

Edgar Filing: AQUA AMERICA INC - Form 10-Q

AQUA AMERICA INC  
Form 10-Q  
May 09, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington D.C. 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 March 31, 2006

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)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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 April 21, 2006.

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129,512,881.

Part I - Financial Information  
Item 1. Financial Statements

## AQUA AMERICA, INC. AND SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS (In thousands of dollars, except per share amounts)

(UNAUDITED)

	March 31, 2006	December 31, 2005
	-----	-----
Assets		
Property, plant and equipment, at cost	\$2,950,523	\$2,900,585
Less: accumulated depreciation	638,352	620,635
	-----	-----
Net property, plant and equipment	2,312,171	2,279,950
	-----	-----
Current assets:		
Cash and cash equivalents	51,445	11,872
Accounts receivable and unbilled revenues, net	57,600	62,690
Inventory, materials and supplies	8,796	7,798
Prepayments and other current assets	7,919	7,596
	-----	-----
Total current assets	125,760	89,956
	-----	-----
Regulatory assets	132,316	130,953
Deferred charges and other assets, net	58,364	57,241
Funds restricted for construction activity	62,522	68,625
	-----	-----
	\$2,691,133	\$2,626,725
	=====	=====
Liabilities and Stockholders' Equity		
Common stockholders' equity:		
Common stock at \$.50 par value, authorized 300,000,000 shares, issued 130,210,197 and 129,658,806 in 2006 and 2005	\$ 65,105	\$ 64,829
Capital in excess of par value	489,110	478,508
Retained earnings	287,893	285,132
Treasury stock, 704,076 and 688,625 shares in 2006 and 2005	(13,356)	(12,914)
Accumulated other comprehensive loss	(3,082)	(3,082)
Unearned compensation	(1,476)	(550)
	-----	-----
Total common stockholders' equity	824,194	811,923
	-----	-----
Minority interest	1,609	1,551
Long-term debt, excluding current portion	916,459	878,438
Commitments and contingencies	--	--
Current liabilities:		
Current portion of long-term debt	24,666	24,645
Loans payable	167,150	138,505
Accounts payable	29,910	55,455
Accrued interest	11,750	13,052
Accrued taxes	6,777	1,111
Other accrued liabilities	28,257	30,571

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Total current liabilities	268,510	263,339
Deferred credits and other liabilities:		
Deferred income taxes and investment tax credits	252,521	250,346
Customers' advances for construction	76,327	74,828
Regulatory liabilities	11,852	11,751
Other	34,701	31,969
Total deferred credits and other liabilities	375,401	368,894
Contributions in aid of construction	304,960	302,580
	\$2,691,133	\$2,626,725

See notes to consolidated financial statements beginning on page 6 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME  
(In thousands, except per share amounts)

(UNAUDITED)

	Three Months Ended March 31,	
	2006	2005
Operating revenues	\$117,949	\$113,988
Costs and expenses:		
Operations and maintenance	51,316	47,309
Depreciation	16,830	14,683
Amortization	1,114	1,228
Taxes other than income taxes	8,067	7,997
	77,327	71,217
Operating income	40,622	42,771
Other expense (income):		
Interest expense, net	14,172	12,795
Allowance for funds used during construction	(918)	(364)
Gain on sale of other assets	(267)	(481)
	27,635	30,821
Income before income taxes	27,635	30,821
Provision for income taxes	11,071	11,950
Net income	\$ 16,564	\$ 18,871
Net income per common share:		
Basic	\$ 0.13	\$ 0.15
Diluted	\$ 0.13	\$ 0.15

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Average common shares outstanding		
during the period:		
Basic	129,181	127,361
	=====	=====
Diluted	130,893	128,886
	=====	=====
Cash dividends declared per common share	\$ 0.1069	\$ 0.0975
	=====	=====

See notes to consolidated financial statements beginning on page 6 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)

