | \$ 6,530 |

Regulated Segment Revenues – These revenues are composed of three main categories: water, wastewater, and other. Water revenues represent revenues earned for supplying customers with water service. Wastewater revenues represent revenues earned for treating wastewater and releasing it into the water supply. Other revenues are associated fees that relate to the regulated business but are not water and wastewater revenues. See description below for a discussion on the performance obligation for each of these revenue streams.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Tariff Revenues – These revenues are categorized by customer class: residential, commercial, fire protection, industrial, and other water and other wastewater. The rates that generate these revenues are approved by the respective state utility commission, and revenues are billed cyclically and accrued for when unbilled. Other water and other wastewater revenues consist primarily of fines, penalties, surcharges, and availability lot fees. Our performance obligation for tariff revenues is to provide potable water or wastewater treatment service to customers. This performance obligation is satisfied over time as the services are rendered.

Alternative Revenue Program – These revenues represent the difference between the actual billed utility water and wastewater revenues for Aqua Illinois and the revenues set in the last Aqua Illinois rate case. We recognize revenues based on the target amount established in the last rate case, and then record either a regulatory asset or liability based on the cumulative difference between the target and actual, which results in either a refund due to customers or a payment from customers. This revenue program represents a contract between the utility and its regulators, not customers, and therefore is not within the scope of the FASB's accounting guidance for recognizing revenue from contracts with customers.

Other Utility Revenues – Other utility revenues represent revenues earned primarily from: antenna revenues, which represent fees received from telecommunication operators that have put cellular antennas on our water towers, operation and maintenance and billing contracts, which represent fees earned from municipalities for our operation of their water or wastewater treatment services or performing billing services, and fees earned from developers for accessing our water mains. The performance obligations vary for these revenues, but all are primarily recognized over time as the service is delivered.

Other and Eliminations – Other and eliminations consist of our market-based revenues, which comprises: Aqua Infrastructure and Aqua Resources (described below), and intercompany eliminations for revenue billed between our subsidiaries.

Aqua Infrastructure is the holding company for our 49% investment in a joint venture that operates a private pipeline system to supply raw water to natural gas well drilling operations in the Marcellus Shale of north central Pennsylvania. The joint venture earns revenues through providing non-utility raw water supply services to natural gas drilling companies which enter into water supply contracts. The performance obligation is to deliver non-potable water to the joint venture's customers. Aqua Infrastructure's share of the revenues recognized by the joint venture is

reflected, net, in equity earnings in joint venture on our consolidated statements of net income.

Aqua Resources earns revenues by providing non-regulated water and wastewater services through operating and maintenance contracts, and third-party water and sewer service line repair. The performance obligations are performing agreed upon services in the contract, most commonly operation of third-party water or wastewater treatment services, or billing services, or allowing the use of our logo to a third-party water and sewer service line repair. Revenues are primarily recognized over time as service is delivered.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 3 – Goodwill

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

| | Regulated Segment | Other | Consolidated |
|--|----------------------|----------|--------------|
| Balance at December 31, 2017 | \$ 37,389 | \$ 4,841 | \$ 42,230 |
| Goodwill acquired | 25 | - | 25 |
| Reclassification to utility plant acquisition adjustment | (25) | - | (25) |
| Other | (180) | - | (180) |
| Balance at June 30, 2018 | \$ 37,209 | \$ 4,841 | \$ 42,050 |

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.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 4 – Acquisitions

During the first six months of 2018, the Company completed three acquisitions of water and wastewater utility systems in various states adding 448 customers. The total purchase price of these utility systems consisted of \$190 in cash. The purchase price allocation for these acquisitions consisted primarily of acquired property, plant and equipment. The pro forma effect of the businesses acquired is not material either individually or collectively to the Company's results of operations.

In July 2018, the Company entered into a purchase agreement to acquire the wastewater utility system assets of Cheltenham Township, Pennsylvania, which serves approximately 10,500 customers for \$50,250. The purchase price for this pending acquisition is subject to certain adjustments at closing, and is subject to regulatory approval, including the final determination of the fair value of the rate base acquired.

In addition to the Company's pending acquisition in Cheltenham Township, Pennsylvania, as part of the Company's growth-through-acquisition strategy, the Company entered into purchase agreements to acquire the water or wastewater utility system assets of seven municipalities for a total combined purchase price in cash of \$152,800, which we plan to finance by the issuance of debt. The purchase price for these acquisitions is subject to certain adjustments at closing, and the acquisitions are subject to regulatory approvals, including the final determination of the fair value of the rate base acquired. In July 2018, we closed on the following acquisitions:

- Manteno, Illinois for \$25,000 in cash, which serves approximately 3,800 wastewater customers, and
- Limerick, Pennsylvania for \$75,100 in cash, which serves approximately 5,400 wastewater customers.

Closings for our remaining acquisitions are expected to occur by the end of 2019, subject to the timing of the regulatory approval process. In total, these acquisitions will add approximately 16,750 customers in two of the states in which the Company operates in.

During 2017, the Company completed four acquisitions of water and wastewater utility systems in various states adding 1,003 customers. The total purchase price of these utility systems consisted of \$5,860 in cash, which resulted in \$72 of goodwill being recorded. The pro forma effect of the businesses acquired is not material either individually or collectively to the Company's results of operations.

Note 5 – Assets Held for Sale

In the first quarter of 2017, the Company decided to market for sale a water system that serves approximately 265 customers. This water system is reported as assets held for sale in the Company's consolidated balance sheet. The Company has been in discussions with a potential buyer for the water system and is currently negotiating the terms of a sale, which will require regulatory approval.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

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Note 6 – Capitalization

In June 2018, the Company amended its unsecured revolving credit facility, to extend the expiration from February 2021 to June 2023, and to increase the facility from \$250,000 to \$500,000. 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.

