Large Filing Separator Sheet

Case Number: 09-1044-WW-AIR

File Date: 12/11/09

Section: 2

Number of Pages: 204

Description of Document: Supplemental Information

AQUA™

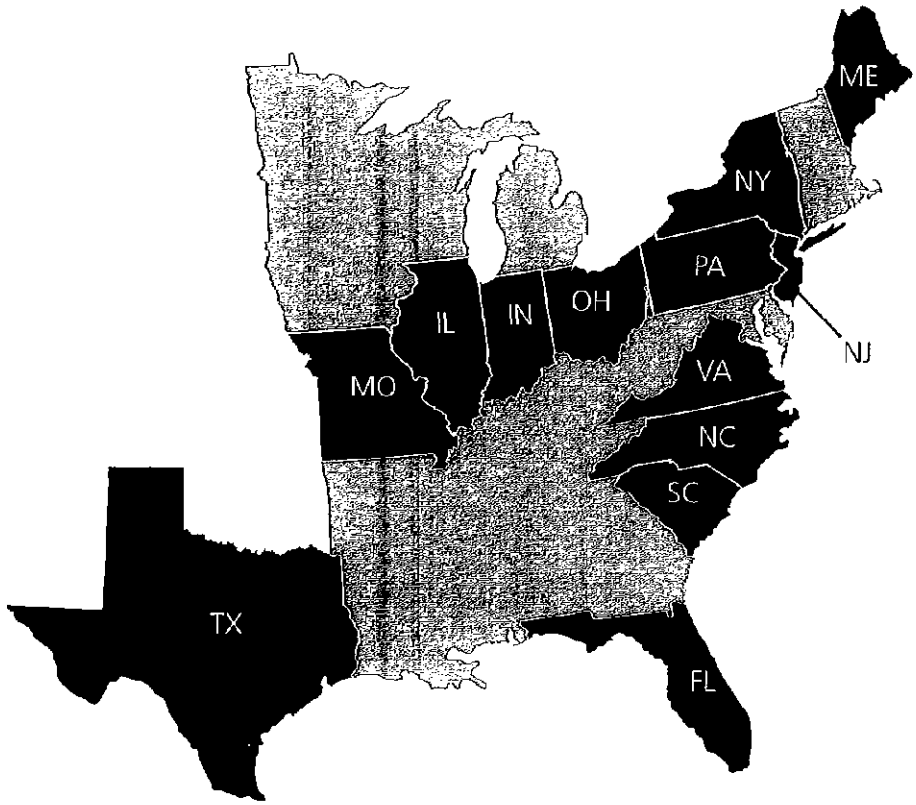
AQUA AMERICA, INC.
2006 ANNUAL REPORT

FINANCIAL HIGHLIGHTS (in thousands, except per share amounts)

	2006	2005	Percent Change
Operating revenues	$ 533,491	$ 496,779	7.4
Net income	92,004	91,156	0.9
Diluted net income per common share	0.70	0.71	(1.4)
Annual dividend rate per common share	0.46	0.4276	7.6
Common stockholders' equity	921,630	811,923	13.5
Total assets	2,877,903	2,635,046	9.2
Capital additions (a)	271,706	237,462	14.4
Number of utility customers served (b)	927,235	864,894	7.2

(a) Excludes net payments for acquisitions of utility systems and other: $11,848 in 2006 and $11,633 in 2005.
(b) 2006 includes 44,792 customers associated with the New York Water Service Corporation acquisition that was completed on January 1, 2007.

NATIONAL FOOTPRINT



Aqua America, Inc. is a U.S.-based publicly traded water and wastewater utility holding company serving approximately 2.8 million residents in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, New York, Indiana, Florida, Virginia, Maine, Missouri and South Carolina.

Aqua America is listed on the New York and Philadelphia Stock Exchanges under the ticker symbol **WTR**.

AQUA

TO OUR SHAREHOLDERS

March 9, 2007

Growth continued to be a key part of our performance in 2006.

During the past year, our growth-through-acquisition strategy, coupled with organic growth, added more than 62,000 new customers, or 7 percent, to our customer base. The majority of these customers came through the acquisition of New York Water Service Corporation, which serves approximately 45,000 customers on Long Island. Shortly after closing New York Water Service, we continued building on our New York base by entering into an agreement with Kelda Group, Inc. to acquire the nearby Aquarion Water Company of Sea Cliff, Inc., which serves approximately 4,500 Long Island customers.

The majority of our 28 acquisitions in 2006 were "tuck-ins"— acquisitions of small systems located in close proximity to our existing systems. Purchasing water and wastewater assets of nearby systems allows us to realize economies of scale, increase revenues and add new platforms for future capital investment and customer growth.

Included in the 28 acquisitions are four new septage hauling operations that complement our wastewater business and allow us to provide additional services to our residential and commercial water customers in Pennsylvania.

In August, Aqua America's Board of Directors approved and announced a quarterly dividend increase of eight percent from $0.1069 per common share to $0.115 per common share. With the dividend paid on September 1, 2006, we effected our 16th dividend increase in the last 15 years. The increase marked the eighth consecutive year in which the dividend was increased greater than five percent.

"In 2006, we used our experience as a trusted water company to increase our customer base by more than 62,000 customers."

Operating results in 2006 were adversely affected by weather, regulatory lag, the inflationary impact on production costs, expensing of stock options, and a rapid rise in short-term interest rates. Operating revenues grew more than seven percent to $533.5 million in 2006 from $496.8 million in 2005. Net income was up slightly at $92.0 million compared to $91.2 million during 2005. Corresponding diluted earnings per share was $0.70 in 2006 versus $0.71 for the full year 2005, on three percent more shares outstanding.

We spent record amounts of capital in 2006, approximately $272 million, to upgrade and expand our water and wastewater systems around the country. Prudent capital investment allows us to continue to deliver quality water and reliable service to our customers and receive a fair return on that investment from regulators.

In 2006, we received rate relief in our largest operating subsidiary, Aqua Pennsylvania, and in other states, which is expected to provide about $40.0 million in annualized revenue.

In 2006, we were pleased to add two new directors to our board: Ms. Ellen T. Ruff, the president of Duke Energy Carolinas and Mr. Andrew Sordoni, III, the former president and chairman of C-TEC Corporation and an officer and chairman of Sordoni Construction Services. We welcome the addition of both esteemed executives to our board and have already benefited from their contributions.

As we welcome Ms. Ruff and Mr. Sordoni, we would like to offer our gratitude to retiring Directors John F. McCaughan and John E. Menario. Mr. McCaughan has served on the board since 1984, helping foster the company's return to its core business as a water and wastewater utility with a successful growth-through-acquisition strategy that nearly tripled the company's customer base during his tenure.

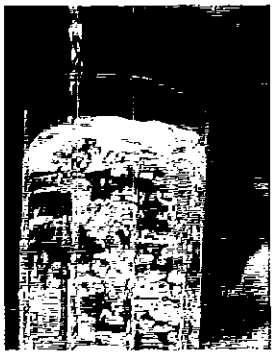
Mr. Menario joined the board in 1999 after having served as chairman of the board of Consumers Water Company, which merged with Aqua that same year. Mr. Menario played a key role in the company's merger and continued to provide key counsel during his tenure as we moved forward with the subsequent acquisitions of the AquaSource companies, Heater Utilities and Florida Water. These acquisitions added eight more states to our operations.

We wish Messrs. McCaughan and Menario the best during their retirement and thank them for their years of dedicated service.

With 120 years in the water industry and as one of the nation's largest water companies, we look forward with confidence in our long-term strategy to continue to grow through acquisitions and to make prudent capital investments. This strategy will allow us to receive fair returns for our shareholders while enabling us to continue to provide a quality product and reliable service at a reasonable price to our customers.

With 53,000 water systems and 16,000 wastewater systems in the United States today, we believe the opportunities to continue to implement our strategy are plentiful.

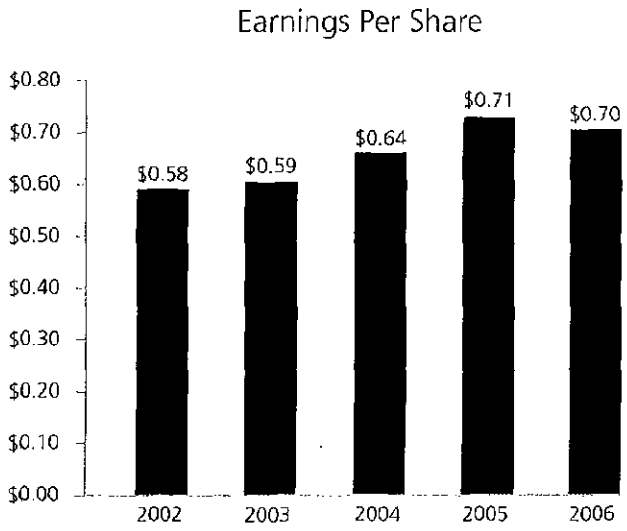
Thank you for your continued support.

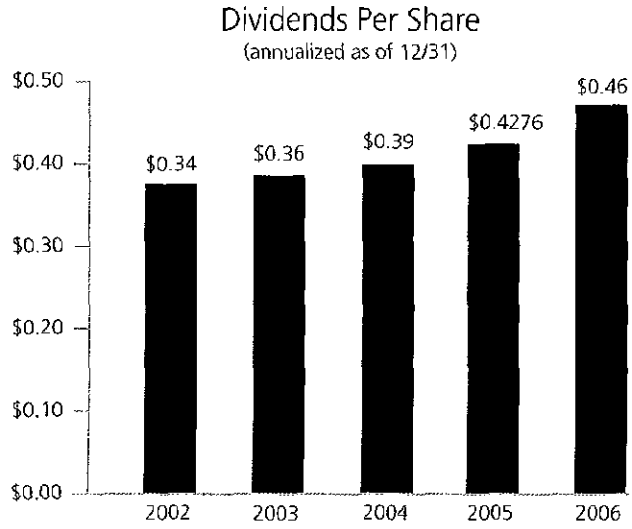


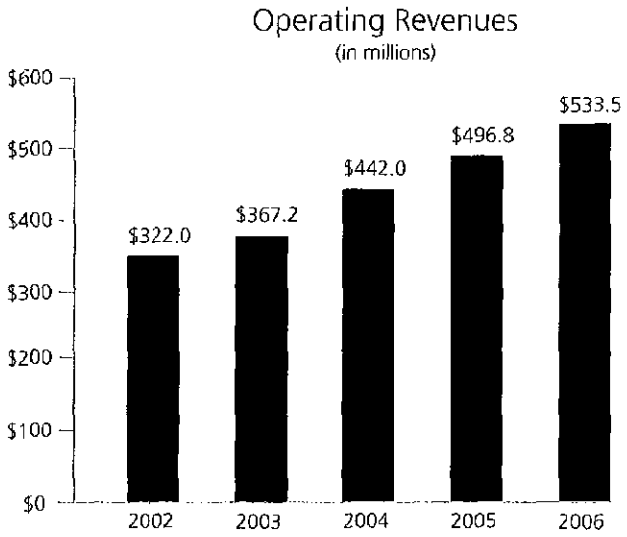
Nicholas DeBenedictis

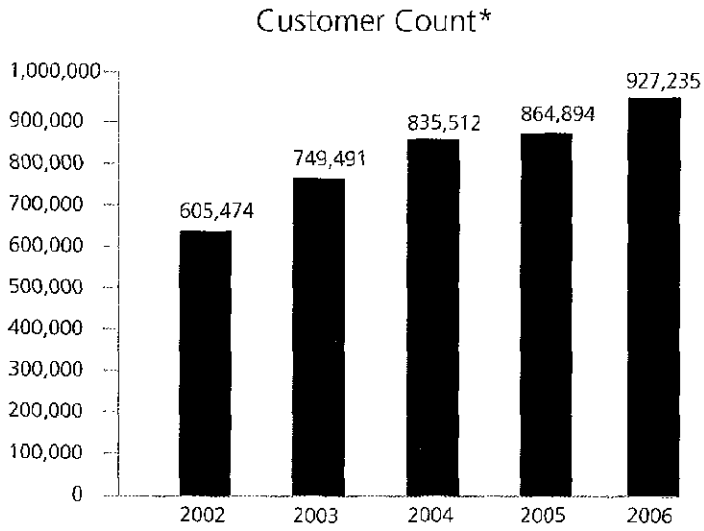
2006 Dividend Highlights

- Increased cash dividend by eight percent to $0.46 on an annualized basis as of September 1, 2006.
- Sixteen cash dividend increases in the last 15 years.
- Paid dividends for more than 60 consecutive years.









* 2006 includes 44,792 customers associated with the New York Water Service Corporation acquisition that was completed on January 1, 2007.

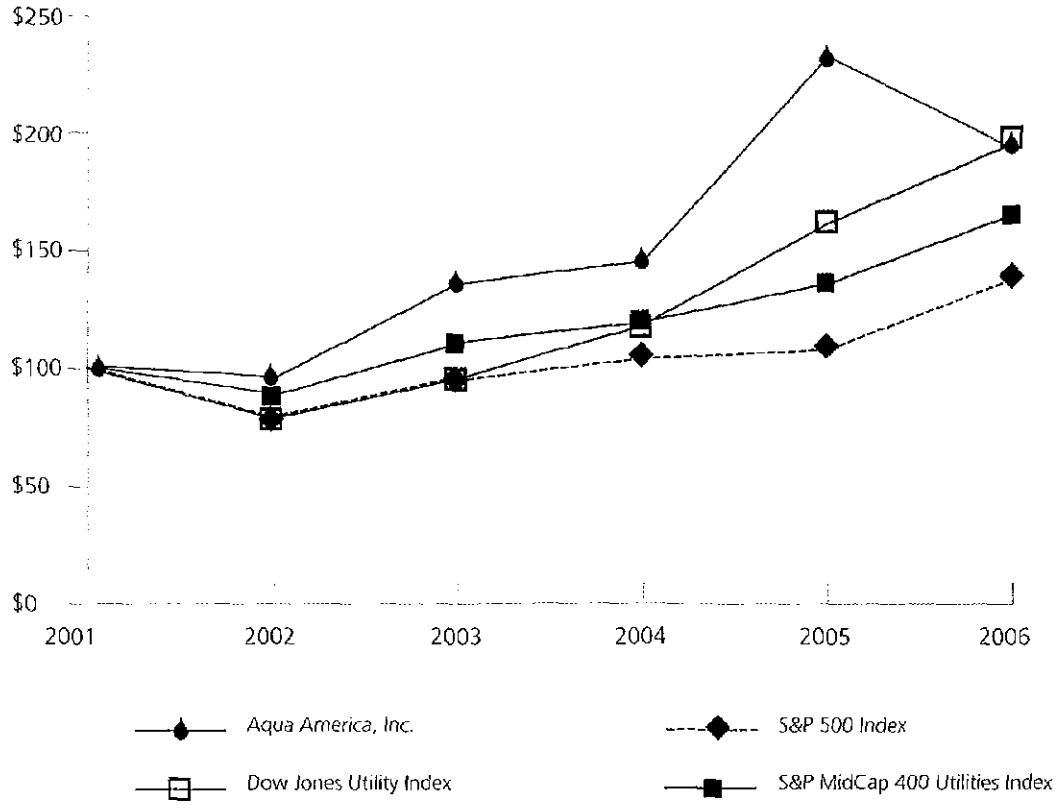
Five-Year Cumulative Total Shareholder Return

The graph below compares Aqua America, Inc.'s five-year cumulative total shareholder return on common stock as compared with the cumulative total returns of the S&P 500 Index, the Dow Jones Utility Index and the S&P MidCap 400 Utilities Index. The graph tracks the performance of a $100 investment in our common stock and in each of the indices (with the reinvestment of all dividends) for the five-year period ended December 31, 2006. In the past, the Company has used the Dow Jones Utility Index for its peer group comparison. The Company has adopted the S&P MidCap 400 Utilities Index to be used for future peer group comparisons, due to Aqua America, Inc.'s inclusion in the index, as well as the comparable size of the component companies within the index.

The Dow Jones Utility Index and the S&P MidCap 400 Utilities Index are both presented in the graph below this year for comparison purposes. The S&P MidCap 400 Utilities Index consists of the following companies: AGL Resources, Inc.; Alliant Energy Corporation; Aqua America, Inc.; Aquila, Inc.; Black Hills Corporation; DPL Inc.; Duquesne Light Holdings, Inc.; Energy East Corporation; Equitable Resources, Inc.; Great Plains Energy, Inc.; Hawaiian Electric Industries, Inc.; Idacorp Inc.; MDU Resources Group, Inc.; National Fuel Gas Co.; Northeast Utilities; NSTAR; OGE Energy Corporation; Oneok Inc.; Pepco Holdings, Inc.; PNM Resources, Inc.; Puget Energy, Inc.; SCANA Corporation; Sierra Pacific Resources; Vectren Corporation; Westar Energy, Inc.; WGL Holdings, Inc.; Wisconsin Energy Corporation and WPS Resources Corporation.

Comparison of Five-Year Cumulative Total Shareholder Return*

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



*$100 invested on 12/31/01 in stock or index, including revinvestment of dividends.

	Fiscal year ending December 31,					
	2001	2002	2003	2004	2005	2006
Aqua America, Inc.	100.00	93.64	128.77	146.66	221.10	187.93
S&P 500 Index	100.00	77.90	100.24	111.15	116.61	135.03
Dow Jones Utility Index	100.00	76.62	99.14	129.12	161.57	188.44
S&P MidCap 400 Utilities Index	100.00	87.99	111.80	131.10	141.16	172.60

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

Board of Directors

Nicholas DeBenedictis, 61
Chairman, President and CEO
Aqua America, Inc.
Director since 1992

Mary C. Carroll, 66
Consultant and Community Volunteer
Director since 1981

Richard Glanton, 60
Senior Vice President
Exelon Corporation
Director since 1995

Lon R. Greenberg, 56
Chairman and CEO
UGI Corporation
Director since 2005

William P. Hankowsky, 55
Chairman, President and CEO
Liberty Property Trust
Director since 2004

Constantine Papadakis, 61
President
Drexel University
Director since 2005

Ellen T. Ruff, 59
President
Duke Energy Carolinas
Director since 2006

Richard L. Smoot, 66
Regional Chairman, Advisory Board
Philadelphia and Southern New Jersey
PNC Financial Services Group (Retired)
Director since 1997

Andrew J. Sordoni, III, 66
Former President and Chairman,
C-TEC Corporation
Chairman, Sordoni Construction Services, Inc.
Director since 2006

Officers

Nicholas DeBenedictis, 61
Chairman, President and CEO

Christopher H. Franklin, 42
Regional President
Aqua America – Southern Operations
Senior Vice President
Public Affairs and Customer Operations

Mark J. Kropilak, 50
Senior Vice President
Corporate Development and Corporate Counsel

Karl M. Kyriss, 56
Regional President
Aqua America – Mid-Atlantic Operations

Robert G. Liptak, 58
Regional President
Aqua America – Northern Operations

Kathy L. Pape, 54
Senior Vice President
Treasurer and Rates Counsel

Richard R. Riegler, 60
Vice President
Engineering and Environmental Affairs

Robert A. Rubin, 44
Vice President
Chief Accounting Officer and Controller

David P. Smeltzer, 48
Chief Financial Officer

Roy H. Stahl, Esq., 54
Chief Administrative Officer,
General Counsel and Secretary

Experience Water

Every day you experience the benefits of water. Water nourishes us, keeps us clean and helps our food grow. More than 60 percent of our bodies are water. Without it, the human body will survive only a few days. No other nutrient deficiency has such profound effects.