	March 31, 2006	December 31, 2005
	-----	-----
Common stockholders' equity:		
Common stock, \$.50 par value	\$ 65,105	\$ 64,829
Capital in excess of par value	489,110	478,508
Retained earnings	287,893	285,132
Treasury stock	(13,356)	(12,914)
Accumulated other comprehensive loss	(3,082)	(3,082)
Unearned compensation	(1,476)	(550)
	-----	-----
Total common stockholders' equity	824,194	811,923
	-----	-----
Long-term debt:		
Long-term debt of subsidiaries (substantially secured by utility plant):		
Interest Rate Range		
0.00% to 2.49%	22,166	21,574
2.50% to 2.99%	29,070	28,684
3.00% to 3.49%	17,356	17,380
3.50% to 3.99%	6,680	6,748
4.00% to 4.49%	1,300	1,300
4.50% to 4.99%	29,395	29,395
5.00% to 5.49%	262,580	262,588
5.50% to 5.99%	79,000	79,000
6.00% to 6.49%	88,504	88,504
6.50% to 6.99%	32,000	32,000
7.00% to 7.49%	13,734	15,878
7.50% to 7.99%	24,955	25,012
8.00% to 8.49%	26,454	26,507
8.50% to 8.99%	9,000	9,000
9.00% to 9.49%	46,676	46,764
9.50% to 9.99%	40,439	40,933
10.00% to 10.50%	6,000	6,000
	-----	-----

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	735,309	737,267
Unsecured notes payable, 4.87%, maturing in various installments 2010 through 2023	135,000	135,000
Unsecured notes payable, 5.95%, due in 2023 through 2034	40,000	--
Unsecured notes payable, 5.01%, due 2015	18,000	18,000
Unsecured notes payable, 5.20%, due 2020	12,000	12,000
Notes payable, 6.05%, maturing in 2006 through 2008	816	816
	-----	-----
	941,125	903,083
Current portion of long-term debt	24,666	24,645
	-----	-----
Long-term debt, excluding current portion	916,459	878,438
	-----	-----
Total capitalization	\$1,740,653	\$1,690,361
	=====	=====

See notes to consolidated financial statements beginning on page 6 of this report.

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AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF COMMON STOCKHOLDERS' EQUITY  
(In thousands of dollars)

(UNAUDITED)

	Common Stock	Capital in excess of par value	Retained earnings	Treasury Stock	Accumu Oth Compreh Lo
	-----	-----	-----	-----	-----
Balance at December 31, 2005	\$64,829	\$478,508	\$285,132	\$(12,914)	\$(3,
Net income	--	--	16,564	--	
Dividends paid	--	--	(13,803)	--	
Sale of stock (91,288 shares)	41	2,054	--	250	
Repurchase of stock (24,096 shares)	--	--	--	(692)	
Equity Compensation Plan (35,000 shares)	18	1,013	--	--	
Exercise of stock options (433,748 shares)	217	5,040	--	--	
Stock-based compensation	--	759	--	--	
Employee stock plan tax benefits	--	1,736	--	--	
	-----	-----	-----	-----	-----
Balance at March 31, 2006	\$65,105	\$489,110	\$287,893	\$(13,356)	\$(3,
	=====	=====	=====	=====	=====

See notes to consolidated financial statements beginning on page 6 of this report.

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## AQUA AMERICA, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOW (In thousands of dollars)

(UNAUDITED)

	Three Months Ended March 31,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 16,564	\$ 18,871
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	17,944	15,911
Deferred income taxes	2,026	740
Gain on sale of other assets	(267)	(481)
Stock-based compensation	662	--
Net increase in receivables, inventory and prepayments	3,321	14,421
Net decrease in payables, accrued interest, accrued taxes and other accrued liabilities	(28,229)	(8,942)
Other	1,088	(1,527)
Net cash flows from operating activities	13,109	38,993
Cash flows from investing activities:		
Property, plant and equipment additions, including allowance for funds used during construction of \$918 and \$364	(46,888)	(34,341)
Acquisitions of water and wastewater systems, net	(2,506)	(1,661)
Proceeds from the sale of other assets	267	484
Additions to funds restricted for construction activity	(972)	(43)
Release of funds previously restricted for construction activity	7,075	7,860
Other	(372)	(52)
Net cash flows used in investing activities	(43,396)	(27,753)
Cash flows from financing activities:		
Customers' advances and contributions in aid of construction	2,167	2,559
Repayments of customers' advances	(747)	(1,001)
Net proceeds (repayments) of short-term debt	28,645	(1,575)
Proceeds from long-term debt	41,624	29,918
Repayments of long-term debt	(3,718)	(24,583)
Change in cash overdraft position	7,329	(6,543)
Proceeds from exercised stock options	5,257	2,674
Stock-based compensation windfall tax benefits	1,453	--
Proceeds from issuing common stock	2,345	2,174
Repurchase of common stock	(692)	(124)
Dividends paid on common stock	(13,803)	(12,411)
Net cash flows from (used in) financing activities	69,860	(8,912)
Net increase in cash and cash equivalents	39,573	2,328
Cash and cash equivalents at beginning of period	11,872	14,192
Cash and cash equivalents at end of period	\$ 51,445	\$ 16,520