In June 2018, Aqua Pennsylvania issued \$100,000 of first mortgage bonds, of which \$25,000 is due in 2042, \$10,000 is due in 2045, and \$65,000 is due in 2048 with interest rates of 3.99%, 4.04%, and 4.09%, respectively. The proceeds from these bonds were used to repay existing indebtedness and for general corporate purposes.

In July 2018, Aqua Pennsylvania redeemed \$49,660 of tax-exempt bonds at 5.25% that were originally maturing in 2042 and 2043, respectively.

Note 7 –Financial Instruments

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:

- 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 June 30, 2018.

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.

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The fair value of loans payable is determined based on its carrying amount and utilizing Level 1 methods and assumptions. As of December 31, 2017, the carrying amount of the Company's loans payable was \$3,650, which equates to their estimated fair value. The fair value of cash and cash equivalents, which is comprised of uninvested cash, is determined based on the net asset value per unit utilizing Level 1 methods and assumptions. As of June 30, 2018 and December 31, 2017, the carrying amounts of the Company's cash and cash equivalents was \$52,948 and \$4,204, respectively, which equates to their fair value. The Company's assets underlying the deferred compensation and non-qualified pension plans are determined by the fair value of mutual funds, which are based on quoted market prices from active markets utilizing Level 1 methods and assumptions. As of June 30, 2018 and December 31, 2017, the carrying amount of these securities was \$21,759 and \$21,776, which equates to their fair value, and is reported in the consolidated balance sheet in deferred charges and other assets.

Unrealized gain and losses on equity securities held in conjunction with our non-qualified pension plan is as follows:

| | Three Months Ended June 30, 2018 | Six Months Ended June 30, 2018 |
|---|---|---|
| Net gain (loss) recognized during the period on equity securities | \$ 19 | \$ (2) |
| Less: net gain / loss recognized during the period on equity securities sold during the period | - | - |
| Unrealized gain (loss) recognized during the reporting period on equity securities still held at the reporting date | \$ 19 | \$ (2) |

The net gain (loss) recognized on equity securities is presented on the consolidated statements of net income on the line item "Other." Additionally, the unrealized gain (loss) recognized during the three and six months ended June 30, 2017, was reported on the consolidated statements of comprehensive income.

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

| | June 30, 2018 | December 31, 2017 |
|----------------------|------------------|-------------------------|
| Carrying amount | \$ 2,320,903 | \$ 2,143,127 |
| Estimated fair value | 2,322,759 | 2,262,785 |

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 \$93,342 as of June 30, 2018, and \$93,186 as of December 31, 2017. 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 rates. Portions of these non-interest bearing instruments are payable annually through 2028 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.

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Note 8 – 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 | | Six Months Ended | |
|---|---------------------------|---------|------------------|---------|
| | Ended June 30, 2018 | 2017 | 2018 | 2017 |
| Average common shares outstanding during the period for basic computation | 177,901 | 177,609 | 177,852 | 177,545 |
| Dilutive effect of employee stock-based compensation | 372 | 436 | 447 | 497 |
| Average common shares outstanding during the period for diluted computation | 178,273 | 178,045 | 178,299 | 178,042 |

For the three months ended June 30, 2017 and the six months ended June 30, 2018 and 2017, 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. For the three months ended June 30, 2018, employee stock options to purchase 159,244 shares of common stock were excluded from the calculation of diluted net income per share as the calculated cost to exercise the stock options was greater than the average market price of the Company's common stock during this period.

Note 9 – 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. 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 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

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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 June 30, 2018, 3,413,103 shares were still available for issuance under the 2009 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 | | Six Months Ended | |
|---|---------------------------|--------|------------------|----------|
| | Ended June 30, 2018 | 2017 | 2018 | 2017 |
| Stock-based compensation within operations and maintenance expenses | \$ 1,339 | \$ 971 | \$ 2,198 | \$ 1,841 |
| Income tax benefit | 373 | 394 | 614 | 747 |

The following table summarizes the PSU transactions for the six months ended June 30, 2018:

| | Number of Share Units | Weighted Average Fair Value |
|---|-----------------------------|-----------------------------------|
| Nonvested share units at beginning of period | 452,333 | \$ 26.16 |
| Granted | 87,593 | 37.65 |
| Performance criteria adjustment | 9,505 | 31.89 |
| Forfeited | (7,780) | 30.61 |
| Share units vested in prior period and issued in current period | 9,400 | 26.54 |

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| | | |
|--|-----------|-------|
| Share units issued | (136,081) | 31.70 |
| Nonvested share units at end of period | 414,970 | 26.83 |

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 six months ended June 30, 2018 and 2017 was \$37.65 and \$30.79, 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 the Company's 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

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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 the compensation cost and income tax benefit for stock-based compensation related to RSUs:

| | Three Months Ended June 30, 2018 | | Six Months Ended June 30, 2018 | |
|---|---|--------|---|--------|
| | 2018 | 2017 | 2018 | 2017 |
| Stock-based compensation within operations and maintenance expenses | \$ 355 | \$ 322 | \$ 706 | \$ 603 |
| Income tax benefit | 100 | 133 | 201 | 249 |

The following table summarizes the RSU transactions for the six months ended June 30, 2018:

| | Number of Stock Units | Weighted Average Fair Value |
|---|-----------------------------|-----------------------------------|
| Nonvested stock units at beginning of period | 116,787 | \$ 29.46 |
| Granted | 54,073 | 34.91 |
| Stock units vested in prior period and issued in current period | 1,467 | 31.47 |
| Stock units vested and issued | (42,836) | 26.39 |
| Forfeited | (322) | 34.91 |
| Nonvested stock units at end of period | 129,169 | 32.77 |

The per unit weighted-average fair value at the date of grant for RSUs granted during the six months ended June 30, 2018 and 2017 was \$34.91 and \$30.37, respectively.