Providing such an essential product comes with enormous responsibility. At Aqua America (Aqua), we have more than 120 years of experience providing our customers with quality, reliable water. As one of the country's oldest water utilities, Aqua's experience not only spans time, it spans geography with utilities in mid-Atlantic, southern, midwestern and New England states.

Our experience spans professions with scientists who staff our laboratory with numerous state certifications; engineers who design distribution systems and treatment facilities; licensed treatment operators who service our treatment facilities and a host of other professionals needed to provide you with water.

Experience Growth

Since the early 1990s, Aqua has seen significant customer growth as a result of its growth-through-acquisition strategy. Through its experience, Aqua management has grown the company's revenues not by soley raising rates but also by increasing customers and acquiring additional systems. This customer growth allowed Aqua to capitalize on economies of scale and helps the company moderate rates.

Adding customers also allowed Aqua to increase revenues and gain additional operating efficiencies. Aqua's customer base has grown from roughly 237,000 customer accounts (700,000 residents) at year-end 1991 to roughly 927,000 customer accounts (approximately 2.8 million residents) at year-end 2006. This growth is the result of more than 200 acquisitions and growth ventures that expanded the company from a regional water utility serving customers in four suburban Philadelphia counties to a national company serving customers in 13 states.

A newborn baby's body is 75 percent water. However, as you age, that percent decreases. The amount of water in an adult man's body could be as little as 60 percent.

Experience a New Opportunity

Although Aqua's experience and core business is drinking water, in 1996 the company acquired its first wastewater system — a small private, 300-customer wastewater system in Chester County, Pennsylvania. Aqua's interest in wastewater was a natural extension of its growth strategy because of the overlap of business and operations functions in the drinking water and wastewater industries,

including engineering and design, capital investments and public utility regulation. It also offered Aqua the ability to improve the quality of wastewater discharges (effluent) released into streams and the uses for effluent, such as groundwater recharge. Since its first wastewater acquisition, Aqua's wastewater customer base has grown to more than 90,000 customer accounts (about 270,000 residents).

Aqua is gaining new experience in another segment of the wastewater industry. In 2005, Aqua purchased a small private southeast Pennsylvania company that provides commercial and residential wastewater services, such as sludge and bulk wastewater hauling and septic tank clean-outs.

Since then, Aqua has purchased four additional private companies that offer the same services. These businesses complement Aqua's expertise in regulated wastewater treatment and disposal operations. They also provide an opportunity to offer additional services to our existing water customers with septic systems.

Experience Prudent Capital Investment

The water industry is the most capital intensive of all utilities, having to invest more capital per dollar of revenue earned than any other utility. With nearly $3 billion in assets — most buried beneath the ground — Aqua is heavily vested in the communities it serves.

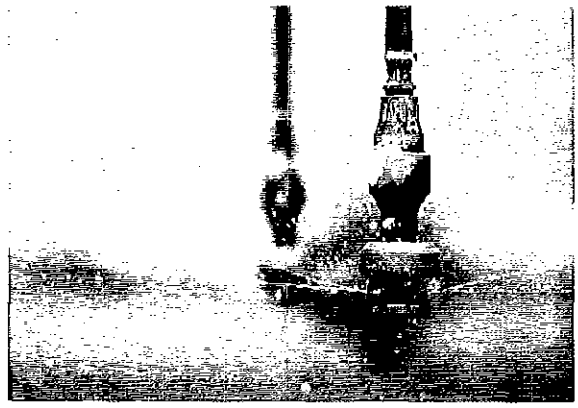
Our experience has shaped our proactive approach to infrastructure rehabilitation. We perform needed maintenance at our treatment and operating facilities to ensure optimum performance throughout the life of these facilities. In 2003, the Environmental Protection Agency (EPA) estimated that $277 billion would be needed over the next 20 years to maintain and upgrade the nation's water infrastructure.

To maintain reliability and water quality, Aqua invests significant capital in its infrastructure. In 2006, the company spent about $272 million to replace and upgrade aging pipe, storage tanks, treatment facilities, pumping stations, etc. Prudent and disciplined capital investment allows customers to continue to receive reliable service and quality water and allows Aqua to earn a fair rate of return on its investment for shareholders.

Water treatment plants, sewer and distribution lines and storage facilities ensure protection of public health. That's why infrastructure upgrades are necessary to sustain our water quality.

Experience Technology

Water quality has always been a top priority at Aqua. The company was founded in 1886 by Swarthmore College professors who were concerned about water quality in their community. More than a century later, Aqua continues that tradition by using advanced treatment technology to address water quality challenges. Aqua was the first water utility in Illinois to install treatment on a surface water supply (rivers, lakes, streams) to address seasonal spikes in nitrate levels from agricultural runoff.



When the EPA adopted a new, more stringent standard for arsenic, Aqua had one well that slightly exceeded the new proposed limit. To remedy the exceedance, Aqua was among the first in Pennsylvania to use a new disposable media treatment system well in advance of the regulatory guidelines.

Aqua has brought the same philosophy to wastewater treatment. In Florida, special filters to remove total nitrates and phosphorus at the Fruitville (Sarasota) wastewater treatment plant have been installed to meet self-imposed nutrient removal goals. These goals are more rigorous than the regulatory permit limits for the plant and even surpass strict Florida standards for advanced wastewater treatment. This effluent is beneficially used for irrigation. Other Aqua wastewater facilities in Florida, Texas and Illinois produce high quality effluent for golf course irrigation and other uses.

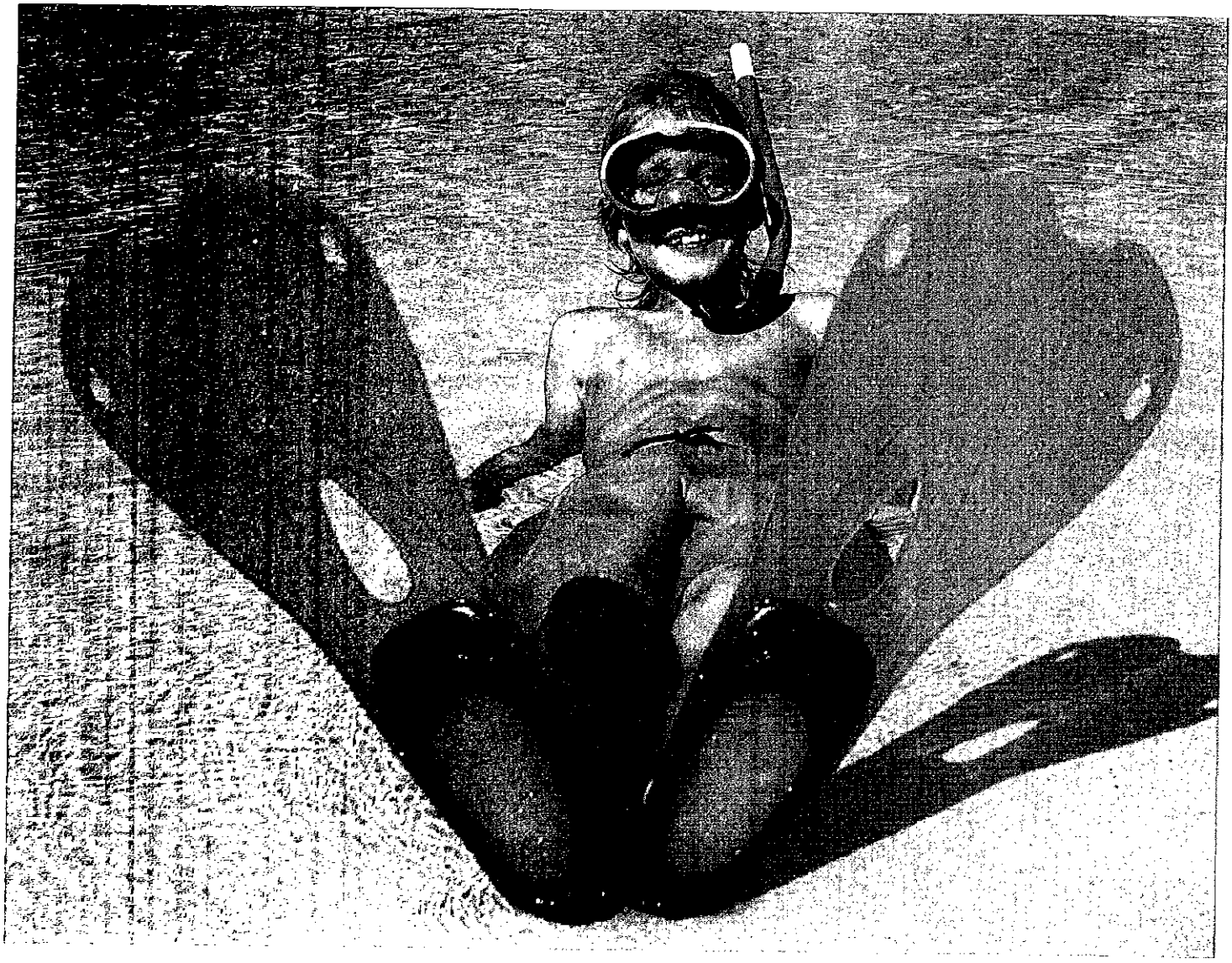
Experience the Future

Aqua's plans for the future are as clear as its product. With 53,000 water systems in the United States and 84 percent of them serving fewer than 3,300 people, the need for consolidation is obvious. As it has done successfully since embarking on its growth strategy in the early 1990s, Aqua will continue to pursue strategic growth opportunities that will allow it to take advantage of economies of scale to gain efficiencies.

Without water, food production would be impossible. Six gallons of water are needed to produce one serving of lettuce, and more than 2,600 gallons are needed to produce one serving of steak.

Aqua will also continue to prudently invest capital to provide quality service and adhere to water quality standards, while increasing opportunities for fair returns on its investment for shareholders.

As the only utility that is ingested and the only one required to sustain life, it is clear that water will always be key to life. The future is water—without it, there is no future. ♦



AQUA℠

Aqua America, Inc. 2006 Annual Report Financial Data

This page was intentionally left blank

FORWARD-LOOKING STATEMENTS

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

- recovery of capital expenditures and expenses in rates;
- projected capital expenditures;
- availability of capital financing;
- dividend payment projections;
- future financing plans;
- future pension contributions;
- opportunities for future acquisitions, the success of pending acquisitions and the impact of future acquisitions;
- acquisition-related costs and synergies;
- the capacity of our water supplies, water facilities and wastewater facilities;
- the availability and cost of key production necessities, including power, chemicals and purchased water or wastewater services;
- the availability of qualified personnel;
- the return performance of our defined benefit pension plan assets;
- general economic conditions;
- the impact of geographic diversity on our exposure to unusual weather; and
- the impact of accounting pronouncements.

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

- changes in general economic, business and financial market conditions;
- changes in government regulations and policies, including environmental and public utility regulations and policies;
- changes in environmental conditions, including those that result in water use restrictions;
- abnormal weather conditions;
- changes in, or unanticipated, capital requirements;
- changes in our credit rating or the market price of our common stock;
- our ability to integrate businesses, technologies or services which we may acquire;
- our ability to manage the expansion of our business;
- the extent to which we are able to develop and market new and improved services;
- the effect of the loss of major customers;
- our ability to retain the services of key personnel and to hire qualified personnel as we expand;
- increasing difficulties in obtaining insurance and increased cost of insurance;
- cost overruns relating to improvements or the expansion of our operations;
- changes in accounting pronouncements; and
- civil disturbance or terroristic threats or acts.

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

OVERVIEW

The Company

Aqua America, Inc. is the holding company for regulated utilities providing water or wastewater services to what we estimate to be approximately 2.8 million people in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, New York, Florida, Indiana, Virginia, Maine, Missouri and South Carolina. Our largest operating subsidiary, Aqua Pennsylvania, Inc., accounted for approximately 55% of our operating revenues for 2006 and, as of December 31, 2006, provided water or wastewater services to approximately one-half of the total number of people we serve, is located in the suburban areas north and west of the City of Philadelphia and in 23 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, and septage hauling services, close to our utility companies' service territories.

Industry Mission

The mission of the investor-owned water utility industry is to provide quality and reliable water service at an affordable price for the customer, with a fair return for shareholders. A number of challenges face the industry, including:

- strict environmental, health and safety standards;
- the need for substantial capital investment;
- economic regulation by state, and/or, in some cases, local government; and
- the impact of weather and drought conditions on water sales demand.

Economic Regulation

Most of our water and wastewater utility operations are subject to regulation by their respective state regulatory commissions, which have broad administrative power and authority to regulate rates and charges, determine franchise areas and conditions of service, approve acquisitions and authorize the issuance of securities. The regulatory commissions also establish uniform systems of accounts and approve the terms of contracts with affiliates and customers, business combinations with other utility systems, loans and other financings, and the franchise areas that we serve. A small number of our operations are subject to rate regulation by county or city government. The profitability of our utility operations is influenced to a great extent by the timeliness and adequacy of rate allowances in the various states in which we operate.

Rate Case Management Capability–We strive to achieve the industry mission by effective planning and efficient use of our resources. We maintain a rate case management capability to pursue timely and adequate returns on the capital investments that we make in improving or replacing water mains, treatment plants and other infrastructure. This capability is important in our continued profitability and in providing a fair return to our shareholders, and thus providing access to capital markets to help fund these investments. Accordingly, we execute a rate case management strategy to provide that the rates of the utility operations reflect, to the extent practicable, the timely recovery of increases in costs of operations, capital, taxes, energy, materials and compliance with environmental regulations. In assessing our rate case strategy, we consider the amount of utility plant additions and replacements made since the previous rate decision, the changes in the cost of capital, changes in the capital structure and changes in other costs. Based on these assessments, our utility operations periodically file rate increase requests with their respective state regulatory commissions or local regulatory authorities. In general, as a regulated enterprise, our water and wastewater rates are established to provide recovery of utility costs, taxes, interest on debt used to finance facilities and a return on equity used to finance facilities. Our ability to recover our expenses in a timely manner and earn a return on equity employed in the business determines the profitability of the Company.

All of the states in which we acquired operations in 2004 and 2003 permit some form of consolidated rates in varying degrees, but none currently permits us to fully consolidate rate filings state-wide. Between August 2003 and December 2006, we have filed rate filings in over 121 operating divisions. Due to the length of time since the last rate increase for some acquired systems and the large amount of capital improvements relative to the number of customers in some smaller systems, the proposed rate increase in some of these systems may be substantial. While each of these rate filings will proceed through the applicable regulatory process, we can provide no assurance that the rate increases will be granted in a timely or sufficient manner to cover the investments and expenses for which we initially sought the rate increases. Further, there remain 20 divisions within these acquired operations where we have not yet filed a rate request.

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

Effects of Inflation–Recovery of the effects of inflation through higher water rates is dependent upon receiving adequate and timely rate increases. However, rate increases are not retroactive and often lag increases in costs caused by inflation. During periods of moderate inflation, as has been experienced in 2006, the effects of inflation on our operating results are noticeable and partly responsible for lower than expected earnings growth.

Growth-Through-Acquisition Strategy

Part of our strategy to meet the industry challenges is to actively explore opportunities to expand our utility operations through acquisitions of water and wastewater utilities either in areas adjacent to our existing service areas or in new service areas, and to explore acquiring non-regulated businesses that are complementary to our regulated water and wastewater operations. This growth-through-acquisition strategy allows us to operate more efficiently by sharing operating expenses over more utility customers and provides new locations for possible future growth. The ability to successfully execute this strategy and meet the industry challenges is largely due to our qualified and trained workforce, which we strive to retain by treating employees fairly and providing our employees with development and growth opportunities.

During 2006 we completed 28 acquisitions, growing our number of customers served by 62,341 or 7.2%, including the customers acquired with the New York Water Services Corporation acquisition. On January 1, 2007, we completed the acquisition of the capital stock of New York Water Service Corporation for $28,866 in cash, as adjusted pursuant to the purchase agreement primarily based on working capital at closing, and the assumption of $23,460 of long-term debt. The operating results of New York Water Service Corporation will be included in our consolidated financial statements beginning January 1, 2007. The acquired operation provides water service to 44,792 customers in several water systems located in Nassau County, Long Island, New York. The acquisition was funded through the issuance of long-term debt that was issued in 2006.

During 2005 and 2006, we completed six acquisitions of non-regulated companies that provide on-site septic tank pumping, sludge hauling and other wastewater-related services to customers in eastern Pennsylvania, New Jersey, Delaware, New York and Maryland. The operating revenues of these businesses for the year ended December 31, 2006 were $5,424 and are excluded from our Regulated segment. In total during 2006, $7,897 in cash was invested in these non-regulated wastewater and septage acquisitions on which we believe we will earn an appropriate return. Please refer to the section captioned "Acquisitions" for an additional discussion of acquisitions.

We believe that utility acquisitions will continue to be the primary source of growth for us. With approximately 53,000 community water systems in the U.S., 84% of which serve less than 3,300 customers, the water industry is the most fragmented of the major utility industries (telephone, natural gas, electric, water and wastewater). In the states where we operate, we believe there are approximately 22,000 public water systems of widely varying size, with the majority of the population being served by government-owned water systems.

Although not as fragmented as the water industry, the wastewater industry in the U.S. also presents opportunities for consolidation. According to the U.S. Environmental Protection Agency's (EPA) most recent survey of publicly-owned wastewater treatment facilities in 2000, there are approximately 16,000 such facilities in the nation serving approximately 72% of the U.S. population. The remaining population represents individual homeowners with their own treatment facilities; for example, community on-lot disposal systems and septic tank systems. The vast majority of wastewater facilities are government-owned rather than privately-owned. The EPA survey also indicated that there are approximately 6,800 wastewater facilities in operation or planned in the 13 states where we operate. We also intend to explore opportunities in the non-regulated wastewater and septage businesses when they complement our utility companies.

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

- the benefits of economies of scale;
- increasingly stringent environmental regulations;
- the need for capital investment; and
- the need for technological and managerial expertise.

We are actively exploring other opportunities to expand our water and wastewater utility operations through acquisitions or otherwise. We intend to continue to pursue acquisitions of municipally-owned and investor-owned water and wastewater systems of all sizes that provide services in areas adjacent to our existing service territories or in new service areas. We continue to explore opportunities for the acquisition of other non-regulated wastewater service and septage businesses that are located near our existing markets, growing our existing revenue base in this business by offering the wastewater services to nearby residents with on-site sewer systems, adding new customers to this business and expanding the services that are provided to them.