See notes to consolidated financial statements beginning on page 6 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 sheet and statement of capitalization of Aqua America, Inc. (the "Company") at March 31, 2006, the consolidated statements of income, and cash flow for the three months ended March 31, 2006 and 2005, and the consolidated statement of common stockholders' equity for the three months ended March 31, 2006, are unaudited, but reflect all adjustments, consisting of only normal recurring accruals, which are, in the opinion of management, necessary to present fairly the consolidated financial position, the changes in common stockholders' equity, the consolidated results of operations, and the consolidated cash flow for the periods presented. Because they cover interim periods, the statements and related notes to the financial statements do not include all disclosures and notes normally provided in annual financial statements and, therefore, should be read in conjunction with the Aqua America Annual Report on Form 10-K for the year ended December 31, 2005. The results of operations for interim periods may not be indicative of the results that may be expected for the entire year.

Certain prior year amounts have been changed to conform with current year's presentation. Prior to the fourth quarter of 2005, cash overdrafts were reported as components of cash or loans payable. This presentation was changed to classify cash overdrafts as accounts payable. Accordingly, applicable historical balance sheet and cash flow amounts have been revised to conform to the new presentation and a new line has been added in the cash flow from financing activities section titled "change in cash overdraft position." This revision had no impact on the Company's net income, cash flows from operating activities or cash flows used in investing activities. The revision increased the Company's net cash flows used in financing activities from that which was previously reported by \$1,971 for the three months ended March 31, 2005. Share and per share data have been restated to give effect to the 2005 4-for-3 common stock split.

Note 2 Long-term Debt and Loans Payable

In March 2006, the Company's Pennsylvania operating subsidiary issued \$40,000 of unsecured notes at 5.95% of which \$10,000 are due in 2023, 2024, 2033 and 2034. Proceeds from the sale of bonds were received on March 31, 2006 and the proceeds were used to repay short-term borrowings in April 2006.

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## AQUA AMERICA, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts) (continued)  
(UNAUDITED)

Note 3 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 options is included in the computation of diluted net income per common share. The following table summarizes the shares, in thousands, used in computing basic and diluted net income per common share:

	Three Months Ended March 31,	
	2006	2005
Average common shares outstanding during the period for basic computation	129,181	127,361
Dilutive effect of employee stock options	1,712	1,525
Average common shares outstanding during the period for diluted computation	130,893	128,886

For the quarters ended March 31, 2006 and 2005, employee stock options to purchase 611,350 and 829,867 shares of common stock, respectively, were excluded from the calculations of diluted net income per share as the options' exercise price was greater than the average market price of the Company's common stock during these periods.

Note 4 Stock-based Compensation

Under the Company's 2004 Equity Compensation Plan (the "2004 Plan"), as approved by the shareholders to replace the 1994 Equity Compensation Plan (the "1994 Plan"), qualified and nonqualified stock options may be granted to officers, key employees and consultants at prices equal to the market price of the stock on the day of the grant. Officers and key employees may also be granted dividend equivalents and restricted stock. Restricted stock may also be granted to non-employee members of the Board of Directors. The 2004 Plan authorizes 4,900,000 shares for issuance under the plan. A maximum of 50% of the shares available for issuance under the 2004 Plan may be issued as restricted stock and the maximum number of shares that may be subject to grants under the plans to any one individual in any one year is 200,000. Awards under the 2004 Plan are made by a committee of the Board of Directors. At March 31, 2006, 3,456,803 shares underlying stock option and restricted stock awards were still available for grant under the 2004 Plan, although under the terms of the 2004 Plan, terminated, expired or forfeited grants under the 1994 Plan and shares withheld to satisfy tax withholding requirements under the plan may be re-issued under the plan.