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Stock Options – A stock option represents the option to purchase a number of shares of common stock of the Company as specified in the stock option grant agreement at the exercise price per share as determined by the closing market price of our common stock on the grant date. Stock options are exercisable in installments of 33% annually, starting one year from the grant date and expire 10 years from the grant date. The fair value of each stock option is amortized into compensation expense using the graded-vesting method, which results in the recognition of compensation costs over the requisite service period for each separately vesting tranche of the stock options as though the stock options were, in substance, multiple stock option grants. The following table provides the compensation cost and income tax benefit for stock-based compensation related to stock options:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------------|-------|---------------------------------|--------|
| | 2018 | 2017 | 2018 | 2017 |
| Stock-based compensation within operations and maintenance expenses | \$ 154 | \$ 74 | \$ 248 | \$ 104 |
| Income tax benefit | 42 | 33 | 101 | 125 |

The fair value of options was estimated at the grant date using the Black-Scholes option-pricing model. The following assumptions were used in the application of this valuation model:

| | 2018 | 2017 |
|----------------------------------|---------|---------|
| Expected term (years) | 5.46 | 5.45 |
| Risk-free interest rate | 2.72% | 2.01% |
| Expected volatility | 17.2% | 17.7% |
| Dividend yield | 2.37% | 2.51% |
| Grant date fair value per option | \$ 5.10 | \$ 4.07 |

Historical information was the principal basis for the selection of the expected term and dividend yield. The expected volatility is based on a weighted-average combination of historical and implied volatilities over a time period that approximates the expected term of the option. The risk-free interest rate was selected based upon the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option.

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The following table summarizes stock option transactions for the six months ended June 30, 2018:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Life (years) | Aggregate Intrinsic Value |
|------------------------------------|----------|--|--|---------------------------------|
| Outstanding at beginning of period | 364,932 | \$ 19.83 | | |
| Granted | 160,859 | 34.51 | | |
| Forfeited | (4,489) | 31.92 | | |
| Expired / Cancelled | (107) | 30.47 | | |
| Exercised | (63,099) | 16.14 | | |
| Outstanding at end of period | 458,096 | \$ 25.37 | 5.9 | \$ 4,494 |
| Exercisable at end of period | 225,117 | \$ 17.23 | 2.4 | \$ 4,040 |

Stock Awards – Stock awards represent the issuance of the Company’s common stock, without restriction. The issuance of stock awards results in compensation expense which is equal to the fair market value of the stock on the grant date, and is expensed immediately upon grant. The following table provides the compensation cost and income tax benefit for stock-based compensation related to stock awards:

| | Three Months Ended June 30, 2018 | | Six Months Ended June 30, 2017 | |
|---|---|--------|---|--------|
| Stock-based compensation within operations and maintenance expenses | \$ 140 | \$ 131 | \$ 280 | \$ 262 |
| Income tax benefit | 41 | 54 | 81 | 109 |

The following table summarizes stock award transactions for the six months ended June 30, 2018:

| | Number of Stock Awards | Weighted Average Fair Value |
|---|------------------------------|-----------------------------------|
| Nonvested stock awards at beginning of period | - | \$ - |
| Granted | 8,099 | 34.58 |
| Vested | (8,099) | 34.58 |
| Nonvested stock awards at end of period | - | - |

The per unit weighted-average fair value at the date of grant for stock awards granted during the six months ended June 30, 2018 and 2017 was \$34.58 and \$32.79, respectively.

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Note 10 – 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 | | Six Months Ended | |
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Service cost | \$ 812 | \$ 794 | \$ 1,625 | \$ 1,587 |
| Interest cost | 2,874 | 3,108 | 5,748 | 6,217 |
| Expected return on plan assets | (4,553) | (4,270) | (9,106) | (8,539) |
| Amortization of prior service cost | 132 | 145 | 264 | 290 |
| Amortization of actuarial loss | 1,823 | 2,001 | 3,646 | 4,002 |
| Net periodic benefit cost | \$ 1,088 | \$ 1,778 | \$ 2,177 | \$ 3,557 |
| | Other | | | |
| | Postretirement Benefits | | | |
| | Three Months | | Six Months Ended | |
| | Ended | | June 30, | |
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Service cost | \$ 262 | \$ 255 | \$ 525 | \$ 510 |
| Interest cost | 708 | 737 | 1,416 | 1,473 |
| Expected return on plan assets | (677) | (647) | (1,353) | (1,294) |
| Amortization of prior service cost | (127) | (127) | (255) | (254) |
| Amortization of actuarial loss | 296 | 291 | 591 | 583 |
| Net periodic benefit cost | \$ 462 | \$ 509 | \$ 924 | \$ 1,018 |

The components of net periodic benefit cost other than service cost are presented on the consolidated statements of net income on the line item “Other.”

The Company made cash contributions of \$8,627 to its Pension Plan during the first six months of 2018, and intends to make additional cash contributions of \$3,857 to the Pension Plan during the remainder of 2018.