Sendout

"Sendout" represents the quantity of treated water delivered to our distribution systems. We use sendout as an indicator of customer demand. Weather conditions tend to impact water consumption, particularly in our northern service territories during the late spring and summer months when nonessential and recreational use of water is at its highest. Consequently, a higher proportion of annual operating revenues is realized in the second and third quarters. In general during this period, an extended period of dry weather increases water consumption, while above average rainfall decreases water consumption. Also, an increase in the average temperature generally causes an increase in water consumption. Conservation efforts, construction codes which require the use of low flow plumbing fixtures, as well as mandated water use restrictions in response to drought conditions, also affect water consumption.

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

The geographic diversity of our utility customer base helps reduce our exposure to extreme or unusual weather conditions in any one area of our service territory. Our geographic diversity has continued to increase as a result of the Heater and Florida Water acquisitions which closed in mid-year 2004 and the AquaSource acquisition which closed in 2003. During the year ended December 31, 2006, our operating revenues were derived principally from the following states: 55% in Pennsylvania, 9% in Texas, 7% in Ohio, 7% in Illinois, and 6% in North Carolina.

Consolidated Selected Financial and Operating Statistics

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

Years ended December 31,	2006 (a)	2005	2004 (b)	2003 (c)	2002 (d)
Utility customers:					
Residential water	780,828	724,954	702,367	624,355	535,506
Commercial water	36,280	33,975	33,720	33,015	30,355
Industrial water	1,337	1,356	1,365	1,397	1,423
Other water	15,587	15,584	15,700	20,483	16,466
Wastewater	93,203	89,025	82,360	70,241	21,724
Total	927,235	864,894	835,512	749,491	605,474
Operating revenues:					
Residential water	$ 317,770	$ 295,473	$ 264,910	$ 218,487	$ 197,190
Commercial water	76,076	73,455	65,605	61,343	55,962
Industrial water	18,752	18,364	17,377	17,675	17,221
Other water	51,263	50,827	44,593	40,048	36,255
Wastewater	48,907	42,176	35,931	17,874	8,210
Other	13,525	13,161	11,556	9,821	5,861
Regulated segment total	526,293	493,456	439,972	365,248	320,699
Other	7,198	3,323	2,067	1,985	1,329
Consolidated	$ 533,491	$ 496,779	$ 442,039	$ 367,233	$ 322,028
Operations and maintenance expense	$ 219,560	$ 203,088	$ 178,345	$ 140,602	$ 117,735
Net income available to common stock	$ 92,004	$ 91,156	$ 80,007	$ 70,785	$ 67,154
Capital expenditures	$ 271,706	$ 237,462	$ 195,736	$ 163,320	$ 136,164
Operating Statistics					
Selected operating results as a percentage of operating revenues:					
Operations and maintenance	41.2%	40.9%	40.3%	38.3%	36.6%
Depreciation and amortization	14.1%	13.2%	13.3%	14.0%	13.8%
Taxes other than income taxes	6.2%	6.4%	6.2%	5.9%	6.0%
Interest expense, net	10.9%	10.4%	11.0%	12.2%	12.5%
Net income available to common stock	17.2%	18.3%	18.1%	19.3%	20.9%
Return on average stockholders' equity	10.6%	11.7%	11.4%	12.3%	13.9%
Effective tax rates	39.6%	38.4%	39.4%	39.3%	38.5%

(a) 2006 includes 44,792 customers associated with the New York Water Service Corporation acquisition which was completed on January 1, 2007. The operating results of this acquisition will be reported in our consolidated financial statements beginning January 1, 2007.

(b) Net income available to common stock includes the gain of $1,522 ($2,342 pre-tax) realized on the sale of our Geneva, Ohio water system. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. 2004 includes a partial year of financial results for the mid-year acquisition of Heater Utilities, Inc. and certain utility assets of Florida Water Services Corporation.

(c) 2003 includes five months of financial results for the AquaSource operations acquired in July 2003.

(d) Net income available to common stock and net income includes the gain of $3,690 ($5,676 pre-tax) realized on the sale of a portion of our Ashtabula, Ohio water system.

Performance Measures Considered by Management

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

Our operating expense ratio is one measure that we use to evaluate our operating efficiency and management effectiveness in light of the changing nature of our company. During the past five years, our operating expense ratio has been effected over time due to a number of factors, including the following:

- ***Acquisitions***–The AquaSource, Heater Utilities, Inc. and Florida Water Services acquisitions increased our operating expense ratio due to the operating revenues generated by these operations being accompanied by a higher ratio of operations and maintenance expenses as compared to the rest of the pre-existing, more densely-populated and integrated Aqua America operations. The Aqua South operations can be characterized as having relatively higher fixed operating costs, in contrast to the rest of the Aqua America operations which generally consist of larger, interconnected systems, with higher fixed capital costs (utility plant investment) and lower operating costs per customer. In addition, we completed several acquisitions of companies that provide on-site septic tank pumping and sludge hauling services during 2006. The cost-structure of these businesses differs from our utility companies in that these businesses have a higher ratio of operations and maintenance expenses to operating revenues and a lower-degree of capital investment and consequently a lower ratio of fixed capital costs (plant investment requirements are lower) versus operating revenues. As a result, the ratio of operating income compared to operating revenues is comparable between the businesses. The non-regulated wastewater and septage hauling service business is not a component of our Regulated segment.
- ***Regulatory lag***–The efficiency ratio is influenced by regulatory lag, i.e., increases in operations and maintenance expenses without an immediate corresponding increase in operating revenues, decreases in operating revenues without a commensurate decrease in operations and maintenance expense, such as changes in water consumption as impacted by weather conditions, or a gap between the time that a capital project is completed and the recovery of its costs in rates.
- ***New accounting pronouncements***–Our 2006 results reflect the effects of the adoption of SFAS No. 123R, "Share-Based Payment." As required, we began to record compensation expense for the fair value of stock options granted and the adoption of this accounting standard increased our 2006 operations and maintenance expense by $2,894. Prior to 2006, no compensation expense related to granting of stock options had been recognized in the financial statements.

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

RESULTS OF OPERATIONS

Our net income has grown at an annual compound rate of approximately 8.9% during the five-year period ended December 31, 2006. During the past five years, operating revenues grew at a compound rate of 11.7% and total expenses, exclusive of income taxes, grew at a compound rate of 12.9%.

Operating Segments

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

- Thirteen segments are comprised of our water and wastewater regulated utility operations in the thirteen states where we provide these services. These operating segments are aggregated into one reportable segment since each of these operating segments has the following similarities: economic characteristics, nature of services, production processes, customers, water distribution or wastewater collection methods, and the nature of the regulatory environment. Our single reportable segment is named the Regulated segment.
- One segment is not quantitatively significant to be reportable and is comprised of the businesses that provide on-site septic tank pumping, sludge hauling services, data processing service fees and certain other non-regulated water and wastewater services. This segment is included as a component of "other," in addition to corporate costs that have not been allocated to the Regulated segment and intersegment eliminations. Corporate costs include certain general and

administrative expenses, and interest expense for certain of our utility companies that do not have their own credit facilities.

Prior to the acquisition in 2006 of companies that provide on-site septic tank pumping and sludge hauling services, our non-regulated operations were limited in scope and impact on our financial results. As a result we previously operated them as part of our regulated operating segments. We made this determination based on an evaluation of our operating segments during the fourth quarter of 2006. Unless specifically noted, the following discussion and analysis provides information on our consolidated result of operations. The following table provides the Regulated segment and Consolidated information for the years ended December 31, 2006, 2005 and 2004:

	2006			2005		
	Regulated	Other	Consolidated	Regulated	Other	Consolidated
Operating revenues	$ 526,293	$ 7,198	$ 533,491	$ 493,456	$ 3,323	$ 496,779
Operations and maintenance expense	216,919	2,641	219,560	202,662	426	203,088
Taxes other than income taxes	32,273	1,070	33,343	30,820	876	31,696
Earnings before interest, taxes, depreciation and amortization	$ 277,101	$ 3,487	280,588	$ 259,974	$ 2,021	261,995
Depreciation and amortization			75,041			65,488
Operating income			205,547			196,507
Interest expense, net of AFUDC			54,491			49,615
Gain on sale of other assets			(1,194)			(1,177)
Provision for income taxes			60,246			56,913
Net income			$ 92,004			$ 91,156

	2004		
	Regulated	Other	Consolidated
Operating revenues	$ 439,972	$ 2,067	$ 442,039
Operations and maintenance expense	179,332	(987)	178,345
Taxes other than income taxes	26,963	633	27,596
Earnings before interest, taxes, depreciation and amortization	$ 233,677	$ 2,421	236,098
Depreciation and amortization			58,864
Operating income			177,234
Interest expense, net of AFUDC			46,375
Gain on sale of other assets			(1,272)
Provision for income taxes			52,124
Net income			$ 80,007

Consolidated Results

Operating Revenues–The growth in revenues over the past five years is a result of increases in the customer base, water rates and the acquisition of non-regulated operations. The number of customers increased at an annual compound rate of 9.6% in the past five years primarily as a result of acquisitions of water and wastewater systems, including the January 1, 2007 acquisition of New York Water Service Corporation, the mid-year 2004 Heater and Florida Water Services acquisitions, and the AquaSource acquisition completed July 2003. The operating revenues and financial results of New York Water Service Corporation will be included in our consolidated financial statements beginning January 1, 2007. Acquisitions in our Regulated segment have provided additional water and wastewater revenues of approximately $4,715 in 2006, $12,630 in 2005 and $54,900 in 2004. Excluding the effect of acquisitions, our customer base increased at a five-year annual compound rate of 1.8%. Rate increases implemented during the past three years have provided additional operating revenues of approximately $32,000 in 2006, $26,800 in 2005 and $15,800 in 2004.

On June 22, 2006, the Pennsylvania Public Utility Commission (PAPUC) granted our Pennsylvania operating subsidiary a $24,900 base water rate increase, on an annualized basis. The rates in effect at the time of the filing included $12,397 in

Distribution System Improvement Charges ("DSIC") or 5% above the prior base rates. Consequently, the total base rates increased by $37,297 and the DSIC was reset to zero.

On August 5, 2004, the PAPUC granted our Pennsylvania operating subsidiary a $13,800 base rate increase. The rates in effect at the time of the filing included $11,200 in DSIC or 5.0% above the prior base rates. Consequently, the total base rates increased by $25,000 and the DSIC was reset to zero.

In May 2004, our operating subsidiary in Texas filed an application with the Texas Commission on Environmental Quality (TCEQ) to increase rates, on an annualized basis, 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 our 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 TCEQ and several parties have joined the proceeding to challenge our rate request. We commenced billing for the requested rates and implemented the deferral plan in August 2004, in accordance with authorization from the TCEQ in July 2004. The additional revenue billed and collected prior to the final ruling is subject to refund based on the outcome of the ruling. The revenue recognized and the expenses deferred by us reflect an estimate of the final outcome of the ruling. 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. In December 2006, the TCEQ held hearings and issued a rate schedule that provided further clarification and an indication of the expected outcome of the rate proceeding. Based on our review of the present circumstances and as a result of the December 2006 hearings, we have revised our estimate of the final outcome of the TCEQ proceeding. During the fourth quarter of 2006, the revenue reserve was adjusted and additional revenues were recognized of $1,487 and the regulatory asset was increased resulting in lower expenses recognized of $1,199. As of December 31, 2006, we have deferred $12,382 of operating costs and $2,804 of rate case expenses; and recognized $14,859 of revenue that is subject to refund depending on the outcome of the final commission order.

Our operating subsidiaries located in other states received rate increases representing estimated annualized revenues of $7,366 in 2006 resulting from 32 rate decisions, $5,142 in 2005 resulting from 23 decisions, and $6,673 in 2004 resulting from 14 rate decisions. Revenues from these increases realized in the year of grant were approximately $3,580 in 2006, $3,144 in 2005 and $3,995 in 2004. These operating subsidiaries currently have filed 96 rate requests which are being reviewed by the state regulatory commissions, proposing an aggregate increase of $9,831 in annual revenues. During 2007, we intend to file 27 additional rate requests proposing an aggregate of approximately $26,300 of increased annual revenues; however we can provide no assurance that the full amount of the requested rate increases will be granted.

Currently, Pennsylvania, Illinois, Ohio, New York, Indiana and Missouri allow for the use of infrastructure rehabilitation surcharges. In Pennsylvania, this mechanism is referred to as a DSIC. These surcharge mechanisms typically adjust periodically based on additional qualified capital expenditures completed or anticipated in a future period. The infrastructure rehabilitation surcharge is capped as a percentage of base rates, generally at 5% to 9% of base rates, and is reset to zero when new base rates that reflect the costs of those additions become effective or when a utility's earnings exceed a regulatory benchmark. Infrastructure rehabilitation surcharges provided revenues of $7,873 in 2006, $10,186 in 2005 and $7,817 in 2004.

Our Regulated segment also includes certain non-regulated operating revenues of $13,525 in 2006, $13,161 in 2005 and $11,556 in 2004. These operating revenues are associated with contract operations that are integral to the utility business and operations. These amounts vary over time according to the level of activity associated with the utility contract operations.

In addition to the Regulated segment operating revenues, we had other non-regulated revenues that were primarily associated with non-regulated wastewater, septage, operating and maintenance contracts, and data processing service fees of $7,198 in 2006, $3,323 in 2005 and $2,067 in 2004. The increase in 2006 over 2005 was primarily due to the acquisition of several septage businesses during 2006. The increase in 2005 over 2004 resulted primarily from the additional revenues associated with the acquisition of an on-site septic tank pumping business, and increased revenues resulting from new and expanded contract operations. Acquisitions outside our Regulated segment have provided additional operating revenues of approximately $3,935 in 2006, $1,082 in 2005, and no additional operating revenues in 2004.

Operations and Maintenance Expenses–Operations and maintenance expenses totaled $219,560 in 2006, $203,088 in 2005 and $178,345 in 2004. Most elements of operating costs are subject to the effects of inflation, and changes in the number of customers served. Several elements are subject to the effects of changes in water consumption, weather and the degree of water treatment required due to variations in the quality of the raw water. The principal elements of operating costs are labor

and employee benefits, electricity, chemicals, maintenance expenses and insurance costs. Electricity and chemical expenses vary in relationship to water consumption, raw water quality, and to a lesser extent the competitive electric market in some of the states in which we operate. Maintenance expenses are sensitive to extremely cold weather, which can cause water mains to rupture. Operations and maintenance expenses increased in 2006 as compared to 2005 by $16,472 or 8.1% primarily due to the additional operating costs associated with acquisitions of $6,316, increased water production expenses of $3,576, increased insurance expense, driven by higher claims of $1,945, stock-based compensation expense of $2,894, a reduction in the deferral of expenses related to the Texas rate case filing of $1,989, and normal increases in other operating costs, offset partially by receipt of $1,500 relating to a waiver of certain contractual rights reported outside of the Regulated segment. The additional operating costs associated with acquisitions noted above includes $3,760 associated with the businesses that provide on-site septic tank pumping, sludge hauling services and other non-regulated water and wastewater services which are not a component of the Regulated segment.

Operations and maintenance expenses increased in 2005 as compared to 2004 by $24,743 or 13.9% primarily due to the additional operating costs associated with acquisitions of $9,574, additional water production expenses of $3,856, increased postretirement benefit costs of $2,430, higher insurance costs due to the absence in 2005 of the favorable claim settlements that had occurred in 2004 of $2,142, and the effect of the $2,342 gain on the sale of the Geneva water system which was recorded as a component of operations and maintenance expense in 2004. In the consolidated statement of income for 2004, the gain on the sale of the Geneva water system is reported as a component of the line titled operations and maintenance expense.

Depreciation and Amortization Expenses–Depreciation expense was $70,895 in 2006, $60,747 in 2005 and $54,564 in 2004, and has increased principally as a result of the significant capital expenditures made to expand and improve our utility facilities, and as a result of acquisitions of water and wastewater systems.

Amortization expense was $4,146 in 2006, $4,741 in 2005 and $4,300 in 2004. The decrease in 2006 and the increase in 2005 is due to the amortization of the costs associated with, and other costs being recovered in, various rate filings. Expenses associated with filing rate cases are deferred and amortized over periods that generally range from one to three years.

Taxes Other than Income Taxes–Taxes other than income taxes increased by $1,647 or 5.2% in 2006 as compared to 2005 and $4,100 or 14.9% in 2005 as compared to 2004. The increase in 2006 is due to additional state and local taxes, primarily property taxes. The increase in 2005 is due to additional taxes associated with acquisitions and increases in state and local taxes. The other taxes associated with acquisitions resulted from the effect of the mid-year 2004 acquisitions of Heater Utilities and the systems of Florida Water.

Interest Expense, net–Net interest expense was $58,432 in 2006, $52,062 in 2005 and $48,679 in 2004. Interest income of $3,241 in 2006, $3,040 in 2005 and $1,762 in 2004 was netted against interest expense. Interest expense increased in 2006 primarily due to additional borrowings to finance capital projects and acquisitions, and increased interest rates on short-term borrowings. Interest expense increased in 2005 primarily as a result of higher levels of borrowings, offset partially by the effects of decreased interest rates on borrowings. The higher level of average borrowings in 2005 was used to finance the Heater and Florida Water acquisitions in mid-year 2004, and capital expenditures. Interest income decreased in 2006 due to a reduction in investment income earned in 2006 as compared to 2005. Interest income increased in 2005 due to additional investment income earned in 2005 on the proceeds from the issuance of tax-exempt bonds while being held by trustees pending completion of projects financed with the issues. Such interest income is capitalized through our allowance for funds used during construction, a reduction to net interest expense. Interest expense on long-term debt during 2006 and 2005 was favorably impacted by a reduction in the weighted cost of long-term debt from 6.00% at December 31, 2004, to 5.74% at December 31, 2005, and to 5.72% at December 31, 2006.

Allowance for Funds Used During Construction–The allowance for funds used during construction (AFUDC) was $3,941 in 2006, $2,447 in 2005 and $2,304 in 2004 and has varied over the years as a result of changes in the average balance of utility plant construction work in progress (CWIP), to which AFUDC is applied, and to changes in the AFUDC rate. The increase in 2006 is due to an increase in the average balance of CWIP to which AFUDC is applied and an increase in the AFUDC rate which is based on short-term interest rates. The increase in 2005 is due to an increase in the average balance of CWIP to which AFUDC is applied, and additional AFUDC recorded as an adjustment in 2005 of $719 resulting from the identification of a previously issued rate order which allowed the continuation of AFUDC on certain capital projects subsequent to being placed into utility service. This post-in-service AFUDC was not recognized in prior periods. These variances were partially offset by investment income earned during 2005, which reduced AFUDC.