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### AQUA AMERICA, INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts) (continued)  
(UNAUDITED)

STOCK OPTIONS—Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123R, "Share-Based Payment," which revised SFAS No. 123, "Accounting for Stock-based Compensation," and superseded APB No. 25, "Accounting for Stock Issued to Employees." Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic value method in accordance with APB Opinion No. 25. Accordingly, no compensation expense related to granting of stock options had been recognized in the financial statements prior to adoption of SFAS No. 123R for stock options that were granted, as the grant price equaled the market price on the date of grant.

The Company adopted this standard using the modified prospective method, and accordingly the financial statement amounts for the prior periods presented in this Form 10-Q have not been restated to reflect the fair value method of expensing share-based compensation. Under this transition method, compensation cost recognized in the three months ended March 31, 2006 includes compensation cost for all share-based payments granted prior to, but not vested as of January 1, 2006, and share-based payments granted after January 1, 2006. For the three months ended March 31, 2006, the impact of the adoption of SFAS No. 123R as compared to if the Company had continued to account for share-based compensation under APB Opinion No. 25: increased operations and maintenance expense by \$662, increased capitalized compensation costs by \$97, lowered income tax expense by \$162, lowered net income by \$500 and lowered basic and diluted net income per share by \$0.004. SFAS 123R requires the Company to estimate forfeitures in calculating the compensation expense instead of recognizing these forfeitures and the resulting reduction in compensation expense as they occur. As of January 1, 2006, the cumulative after-tax effect of this change in accounting for forfeitures, if this adjustment was recorded, would have been to reduce stock-based compensation by \$12. The estimate of forfeitures will be adjusted over the vesting period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. The adoption of this standard had no impact on net cash flows and results in the reclassification on the consolidated cash flow statements of related tax benefits from cash flows from operating activities to cash flows from financing activities to the extent these tax benefits exceeded the associated compensation cost recognized in the income statement.

Options are exercisable in installments of 33% annually, starting one year from the date of the grant and expire 10 years from the date of the grant. The fair value of each option is amortized into compensation expense on a straight-line basis over their respective 36 month vesting period, net of estimated forfeitures. The fair value of options was estimated at the grant date using the Black-Scholes option-pricing model. The per share weighted-average fair value at the date of grant for stock options granted during the three months ended March 31, 2006 and the year ended December 31, 2005 was \$7.82 and \$4.54 per option, respectively. The application of this valuation model relies on the following assumptions that are judgmental and sensitive in the determination of the compensation expense:

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts) (continued)  
(UNAUDITED)

	2006	2005
	----	----
Expected term (years)	5.2	5.2
Risk-free interest rate	4.7%	4.0%
Expected volatility	25.8%	27.8%
Dividend yield	1.76%	2.40%

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.

The following table summarizes stock option transactions for the three months ended March 31, 2006:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (years)	Aggregate Intrinsic Value
	-----	-----	-----	-----
Options:				
Outstanding at beginning of period	3,492,363	\$13.70	6.9	
Granted	611,950	\$29.46		
Forfeited	(6,790)	\$18.85		
Expired	--	\$ --		
Exercised	(433,748)	\$12.13		
	-----	-----	-----	-----
Outstanding at end of period	3,663,775	\$16.51	7.3	\$42,430
	=====	=====	===	=====
Exercisable at end of period	2,223,565	\$12.62	6.2	\$33,796
	=====	=====	===	=====

The aggregate intrinsic value of options exercised during the first quarter of 2006 and 2005 was \$6,986 and \$3,451, respectively. The intrinsic value of stock options is the amount by which the market price of the stock on a given date, such as at the end of the period or on the day of exercise, exceeded the market price of stock on the date of grant.

The following table summarizes information about the options outstanding and options exercisable as of March 31, 2006:

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AQUA AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts) (continued)  
(UNAUDITED)

	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Remaining Life (years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Range of prices:					
\$ 5.81 - 9.99	450,694	3.0	\$ 7.51	450,694	\$ 7.51
\$10.00 - 12.99	1,108,191	6.2	12.20	1,108,191	12.20
\$13.00 - 15.99	99,161	7.2	13.75	44,993	13.76
\$16.00 - 16.99	614,530	8.0	16.15	375,211	16.15
\$17.00 - 18.33	779,849	8.9	18.33	244,476	18.33
\$29.00 - 29.99	611,350	9.9	29.46	--	--
	3,663,775	7.3	\$16.51	2,223,565	\$12.62
	=====	===	=====	=====	=====

As of March 31, 2006, there was \$8,555 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plans. The cost is expected to be recognized over a weighted-average period of 1.7 years.