Note 11 – Water and Wastewater Rates

During the first six months of 2018, the Company's operating divisions in Illinois and Ohio were granted base rate increases designed to increase total operating revenues on an annual basis by \$8,640. On April 6, 2018, the base rate case in Illinois was petitioned for a rehearing; however, this petition was denied on April 19, 2018. No appeals were filed and the approved rates are considered final. Further, during the

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first six months of 2018, the Company's operating divisions in Pennsylvania, North Carolina, and New Jersey received approval to bill infrastructure rehabilitation surcharges designed to increase total operating revenues on an annual basis by \$19,343. Additionally, commencing in the second quarter of 2018, due to the decrease in our federal income tax rate from 35% to 21% from the Tax Cuts and Jobs Act, the Company's operating divisions in Texas, New Jersey, Ohio, and Indiana implemented base rate reductions or added credits to customer bills that are estimated to reduce total operating revenues by \$7,959 on an annualized basis.

As of February 10, 2018, the Company had been billing interim rates in Virginia, which had a base rate case filing in progress. Because of the Tax Cuts and Jobs Act, which reduced our federal income tax rate from 35% to 21%, our Virginia subsidiary reduced its water rate increase request and eliminated its wastewater rate increase request. In May 2018, the rates charged to our Virginia customers reverted to the previous rates, pursuant to a submitted stipulation, which is currently pending approval by the Virginia State Corporation Commission. As of June 30, 2018, \$183 of billings already collected has been refunded to our Virginia customers.

Note 12 – Taxes Other than Income Taxes

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

| | Three Months Ended | | Six Months Ended | |
|--------------------------------------|--------------------|-----------|------------------|-----------|
| | June 30, 2018 | 2017 | June 30, 2018 | 2017 |
| Property | \$ 6,775 | \$ 6,867 | \$ 13,524 | \$ 13,652 |
| Gross receipts, excise and franchise | 3,789 | 3,363 | 7,053 | 6,538 |
| Payroll | 2,180 | 2,132 | 5,455 | 5,256 |
| Regulatory assessments | 627 | 630 | 1,254 | 1,259 |
| Pumping fees | 1,424 | 1,350 | 2,415 | 2,294 |
| Other | 34 | 77 | 95 | 157 |
| Total taxes other than income | \$ 14,829 | \$ 14,419 | \$ 29,796 | \$ 29,156 |

Note 13 – 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 its water and wastewater regulated utility companies which are organized by the states where the Company provides water and wastewater services. These operating segments are aggregated into one reportable segment because 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 Infrastructure and Aqua Resources. Aqua Infrastructure provides non-utility raw water supply services for firms in the natural gas drilling industry. Aqua Resources provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to its utility companies' service territories; and offers,

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through a third-party, water and sewer service line protection solutions and repair services to households. 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.

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

| | Three Months Ended June 30, 2018 | | | Three Months Ended June 30, 2017 | | |
|---|-------------------------------------|----------|--------------|-------------------------------------|----------|--------------|
| | Regulated | Other | Consolidated | Regulated | Other | Consolidated |
| Operating revenues | \$ 210,824 | \$ 1,036 | \$ 211,860 | \$ 201,960 | \$ 1,458 | \$ 203,418 |
| Operations and maintenance expense | 73,047 | 468 | 73,515 | 71,322 | (1,707) | 69,615 |
| Depreciation | 36,603 | 10 | 36,613 | 34,141 | (734) | 33,407 |
| Amortization | 103 | 46 | 149 | 145 | (18) | 127 |
| Operating income | 86,672 | 82 | 86,754 | 82,390 | 3,460 | 85,850 |
| Interest expense, net | 21,756 | 1,967 | 23,723 | 19,747 | 1,640 | 21,387 |
| Allowance for funds used during construction | 2,577 | - | 2,577 | 3,463 | - | 3,463 |
| Income tax expense (benefit) | (147) | (220) | (367) | 5,249 | 320 | 5,569 |
| Net income (loss) | 67,877 | (1,287) | 66,590 | 59,629 | 1,339 | 60,968 |
| | | | | | | |
| | Six Months Ended June 30, 2018 | | | Six Months Ended June 30, 2017 | | |
| | Regulated | Other | Consolidated | Regulated | Other | Consolidated |
| Operating revenues | \$ 404,331 | \$ 1,876 | \$ 406,207 | \$ 388,309 | \$ 2,896 | \$ 391,205 |
| Operations and maintenance expense | 144,350 | 3,111 | 147,461 | 137,592 | (87) | 137,505 |
| Depreciation | 72,561 | 19 | 72,580 | 67,807 | (563) | 67,244 |
| Amortization | 191 | 88 | 279 | 354 | (38) | 316 |
| Operating income (loss) | 158,730 | (2,639) | 156,091 | 154,697 | 2,287 | 156,984 |
| Interest expense, net | 43,464 | 3,730 | 47,194 | 39,524 | 3,189 | 42,713 |
| Allowance for funds used during construction | 5,444 | - | 5,444 | 6,656 | - | 6,656 |
| Income tax expense (benefit) | (790) | (1,708) | (2,498) | 9,105 | (606) | 8,499 |
| Net income (loss) | 121,904 | (4,475) | 117,429 | 110,525 | (485) | 110,040 |
| Capital expenditures | 216,614 | - | 216,614 | 208,174 | 298 | 208,472 |

| | June 30, 2018 | December 31, 2017 |
|---------------|------------------|-------------------------|
| Total assets: | | |
| Regulated | \$ 6,484,778 | \$ 6,236,109 |
| Other | 85,567 | 96,354 |
| Consolidated | \$ 6,570,345 | \$ 6,332,463 |

Note 14 – Commitments and Contingencies

The Company is routinely involved in various disputes, claims, lawsuits and other regulatory and legal matters, including both asserted and unasserted legal claims, in the ordinary course of business. The status of each such matter, referred to herein as a loss contingency, is reviewed and assessed in accordance with applicable accounting rules regarding the nature of the matter, the likelihood that a loss will be incurred, and the amounts involved. As of June 30, 2018, the aggregate amount of \$18,602 is

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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, the Company has insurance coverage for certain of these loss contingencies, and as of June 30, 2018, estimates that approximately \$6,541 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.