Gain on Sale of Other Assets–Gain on sale of other assets totaled $1,194 in 2006, $1,177 in 2005 and $1,272 in 2004 and consisted of gains on land and marketable securities sales. Gain on sale of land totaled $1,194 in 2006, $1,177 in 2005 and $869 in 2004. Gain on sale of marketable securities totaled $403 in 2004.

Income Taxes–Our effective income tax rate was 39.6% in 2006, 38.4% in 2005 and 39.4% in 2004. The change in the effective tax rate in 2006 was due to an increase in our expenses that are not tax-deductible, including a portion of the stock-based compensation expense. The change in the effective tax rates in 2005 is due to differences between tax deductible expenses and book expenses and the recognition of the American Jobs Creation Act tax deduction for qualified domestic production activities that reduced our tax provision by approximately $740.

Summary–Operating income was $205,547 in 2006, $196,507 in 2005 and $177,234 in 2004 and net income was $92,004 in 2006, $91,156 in 2005 and $80,007 in 2004. Diluted income per share was $0.70 in 2006, $0.71 in 2005 and $0.64 in 2004. The changes in the per share income in 2006 and 2005 over the previous years were due to the aforementioned changes in income and impacted by a 2.0% increase in the average number of common shares outstanding during 2006 and a 2.8% increase in the average number of common shares outstanding during 2005, respectively. The increase in the number of shares outstanding in 2006 is primarily a result of the additional shares issued in common share offerings and additional shares issued through our dividend reinvestment plan. The increase in the number of shares outstanding in 2005 is primarily a result of the additional shares issued through our dividend reinvestment plan, employee stock purchase plan and equity compensation plan.

Although we have experienced increased income in the recent past, continued adequate rate increases reflecting increased operating costs and new capital investments are important to the future realization of improved profitability.

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

	Three Months Ended December 31,	
	2006	2005
Operating revenues	$ 136,843	$ 122,908
Operations and maintenance	53,684	52,222
Depreciation and amortization	19,494	16,971
Taxes other than income taxes	8,352	7,663
	81,530	76,856
Operating income	55,313	46,052
Interest expense, net	14,764	13,447
Allowance for funds used during construction	(1,040)	(950)
Gain on sale of other assets	(360)	(595)
Income before income taxes	41,949	34,150
Provision for income taxes	16,226	12,000
Net income	$ 25,723	$ 22,150

The increase in operating revenues was a result of additional revenues of $13,800 resulting from an increase in water and wastewater rates implemented in various operating subsidiaries, including operating revenues of $1,487 recognized during the fourth quarter of 2006 from our revised estimate of the final outcome of the Texas rate proceeding as described in the section named "Operating Revenues." In addition, operating revenues increased due to additional revenues associated with acquisitions of $3,529, offset partially by lower infrastructure rehabilitation surcharge revenue of $2,170. The higher operations and maintenance expense is due primarily to $3,067 of additional operating costs associated with acquisitions, and higher water production costs of $449, offset partially by $1,199 of additional expenses deferred during the fourth quarter of 2006 resulting from an increase in the regulatory asset associated with the Texas rate case proceeding, and lower insurance expense of $781 due to a reduction in claims. The increased depreciation expense reflects the utility plant placed in service since the fourth quarter of 2005. Other taxes increased due to higher property taxes and additional local taxes incurred in the fourth quarter of 2006. The increased interest expense is due to additional borrowings to finance capital projects and increased interest rates on short-term borrowings.

FINANCIAL CONDITION

Consolidated Cash Flow and Capital Expenditures

Net operating cash flow, dividends paid on common stock, capital expenditures, including allowances for funds used during construction, and expenditures for acquiring water and wastewater systems for the five years ended December 31, 2006 were as follows:

	Net Operating Cash Flow	Common Dividends	Capital Expenditures	Acquisitions
2002	$ 121,560	$ 36,789	$ 136,164	$ 8,914
2003	143,373	39,917	163,320	192,331
2004	173,603	45,807	195,736	54,300
2005	199,674	51,139	237,462	11,633
2006	170,726	58,023	271,706	11,848
	$ 808,936	$ 231,675	$ 1,004,388	$ 279,026

Included in capital expenditures for the five-year period are: expenditures for the modernization and replacement of existing treatment plants, new water mains and customer service lines, rehabilitation of existing water mains and hydrants, water meters and an office building expansion. During this five-year period, we received $59,475 of customer advances and contributions in aid of construction to finance new water mains and related facilities which are not included in the capital expenditures presented in the above table. In addition, during this period, we have made sinking fund contributions and repaid debt in the amount of $251,639, retired $1,116 of preferred stock, and have refunded $24,217 of customer advances for construction. Common dividends increased during the past five years as a result of an annual increase in the common dividends declared and paid and an increase in the number of shares outstanding during the period.

Our planned 2007 capital program, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to be $235,800 of which $80,308 is for infrastructure rehabilitation surcharge-qualified projects. Our planned capital program includes spending for infrastructure rehabilitation in response to the infrastructure rehabilitation surcharge mechanisms, and should these mechanisms be discontinued for any reason, which is not anticipated, we would re-evaluate the magnitude of our capital program. Our 2007 capital program, along with $31,155 of sinking fund obligations and debt maturities, $28,866 for the acquisition of New York Water Service Corporation and $103,482 of other contractual cash obligations, as reported in the section captioned "Contractual Obligations", has been or is expected to be financed through internally-generated funds, our revolving credit facilities, the issuance of equity through public offerings or through settlement in common shares of the forward equity sale agreement, and the issuance of long-term debt. The New York Water Service Corporation, which was acquired in January 2007, was financed through the issuance of unsecured long-term notes that were issued in December 2006.

Future utility construction in the period 2008 through 2011, including recurring programs, such as the ongoing replacement of water meters, water treatment plant upgrades, storage facility renovations, the rehabilitation of water mains and additional transmission mains to meet customer demands, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to require aggregate expenditures of approximately $1,000,000. We anticipate that approximately one-half of these expenditures will require external financing of debt and the additional issuance of common stock through our dividend reinvestment and stock purchase plans and the issuance of equity through public offerings or through settlement in common shares of the forward equity sale agreement. We expect to refinance $112,155 of sinking fund obligations and debt maturities during this period as they become due with new issues of long-term debt. The estimates discussed above do not include any amounts for possible future acquisitions of water systems or the financing necessary to support them.

Our primary source of liquidity is cash flows from operations, borrowings under various short-term lines of credit and other credit facilities, and customer advances and contributions in aid of construction. Our cash flow from operations, or internally-generated funds, is impacted by the timing of rate relief and water consumption. We fund our capital and acquisition programs

through internally-generated funds, supplemented by short-term borrowings. Over time, we refinance our short-term borrowings with long-term debt and proceeds from the issuance of common stock. The ability to finance our future construction programs, as well as our acquisition activities, depends on our ability to attract the necessary external financing and maintain internally-generated funds. Rate orders permitting compensatory rates of return on invested capital and timely rate adjustments will be required by our operating subsidiaries to achieve an adequate level of earnings and cash flow to enable them to secure the capital they will need to operate and to maintain satisfactory debt coverage ratios.

Acquisitions

During the past five years, we have expended cash of $279,026 and issued 263,169 shares of common stock, valued at $3,420 at the time of the acquisition, related to the acquisition of utility systems, both water and wastewater utilities, and non-regulated businesses that provide wastewater and septage hauling services. We included the operating results of these acquisitions in our consolidated financial statements beginning on the respective acquisition date.

On January 1, 2007 we completed the acquisition of the capital stock of New York Water Service Corporation for $28,866 in cash, as adjusted pursuant to the purchase agreement primarily based on working capital at closing, and the assumption of $23,460 of long-term debt. The operating results of New York Water Service Corporation will be included in our consolidated financial statements beginning January 1, 2007. The acquired operation provides water service to 44,792 customers in several water systems located in Nassau County, Long Island, New York. For the fiscal year ended December 31, 2005, New York Water Service had operating revenues of $21,773. The acquisition will be accounted for as a purchase and will be recorded in the first quarter of 2007. The acquisition was funded through the issuance of long-term debt that was issued in 2006.

In addition during 2006, we completed 27 acquisitions for $11,848 in cash. The acquisitions completed in 2006 included both water and wastewater systems in seven of the states in which we operate, and the acquisition of several non-regulated companies that provide on-site septic tank pumping, sludge hauling services and other wastewater services to customers in eastern Pennsylvania, New Jersey, Delaware, New York and Maryland.

During 2005, we completed 30 acquisitions for $11,633 in cash and the issuance of 24,684 shares of common stock. The acquisitions completed in 2005 included both water and wastewater systems in seven of the states in which we operate. On June 1, 2004, we acquired the capital stock of Heater Utilities, Inc. for $48,000 in cash and the assumption of long-term debt of $19,219 and short-term debt of $8,500. At the date of the acquisition, Heater provided water and wastewater service to over 50,000 water and wastewater customers primarily in the areas of suburban Raleigh, Charlotte, Gastonia and Fayetteville, North Carolina. The acquisition was accounted for as a purchase and accordingly, we recorded goodwill of $18,842. As part of the North Carolina Utilities Commission approval process for this acquisition, the Commission approved a mechanism through which we could recover up to two-thirds of the goodwill through customer rates in the future upon achieving certain objectives. We are pursuing these objectives to facilitate recognition of this premium in customer rates. However, there can be no assurance that we will be able to achieve these objectives and recover such amount of goodwill.

On June 30, 2004, we acquired certain utility assets of Florida Water Services Corporation, comprised of 63 water and wastewater systems located in central Florida for $13,090 in cash, the final purchase price as adjusted pursuant to the purchase agreement. In accordance with Florida Public Service Commission procedures, the acquisition was approved by the Commission and rate base was determined on December 20, 2005. Under the terms of the purchase agreement, the Commission's rate base determination resulted in the final purchase price which did not result in the recognition of goodwill.

The acquisitions of Heater and the Florida Water Systems were initially funded by a portion of the proceeds from the issuance by Aqua America of an unsecured short-term note which was subsequently repaid by Aqua America with the proceeds from the February 2005 issuance of $30,000 of unsecured notes and the issuance of 2,606,667 shares of common stock in a secondary equity offering for proceeds of $42,600, net of expenses. In February 2005, Aqua America issued $18,000 of notes due in 2015 with an interest rate of 5.01% and $12,000 of notes due in 2020 with an interest rate of 5.20%.

In 2003, we completed the acquisition of four operating water and wastewater subsidiaries of AquaSource, Inc., a subsidiary of DQE, Inc., including selected, integrated operating and maintenance contracts and related assets (individually and collectively the acquisition is referred to as "AquaSource") for $190,717 in cash, as adjusted pursuant to the purchase agreement based on working capital at closing. In 2004, we were awarded and received $12,289 plus interest in an arbitration related to the calculation of the final purchase price under the terms of the purchase agreement, which resulted in a final purchase price of $178,428. In the consolidated statement of cash flow for 2004, the $12,289 award has been reported as proceeds on the line titled acquisitions of utility systems and other, net. The acquisition was funded by a portion of the proceeds from the 2003

issuance of $135,000 of unsecured notes due in 2023, with an interest rate of 4.87%, and the issuance of 6,666,667 shares of common stock through a shelf registration. The acquired operations of AquaSource serve over 130,000 water and wastewater customer accounts in 11 states (including the Connecticut and Kentucky operations which were subsequently sold to other parties). Please refer to the section captioned "Dispositions" for a discussion of the disposition of the AquaSource operations located in Connecticut and Kentucky. The acquisition provides an expanded platform from which to extend our growth-through-acquisition strategy of acquiring water and wastewater systems that are near or adjacent to our existing service territories. The AquaSource operations are comprised of approximately 600 small systems, which are generally clustered in regions to achieve some level of operating efficiency.

We continue to hold acquisition discussions with several water and wastewater systems. Generally acquisitions are expected to be financed through the issuance of equity (for the acquisition of some investor-owned systems) or funded initially with short-term debt with subsequent repayment from the proceeds of long-term debt or proceeds from equity offerings.

Dispositions

In 2004, as a result of the settlement of a condemnation action, our Ohio operating subsidiary sold its water utility assets within the municipal boundaries of the City of Geneva in Ashtabula County, Ohio for net proceeds of approximately $4,716, which was in excess of the book value for these assets. The proceeds were used to pay-down short-term debt and the sale resulted in the recognition in 2004 of a gain on the sale of these assets, net of expenses, of $2,342. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. We continue to operate this water system for the City of Geneva under a multi-year operating contract that expires in December 2008. These water utility assets represented less than 1% of Aqua America's total assets, and the total number of customers included in the water system sold represented less than 1% of our total utility customer base.

We reviewed and evaluated areas of our business and operating divisions that were acquired in 2003 with the AquaSource operations and have completed the following sale transactions of operating divisions acquired as part of the AquaSource transaction:

- In 2004, we sold our only operation in Kentucky. The sale price approximated our investment in this operation. The operation represented approximately 0.2% of the operations acquired from AquaSource, Inc.
- In 2003, we completed the sale of our only operation in Connecticut. The sale price of $4,000 approximated our investment in this operation. The operation represented approximately 2% of the operations acquired from AquaSource, Inc.

In 2002, as a result of the settlement of a condemnation action, our Ohio operating subsidiary sold to Ashtabula County, Ohio the water utility assets in the unincorporated areas of Ashtabula County and the area within the Village of Geneva on the Lake for net proceeds of $12,118, which was in excess of the book value for these assets. The proceeds were used to pay down short-term debt, and the sale resulted in the recognition in 2002 of a gain on the sale of these assets, net of expenses, of $5,676. We continue to operate this water system for Ashtabula County under a multi-year operating contract that expires in December 2008. The water utility assets sold represented less than 1% of our total assets, and the total number of customers included in the water system sold represented less than 1% of our total customer base.

The City of Fort Wayne, Indiana has authorized the acquisition, by eminent domain or otherwise, of a portion of the utility assets of one of the operating subsidiaries that we acquired in connection with the AquaSource acquisition. We have challenged whether the City is following the correct legal procedures in connection with the City's attempted condemnation and we have challenged the City's valuation of this portion of our system. The portion of the system under consideration represents approximately 1% of our total utility customer base. While we continue to discuss this matter with officials from the City of Fort Wayne, we continue to protect our legal interests in this proceeding. A sanitary district in Illinois and a city in Texas have also indicated interest in acquisition, by eminent domain or otherwise, of all or a portion of the utility assets of two of our operations. The systems represent approximately 3,000 customers or less than 0.5% of our total utility customer base. We believe that we will be entitled to fair market value for our assets if they are condemned, and that the fair market value will be in excess of the book value for such assets.

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

Sources of Capital

Since net operating cash flow plus advances and contributions in aid of construction have not been sufficient to fully fund cash requirements, we issued approximately $697,379 of long-term debt and obtained other short-term borrowings during the past five years. During the past five years, the Trustees released an aggregate $8,277 of the proceeds from certain long-term debt issuances in accordance with when the projects financed with the issues were completed. At December 31, 2006, we had short-term lines of credit and other credit facilities of $238,000, of which $118,850 was available. Our short-term lines of credit and other credit facilities are either payable on demand or have a 364-day term.

In December 2005, we filed a universal shelf registration with the SEC to allow for the potential future sale by us, from time to time, in one or more public offerings, of an indeterminant amount of our common stock, preferred stock, debt securities and other securities specified therein at indeterminant prices.

In August 2006, we entered into a forward equity sale agreement for 3,525,000 shares of common stock with a third party ("forward purchaser"). In connection with the forward equity sale agreement, the forward purchaser borrowed an equal number of shares of our common stock from stock lenders and sold the borrowed shares to the public. We will not receive any proceeds from the sale of our common stock by the forward purchaser until settlement of all or a portion of the forward equity sale agreement. The actual proceeds to be received by us will vary depending upon the settlement date, the number of shares designated for settlement on that settlement date and the method of settlement. We intend to use any proceeds received by us upon settlement of the forward equity sale agreement to fund our future capital expenditure program and acquisitions, and for working capital and other general corporate purposes. During the last three years, we completed the following offerings of equity:

- In June 2006, we sold 1,750,000 shares of common stock in a public offering for proceeds of $37,400, net of expenses. In August 2006, we sold 500,000 shares of common stock in a public offering for proceeds of $10,700, net of expenses. The net proceeds from these offerings were used to fund our capital expenditure program and acquisitions, and for working capital and other general corporate purposes.
- In November 2004, we sold 2,606,667 shares of common stock in a public offering for proceeds of $42,600, net of expenses. The net proceeds were used to repay a portion of our short-term debt. The short-term debt was incurred by Aqua America in connection with the Heater and Florida Water acquisitions.

In addition, we have a shelf registration statement filed with the SEC to permit the offering from time to time of shares of common stock and shares of preferred stock in connection with acquisitions. During 2006, 2004 and 2003, we did not issue any shares under the acquisition shelf registration. During 2005, we issued 24,684 shares of common stock totaling $675 to acquire a water system. During 2002, we issued 238,219 shares of common stock totaling $2,745 to acquire water and wastewater systems. The balance remaining available for use under the acquisition shelf registration as of December 31, 2006 is 2,194,262 shares. We will determine the form and terms of any securities issued under these shelf registrations at the time of issuance.

We offer a Dividend Reinvestment and Direct Stock Purchase Plan (Plan) that provides a convenient and economical way to purchase shares of Aqua America, Inc. Under the direct stock purchase portion of the Plan, shares are sold throughout the year. The dividend reinvestment portion of the Plan offers a 5% discount on the purchase of shares of common stock with reinvested dividends. As of the December 2006 dividend payment, holders of 16.1% of the common shares outstanding participated in the dividend reinvestment portion of the Plan. The shares issued under the Plan are either original issue shares or shares purchased by the Company's transfer agent in the open-market. During the past five years, we have sold 2,382,804 original issue shares of common stock for net proceeds of $39,072 through the dividend reinvestment portion of the Plan and we used the proceeds to invest in our operating subsidiaries, to repay short-term debt, and for general corporate purposes.

The Board of Directors has authorized us to purchase our common stock, from time to time, in the open market or through privately negotiated transactions. We have not purchased any shares under this authorization since 2000. As of December 31, 2006, 548,278 shares remain available for repurchase. Funding for future stock purchases, if any, is not expected to have a material impact on our financial position.