The following table provides the pro forma net income and earnings per share for the three months ended March 31, 2005 as if compensation cost for stock-based employee compensation was determined as of the grant date under the fair value method of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148.

Net income, as reported:	\$18,871
Add: stock-based employee compensation expense included in reported net income, net of tax	58
Less: pro forma expense related to stock options granted, net of tax effects	(503)
Pro forma	\$18,426
	=====
Basic net income per share:	
As reported	\$ 0.15
Pro forma	0.14
Diluted net income per share:	
As reported	\$ 0.15
Pro forma	0.14

For the purposes of this pro forma disclosure, the fair value of the options at the date of grant was estimated using the Black-Scholes option-pricing model.

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## AQUA AMERICA, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts) (continued)  
(UNAUDITED)

RESTRICTED STOCK—Restricted stock awards provide the grantee with the rights of a shareholder, including the right to receive dividends and to vote such shares, but not the right to sell or otherwise transfer the shares during the restriction period. Restricted stock awards result in compensation expense which is equal to the fair market value of the stock on the date of the grant and is amortized ratably over the restriction period. The adoption of SFAS No. 123R had no impact on the Company's recognition of stock-based compensation expense associated with restricted stock awards. The Company expects forfeitures of restricted stock to be de minimus. There were no forfeitures during the three months ended March 31, 2006 nor have there been forfeitures prior to the adoption of SFAS 123R for the grants that were under restriction as of January 1, 2006.

During the three months ended March 31, 2006 and 2005, the Company recorded stock-based compensation related to restricted stock awards as amortization expense in the amounts of \$105 and \$96, respectively. The following table summarizes non-vested restricted stock transactions for the three months ended March 31, 2006:

	Number of Shares	Weighted Average Fair Value
	-----	-----
Nonvested shares at beginning of period	43,998	\$17.70
Granted	35,000	\$29.46
Vested	(17,110)	\$17.41
Forfeited	--	\$ --
	-----	-----
Nonvested shares at end of period	61,888	\$24.43
	=====	=====

The total value of awards for which restrictions lapsed during the three months ended March 31, 2006 was \$488. As of March 31, 2006, \$1,476 of unrecognized compensation costs related to restricted stock is expected to be recognized over a weighted-average period of 1.7 years. The aggregate intrinsic value of restricted stock as of March 31, 2006 was \$1,722. The aggregate intrinsic value of restricted stock is based on the number of shares of restricted stock and the market value of the Company's common stock as of the period end date.

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## AQUA AMERICA, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts) (continued)  
(UNAUDITED)

Note 5 Pension Plans and Other Postretirement Benefits

The Company maintains a qualified defined benefit plan, nonqualified

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pension plans and other postretirement benefit plans for certain of its employees. The net periodic benefit cost is based on estimated values provided by independent actuaries. The following tables provide the components of net periodic benefit costs:

	Pension Benefits	
	-----	
	Three Months Ended	
	March 31,	
	-----	
	2006	2005
	-----	-----
Service cost	\$ 1,275	\$ 1,260
Interest cost	2,566	2,483
Expected return on plan assets	(2,375)	(2,385)
Amortization of transition obligation (asset)	(53)	(53)
Amortization of prior service cost	58	100
Amortization of actuarial loss	480	423
Capitalized costs	(472)	(429)
	-----	-----
Net periodic benefit cost	\$ 1,479	\$ 1,399
	=====	=====
	Other	
	Postretirement Benefits	
	-----	
	Three Months Ended	
	March 31,	
	-----	
	2006	2005
	-----	-----
Service cost	\$ 280	\$ 330
Interest cost	418	483
Expected return on plan assets	(320)	(313)
Amortization of transition obligation (asset)	203	200
Amortization of prior service cost	(183)	(15)
Amortization of actuarial loss	88	55
Amortization of regulatory asset	38	38
Capitalized costs	(188)	(173)
	-----	-----
Net periodic benefit cost	\$ 336	\$ 605
	=====	=====

The Company contributed \$2,652 in April 2006 to its defined benefit pension plan and intends to contribute \$3,748 during the balance of 2006. In addition, the Company expects to contribute approximately \$2,882 for the funding of its other postretirement benefits.