In addition to the aforementioned loss contingencies, the Company self-insures its employee medical benefit program, and maintains stop-loss coverage to limit the exposure arising from these claims. The Company's reserve for these claims totaled \$1,451 at June 30, 2018 and represents a reserve for unpaid claim costs, including an estimate for the cost of incurred but not reported claims.

Note 15 – Income Taxes

During the six months ended June 30, 2018, the Company's Federal net operating loss ("NOL") carryforward decreased by \$26,393. In addition, during the six months ended June 30, 2018, the Company's state NOL carryforward increased by \$15,835. As of June 30, 2018, the balance of the Company's Federal NOL was \$36,909. The Company believes its Federal NOL carryforward is more likely than not to be recovered and requires no valuation allowance. As of June 30, 2018, the balance of the Company's gross state NOL was \$642,923, a portion of which is offset by a valuation allowance because the Company does not believe the state NOLs are more likely than not to be realized. The Company's Federal and state NOL carryforwards begin to expire in 2032 and 2023, respectively. The Company's Federal and state NOL carryforwards are reduced by an unrecognized tax position, on a gross basis, of \$64,914 and

\$85,550, respectively. The amounts of the Company's Federal and state NOL carryforwards prior to being reduced by the unrecognized tax positions were \$101,823 and \$728,473 respectively. The Company records its unrecognized tax benefit as a reduction to its deferred income tax liability.

In accordance with a 2012 settlement agreement with the Pennsylvania Public Utility Commission, Aqua Pennsylvania expenses, for tax purposes, qualifying utility asset improvement costs, which results in a substantial reduction in income tax expense and greater net income and cash flows. The Company's effective income tax rate for the second quarter of 2018 and 2017 was -0.6% and 8.4%, respectively, and for the first six months of 2018 and 2017 was -2.2% and 7.2%, respectively.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

As of June 30, 2018, the total gross unrecognized tax benefit was \$18,986. As a result of the regulatory treatment afforded for qualifying infrastructure improvements in Pennsylvania, \$25,569, if recognized, would affect the Company's effective tax rate. At December 31, 2017, the Company had unrecognized tax benefits of \$17,583.

Accounting rules for uncertain tax positions specify that tax positions for which the timing of resolution is uncertain should be classified as long-term liabilities. Judgment is required in evaluating the Company's uncertain tax positions and determining the provision for income taxes. Management believes that an adequate provision has been made for any adjustments that may result from tax examinations. Although the timing of income tax audit resolutions and negotiations with taxing authorities is highly uncertain, the Company does not anticipate a significant change to the total amount of unrecognized income tax benefits within the next 12 months.

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "TCJA") into law. Substantially all of the provisions of the TCJA are effective for taxable years beginning after December 31, 2017. The TCJA includes significant changes to the Internal Revenue Code and the taxation of business entities, and includes specific provisions related to regulated public utilities. Significant changes that impact the Company included in the TCJA are a reduction in the corporate federal income tax rate from 35% to 21%, effective January 1, 2018, and a limitation of the utilization of NOLs arising after December 31, 2017 to 80% of taxable income with an indefinite carryforward. The specific TCJA provisions related to our regulated entities generally allow for the continued deductibility of interest expense, the elimination of full expensing for tax purposes of certain property acquired after September 27, 2017 and the continuation of certain rate normalization requirements for accelerated depreciation benefits. Our market-based companies still qualify for 100% deductibility of qualifying property acquired after September 27, 2017.

In accordance with the FASB's accounting guidance for income taxes, the tax effects of changes in tax laws must be recognized in the period in which the law is enacted, or December 22, 2017 for the TCJA. Additionally, deferred tax assets and liabilities are required to be measured at the enacted tax rate expected to apply when temporary differences are to be realized or settled. Thus, at the date of enactment, the Company's deferred taxes were re-measured based upon the new tax rate. For our regulated entities, the change in deferred taxes is recorded as either an offset to a regulatory asset or liability and may be subject to refund to customers. In instances where the deferred tax balances are not in ratemaking, such as the Company's market-based operations, the change in deferred taxes is recorded as an adjustment to our deferred tax provision.

The staff of the SEC has recognized the complexity of reflecting the impacts of the TCJA, and on December 22, 2017 issued guidance, which clarifies accounting for income taxes if information is not yet available or complete and provides for up to a one year period in which to complete the required analyses and accounting (the measurement period). The guidance describes three scenarios (or “buckets”) associated with a company’s status of accounting for income tax reform: (1) a company is complete with its accounting for certain effects of tax reform, (2) a company is able to determine a reasonable estimate for certain effects of tax reform and records that estimate as a provisional amount, or (3) a company is not able to determine a reasonable estimate and therefore continues to apply the FASB’s accounting guidance, based on the provisions of the tax laws that were in effect immediately prior to the TCJA being enacted.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

The Company has completed or has made a reasonable estimate for the measurement and accounting of the effect of the TCJA which were reflected in the December 31, 2017 financial statements, which resulted in a decrease to the accumulated deferred income tax liability of \$303,320. Additionally, due to the reduction in the Company's corporate income tax rate, in the first quarter of 2018, the Company reserved \$2,532 for amounts expected to be refundable to utility customers. During the first quarter of 2018, in Illinois and Virginia, the Company's base rates have been adjusted to reflect the lower corporate income tax rate, and Texas and New Jersey implemented adjusted tariff rates in the second quarter of 2018. In the second quarter of 2018, the Company reserved \$1,251 for amounts expected to be refundable to utility customers.