Off-Balance Sheet Financing Arrangements

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

Contractual Obligations

The following table summarizes our contractual cash obligations as of December 31, 2006:

	Payments Due By Period						
	2007	2008	2009	2010	2011	Thereafter	Total
Long-term debt (a)	$ 31,155	$ 23,961	$ 7,004	$ 54,192	$ 26,998	$ 839,505	$ 982,815
Interest on fixed-rate, long-term debt (b)	56,066	53,369	52,690	50,037	46,880	588,756	847,798
Operating leases (c)	4,007	3,659	2,148	1,092	694	17,136	28,736
Unconditional purchase obligations (d)	10,764	10,333	10,008	9,582	9,774	59,091	109,552
Other purchase obligations (e)	20,614	-	-	-	-	-	20,614
Postretirement benefit plans' obligations (f)	10,260	-	-	-	-	-	10,260
Other obligations (g)	1,771	200	190	-	-	3,000	5,161
Total	$ 134,637	$ 91,522	$ 72,040	$ 114,903	$ 84,346	$ 1,507,488	$2,004,936

(a) Represents sinking fund obligations and debt maturities.
(b) Represents interest payable on fixed-rate, long-term debt. Amounts reported may differ from actual due to future refinancing of debt.
(c) Represents operating leases that are noncancelable, before expiration, for the lease of motor vehicles, buildings, land and other equipment.
(d) Represents our commitment to purchase minimum quantities of water as stipulated in agreements with other water purveyors. We use purchased water to supplement our water supply, particularly during periods of peak customer demand. Our actual purchases may exceed the minimum required levels.
(e) Represents an approximation of the open purchase orders as of the period end for goods and services purchased in the ordinary course of business.
(f) Represents contributions expected to be made to postretirement benefit plans. The amount of required contributions in 2008 and thereafter is not determinable.
(g) Represents capital expenditures estimated to be required under legal and binding contractual obligations.

In addition to these obligations, we pay refunds on Customers' Advances for Construction over a specific period of time based on operating revenues related to developer-installed water mains or as new customers are connected to and take service from such mains. After all refunds are paid, any remaining balance is transferred to Contributions in Aid of Construction. The refund amounts are not included in the above table because the refund amounts and timing are dependent upon several variables, including new customer connections, customer consumption levels and future rate increases, which cannot be accurately estimated. Portions of these refund amounts are payable annually through 2021 and amounts not paid by the contract expiration dates become non-refundable.

We will fund these contractual obligations with cash flows from operations and liquidity sources held by or available to us. On January 1, 2007, we completed the acquisition of New York Water Service Corporation for $28,866 in cash and the assumption of $23,460 of long-term debt. The acquisition was funded through the issuance of long-term debt that was issued in 2006 and included in the table above.

Market Risk

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. The exposure to changes in interest rates is a result of financings through the issuance of fixed-rate, long-term debt. Such exposure is typically related to financings between utility rate increases, because generally our rate increases provide a revenue level to allow recovery of our current cost of capital. Interest rate risk is managed through the use of a combination of long-term debt, which is at fixed interest rates and short-term debt, which is at floating interest rates. As of December 31, 2006, the debt maturities by period and the weighted average interest rate for fixed-rate, long-term debt are as follows:

	2007	2008	2009	2010	2011	Thereafter	Total	Fair Value
Long-term debt (fixed rate)	$31,155	$23,961	$ 7,004	$54,192	$26,998	$839,505	$982,815	$ 986,487
Weighted average interest rate	5.10%	6.63%	4.81%	6.43%	6.42%	5.65%	5.72%	

From time to time, we make investments in marketable equity securities. As a result, we are exposed to the risk of changes in equity prices for the "available for sale" marketable equity securities. As of December 31, 2006, our carrying value of certain investments was $499, which reflects the market value of such investments and is in excess of our original cost. As of December 31, 2005, we owned no marketable equity securities.

Capitalization

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

December 31,	2006	2005	2004	2003	2002
Long-term debt*	51.6%	52.7%	52.8%	52.8%	55.6%
Common stockholders' equity	48.4%	47.3%	47.2%	47.2%	44.4%
	100.0%	100.0%	100.0%	100.0%	100.0%

*Includes current portion.

Over the past five years, the changes in the capitalization ratios primarily resulted from the issuance of common stock, the issuance of debt to finance our acquisitions and capital program, and the 2002 repurchase of common stock from a large shareholder that was subsequently reissued in 2003. It is our goal to maintain an equity ratio adequate to support the current Standard and Poors corporate credit rating of "A+" and its senior secured debt rating of "AA-" for Aqua Pennsylvania, our largest operating subsidiary.

Dividends on Common Stock

We have paid common dividends consecutively for 62 years. Effective September 1, 2006, our Board of Directors authorized an increase of 7.6% in the dividend rate over the amount we paid in the previous quarter. As a result of this authorization, beginning with the dividend payment in September 2006, the annual dividend rate increased to $0.46 per share from $0.4276 per share. This is the 16th dividend increase in the past 15 years and the eighth consecutive year that we have increased our dividend in excess of five percent. We presently intend to pay quarterly cash dividends in the future, on March 1, June 1, September 1 and December 1, subject to our earnings and financial condition, restrictions set forth in our debt instruments, regulatory requirements and such other factors as our Board of Directors may deem relevant. During the past five years, our common dividends paid have averaged 57.8% of net income.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our financial condition and results of operations are impacted by the methods, assumptions, and estimates used in the application of critical accounting policies. The following accounting policies are particularly important to our financial condition or results of operations, and require estimates or other judgments of matters of uncertainty. Changes in the estimates or other judgments included within these accounting policies could result in a significant change to the financial statements.

We believe our most critical accounting policies include revenue recognition, the use of regulatory assets and liabilities as permitted by Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation," the valuation of our long-lived assets which consist primarily of Utility Plant in Service, regulatory assets and goodwill, our accounting for postretirement benefits and our accounting for income taxes. We have discussed the selection and development of our critical accounting policies and estimates with the Audit Committee of the Board of Directors.

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

In some operating divisions, we commence the billing of our utility customers, under new rates, upon authorization from the respective regulatory commission and before the final commission rate order is issued. The revenue recognized reflects an estimate based on our judgment of the final outcome of the ruling. We monitor the facts and circumstances regularly, and revise the estimate as required. The revenue billed and collected prior to the final ruling is subject to refund based on the final ruling. Please refer to the section named "Operating Revenues" for a discussion of revenue currently being recognized under rate filings that are not final.

Regulatory Assets and Liabilities—SFAS No. 71 stipulates generally accepted accounting principles for companies whose rates are established by or are subject to approval by an independent third-party regulator. In accordance with SFAS No. 71, we defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that these costs and credits will be recognized in the rate-making process in a period different from when the costs and credits were incurred. These deferred amounts, both assets and liabilities, are then recognized in the income statement in the same period that they are reflected in our rates charged for water and wastewater service. In the event that our assessment as to the probability of the inclusion in the rate-making process is incorrect, the associated regulatory asset or liability would be adjusted to reflect the change in our assessment or change in regulatory approval.

Valuation of Long-Lived Assets, Goodwill and Intangible Assets—In accordance with the requirements of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", we review for impairment of our long-lived assets, including Utility Plant in Service. We also review regulatory assets for the continued application of SFAS No. 71. Our review determines whether there have been changes in circumstances or events that have occurred that require adjustments to the carrying value of these assets. In accordance with SFAS No. 71, adjustments to the carrying value of these assets would be made in instances where the inclusion in the rate-making process is unlikely.

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," we test the goodwill attributable to each of our reporting units for impairment at least annually on July 31, or more often, if certain circumstances indicate a possible impairment may exist. We evaluate goodwill for impairment using the discounted cash flow methodologies, transaction values for other comparable companies, and other valuation techniques for all of our reporting units with goodwill balances. The evaluation requires significant management judgment and estimates that are based on budgets, general strategic business plans, historical trends and other data and relevant factors. If changes in circumstances or events occur, or estimates and assumptions which were used in our impairment test change, we may be required to record an impairment charge for goodwill. Based on our comparison of the estimated fair value of each reporting unit to their respective carrying amounts, the impairment test performed in 2006 concluded that none of our goodwill was impaired.

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

Our discount rate assumption was determined using a yield curve that was produced from a universe containing over 500 U.S.-issued Aa-graded corporate bonds, all of which were noncallable (or callable with make-whole provisions), and excluding the 10% of the bonds with the highest yields and the 10% with the lowest yields. The discount rate was then developed as the

single rate that would produce the same present value as if we used spot rates, for various time periods, to discount the projected pension benefit payments. Our pension expense and liability (benefit obligations) increases as the discount rate is reduced. A 25 basis-point reduction in this assumption would have increased 2006 pension expense by $660 and the pension liabilities by $6,500. The present values of Aqua America's future pension and other postretirement obligations were determined using discount rates of 5.90% at December 31, 2006 and 5.65% at December 31, 2005. Our expense under these plans is determined using the discount rate as of the beginning of the year, which was 5.65% for 2006, and will be 5.90% for 2007.

Our expected return on assets is determined by evaluating the asset class return expectations with our advisors as well as actual, long-term, historical results of our asset returns. Our pension expense increases as the expected return on assets decreases. A 25 basis-point reduction in this assumption would have increased 2006 pension expense by $300. For 2006, we used an 8.0% expected return on assets assumption which will remain unchanged for 2007. The expected return on assets is based on a targeted allocation of 50% to 75% equities and 25% to 50% fixed income. We believe that our actual long-term asset allocation on average will approximate the targeted allocation. Our targeted allocation is driven by the investment strategy to earn a reasonable rate of return while maintaining risk at acceptable levels through the diversification of investments across and within various asset categories.

We adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)" on December 31, 2006. As a result of adopting SFAS No. 158 on December 31, 2006, we recorded the underfunded status of our pension and other postretirement benefit plans on the balance sheet and recorded a regulatory asset for these costs that would otherwise be charged to common stockholders' equity, as we anticipate recoverability of the costs through customer rates. See the section titled "Impact of Recent Accounting Pronouncements" for additional information. As a result of adopting SFAS No. 158, the additional minimum liability associated with our defined benefit pension plan was eliminated as it is no longer required to be recorded under SFAS No. 158. Prior to the adoption of SFAS No. 158 on December 31, 2006, our additional minimum liability was $3,498. The additional minimum liability was a result of the accumulated benefit obligation exceeding the fair value of plan assets. The decrease in the additional minimum liability from December 31, 2005 of $10,909 to December 31, 2006 of $3,498, prior to adoption of SFAS No. 158, resulted from the effect of an increased discount rate and an increase in pension plan assets during 2006 due to positive equity market performance and pension contributions. A portion of the December 31, 2005 and all of the December 31, 2006 additional minimum liability prior to adoption of SFAS No. 158, resulted in the establishment of a regulatory asset as we expect recovery of the future, increased pension expense through customer rates.

Funding requirements for qualified defined benefit pension plans are determined by government regulations and not by accounting pronouncements. In accordance with our funding policy, during 2007 our required pension contribution is expected to be approximately $7,300. The Pension Protection Act of 2006 was signed into law in August 2006. We are currently evaluating this legislation and the effect it will have on our future pension contributions and do not expect our estimate for the 2007 funding amount to change. However, future contributions may be impacted by the effect of the Pension Protection Act of 2006, though we expect future changes in the amount of contributions and expense recognized to be generally included in customer rates.

Accounting for Income taxes—We estimate the amount of income tax payable or refundable for the current year and the deferred income tax liabilities and assets that results from estimating temporary differences resulting from the treatment of certain items, such as depreciation, for tax and financial statement reporting. These differences result in the recognition of a deferred tax asset or liability on our consolidated balance sheet and require us to make judgments regarding the probability of the ultimate tax impact of the various transactions we enter into. Based on these judgments we may record tax reserves or adjustments to valuation allowances on deferred tax assets to reflect the expected realization of future tax benefits. Actual income taxes could vary from these estimates and changes in these estimates can increase income tax expense in the period that these changes in estimates occur. On January 1, 2007, we adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-An Interpretation of FASB Statement No. 109," which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. See the section titled "Impact of Recent Accounting Pronouncements" for additional information.

IMPACT OF RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)." This statement requires the recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. Under SFAS No. 158, actuarial gains and losses, prior service costs or credits, and any remaining transition assets or obligations that have not been recognized under previous accounting standards that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects. We adopted SFAS No. 158 on December 31, 2006 as required. Because we are subject to regulation in the states in which we operate, we maintain our accounts in accordance with the regulatory authority's rules and guidelines, which may differ from other authoritative accounting pronouncements. In those instances, we follow the guidance of SFAS No. 71. Based on prior regulatory experience, and in accordance with SFAS No. 71, we recorded a regulatory asset for the pension and other postretirement benefit costs associated with SFAS No. 158, that would otherwise be charged to common stockholders' equity, for which we anticipate recoverability through customer rates. As a result, the impact of adopting SFAS No. 158 on our Consolidated Balance Sheet was to increase total liabilities by $30,305, and increase total assets by $30,305. The adoption of this standard had no impact on our results of operations or cash flow, and the impact on financial position is described above. See the Pension Plans and Other Postretirement Benefits footnote to the consolidated financial statements for further information and the required disclosures under SFAS No. 158.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. The statement applies when other statements require or permit the fair value measurement of assets and liabilities. This statement does not expand the use of fair value measurement. SFAS No. 157 is effective for our fiscal year beginning January 1, 2008. We are currently evaluating the provisions of this statement and have not yet determined the effect of adoption on our results of operations or financial position.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides guidance on how prior year misstatements should be considered when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. We adopted SAB 108 as required for the fiscal year ended December 31, 2006 and it did not have a material impact on our results of operations or financial position.

In June 2006, the FASB issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109," which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We adopted FIN 48 as required on January 1, 2007 and it did not have a material effect on our results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment." SFAS No. 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 consolidated financial statement amounts for the prior periods presented in this report have not been restated to reflect the fair value method of expensing share-based compensation. During 2006, the adoption of SFAS No. 123R increased operations and maintenance expense by $2,894, lowered net income by $2,568, and lowered diluted net income per share by $0.019. The adoption of this standard had no material impact on our 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 exceed the associated compensation cost recognized in the income statement. As of the date of adoption, we calculated our pool of windfall tax benefits in accordance with the method outlined in SFAS No. 123R. See the Employee Stock and Incentive Plan footnote to the consolidated financial statements for further information and the required disclosures under SFAS No 123R.

AQUA AMERICA, INC. AND SUBSIDIARIES

Management's Report On Internal Control Over Financial Reporting

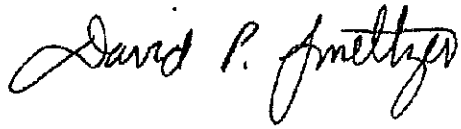
Management of Aqua America, Inc. (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the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

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

In assessing the effectiveness of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. As a result of management's assessment and based on the criteria in the framework, management has concluded that, as of December 31, 2006, the Company's internal control over financial reporting was effective.

The Company's independent registered public accounting firm, PricewaterhouseCoopers LLP, has audited management's assessment of the effectiveness of the Company's internal control over financial reporting, as stated in their report which appears herein.

Nicholas DeBenedictis
Chairman, President and Chief Executive Officer



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

February 27, 2007

Report of Independent Registered Public Accounting Firm

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

We have completed integrated audits of Aqua America, Inc.'s consolidated financial statements and of its internal control over financial reporting as of December 31, 2006 in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated Financial Statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income and comprehensive income, of capitalization, of common stockholders' equity and of cash flows present fairly, in all material respects, the financial position of Aqua America, Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed under Summary of Significant Accounting Policies–Recent Accounting Pronouncements in the notes to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006 and the manner in which it accounts for its defined benefit pension and other postretirement plans effective December 31, 2006.

Internal Control Over Financial Reporting

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control – Integrated Framework issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

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

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Philadelphia, Pennsylvania
February 27, 2007

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(In thousands, except per share amounts)
Years ended December 31, 2006, 2005 and 2004

	2006	2005	2004
Operating revenues	$ 533,491	$ 496,779	$ 442,039
Costs and expenses:			
Operations and maintenance	219,560	203,088	178,345
Depreciation	70,895	60,747	54,564
Amortization	4,146	4,741	4,300
Taxes other than income taxes	33,343	31,696	27,596
	327,944	300,272	264,805
Operating income	205,547	196,507	177,234
Other expense (income):			
Interest expense, net	58,432	52,062	48,679
Allowance for funds used during construction	(3,941)	(2,447)	(2,304)
Gain on sale of other assets	(1,194)	(1,177)	(1,272)
Income before income taxes	152,250	148,069	132,131
Provision for income taxes	60,246	56,913	52,124
Net income	$ 92,004	$ 91,156	$ 80,007
Net income	$ 92,004	$ 91,156	$ 80,007
Other comprehensive income (loss), net of tax:			
Minimum pension liability adjustment	3,082	(1,340)	(1,742)
Unrealized holding gains on investments	194	-	59
Reclassification adjustment for gains reported in net income	-	-	(230)
	3,276	(1,340)	(1,913)
Comprehensive income	$ 95,280	$ 89,816	$ 78,094
Net income per common share:			
Basic	$ 0.70	$ 0.72	$ 0.64
Diluted	$ 0.70	$ 0.71	$ 0.64
Average common shares outstanding during the period:			
Basic	130,725	127,364	124,329
Diluted	131,774	129,206	125,710

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands of dollars, except per share amounts)
December 31, 2006 and 2005

	2006	2005
Assets		
Property, plant and equipment, at cost	$ 3,185,111	$ 2,900,585
Less: accumulated depreciation	679,116	620,635
Net property, plant and equipment	2,505,995	2,279,950
Current assets:		
Cash and cash equivalents	44,039	11,872
Accounts receivable and unbilled revenues, net	72,149	62,690
Income tax receivable	-	8,321
Inventory, materials and supplies	8,359	7,798
Prepayments and other current assets	10,153	7,596
Total current assets	134,700	98,277
Regulatory assets	165,063	130,953
Deferred charges and other assets, net	38,075	37,061
Funds restricted for construction activity	11,490	68,625
Goodwill	22,580	20,180
	$ 2,877,903	$ 2,635,046
Liabilities and Stockholders' Equity		
Common stockholders' equity:		
Common stock at $.50 par value, authorized 300,000,000 shares, issued 133,017,325 and 129,658,806 in 2006 and 2005	$ 66,509	$ 64,829
Capital in excess of par value	548,806	478,508
Retained earnings	319,113	285,132
Treasury stock, at cost, 691,746 and 688,625 shares in 2006 and 2005	(12,992)	(12,914)
Accumulated other comprehensive income	194	(3,082)
Unearned compensation	-	(550)
Total common stockholders' equity	921,630	811,923
Minority interest	1,814	1,551
Long-term debt, excluding current portion	951,660	878,438
Commitments and contingencies	-	-
Current liabilities:		
Current portion of long-term debt	31,155	24,645
Loans payable	119,150	138,505
Accounts payable	49,406	55,455
Accrued interest	14,050	13,052
Accrued taxes	19,350	9,432
Other accrued liabilities	22,500	30,571
Total current liabilities	255,611	271,660
Deferred credits and other liabilities:		
Deferred income taxes and investment tax credits	273,199	250,346
Customers' advances for construction	76,820	74,828
Regulatory liabilities	11,592	11,751
Other	64,879	31,969
Total deferred credits and other liabilities	426,490	368,894
Contributions in aid of construction	320,698	302,580
	$ 2,877,903	$ 2,635,046

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CAPITALIZATION
(In thousands of dollars, except per share amounts)
December 31, 2006 and 2005