### AQUA AMERICA, INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except per share amounts) (continued)  
(UNAUDITED)

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In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment." SFAS 123R generally requires that the Company measure the cost of employee services received in exchange for stock-based awards on the grant-date fair value and this cost will be recognized over the period during which an employee provides service in exchange for the award. Prior to the adoption of SFAS No. 123R on January 1, 2006, the Company provided pro forma disclosure of its compensation costs associated with the fair value of stock options that had been granted, and accordingly, no compensation costs were recognized in its consolidated financial statements. The Company adopted this standard using the modified prospective method, and accordingly, the financial statement amounts for the prior periods presented in this Form 10-Q have not been restated to reflect the fair value method of expensing share-based compensation. During the first quarter of 2006, the adoption of SFAS 123R lowered net income by \$500 and increased operations and maintenance expense by \$662. The after-tax impact of adopting SFAS 123R is expected to approximate \$3,000 during the year ending December 31, 2006. The adoption of this standard had no material impact on the Company's overall financial position, no impact on cash flow, and results in the reclassification on the consolidated cash flow statements of related tax benefits from cash flows from operating activities to cash flows from financing activities to the extent these tax benefits exceeded the associated compensation cost recognized in the income statement. See Note 4 for further information and the required disclosures under SFAS 123R.

### Note 7 Water and Wastewater Rates

In May 2004, the Company's operating subsidiaries in Texas filed an application with the Texas Commission on Environmental Quality to increase rates by \$11,920 over a multi-year period. The application seeks to increase annual revenues in phases and is accompanied by a plan to defer and amortize a portion of the Company's depreciation, operating and other tax expense over a similar multi-year period, such that the impact on operating income approximates the requested amount during the first years that the new rates are in effect. The application is currently pending before the Commission and several customers and municipalities have joined the proceeding to challenge the rate request. The Company commenced billing for the requested rates and implemented the deferral plan in August 2004. The additional revenue billed and collected prior to the final ruling are subject to refund based on the outcome of the ruling. The revenue recognized and the expenses deferred by the Company reflect an estimate of the final outcome of the ruling. As of March 31, 2006, the Company has deferred \$10,329 of expenses and recognized \$6,868 of revenue that is subject to refund based on the outcome of the final commission order, which is not expected to be issued prior to December 2006.

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

AQUA AMERICA, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

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FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(In thousands of dollars, except per share amounts)

### 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: our use of cash; projected capital expenditures; liquidity; possible acquisitions and other growth ventures; the completion of various construction projects; the projected timing and annual value of rate increases; the recovery of certain costs and capital investments through rate increase requests; the projected effects of recent accounting pronouncements, as well as information contained elsewhere in this report where statements are preceded by, followed by or include the words "believes," "expects," "anticipates," "plans" or similar expressions. These statements are based on a number of assumptions concerning future events, and are subject to a number of uncertainties and other factors, many of which are outside our control. Actual results may differ materially from such statements for a number of reasons, including the effects of regulation, abnormal weather, changes in capital requirements and funding, acquisitions, and our ability to assimilate acquired operations. In addition to these uncertainties or factors, our future results may be affected by the factors and risk factors set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005. We undertake no obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.

### General Information

Nature of Operations - Aqua America, Inc. ("we" or "us"), a Pennsylvania corporation, is the holding company for regulated utilities providing water or wastewater services to what we estimate to be more than 2.5 million people in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, Florida, Indiana, Virginia, Maine, Missouri, New York and South Carolina. Our largest operating subsidiary, Aqua Pennsylvania, Inc., provides water or wastewater services to approximately one-half of the total number of people we serve, located in the suburban areas north and west of the City of Philadelphia and in 22 other counties in Pennsylvania. Our other subsidiaries provide similar services in 12 other states. In addition, we provide water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to our operating companies' service territories. We are the largest U.S.-based publicly-traded water utility based on number of people served.