As of December 31, 2017, the Company had provisionally estimated that \$175,108 of deferred income tax liabilities for our Pennsylvania subsidiary will be a regulatory liability as a result of the accounting effect of the TCJA. In May 2018, the Pennsylvania Public Utility Commission ("PA PUC") issued an order that set forth the requirements for utilities to either immediately initiate the refund or otherwise address the impacts of the TCJA in the utilities' next rate case. Aqua Pennsylvania was included in the rate filing group of utilities as the Company plans to file a base rate case in August 2018, during which the PA PUC is expected to address the effects of the TCJA within the base rate case filing. Additionally, the PA PUC has ordered that all rates charged by utilities, including those billed by Aqua Pennsylvania since January 1, 2018, are temporary and subject to refund pending the outcome of its review of the effects of the TCJA within the next base rate case. Based on the Company's review of the present circumstances, no reserve is considered necessary for the revenue recognized to date in 2018.

Additionally, two operating divisions in Ohio operate under locally-negotiated contractual rates with their respective counties, and it is expected that negotiations will result in a contract that will return to customers the effects of the reduction in the corporate net income tax rate under the TCJA; however, these negotiations have not yet started. As of December 31, 2017, the Company had provisionally estimated that \$9,419 of deferred income tax liabilities for these two divisions will be a regulatory liability. Overall, the Company has applied a reasonable interpretation of the impact of the TCJA and a reasonable estimate of the regulatory resolution. Further clarification of the TCJA and regulatory resolution may change the amounts estimated for the deferred income tax provision and the accumulated deferred income tax liability.

The Company's regulated operations accounting for income taxes are impacted by the FASB's accounting guidance for regulated operations. Reductions in accumulated deferred income tax balances due to the reduction in the Federal corporate income tax rates to 21% under the provisions of the TCJA will result in amounts previously collected from utility customers for these deferred taxes to be refundable to such customers, generally through reductions in future

rates. The TCJA includes provisions that stipulate how these excess deferred taxes related to certain accelerated tax depreciation deduction benefits are to be passed back to customers. Potential refunds of other deferred taxes will be determined by our state regulators. Our state regulatory commissions have or are in the process of issuing procedural orders directing how the tax law changes are to be reflected in our utility customer rates.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

Note 16 – Recent Accounting Pronouncements

In March 2017, the FASB issued updated accounting guidance on the presentation of net periodic pension and postretirement benefit cost (net benefit cost). Historically, net benefit cost is reported as an employee cost within operating income, net of amounts capitalized. The guidance requires the bifurcation of net benefit cost. The service cost component will be presented with other employee compensation costs in operating income and the other components of net benefit cost will be reported separately outside of operating income, and will not be eligible for capitalization. The guidance is effective for annual reporting periods beginning after December 15, 2017, and interim periods within that reporting period, and is to be applied retrospectively for the presentation of the service cost component and the other components of net benefit cost, and on a prospective basis for the capitalization of only the service cost component of net benefit cost. On January 1, 2018, the Company adopted the updated guidance, which did not have a material impact on its results of operations or financial position, and resulted in the reclassification, for the three and six months ended June 30, 2017, of \$1,238 and \$2,478, respectively, for the other components of net benefit cost from operations and maintenance expense to other in the consolidated statements of net income.

In June 2016, the FASB issued updated accounting guidance on accounting for impairments of financial instruments, including trade receivables, which requires companies to estimate expected credit losses on trade receivables over their contractual life. Historically, companies reserve for expected credit losses by applying historical loss percentages to respective aging categories. Under the updated accounting guidance, companies will use a forward-looking methodology that incorporates lifetime expected credit losses, which will result in an allowance for expected credit losses for receivables that are either current or not yet due, which historically have not been reserved for. The updated accounting guidance is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years, with early adoption available. The Company is evaluating the requirements of the updated guidance to determine the impact of adoption.

In 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 in the process of evaluating the requirements of the updated guidance to determine the impact adoption will have on its consolidated financial statements; however, the Company expects that the adoption of the updated accounting guidance on accounting for leases should not have a

material impact on the Company's consolidated balance sheet due to the recognition of right-of-use assets and lease liabilities.

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(In thousands of dollars, except per share amounts)

(UNAUDITED)

In January 2016, the FASB issued updated accounting guidance on the recognition and measurement of financial assets and financial liabilities, which amends certain aspects of recognition, measurement, presentation, and disclosure of financial instruments, including the requirement to measure certain equity investments at fair value with changes in fair value recognized in net income. The updated guidance is effective for interim and annual periods beginning after December 31, 2017. On January 1, 2018, the Company adopted the updated guidance, which did not have a material impact on its results of operations or financial position, and resulted in the recognition of \$860 of previous unrealized gains, which was recorded as an adjustment to beginning retained earnings (refer to the presentation of “cumulative effect of change in accounting principle – financial instruments” on the Company’s consolidated statement of equity).

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. In 2017, the American Institute of Certified Public Accountants (“AICPA”) power and utility entities revenue recognition task force determined that contributions in aid of construction are not in the scope of the new standard, which was approved by the AICPA’s revenue recognition working group. The Company implemented the updated guidance using the modified retrospective approach on January 1, 2018, which did not result in a change in the Company’s measurement of revenue, and reached the following conclusions:

- The Company’s tariff sale contracts, including those with lower credit quality customers, are generally deemed to be probable of collection, and thus the timing of revenue recognition will continue to be concurrent with the delivery of water and wastewater services, consistent with our current practice.
- Contributions in aid of construction are outside of the scope of the standard, and will continue to be accounted for as a noncurrent liability.