	2006	2005
Common stockholders' equity:		
Common stock, $.50 par value	$ 66,509	$ 64,829
Capital in excess of par value	548,806	478,508
Retained earnings	319,113	285,132
Treasury stock, at cost	(12,992)	(12,914)
Accumulated other comprehensive income	194	(3,082)
Unearned compensation	-	(550)
Total common stockholders' equity	921,630	811,923
Long-term debt:		
Long-term debt of subsidiaries (substantially secured by utility plant):		
Interest Rate Range		
0.00% to 2.49%	25,740	21,574
2.50% to 2.99%	25,272	28,684
3.00% to 3.49%	17,220	17,380
3.50% to 3.99%	6,073	6,748
4.00% to 4.99%	30,645	30,695
5.00% to 5.49%	262,496	262,588
5.50% to 5.99%	79,000	79,000
6.00% to 6.49%	94,360	88,504
6.50% to 6.99%	22,000	32,000
7.00% to 7.49%	13,288	15,878
7.50% to 7.99%	24,778	25,012
8.00% to 8.49%	26,288	26,507
8.50% to 8.99%	9,000	9,000
9.00% to 9.49%	46,101	46,764
9.50% to 9.99%	38,738	40,933
10.00% to 10.50%	6,000	6,000
	726,999	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, 5.64%, due in 2014 through 2021	20,000	-
Unsecured notes payable, 5.54%, due in 2013 through 2018	30,000	-
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 2007 and 2008	816	816
	982,815	903,083
Current portion of long-term debt	31,155	24,645
Long-term debt, excluding current portion	951,660	878,438
Total capitalization	$ 1,873,290	$ 1,690,361

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMMON STOCKHOLDERS' EQUITY

(In thousands of dollars, except per share amounts)

	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Accumulated Other Comprehensive Income	Unearned Compensation on Restricted Stock	Total
Balance at December 31, 2003	$46,635	$413,008	$210,915	$(12,611)	$ 171	$ -	$658,118
Net income	-	-	80,007	-	-	-	80,007
Other comprehensive income (loss):							
Minimum pension liability adjustment, net of income tax of $938	-	-	-	-	(1,742)	-	(1,742)
Unrealized gain on securities, net of income tax of $32	-	-	-	-	59	-	59
Less: reclassification adjustment for gains reported in net income, net of income tax of $173	-	-	-	-	(230)	-	(230)
Dividends	-	-	(45,807)	-	-	-	(45,807)
Sale of stock (3,181,203 shares)	1,170	48,971	-	991	-	-	51,132
Repurchase of stock (51,808 shares)	-	-	-	(1,082)	-	-	(1,082)
Equity Compensation Plan (45,535 shares)	17	692	-	-	-	-	709
Exercise of stock options (570,064 shares)	214	4,847	-	-	-	-	5,061
Employee stock plan tax benefits	-	1,006	-	-	-	-	1,006
Balance at December 31, 2004	48,036	468,524	245,115	(12,702)	(1,742)	-	747,231
Net income	-	-	91,156	-	-	-	91,156
Other comprehensive loss: minimum pension liability adjustment, net of income tax of $722	-	-	-	-	(1,340)	-	(1,340)
Dividends	-	-	(51,139)	-	-	-	(51,139)
Stock issued for acquisitions (24,684 shares)	12	663	-	-	-	-	675
Stock split	16,095	(16,095)	-	-	-	-	-
Sale of stock (471,682 shares)	161	7,943	-	1,537	-	-	9,641
Repurchase of stock (56,930 shares)	-	-	-	(1,749)	-	-	(1,749)
Equity Compensation Plan (37,751 shares)	14	708	-	-	-	(722)	-
Exercise of stock options (1,327,717 shares)	511	11,264	-	-	-	-	11,775
Employee stock plan tax benefits	-	5,501	-	-	-	-	5,501
Amortization of unearned compensation	-	-	-	-	-	172	172
Balance at December 31, 2005	64,829	478,508	285,132	(12,914)	(3,082)	(550)	811,923
Net income	-	-	92,004	-	-	-	92,004
Other comprehensive income:							
Unrealized holding gain on investments, net of income tax of $105	-	-	-	-	194	-	194
Minimum pension liability adjustment, net of income tax of $1,660	-	-	-	-	3,082	-	3,082
Dividends	-	-	(58,023)	-	-	-	(58,023)
Sale of stock (2,688,332 shares)	1,328	55,866	-	894	-	-	58,088
Repurchase of stock (36,346 shares)	-	-	-	(972)	-	-	(972)
Equity Compensation Plan (37,200 shares)	19	(19)	-	-	-	-	-
Reclassification of unearned compensation	-	(550)	-	-	-	550	-
Exercise of stock options (666,212 shares)	333	7,629	-	-	-	-	7,962
Stock-based compensation	-	4,235	-	-	-	-	4,235
Employee stock plan tax benefits	-	3,137	-	-	-	-	3,137
Balance at December 31, 2006	$66,509	$548,806	$319,113	$(12,992)	$ 194	$ -	$921,630

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands of dollars)
Years ended December 31, 2006, 2005 and 2004

	2006	2005	2004
Cash flows from operating activities:			
Net income	$ 92,004	$ 91,156	$ 80,007
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	75,041	65,488	58,864
Deferred income taxes	10,794	26,027	40,577
Stock-based compensation	3,604	-	-
Gain on sale of water system	-	-	(2,342)
Gain on sale of other assets	(1,194)	(1,177)	(1,272)
Net decrease (increase) in receivables, inventory and prepayments	(8,769)	7,572	(2,766)
Net increase (decrease) in payables, accrued interest, accrued taxes and other accrued liabilities	(5,609)	12,933	863
Other	4,855	(2,325)	(328)
Net cash flows from operating activities	170,726	199,674	173,603
Cash flows from investing activities:			
Property, plant and equipment additions, including allowance for funds used during construction of $3,941, $2,447 and $2,304	(271,706)	(237,462)	(195,736)
Acquisitions of utility systems and other, net	(11,848)	(11,633)	(54,300)
Release of funds previously restricted for construction activity	59,467	56,137	14,015
Additions to funds restricted for construction activity	(2,332)	(107,566)	(2,772)
Net proceeds from the sale of water systems	-	-	4,716
Net proceeds from the sale of other assets	1,283	1,300	2,098
Other	(213)	102	(517)
Net cash flows used in investing activities	(225,349)	(299,122)	(232,496)
Cash flows from financing activities:			
Customers' advances and contributions in aid of construction	12,031	14,728	14,269
Repayments of customers' advances	(5,168)	(4,792)	(4,930)
Net proceeds (repayments) of short-term debt	(19,355)	63,695	(30,150)
Proceeds from long-term debt	103,360	147,012	130,258
Repayments of long-term debt	(24,606)	(83,235)	(55,928)
Change in cash overdraft position	11,166	(8,808)	(2,190)
Proceeds from issuing common stock	58,088	9,641	51,132
Proceeds from exercised stock options	7,962	11,775	5,061
Stock-based compensation windfall tax benefits	2,307	-	-
Repurchase of common stock	(972)	(1,749)	(1,082)
Dividends paid on common stock	(58,023)	(51,139)	(45,807)
Other	-	-	179
Net cash flows from financing activities	86,790	97,128	60,812
Net increase (decrease) in cash and cash equivalents	32,167	(2,320)	1,919
Cash and cash equivalents at beginning of year	11,872	14,192	12,273
Cash and cash equivalents at end of year	$ 44,039	$ 11,872	$ 14,192
Cash paid during the year for:			
Interest, net of amounts capitalized	$ 53,222	$ 48,278	$ 45,261
Income taxes	$ 28,700	$ 30,734	$ 22,322

See Summary of Significant Accounting Policies-Customers' Advances for Construction, Acquisitions and Employee Stock and Incentive Plans footnotes for description of non-cash activities.
See accompanying notes to consolidated financial statements.

Summary of Significant Accounting Policies

Nature of Operations—Aqua America, Inc. ("Aqua America" or the "Company") is the holding company for regulated utilities providing water or wastewater services in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, New York, Florida, Indiana, Virginia, Maine, Missouri and South Carolina. Our largest operating subsidiary, Aqua Pennsylvania, Inc., accounted for approximately 55% of our operating revenues for 2006 and provided water or wastewater services to customers in the suburban areas north and west of the City of Philadelphia and in 23 other counties in Pennsylvania. The Company's other subsidiaries provide similar services in 12 other states. In addition, the Company provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties, and septage hauling services, close to our utility companies' service territories.

The company has identified fourteen operating segments and has one reportable segment named the Regulated segment. The reportable segment is comprised of thirteen operating segments for our water and wastewater regulated utility companies which are organized by the states where we provide these services. These operating segments are aggregated into one reportable segment since each of the Company's operating segments has the following similarities: economic characteristics, nature of services, production processes, customers, water distribution or wastewater collection methods, and the nature of the regulatory environment. In addition, one segment is not quantitatively significant to be reportable and is comprised of the businesses that provide on-site septic tank pumping, sludge hauling services and certain other non-regulated water and wastewater services. This segment is included as a component of "other," in addition to corporate costs that have not been allocated to the Regulated segment and intersegment eliminations.

Regulation—Most of the operating companies that are regulated public utilities are subject to regulation by the public utility commissions of the states in which they operate. The respective public utility commissions have jurisdiction with respect to rates, service, accounting procedures, issuance of securities, acquisitions and other matters. Some of the operating companies that are regulated public utilities are subject to rate regulation by county or city government. Regulated public utilities follow Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 provides for the recognition of regulatory assets and liabilities as allowed by regulators for costs or credits that are reflected in current rates or are considered probable of being included in future rates. The regulatory assets or liabilities are then relieved as the cost or credit is reflected in rates.

Consolidation—The consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany accounts and transactions have been eliminated.

Recognition of Revenues—Revenues include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the latest billing to the end of the accounting period. Non-regulated revenues are recognized when services are performed and are primarily associated with septage hauling services, operating and maintenance contracts and data processing service fees. The Company's Regulated segment includes non-regulated revenues that totaled $13,525 in 2006, $13,161 in 2005 and $11,556 in 2004. In addition to the Regulated segment operating revenues, the Company has other non-regulated revenues of $7,198 in 2006, $3,323 in 2005 and $2,067 in 2004.

Property, Plant and Equipment and Depreciation—Property, plant and equipment consist primarily of utility plant. The cost of additions includes contracted cost, direct labor and fringe benefits, materials, overheads and, for certain utility plant, allowance for funds used during construction. Water systems acquired are recorded at estimated original cost of utility plant when first devoted to utility service and the applicable depreciation is recorded to accumulated depreciation. The difference between the estimated original cost, less applicable accumulated depreciation, and the purchase price is recorded as an acquisition adjustment within utility plant. At December 31, 2006, utility plant includes a net credit acquisition adjustment of $51,434, which is generally being amortized from 0 to 20 years. Amortization of the acquisition adjustments totaled $4,239 in 2006, $3,674 in 2005 and $3,961 in 2004.

Utility expenditures for maintenance and repairs, including major maintenance projects and minor renewals and betterments, are charged to operating expenses when incurred in accordance with the system of accounts prescribed by the public utility commissions of the states in which the company operates. The cost of new units of property and betterments are capitalized. Utility expenditures for water main cleaning and relining of pipes are deferred and recorded in net property, plant and equipment in accordance with SFAS No. 71. As of December 31, 2006, $5,192 of costs has been incurred since the last rate proceeding and the Company expects to recover these costs in future rates.

The cost of software upgrades and enhancements are capitalized if they result in added functionality which enable the software to perform tasks it was previously incapable of performing. Certain information technology costs associated with major system installations, conversions and improvements, such as software training, data conversion and business process reengineering costs, are deferred as a regulatory asset if the Company expects to recover these costs in future rates. If these costs are not deferred in accordance with SFAS No. 71, then these costs are charged to operating expenses when incurred. As of December 31, 2006, $5,597 of costs have been deferred, since the last rate proceeding, as a regulatory asset, and the deferral is reported as a component of net property, plant and equipment.

When units of utility property are replaced, retired or abandoned, the recorded value thereof is credited to the asset account and such value, together with the net cost of removal, is charged to accumulated depreciation. To the extent the Company recovers cost of removal or other retirement costs through rates after the retirement costs are incurred, a regulatory asset is recorded. In some cases, the Company recovers retirement costs through rates during the life of the associated asset and before the costs are incurred. These amounts result in a regulatory liability being reported based on the amounts previously recovered through customer rates.

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

In accordance with the requirements of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the long-lived assets of the Company, which consist primarily of Utility Plant in Service and regulatory assets, are reviewed for impairment when changes in circumstances or events occur. There has been no change in circumstances or events that have occurred that require adjustments to the carrying values of these assets.

Allowance for Funds Used During Construction—The allowance for funds used during construction ("AFUDC") is a non-cash credit which represents the estimated cost of funds used to finance the construction of utility plant. In general, AFUDC is applied to construction projects requiring more than one month to complete. No AFUDC is applied to projects funded by customer advances for construction or contributions in aid of construction. AFUDC includes the net cost of borrowed funds and a rate of return on other funds when used, and is recovered through water rates as the utility plant is depreciated. The amount of AFUDC related to equity funds in 2006 was $6 and in 2005 was $1. There was no AFUDC related to equity funds in 2004. No interest was capitalized by our non-regulated businesses.

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

The Company had a book overdraft for certain of its disbursement cash accounts of $13,739 and $2,573 at December 31, 2006 and 2005, respectively. A book overdraft represents transactions that have not cleared the bank accounts at the end of the period. The Company transfers cash on an as-needed basis to fund these items as they clear the bank in subsequent periods. The balance of the book overdraft is reported as accounts payable and the change in the book overdraft balance is reported as cash flows from financing activities.

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

Regulatory Assets, Deferred Charges and Other Assets—Deferred charges and other assets consist of financing expenses, other costs and marketable securities. Deferred bond issuance expenses are amortized by the straight-line method over the life of the related issues. Call premiums related to the early redemption of long-term debt, along with the unamortized balance of the related issuance expense, are deferred and amortized over the life of the long-term debt used to fund the redemption. Other costs, for which the Company has received or expects to receive prospective rate recovery, are deferred as a regulatory asset and amortized over the period of rate recovery in accordance with SFAS No. 71.

Marketable securities are considered "available-for-sale" and accordingly, are carried on the balance sheet at fair market value. Unrecognized gains are included in other comprehensive income.

Goodwill—Goodwill represents the excess cost over the fair value of net tangible and identifiable intangible assets acquired through acquisitions. Goodwill is not amortized but is tested for impairment annually, or more often, if circumstances indicate a possible impairment may exist. In accordance with the requirements of SFAS No. 142, "Goodwill and Other Intangible Assets," the Company tested the goodwill attributable to each of our reporting units for impairment as of July 31, 2006, in conjunction with the timing of our annual strategic business plan. Based on the Company's comparison of the estimated fair value of each reporting unit to their respective carrying amounts, the impairment test concluded that none of its goodwill was impaired. The following table summarizes the changes in the Company's goodwill:

	Regulated Segment	Other	Consolidated
Balance at December 31, 2004	$ 20,122	$ -	$ 20,122
Goodwill acquired during year	-	102	102
Reclassifications to utility plant acquisition adjustment	(44)	-	(44)
Balance at December 31, 2005	20,078	102	20,180
Goodwill acquired during year	226	3,941	4,167
Reclassifications to utility plant acquisition adjustment	(1,767)	-	(1,767)
Balance at December 31, 2006	$ 18,537	$ 4,043	$ 22,580

Income Taxes—The Company accounts for certain income and expense items in different time periods for financial reporting than for tax reporting purposes. Deferred income taxes are provided on the temporary differences between the tax basis of the assets and liabilities, and the amounts at which they are carried in the consolidated financial statements. The income tax effect of temporary differences not allowed currently in rates is recorded as deferred taxes with an offsetting regulatory asset or liability. These deferred income taxes are based on the enacted tax rates expected to be in effect when such temporary differences are projected to reverse. Investment tax credits are deferred and amortized over the estimated useful lives of the related properties.

Customers' Advances for Construction and Contributions in Aid of Construction—Water mains or, in some instances, cash advances to reimburse the Company for its costs to construct water mains, are contributed to the Company by customers, real estate developers and builders in order to extend water service to their properties. The value of these contributions is recorded as Customers' Advances for Construction. Non-cash property, in the form of water mains, has been received, generally from developers, as advances or contributions of $16,852, $15,729 and $9,273 in 2006, 2005 and 2004, respectively. The Company makes refunds on these advances over a specific period of time based on operating revenues related to the main or as new customers are connected to and take service from the main. After all refunds are made, any remaining balance is transferred to Contributions in Aid of Construction. Contributions in aid of construction include direct non-refundable contributions and the portion of customers' advances for construction that become non-refundable. Contributed property is generally not depreciated. Certain of the subsidiaries do depreciate contributed property and amortize contributions in aid of construction at the composite rate of the related property.

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

Stock-Based Compensation—Effective January 1, 2006, the Company accounts for stock-based compensation using the fair value recognition provisions of SFAS No. 123R, "Share-Based Payment". 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. Please refer to the Recent Accounting Pronouncements section of this footnote for information concerning the Company's accounting for stock-based compensation. The following table provides the pro forma net income and earnings per share prior to January 1, 2006 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 "Accounting for Stock-Based Compensation – Transition and Disclosure."

	Years Ended December 31,	
	2005	2004
Net income, as reported	$ 91,156	$ 80,007
Add: stock-based employee compensation expense included in reported net income, net of tax	290	266
Less: pro forma expense related to stock options granted, net of tax effects	(2,054)	(1,990)
Pro forma	$ 89,392	$ 78,283
Basic net income per share:		
As reported	$ 0.72	$ 0.64
Pro forma	0.70	0.63
Diluted net income per share:		
As reported	$ 0.71	$ 0.64
Pro forma	0.69	0.62

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

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

Reclassifications—Certain prior year amounts have been changed to conform with current year's presentation.

Recent Accounting Pronouncements—In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)." This statement requires the recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. Under SFAS No. 158, actuarial gains and losses, prior service costs or credits, and any remaining transition assets or obligations that have not been recognized under previous accounting standards that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects. The Company adopted SFAS No. 158 on December 31, 2006 as required. Because the Company is subject to regulation in the states in which it operates, the Company maintains its accounts in accordance with the regulatory authority's rules and guidelines, which may differ from other authoritative accounting pronouncements. In those instances, the Company follows the guidance of SFAS No. 71. Based on prior regulatory experience, and in accordance with SFAS No. 71, the Company has recorded a regulatory asset for the pension and other postretirement benefit costs associated with SFAS No. 158 that would otherwise be charged to common stockholders' equity, for which the Company anticipates recoverability through customer rates. As a result, the impact of adopting SFAS No. 158 on the Company's Consolidated Balance Sheet was to increase total liabilities by $30,305, and increase total assets by $30,305. The adoption of this standard had no impact on the Company's results of operations or cash flow, and the impact on financial position is described above. See the Pension Plans and Other Postretirement Benefits footnote to the consolidated financial statements for further information and the required disclosures under SFAS No. 158.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. The statement applies when other statements require or permit the fair value measurement of assets and liabilities. This statement does not expand the use of fair value measurement. SFAS No. 157 is effective for the Company's

fiscal year beginning January 1, 2008. The Company is currently evaluating the provisions of this statement and has not yet determined the effect of adoption on its results of operations or financial position.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides guidance on how prior year misstatements should be considered when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. The Company adopted SAB 108 as required for the fiscal year ended December 31, 2006 and it did not have a material impact on its results of operations or financial position.