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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)

### Financial Condition

During the first quarter of 2006, we had \$46,888 of capital expenditures, acquired water and wastewater systems for \$2,506, repaid \$747 of customer advances for construction and repaid debt and made sinking fund contributions and other loan repayments of \$3,718. The capital expenditures were related to

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improvements to treatment plants, new and rehabilitated water mains, tanks, hydrants, and service lines, in addition to well and booster improvements and an office building expansion.

During the first quarter of 2006, the proceeds from the issuance of long-term debt, the proceeds from the issuance of common stock, internally generated funds and available working capital were used to fund the cash requirements discussed above and to pay dividends. In March 2006, our Pennsylvania operating subsidiary issued \$40,000 of unsecured notes at 5.95% of which \$10,000 are due in 2023, 2024, 2033 and 2034. Proceeds from the sale of bonds were received on March 31, 2006 and the proceeds were used to repay short-term borrowings in April 2006. At March 31, 2006, we had short-term lines of credit of \$220,000, of which \$52,850 was available.

Management believes that internally generated funds along with existing credit facilities and the proceeds from the issuance of long-term debt and common stock will be adequate to meet our financing requirements for the balance of the year and beyond.

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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)

#### Results of Operations

##### Analysis of First Quarter of 2006 Compared to First Quarter of 2005

Revenues for the quarter increased \$3,961 or 3.5% primarily due to additional revenues of \$2,376 resulting from increased water and wastewater rates implemented in various operating subsidiaries, \$1,268 of additional revenues from the infrastructure rehabilitation surcharge, and additional water and sewer revenues of \$1,644 associated with a larger customer base due to acquisitions, offset partially by decreased water consumption compared to the first quarter of 2005.

Operations and maintenance expenses increased by \$4,007 or 8.5% primarily due to increased water production costs of \$1,234, stock-based compensation expense of \$662, additional expenses associated with acquisitions of \$1,077, a reduction in the deferral of expenses related to the Texas rate case filing of \$945 and normal increases in other operating costs, offset partially by receipt of \$1,500 relating to a waiver of certain contractual rights. The increased water production costs, principally purchased power and chemicals, were associated with vendor price increases. The stock-based compensation expense of \$662 was associated with stock options and is a component of operations and maintenance expense beginning on January 1, 2006 as a result of adopting a new accounting standard. A portion of the increase in operations and maintenance expense is associated with the change in the cost deferral related to the 2004 Texas rate filing. The rate filing was designed and implemented using a multi-year plan to increase annual revenues in phases, and to defer and amortize a portion of the Company's operating expense over a similar multi-year period. The impact, by design, resulted in a lower expense deferral of \$945 in the first quarter of 2006 than in the same period of 2005. The lower expense deferral results in an increase in expense recognized in conjunction with an additional phase increase in the revenues billed and recognized.



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Depreciation expense increased \$2,147 or 14.6% reflecting the utility plant placed in service since the first quarter of 2005, including the assets acquired through system acquisitions.

Amortization decreased \$114 or 9.3% due to the amortization of the costs associated with, and other costs being recovered in, various rate filings.

Taxes other than income taxes increased by \$70 or 0.9% due to additional state and local taxes incurred in the first quarter of 2005.

Interest expense increased by \$1,377 or 10.8% primarily due to additional borrowings to finance capital projects and increased interest rates on short-term borrowings, offset partially by decreased interest rates on long-term borrowings due to the refinancing of certain existing debt issues.

Allowance for funds used during construction ("AFUDC") increased by \$554 primarily due to an increase in the average balance of utility plant construction work in progress, to which AFUDC is applied; and an increase in the AFUDC rate which is based on short-term interest rates.

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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)

Gain on sale of other assets totaled \$267 in the first quarter of 2006 and \$481 in the first quarter of 2005. The change is due to the timing of sales of land.

Our effective income tax rate was 40.0% in the first quarter of 2006 and 38.8% in the first quarter of 2005. The change was due to an increase in our expenses that are not tax-deductible, including a portion of the stock-based compensation expense in the first quarter of 2006.

Net income for the quarter decreased by \$2,307 or 12.2%, in comparison to the same period in 2005 primarily as a result of the factors described above. On a diluted per share basis, earnings decreased \$0.02 or 13.3% reflecting the change in net income and a 1.6% increase in the average number of common shares outstanding. The increase in the number of shares outstanding is primarily a result of the additional shares sold or issued through the dividend reinvestment plan and the employee stock and incentive plan.