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AQUA AMERICA, INC. AND SUBSIDIARIES

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

(In thousands of dollars, except per share amounts)

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

Forward-looking Statements

This Management’s Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Quarterly Report contain, in addition to historical information, forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements address, among other things: the projected impact of various legal proceedings; the projected effects of recent accounting pronouncements; prospects, plans, objectives, expectations and beliefs of management, as well as information contained in this report where statements are preceded by, followed by or include the words “believes,” “expects,” “estimates,” “anticipates,” “plans,” “future,” “potential,” “probably,” “predictions,” “intends,” “will,” “continue,” “in the event” or the negative of such terms or similar expressions. Forward-looking statements are based on a number of assumptions concerning future events, and are subject to a number of risks, uncertainties and other factors, many of which are outside our control, which could cause actual results to differ materially from those expressed or implied by such statements. These risks and uncertainties include, among others: the effects of regulation, abnormal weather, changes in capital requirements and funding, acquisitions, changes to the capital markets, and our ability to assimilate acquired operations, as well as those risks, uncertainties and other factors discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 under the captions “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in such report. As a result, readers are cautioned not to place undue reliance on any forward-looking statements. We undertake no obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.

General Information

Aqua America, Inc. (“we”, “us”, “our” or the “Company”), a Pennsylvania corporation, is the holding company for regulated utilities providing water or wastewater services to what we estimate to be almost three million people in Pennsylvania, Ohio, Texas, Illinois, North Carolina, New Jersey, Indiana, and Virginia. Our largest operating subsidiary, Aqua Pennsylvania, provides water or wastewater services to approximately one-half of the total number of people we serve, who are located in the suburban areas in counties north and west of the City of Philadelphia and in 27 other

counties in Pennsylvania. Our other regulated utility subsidiaries provide similar services in seven other states. In addition, the Company's market-based activities are conducted through Aqua Infrastructure, LLC and Aqua Resources, Inc. Aqua Infrastructure provides non-utility raw water supply services for firms in the natural gas drilling industry. 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 service line protection solutions and repair services to households.

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AQUA AMERICA, INC. AND SUBSIDIARIES

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

(In thousands of dollars, except per share amounts)

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

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

Financial Condition

During the first six months of 2018, we incurred \$216,614 of capital expenditures, expended \$190 for the acquisition of water and wastewater utility systems, issued \$218,037 of long-term debt, and repaid debt and made sinking fund contributions and other loan repayments of \$41,001. The capital expenditures were related to new and replacement water mains, improvements to treatment plants, tanks, hydrants, and service lines, well and booster improvements, and other enhancements and improvements. The issuance of long-term debt was comprised principally of the funds borrowed under our revolving credit facility, and \$100,000 of first mortgage bonds issued by Aqua Pennsylvania in June 2018. The proceeds from the first mortgage bonds were used to repay existing indebtedness and for general corporate purposes.

In July 2018, we completed the acquisition of Manteno, Illinois for \$25,000 in cash, which serves approximately 3,800 wastewater customers, and Limerick, Pennsylvania for \$75,100 in cash, which serves approximately 5,400 wastewater customers. These acquisitions were funded through the issuance of debt.

At June 30, 2018, we had \$52,948 of cash and cash equivalents compared to \$4,204 at December 31, 2017. During the first six months of 2018, we used the proceeds from the issuance of long-term debt and internally generated funds to fund the cash requirements discussed above and to pay dividends.

At June 30, 2018, our \$500,000 unsecured revolving credit facility, which was amended and now expires in June 2023, had \$323,157 available for borrowing. At June 30, 2018, we had short-term lines of credit of \$135,500, of which \$135,500 was available for borrowing. One of our short-term lines of credit is an Aqua Pennsylvania \$100,000 364-day unsecured revolving credit facility with four banks, which is used to provide working capital, and as of June 30, 2018, \$100,000 was available for borrowing.

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AQUA AMERICA, INC. AND SUBSIDIARIES

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

(In thousands of dollars, except per share amounts)

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

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

Results of Operations

Analysis of Second Quarter of 2018 Compared to Second Quarter of 2017

Revenues increased by \$8,442 or 4.2%, primarily due to:

- an increase in water and wastewater rates and infrastructure rehabilitation surcharges of \$7,426;
- an increase in wastewater revenues of \$1,639 primarily due to an increase in the volume of treated wastewater flows from the City of Ft. Wayne, Indiana at our Indiana wastewater treatment plant; and
- additional water and wastewater revenues of \$1,262 associated with a larger customer base due to organic growth and utility acquisitions;
- offset by a reserve of \$1,251 for amounts expected to be refundable to utility customers associated with the decrease in the corporate income tax rate from 35% to 21% due to the TCJA.

Operations and maintenance expenses increased by \$3,900 or 5.6%, primarily due to:

- an increase in labor and benefits expenses of \$1,551 primarily due to wage increases;
- the prior year effect of a favorable settlement for a disputed contract of \$1,062; and
- an increase in insurance expense of \$441;
- offset by a reduction in operating expenses for our market-based activities of \$690 primarily associated with the completion of the disposition of business units within Aqua Resources, which was finalized in June 2017.

Depreciation expense increased by \$3,206 or 9.6%, primarily due to the utility plant placed in service since June 30, 2017.

Interest expense increased by \$2,336 or 10.9%, primarily due to an increase in average borrowings, offset by a decrease in our effective interest rate.

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AQUA AMERICA, INC. AND SUBSIDIARIES

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

(In thousands of dollars, except per share amounts)

Allowance for funds used during construction ("AFUDC") decreased by \$886, due to a decrease in the average balance of utility plant construction work in progress, to which AFUDC is applied.