In June 2006, the FASB issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109," which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company adopted FIN 48 as required on January 1, 2007 and it did not have a material effect on its results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment." SFAS No. 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, 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 consolidated financial statement amounts for the prior periods presented in this report have not been restated to reflect the fair value method of expensing share-based compensation. During 2006, the adoption of SFAS No. 123R increased operations and maintenance expense by $2,894, lowered net income by $2,568, and lowered diluted net income per share by $0.019. 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 exceed the associated compensation cost recognized in the income statement. See the Employee Stock and Incentive Plan footnote to the consolidated financial statements for further information and the required disclosures under SFAS No. 123R.

Acquisitions

New York Water Service Corporation—Pursuant to our strategy to grow through acquisitions, on January 1, 2007 the Company completed the acquisition of the capital stock of New York Water Service Corporation ("New York Water") for $28,866 in cash, as adjusted pursuant to the purchase agreement primarily based on working capital at closing, and the assumption of $23,460 of long-term debt. The operating results of New York Water will be included in our consolidated financial statements beginning January 1, 2007. The acquired operation provides water service to 44,792 customers in several water systems located in Nassau County, Long Island, New York. For the fiscal year ended December 31, 2005, New York Water had operating revenues of $21,773 (unaudited). The acquisition will be accounted for as a purchase and will be recorded in the first quarter of 2007.

Heater—Pursuant to our strategy to grow through acquisitions, on June 1, 2004 the Company acquired the capital stock of Heater Utilities, Inc. for $48,000 in cash and the assumption of long-term debt of $19,219 and short-term debt of $8,500. At the date of acquisition, Heater provided water and wastewater service to over 50,000 water and wastewater customers primarily in the areas of suburban Raleigh, Charlotte, Gastonia and Fayetteville, North Carolina. The acquisition was accounted for as a purchase and accordingly the Company recorded goodwill of $18,842.

As part of the North Carolina Utilities Commission approval process for this acquisition, the Commission approved a mechanism through which the Company could recover up to two-thirds of the goodwill through customer rates in the future upon achieving certain objectives. The Company is pursuing these objectives to facilitate recognition of this premium in customer rates. However, there can be no assurance that the Company will be able to achieve these objectives and recover such amount of goodwill.

Florida Water—On June 30, 2004, the Company acquired certain utility assets of Florida Water Services Corporation, comprised of 63 water and wastewater systems located in central Florida for $13,090 in cash, the final purchase price as

adjusted pursuant to the purchase agreement. In accordance with Florida Public Service Commission procedures, the acquisition was approved by the Commission and rate base was determined on December 20, 2005. Under the terms of the purchase agreement, the Commission's rate base determination resulted in a reduction of the final purchase price which did not result in the recognition of goodwill.

AquaSource—On July 31, 2003, the Company completed its acquisition of four operating water and wastewater subsidiaries of AquaSource, Inc. (a subsidiary of DQE, Inc.), including selected, integrated operating and maintenance contracts and related assets (individually and collectively the acquisition is referred to as "AquaSource") for $190,717 in cash, as adjusted pursuant to the purchase agreement based on working capital at closing. In August 2004, we were awarded and received $12,289 plus interest in an arbitration related to the calculation of the final purchase price under the terms of the purchase agreement, which resulted in a final purchase price of $178,428. In the consolidated statement of cash flow for 2004, the $12,289 award has been reported as proceeds on the line titled acquisitions of utility systems and other, net.

Other Acquisitions— During 2006, the Company completed 27 acquisitions or other growth ventures in various states for an aggregate purchase price of $11,848 in cash. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company were $4,511.

During 2005, the Company completed 30 acquisitions or other growth ventures in various states. The total purchase price of $12,308 for the systems acquired in 2005 consisted of $11,633 in cash and the issuance of 24,684 shares of the Company's common stock. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company were $6,203 in 2006 and $2,145 in 2005.

During 2004, in addition to the Heater and Florida Water acquisitions, the Company completed 27 acquisitions or other growth ventures in the various states in which the Company operates for an aggregate purchase price of $3,842 in cash. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company were $2,309 in 2006, $1,580 in 2005 and $617 in 2004.

Dispositions

In 2004, as a result of the settlement of a condemnation action, the Company's Ohio operating subsidiary sold its water utility assets within the municipal boundaries of the City of Geneva in Ashtabula County, Ohio for net proceeds of approximately $4,716, which was in excess of the book value for these assets. The proceeds were used to pay-down short-term debt and the sale resulted in the recognition in 2004 of a gain on the sale of these assets, net of expenses, of $2,342. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. We continue to operate this water system for the City of Geneva under a multi-year operating contract that expires in December 2008. These water utility assets represented less than 1% of Aqua America's total assets, and the total number of customers included in the water system sold represented less than 1% of our total utility customer base.

In 2004, the Company sold its only operations in Kentucky. The sale price approximates our investment in this operation. The operation represented approximately 0.2% of the operations acquired from AquaSource, Inc.

The City of Fort Wayne, Indiana has authorized the acquisition, by eminent domain or otherwise, of a portion of the utility assets of one of the operating subsidiaries that the Company acquired in connection with the AquaSource acquisition in 2003. The Company has challenged whether the City is following the correct legal procedures in connection with the City's attempted condemnation and the Company has challenged the City's valuation of this portion of its system. The portion of the system under consideration represents approximately 1% of the Company's total utility customer base. While the Company continues to discuss this matter with officials from the City of Fort Wayne, the Company continues to protect its legal interests in this proceeding. A sanitary district in Illinois and a city in Texas have also indicated interest in acquisition, by eminent domain or otherwise, of all or a portion of the utility assets of two of the Company's operations. The systems represent approximately 3,000 customers or less than 0.5% of our total utility customer base. The Company believes that it will be entitled to fair market value for its assets if they are condemned, and it is believed that the fair market value will be in excess of the book value for such assets.

Property, Plant and Equipment

	December 31, 2006	December 31, 2005	Approximate range of remaining lives
Utility plant and equipment:			
Mains and accessories	$ 1,287,142	$ 1,187,597	15 to 82 years
Services, hydrants, treatment plants and reservoirs	801,755	660,279	5 to 85 years
Operations structures and water tanks	172,850	222,107	15 to 77 years
Miscellaneous pumping and purification equipment	381,149	376,599	5 to 50 years
Meters, data processing, transportation and operating equipment	428,326	341,550	5 to 50 years
Land and other non-depreciable assets	80,479	73,346	-
Utility Plant and equipment	3,151,701	2,861,478	
Utility construction work in progress	76,653	98,898	-
Net utility plant acquisition adjustment	(51,434)	(64,165)	0 to 20 years
Non-utility plant and equipment	8,191	4,374	3 to 25 years
Total property, plant and equipment	$ 3,185,111	$ 2,900,585	

Accounts Receivable

	December 31, 2006	December 31, 2005
Billed utility revenue	$ 49,129	$ 42,541
Unbilled utility revenue	23,842	21,419
Other	4,147	3,136
	77,118	67,096
Less allowance for doubtful accounts	4,969	4,406
Net accounts receivable	$ 72,149	$ 62,690

The Company's utility customers are located principally in the following states: 47% in Pennsylvania, 10% in Ohio, 9% in North Carolina, 8% in Illinois, 6% in Texas, 6% in New Jersey, 5% in Indiana and 4% in Florida. No single customer accounted for more than one percent of the Company's operating revenues during the years ended December 31, 2006, 2005 or 2004. The following table summarizes the changes in the Company's allowance for doubtful accounts:

	2006	2005	2004
Balance at January 1,	$ 4,406	$ 4,849	$ 5,851
Amounts charged to expense	3,716	3,116	3,695
Accounts written off	(3,607)	(4,113)	(5,460)
Recoveries of accounts written off	454	554	701
Allowance acquired through acquisitions	-	-	62
Balance at December 31,	$ 4,969	$ 4,406	$ 4,849

Regulatory Assets and Liabilities

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

	December 31, 2006		December 31, 2005	
	Regulatory Assets	Regulatory Liabilities	Regulatory Assets	Regulatory Liabilities
Income taxes	$ 70,146	$ 2,104	$ 69,531	$ 2,203
Utility plant retirement costs	20,060	8,960	17,421	8,368
Postretirement benefits	36,469	-	10,871	-
Texas rate filing expense deferral	12,382	-	9,486	-
Competitive Transition Charge payment	4,586	-	5,733	-
Water tank painting	4,822	32	4,292	267
Fair value of long-term debt assumed in acquisition	2,594	-	2,804	-
Merger costs	1,111	-	1,641	-
Rate case filing expenses & other	12,893	496	9,174	913
	$ 165,063	$ 11,592	$130,953	$ 11,751

Items giving rise to deferred state income taxes, as well as a portion of deferred Federal income taxes related to certain differences between tax and book depreciation expense, are recognized in the rate setting process on a cash or flow-through basis and will be recovered as they reverse.

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

Postretirement benefits include pension and other postretirement benefits. The pension costs include deferred net pension expense in excess of amounts funded which the Company believes will be recoverable in future years as pension funding is required. In addition, a regulatory asset has been recorded for the costs that would otherwise be charged to common stockholders' equity in accordance with SFAS No. 158, for the underfunded status of our pension and other postretirement benefit plans. See the Pension Plans and Other Postretirement Benefits footnote to the consolidated financial statements for the effect on regulatory assets of the adoption of SFAS No. 158. The regulatory asset related to postretirement benefits other than pensions represents costs that were deferred between the time that the accrual method of accounting for these benefits was adopted in 1993 and the recognition of the accrual method in the Company's rates as prescribed in subsequent rate filings. Amortization of the amount deferred for postretirement benefits other than pensions began in 1994 and is currently being recovered in rates.

The regulatory asset for the Texas rate filing of 2004 results from a multi-year plan to increase annual revenues in phases, and to defer and amortize a portion of the Company's depreciation, operating and other tax expense over a similar multi-year period. These costs will be amortized over a period of time, expected to approximate four years, as determined by the final rate order.

The regulatory asset associated with the Competitive Transition Charge ("CTC") payment represents the full payoff in 2001, net of amortization, of the allocable share of a CTC as negotiated by Aqua Pennsylvania, Inc. from an electric distribution company. The Pennsylvania Electricity Generation Customer Choice and Competition Act permitted electric distribution utilities to recover their stranded costs from its customers in the form of a CTC. Rate recovery of the $11,465 CTC payment began in 2000 and is expected to conclude in 2010.

Expenses associated with water tank painting are deferred and amortized over a period of time as approved in the regulatory process. Water tank painting costs are generally being amortized over a period ranging from 5 to 17 years.

As a requirement of purchase accounting, the Company recorded a fair value adjustment for fixed-rate, long-term debt assumed in acquisitions. The regulatory asset results from the rate setting process continuing to recognize the historical interest cost of the assumed debt.

The regulatory asset related to the recovery of merger costs represents the portion of the Consumers Water Company merger costs that will be recovered in rates as a result of a rate settlement in 2000 and is being amortized over the ten-year recovery period.

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

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

Income Taxes

The provision for income taxes consists of:

	Years Ended December 31,		
	2006	2005	2004
Current:			
Federal	$ 39,956	$ 24,417	$ 2,042
State	9,502	6,586	7,553
	49,458	31,003	9,595
Deferred:			
Federal	9,531	22,294	41,414
State	1,257	3,616	1,115
	10,788	25,910	42,529
Total tax expense	$ 60,246	$ 56,913	$ 52,124

The statutory Federal tax rate is 35% and for states with a corporate net income tax, the state corporate net income tax rates range from 5.00% to 9.99% for all years presented. The Company's Federal income tax returns for all years through 2002 have been closed.

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

	Years Ended December 31,		
	2006	2005	2004
Computed Federal tax expense at statutory rate	$ 53,287	$ 51,824	$ 46,245
Increase in tax expense for depreciation expense to be recovered in future rates	716	806	1,376
Domestic Production Credit	(602)	(656)	-
Stock-based compensation	715	-	-
Deduction for Aqua America common dividends paid under employee benefit plan	(307)	(321)	(245)
Amortization of deferred investment tax credits	(274)	(359)	(285)
Prior year rate reductions	(154)	(437)	(538)
State income taxes, net of federal tax benefit	6,999	6,631	5,634
Other, net	(134)	(575)	(63)
Actual income tax expense	$ 60,246	$ 56,913	$ 52,124

The tax effects of temporary differences between book and tax accounting that give rise to the deferred tax assets and deferred tax liabilities are as follows:

	December 31,	
	2006	2005
Deferred tax assets:		
Customers' advances for construction	$ 17,786	$ 17,549
Costs expensed for book not deducted for tax, principally accrued expenses	2,787	1,803
Utility plant acquisition adjustment basis differences	18,673	29,429
Postretirement benefits	12,530	1,660
Other	295	-
Total gross deferred tax assets	52,071	50,441
Deferred tax liabilities:		
Utility plant, principally due to depreciation and differences in the basis of fixed assets due to variation in tax and book accounting	278,917	267,835
Deferred taxes associated with the gross-up of revenues necessary to recover, in rates, the effect of temporary differences	26,276	25,796
Tax effect of regulatory asset for postretirement benefits	12,530	-
Deferred investment tax credit	5,801	6,066
Other	1,746	1,090
Total gross deferred tax liabilities	325,270	300,787
Net deferred tax liability	$ 273,199	$ 250,346

In June 2006, the FASB issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes–An Interpretation of FASB Statement No. 109," which prescribes a recognition threshold and measurement attribute for the

financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We adopted FIN 48 as required on January 1, 2007 and it did not have a material effect on our results of operations or financial position.

Taxes Other than Income Taxes

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

	Years Ended December 31,		
	2006	2005	2004
Property	$ 14,953	$ 13,247	$ 10,919
Capital Stock	3,675	3,706	3,402
Gross receipts, excise and franchise	6,750	6,483	5,778
Payroll	5,701	5,648	5,134
Other	2,264	2,612	2,363
Total taxes other than income	$ 33,343	$ 31,696	$ 27,596

Commitments and Contingencies

Commitments–The Company maintains agreements with other water purveyors for the purchase of water to supplement its water supply, particularly during periods of peak demand. The agreements stipulate purchases of minimum quantities of water to the year 2026. The estimated annual commitments related to such purchases through 2011 are expected to approximate $10,092 and $59,091 thereafter. The Company purchased approximately $10,497, $10,603 and $8,724 of water under these agreements during the years ended December 31, 2006, 2005 and 2004, respectively.

The Company leases motor vehicles, buildings and other equipment under operating leases that are noncancelable. The future annual minimum lease payments due are: $3,450 in 2007, $3,100 in 2008, $1,587 in 2009, $547 in 2010, $147 in 2011 and $132 thereafter. The Company leases parcels of land on which treatment plants and other facilities are situated and adjacent parcels that are used for watershed protection. The operating leases are noncancelable, expire between 2010 and 2052 and contain certain renewal provisions. Certain leases are subject to an adjustment every five years based on changes in the Consumer Price Index. Subject to the aforesaid adjustment, during each of the next five years, approximately $554 of annual lease payments for land are due, and $17,004 thereafter. The Company leases treatment plants to other parties under lease agreements that require payments to the Company of $366 in 2007, $366 in 2008, $366 in 2009, $366 in 2010, $366 in 2011 and $5,553 thereafter.

Rent expense was $4,478, $3,390 and $3,267 for the years ended December 31, 2006, 2005 and 2004, respectively.

Contingencies–The Company is routinely involved in condemnation proceedings and legal matters during the ordinary course of business. See Water and Wastewater Rates footnote for a discussion of the rate proceeding process involving our subsidiaries in Texas. Although the results of legal proceedings cannot be predicted with certainty, there are no other 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.

Long-term Debt and Loans Payable

The Consolidated Statements of Capitalization provide a summary of long-term debt as of December 31, 2006 and 2005. The supplemental indentures with respect to certain issues of the First Mortgage Bonds restrict the ability of Aqua Pennsylvania, Inc. and certain other operating subsidiaries of the Company to declare dividends, in cash or property, or repurchase or otherwise acquire the stock of these companies. As of December 31, 2006, approximately $326,000 of Aqua Pennsylvania's retained earnings of approximately $346,000 and $76,000 of the retained earnings of $85,000 of certain other subsidiaries were free of these restrictions. Certain supplemental indentures also prohibit Aqua Pennsylvania and certain other subsidiaries of the Company from making loans to, or purchasing the stock of, the Company.

Sinking fund payments are required by the terms of certain issues of long-term debt. The future sinking fund payments and debt maturities of the Company's long-term debt are as follows:

Interest Rate Range	2007	2008	2009	2010	2011	Thereafter
0.00% to 2.49%	$ 1,514	$ 1,614	$ 1,657	$ 1,689	$ 1,714	$ 17,552
2.50% to 2.99%	1,533	1,604	1,649	1,682	1,729	17,075
3.00% to 3.49%	12,248	258	276	287	299	3,852
3.50% to 3.99%	685	695	706	717	328	2,942
4.00% to 4.99%	50	50	55	27,055	55	138,380
5.00% to 5.49%	-	-	-	-	-	292,496
5.50% to 5.99%	-	-	-	-	-	169,000
6.00% to 6.49%	644	10,172	-	-	15,000	69,360
6.50% to 6.99%	10,000	-	-	-	-	12,000
7.00% to 7.49%	2,540	2,585	634	687	744	6,098
7.50% to 7.99%	210	227	245	264	286	23,546
8.00% to 8.49%	152	167	184	202	222	25,361
8.50% to 8.99%	-	-	-	-	-	9,000
9.00% to 9.49%	584	594	604	20,615	5,627	18,077
9.50% to 9.99%	995	5,995	994	994	994	28,766
10.00% to 10.50%	-	-	-	-	-	6,000
Total	$ 31,155	$ 23,961	$ 7,004	$ 54,192	$ 26,998	$ 839,505

In March 2006, Aqua Pennsylvania issued $40,000 of unsecured notes at 5.95% of which $10,000 are due in 2023, 2024, 2033 and 2034. In September 2006, Aqua Pennsylvania issued $20,000 of unsecured notes at 5.64% with amounts due in 2014, 2016, 2020 and 2021. Proceeds from the sales of these notes were used to repay short-term borrowings. In December 2006, the Company issued $30,000 of unsecured notes with an interest rate of 5.54% of which $10,000 are due in 2013, 2017 and 2018. The proceeds of this financing were used to fund acquisitions. At various times during 2006, Aqua Pennsylvania and other operating subsidiaries issued other notes payable and first mortgage bonds in aggregate of $14,728 at a weighted average interest rate of 3.64% due at various times ranging from 2016 to 2036. The proceeds from these issuances were used to reduce a portion of the balance of the short-term debt at each of the respective operating subsidiaries.