#### Impact of Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment." SFAS 123R generally requires that we measure the cost of employee services received in exchange for stock-based awards on the grant-date fair value and this cost will be recognized over the period during which an employee provides service in exchange for the award. Prior to the adoption of SFAS No. 123R on January 1, 2006, we provided pro forma disclosure of our compensation costs associated with the fair value of stock options that had been granted, and accordingly, no compensation costs were recognized in our consolidated financial statements. We adopted this standard using the modified prospective method, and accordingly, the financial statement amounts for the prior periods presented in this Form 10-Q have not been restated to reflect the fair value method of expensing share-based compensation. During the first quarter of 2006, the adoption of SFAS 123R lowered net income by \$500 and increased operations and maintenance expense

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### AQUA AMERICA, INC. AND SUBSIDIARIES

#### 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, 2005. Refer to Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2005 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 functioning effectively to provide reasonable assurance 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 SEC'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

In May 2004, our subsidiaries in Texas filed an application with the Texas Commission on Environmental Quality to increase rates by over a multi-year period. In accordance with authorization from the Texas Commission on Environmental Quality, our subsidiaries commenced billing for the requested rates and deferred recognition of certain expenses for financial statement purposes. Several customers and

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municipalities have joined the proceeding and challenged the requested rate structure, including our request to regionalize rates, and the amount of our requested rate increase. In the event our request is denied completely or in part, we could be required to refund some or all of the revenue billed to-date, and write-off some or all of the regulatory asset for the expense deferral. For more information, see the description under Results of Operation in Management's Discussion and Analysis of Financial Condition and Results of Operation in our Annual Report on Form 10-K for the year ended December 31, 2005, and refer to Note 7 - Water and Wastewater Rates in this Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

There are no other pending legal proceedings to which we or any of our subsidiaries is a party or to which any of their properties is the subject that are material or are expected to have a material effect on our financial position, results of operations or cash flows.

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### AQUA AMERICA, INC. AND SUBSIDIARIES

#### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table summarizes Aqua America's purchases of its common stock for the quarter ended March 31, 2006:

#### Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs (2)
January 1 - 31, 2006	1,765	\$27.77	--	548,278
February 1 - 28, 2006	463	\$27.88	--	548,278
March 1 - 31, 2006	21,868	\$28.79	--	548,278
	-----	-----	---	-----
Total	24,096	\$28.69	--	548,278
	=====	=====	===	=====

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

(2) On August 5, 1997, our Board of Directors authorized a common stock

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repurchase program that was publicly announced on August 7, 1997, for up to 1,007,351 shares. No repurchases have been made under this program since 2000. The program has no fixed expiration date. The number of shares authorized for purchase was adjusted as a result of the stock splits effected in the form of stock distributions since the authorization date.

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### AQUA AMERICA, INC. AND SUBSIDIARIES

#### Item 6. Exhibits

Exhibit No. -----	Description -----
10.1	2006 Salaries; Annual Incentive Compensation Earned in 2005 (filed as Exhibit 10.1 to the Company's Current Report of Form 8-K filed on March 13, 2006, File No. 001-06659, and incorporated by reference herein).
10.2	Acceleration of Payout of 2004 and 2005 Dividend Equivalent Awards; Grants of 2006 Dividend Equivalent Awards; Performance Criteria for Acceleration of Payout of Dividend Equivalent Awards (filed as Exhibit 10.2 to the Company's Current Report of Form 8-K filed on March 13, 2006, File No. 001-06659, and incorporated by reference herein).
10.3	Vesting of Restricted Stock Granted in 2004 and 2005; Grants of Restricted Stock (filed as Exhibit 10.3 to the Company's Current Report of Form 8-K filed on March 13, 2006, File No. 001-06659, and incorporated by reference herein).
31.1	Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934.
31.2	Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934.
32.1	Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350.
32.2	Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350.

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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.

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May 8, 2006

AQUA AMERICA, INC.  
Registrant

NICHOLAS DEBENEDICTIS  
-----  
Nicholas DeBenedictis  
Chairman, President and  
Chief Executive Officer

DAVID P. SMELTZER  
-----  
David P. Smeltzer  
Senior Vice President - Finance  
and Chief Financial Officer

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## EXHIBIT INDEX

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