Equity earnings in joint venture increased by \$1,072 due to an increase in the sale of raw water to firms in the natural gas drilling industry.

Other decreased by \$801 primarily due to a decrease in the non-service cost components of our net benefit cost for pension and postretirement benefits.

Our effective income tax rate was -0.6% in the second quarter of 2018 and 8.4% in the second quarter of 2017. The effective income tax rate decreased due to the reduction in the corporate income tax rate from 35% to 21%, and the effect of additional tax deductions recognized in the second quarter of 2018 for certain qualifying infrastructure improvements for Aqua Pennsylvania.

Net income increased by \$5,622 or 9.2%, primarily as a result of the factors described above.

Analysis of First Six Months of 2018 Compared to First Six Months of 2017

Revenues increased by \$15,002 or 3.8%, primarily due to:

- an increase in water and wastewater rates and infrastructure rehabilitation surcharges of \$12,523;

- additional water and wastewater revenues of \$2,896 associated with a larger customer base due to organic growth and utility acquisitions;
- an increase in customer water consumption; and
- an increase in wastewater revenues of \$2,003 primarily due to an increase in the volume of treated wastewater flows from the City of Ft. Wayne, Indiana at our Indiana wastewater treatment plant;
- offset by a reserve of \$3,783 for amounts expected to be refundable to utility customers associated with the decrease in the corporate income tax rate from 35% to 21% due to the TCJA.

Operations and maintenance expenses increased by \$9,956 or 7.2%, primarily due to:

- an increase in labor and benefits expenses of \$6,095, primarily due to additional overtime expenses for increased maintenance activities in the first quarter and wage increases;
- the prior year effect of a favorable settlement for a disputed contract of \$1,062;
- an increase in maintenance expenses of \$1,057, mainly resulting from expenses incurred due to more severe winter weather conditions; and
- the prior year effect of the favorable treatment of a regulatory asset of \$1,000 due to a rate proceeding that occurred in 2017;

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AQUA AMERICA, INC. AND SUBSIDIARIES

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

(In thousands of dollars, except per share amounts)

· offset by a reduction in operating expenses for our market-based activities of \$2,436 primarily associated with the completion of the disposition of business units within Aqua Resources, which was finalized in June 2017.

Depreciation expense increased by \$5,336 or 7.9%, primarily due to the utility plant placed in service since June 30, 2017.

Interest expense increased by \$4,481 or 10.5%, primarily due to an increase in average borrowings, offset by a decrease in our effective interest rate.

AFUDC decreased by \$1,212, due to a decrease in the average balance of utility plant construction work in progress, to which AFUDC is applied.

Equity earnings in joint venture increased by \$1,484 due to an increase in the sale of raw water to firms in the natural gas drilling industry.

Other decreased by \$1,436 primarily due to a decrease in the non-service cost components of our net benefit cost for pension and postretirement benefits.

Our effective income tax rate was -2.2% during the first six months of 2018 and 7.2% during the first six months of 2017. The effective income tax rate decreased due to the reduction in the corporate income tax rate from 35% to 21%, and the effect of additional tax deductions recognized during the first six months of 2018 for certain qualifying infrastructure improvements for Aqua Pennsylvania.

Net income increased by \$7,389 or 6.7%, primarily as a result of the factors described above.

Impact of Recent Accounting Pronouncements

We describe the impact of recent accounting pronouncements in Note 16, Recent Accounting Pronouncements, to the consolidated financial statements in this report.

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Item 3 – Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. There have been no significant changes in our exposure to market risks since December 31, 2017. Refer to Item 7A of the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, filed February 28, 2018, for additional information.

Item 4 – Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

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

(b) Changes in Internal Control over Financial Reporting

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

Part II. Other Information

Item 1 – Legal Proceedings

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

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

Item 1A – Risk Factors

There have been no material changes to the risks disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017, filed February 28, 2018, under “Part 1, Item 1A – Risk Factors.”

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

The following table summarizes the Company's purchases of its common stock for the quarter ended June 30, 2018:

| Period | Issuer Purchases of Equity Securities | | | |
|------------------|---------------------------------------|------------------------------|--|---|
| | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs |
| April 1-30, 2018 | - | \$ - | - | - |
| May 1-31, 2018 | - | \$ - | - | - |
| June 1-30, 2018 | - | \$ - | - | - |
| Total | - | \$ - | - | - |

Item 6 – Exhibits

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| Exhibit No. | Description |
|-------------|---|
| 4.1 | <u>Bond Purchase Agreement, dated June 29, 2018, by and among Aqua Pennsylvania, Inc., CMFG Life Insurance Company, Manufactures Life Reinsurance Limited, The Lincoln National Life Insurance Company, New York Life Insurance Company, The State Life Insurance Company, and Phoenix Life Insurance Company</u> |
| 10.1 | <u>Revolving Credit Agreement, dated as of June 7, 2018, between Aqua America, Inc. and PNC Bank National Association, CoBank, ACB, The Huntington National Bank, Bank of America, N.A, and Royal Bank of Canada</u> |
| 10.2 | <u>Employment Agreement dated July 1, 2018 between Aqua America, Inc. and Christopher Franklin (Incorporated by reference to Exhibit 10.1 of Form 8-K filed on July 6, 2018)*</u> |
| 31.1 | <u>Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934.</u> |
| 31.2 | <u>Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934.</u> |
| 32.1 | <u>Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350.</u> |
| 32.2 | <u>Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350.</u> |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRES | XBRL Taxonomy Extension Presentation Linkbase Document |

*Indicates management contract or compensatory plan or arrangement

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SIGNATURES

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

August 3, 2018

Aqua America, Inc.
Registrant

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

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