In February 2005, the Company issued $30,000 of unsecured notes of which $18,000 are due in 2015 with an interest rate of 5.01% and $12,000 are due in 2020 with an interest rate of 5.20%. The proceeds of this financing were used to refinance existing short-term debt. In May 2005, Aqua Pennsylvania issued $72,000 of tax-exempt bonds secured by a supplement to its first mortgage indenture at the following terms: $22,000 at 4.87% due 2036, $25,000 at 4.88% due 2037 and $25,000 at 4.89% due 2038. Of the $72,000 in proceeds, $22,000 was used to retire previously issued tax-exempt bonds in August 2005 and the balance of proceeds are restricted to funding the costs of certain capital projects during the period 2005 through 2007. In December 2005, Aqua Pennsylvania issued $25,000 of tax-exempt bonds at 4.82% due 2035, which were secured by a supplement to its first mortgage indenture. The proceeds are restricted to funding certain capital projects during the period 2006 through 2008. At various times during 2005, Aqua Pennsylvania and other operating subsidiaries issued other notes payable, first mortgage bonds and tax-exempt bonds aggregating $24,677 at a weighted-average interest rate of 4.10% due at various times ranging from 2019 to 2035. The proceeds from these issuances were used to reduce a portion of the balance of

short-term debt at each of the respective operating subsidiaries and to redeem $10,260 of first mortgage bonds of an operating subsidiary with an interest rate of 5.60%. As of December 31, 2006, the Trustees for ten issues held $11,490 pending construction of the projects to be financed with the issues and are reported in the consolidated balance sheet as funds restricted for construction activity. The weighted average cost of long-term debt at December 31, 2006 and 2005 was 5.72% and 5.74%, respectively.

Aqua Pennsylvania has a $70,000 364-day revolving credit facility with four banks and the Company has a $20,000 364-day bank revolving credit facility. Funds borrowed under these agreements are classified as loans payable and are used to provide working capital. As of December 31, 2006 and 2005, funds borrowed under the Aqua Pennsylvania revolving credit agreements were $3,000 and $65,000, respectively, and $20,000 and $17,000 were borrowed under the Company's revolving credit agreement, respectively. Interest under these facilities is based, at the borrower's option, on the prime rate, an adjusted federal funds rate, an adjusted London Interbank Offered Rate corresponding to the interest period selected, an adjusted Euro-Rate corresponding to the interest period selected or at rates offered by the banks. These agreements restrict short-term borrowings of Aqua Pennsylvania and the Company. A commitment fee of 1/10 of 1% is charged on the total commitment amount of Aqua Pennsylvania's revolving credit agreement. The average cost of borrowing under these facilities was 5.4% and 3.8%, and the average borrowing was $66,283 and $63,355, during 2006 and 2005, respectively. The maximum amount outstanding at the end of any one month was $85,000 in both 2006 and 2005.

At December 31, 2006 and 2005, the Company had combined short-term lines of credit of $148,000 and $127,000, respectively. Funds borrowed under these lines are classified as loans payable and are used to provide working capital. As of December 31, 2006 and 2005, funds borrowed under the short-term lines of credit were $96,150 and $56,505, respectively. The average borrowing under the lines was $77,528 and $35,610 during 2006 and 2005, respectively. The maximum amount outstanding at the end of any one month was $96,150 in 2006 and $56,505 in 2005. Interest under the lines is based at the Company's option, depending on the line, on the prime rate, an adjusted Euro-Rate, an adjusted federal funds rate or at rates offered by the banks. The average cost of borrowings under all lines during 2006 and 2005 was 5.5% and 3.9%, respectively.

Interest income of $3,241, $3,040 and $1,762 was netted against interest expense on the consolidated statements of income for the years ended December 31, 2006, 2005 and 2004, respectively. The total interest cost was $61,673, $55,102 and $50,441 in 2006, 2005 and 2004, including amounts capitalized of $3,941, $2,447 and $2,304, respectively.

Fair Value of Financial Instruments

The carrying amount of current assets and liabilities that are considered financial instruments approximates their fair value as of the dates presented. The carrying amount and estimated fair value of the Company's long-term debt are as follows:

	December 31,	
	2006	2005
Carrying amount	$ 982,815	$ 903,083
Estimated fair value	986,487	950,479

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. The Company's customers' advances for construction and related tax deposits have a carrying value of $76,820 and $74,828 at December 31, 2006 and 2005, respectively. Their relative fair values cannot be accurately estimated because future refund payments depend on several variables, including new customer connections, customer consumption levels and future rate increases. Portions of these non-interest bearing instruments are payable annually through 2021 and amounts not paid by the contract expiration dates become non-refundable. The fair value of these amounts would, however, be less than their carrying value due to the non-interest bearing feature.

Stockholders' Equity

At December 31, 2006, the Company had 300,000,000 shares of common stock authorized; par value $0.50. Shares outstanding at December 31, 2006, 2005 and 2004 were 132,325,579, 128,970,181 and 127,179,777, respectively. Treasury shares held at December 31, 2006, 2005 and 2004 were 691,746, 688,625 and 686,747, respectively. At December 31, 2006, the Company had 1,738,619 shares of authorized but unissued Series Preferred Stock, $1.00 par value.

In December 2005, the Company filed a universal shelf registration with the Securities and Exchange Commission to allow for the potential future sale by us, from time to time, in one or more public offerings, of an indeterminant amount of our common stock, preferred stock, debt securities and other securities specified therein at indeterminant prices.

In August 2006, the Company entered into a forward equity sale agreement for 3,525,000 shares of common stock with a third-party (the "forward purchaser"). In connection with the forward equity sale agreement, the forward purchaser borrowed an equal number of shares of the Company's common stock from stock lenders and sold the borrowed shares to the public. The Company will not receive any proceeds from the sale of its common stock by the forward purchaser until settlement of the forward equity sale agreement. The actual proceeds to be received by the Company will vary depending upon the settlement date, the number of shares designated for settlement on that settlement date and the method of settlement. Aqua America intends to use any proceeds received upon settlement of the forward equity sale agreement to fund the Company's future capital expenditure program and acquisitions, and for working capital and other general corporate purposes. The forward equity sale agreement is accounted for as an equity instrument and was recorded at a fair value of $0 at inception. It will not be adjusted so long as the Company continues to meet the accounting requirements for equity instruments.

The Company may elect to settle the forward equity sale agreement by means of a physical share settlement, net cash settlement, or net share settlement, on a settlement date or dates, no later than August 1, 2008. The forward equity sale agreement provides that the forward sale price will be computed based upon the initial forward sale price of $21.857 per share. Under limited circumstances or certain unanticipated events, the forward purchaser also has the ability to require the Company to physically settle the forward equity sale agreement in shares prior to the maturity date. The maximum number of shares that could be required to be issued by the Company to settle the forward equity sale agreement is 3,525,000 shares. As of December 31, 2006, a net cash settlement under the forward equity sale agreement would have resulted in a payment by the Company to the forward purchaser of $2,845 or a net share settlement would have resulted in the issuance of 124,876 shares by the Company to the forward purchaser. For each increase or decrease of one dollar in the average market price of Aqua America common stock above or below the forward sale price on December 31, 2006, the cash settlement option from the Company's perspective would decrease or increase by $3,525 and the net share settlement option would decrease by 161,846 shares or increase by 148,234 shares, respectively.

During the last three years, the Company completed the following offerings of equity:

- In June 2006, the Company sold 1,750,000 shares of common stock in a public offering for proceeds of $37,400, net of expenses. In August 2006, the Company sold 500,000 shares of common stock in a public offering for proceeds of $10,700, net of expenses. The net proceeds from these offerings were used to fund the Company's capital expenditure program and acquisitions, and for working capital and other general corporate purposes.
- In November 2004, the Company issued 2,606,667 shares of common stock in a public offering for proceeds of $42,600, net of expenses. The net proceeds were used to repay a portion of the Company's short-term debt. The indebtedness was incurred by Aqua America in connection with acquisitions.

In addition, the Company has a shelf registration statement filed with the Securities and Exchange Commission to permit the offering from time to time of shares of common stock and shares of preferred stock in connection with acquisitions. During 2005, 24,684 shares of common stock totaling $675 were issued by the Company to acquire water and wastewater systems. The balance remaining available for use under the acquisition shelf registration as of December 31, 2006 is 2,194,262 shares. The form and terms of any securities issued under these shelf registrations will be determined at the time of issuance.

The Company has a Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") that allows reinvested dividends to be used to purchase shares of common stock at a five percent discount from the current market value. Under the direct stock purchase program, shares are purchased by investors at market price. The shares issued under the Plan are either original issue shares or shares purchased by the Company's transfer agent in the open-market. During 2006, 2005 and 2004, under the dividend reinvestment portion of the Plan, 405,107, 401,503 and 512,609 original issue shares of common stock were sold providing the Company with proceeds of $9,341, $8,516 and $7,808, respectively.

The Board of Directors has authorized the Company to purchase its common stock, from time to time, in the open market or through privately negotiated transactions. The Company has not repurchased any shares under this authorization since 2000. As of December 31, 2006, 548,278 shares remain available for repurchase.

The Company reports comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income." Accordingly, the Company's accumulated other comprehensive income is reported in the Common Stockholders' Equity section of the Consolidated Balance Sheets, the Consolidated Statements of Common Stockholders' Equity and the related other comprehensive income is reported in the Consolidated Statements of Income and Comprehensive Income. The Company reports its unrealized gains on investments as other comprehensive income and accumulated other comprehensive income. Prior to the fourth quarter of 2006, a portion of the Company's minimum pension liability had been charged to accumulated other comprehensive income or loss. During the fourth quarter of 2006, the Company recorded a regulatory asset for its minimum pension liability as it anticipates recovery of its future pension expense through customer rates. Concurrent with this adjustment, the minimum pension liability was adjusted through other comprehensive income and removed from accumulated other comprehensive income.

Net Income per Common Share and Equity per Common Share

Basic net income per share is based on the weighted average number of common shares outstanding. Diluted net income per share is based on the weighted average number of common shares outstanding and potentially dilutive shares. The dilutive effect of employee stock options and shares issuable under the forward equity sale agreement (from the date the company entered into the forward equity sale agreement to the settlement date) is included in the computation of diluted net income per share. The dilutive effect of stock options and shares issuable under the forward equity sale agreement is calculated using the treasury stock method and expected proceeds upon exercise of the stock options and settlement of the forward equity sale agreement. The following table summarizes the shares, in thousands, used in computing basic and diluted net income per share:

	Years ended December 31,		
	2006	2005	2004
Average common shares outstanding during the period for basic computation	130,725	127,364	124,329
Effect of dilutive securities:			
Employee stock options	978	1,842	1,381
Forward equity shares	71	-	-
Average common shares outstanding during the period for diluted computation	131,774	129,206	125,710

For the years ended December 31, 2006 and 2004, employee stock options outstanding to purchase 581,850 and 759,867 shares of common stock, respectively, were excluded from the calculations of diluted net income per share as the options' exercise prices were greater than the average market price of the Company's common stock. For the year ended December 31, 2005, there were no outstanding employee stock options excluded from the calculation of diluted net income per share as the average market price of the Company's common stock was greater than the options' exercise price.

Equity per common share was $6.96 and $6.30 at December 31, 2006 and 2005, respectively. These amounts were computed by dividing common stockholders' equity by the number of shares of common stock outstanding at the end of each year.

Shareholder Rights Plan

The Company has a Shareholder Rights Plan designed to protect the Company's shareholders in the event of an unsolicited unfair offer to acquire the Company. Each outstanding common share is entitled to one Right which is evidenced by the common share certificate. In the event that any person acquires 20% or more of the outstanding common shares or commences a tender or exchange offer which, if consummated, would result in a person or corporation owning at least 20% of the outstanding common shares of the Company, the Rights will begin to trade independently from the common shares and, if certain circumstances occur, including the acquisition by a person of 20% or more of the outstanding common shares, each Right would then entitle its holder to purchase a number of common shares of the Company at a substantial discount. If the Company is involved in a merger or other business combination at any time after the Rights become exercisable, the Rights will entitle the holder to acquire a certain number of shares of common stock of the acquiring company at a substantial discount. The Rights are redeemable by the Company at a redemption price of $.01 per Right at any time before the Rights become exercisable. The Rights will expire on March 1, 2008, unless previously redeemed.

Employee Stock and Incentive Plan

Under the 2004 Equity Compensation Plan (the "2004 Plan"), as approved by the shareholders to replace the 1994 Equity Compensation Plan (the "1994 Plan"), qualified and non-qualified 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 December 31, 2006, 3,521,136 options 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 1994 Plan may be re-issued under the plan.

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 report have not been restated to reflect the fair value method of expensing share-based compensation. Under this transition method, compensation cost recognized in the year ended December 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 year ended December 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 $2,894, increased capitalized compensation costs within property, plant and equipment by $631, lowered income tax expense by $326, lowered net income by $2,568, lowered diluted net income per share by $0.019, and lowered basic net income per share by $0.02. 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 as determined under SFAS 123R. As of the date of adoption, the Company has calculated its pool of windfall tax benefits in accordance with the method outlined in SFAS 123R.

Options under the plans were issued at the market price of the stock on the day of the grant. Options are exercisable in installments of 33% annually, starting one year from the date of the grant and expire 10 years from the date of the grant. The fair value of 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 years ended December 31, 2006, 2005 and 2004 was $7.82, $4.54 and $4.07 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 for the periods reported:

	2006	2005	2004
Expected term (years)	5.2	5.2	4.5
Risk-free interest rate	4.7%	4.0%	4.0%
Expected volatility	25.8%	27.8%	29.9%
Dividend yield	1.76%	2.40%	2.23%

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 year ended December 31, 2006:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (years)	Aggregate Intrinsic Value
Options:				
Outstanding, beginning of year	3,492,363	$ 13.70		
Granted	611,950	29.46		
Forfeited	(46,684)	22.84		
Expired	(26,639)	22.04		
Exercised	(666,212)	11.95		
Outstanding, end of year	3,364,778	$ 16.72	6.6	$ 24,268
Exercisable, end of year	2,044,825	$ 12.76	5.4	$ 20,486

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 the aggregate intrinsic value of stock options exercised and the fair value of stock options which became vested:

	Years ended December 31,		
	2006	2005	2004
Intrinsic value of options exercised	$ 9,779	$ 18,473	$ 4,180
Fair value of options vested	3,794	3,532	3,079

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

	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	382,949	2.3	$ 7.60	382,949	$ 7.60
$10.00 - 12.99	997,750	5.4	12.21	997,750	12.21
$13.00 - 15.99	90,779	6.4	13.76	90,779	13.76
$16.00 - 16.99	576,865	7.3	16.15	347,925	16.15
$17.00 - 18.33	734,585	8.2	18.33	225,422	18.33
$29.00 - 29.99	581,850	9.3	29.46	-	-
	3,364,778	6.6	$ 16.72	2,044,825	$ 12.76

As of December 31, 2006, there was $4,732 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 1.1 years.

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 prior to the adoption of SFAS 123R for the grants that were under restriction as of January 1, 2006. During the years ended December 31, 2006, 2005 and 2004, the company recorded stock-based compensation related to restricted stock awards as operations and maintenance expense in the amounts of $710, $495 and $439, respectively. The following table summarizes nonvested restricted stock transactions for the year ended December 31, 2006:

	Number of Shares	Weighted Average Fair Value
Nonvested shares at beginning of period	43,998	$ 17.70
Granted	42,200	28.39
Vested	(24,310)	19.11
Forfeited	(5,000)	29.46
Nonvested shares at end of period	56,888	$ 23.98

The following table summarizes the value of restricted stock awards at the date the restriction lapsed:

	Years ended December 31,		
	2006	2005	2004
Intrinsic value of restricted stock awards vested	$ 660	$ 614	$ 449
Fair value of restricted stock awards vested	465	500	360

As of December 31, 2006, $890 of unrecognized compensation costs related to restricted stock is expected to be recognized over a weighted-average period of 1.0 year. The aggregate intrinsic value of restricted stock as of December 31, 2006 was $1,296. 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.

Pension Plans and Other Postretirement Benefits

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

In addition to providing pension benefits, the Company offers certain Postretirement Benefits other than Pensions ("PBOPs") to employees hired before April 1, 2003 and retiring with a minimum level of service. These PBOPs include continuation of medical and prescription drug benefits for eligible retirees and life insurance benefits for certain eligible retirees. The Company funds its gross PBOP cost through various trust accounts. The benefits of retired officers and certain other retirees are paid by the Company and not from plan assets due to limitations imposed by the Internal Revenue Code.

The Company adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)" on December 31, 2006. As a result of adopting SFAS No. 158, the Company recorded the underfunded status of its pension and other postretirement benefit plans on the balance sheet and recorded a regulatory asset for these costs that would otherwise be charged to common stockholders' equity, as we anticipate recoverability of the costs through customer rates. As a result of adopting SFAS No. 158, the additional minimum liability associated with the Company's defined benefit pension plan was eliminated as it is no longer required to be recorded under SFAS No. 158. Prior to the adoption of SFAS No. 158 on December 31, 2006, the Company's additional minimum liability was $3,498. The additional minimum liability was a result of the accumulated benefit obligation exceeding the fair value of plan assets. The decrease in the additional minimum liability from December 31, 2005 of $10,909 to December 31, 2006 of $3,498, prior to adoption of SFAS No. 158, resulted from the effect of an increased discount rate and an increase in pension plan assets during 2006 due to positive equity market performance and pension contributions. In accordance with SFAS No. 158, the Company's 2005 accounting and related disclosures were not affected by the adoption of the new accounting standard. The adoption of this standard had no impact on the Company's results of operations or cash flow. The table below summarizes the incremental effects of SFAS No. 158 adoption on the individual line items on the Company's Consolidated Balance Sheet at December 31, 2006:

	Pre - SFAS No. 158 Adoption	SFAS No. 158 Adjustment	Post - SFAS No. 158 Adoption
Assets:			
Regulatory assets	$ 4,167	$ 32,302	$ 36,469
Deferred charges and other assets, net	1,997	(1,997)	-
	$ 6,164	$ 30,305	$ 36,469
Liabilities:			
Other accrued liabilities	$ 10,391	$ (10,260)	$ 131
Other liabilities	18,718	40,565	59,283
	$ 29,109	$ 30,305	$ 59,414

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

	Pension Benefits	Other Postretirement Benefits
Years:		
2007	$ 7,017	$ 964
2008	7,363	1,024
2009	7,794	1,105
2010	8,259	1,210
2011	8,848	1,293
2012 - 2016	56,262	8,186

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

	Pension Benefits		Other Postretirement Benefits	
	2006	2005	2006	2005
Change in benefit obligation:				
Benefit obligation at January 1,	$ 179,741	$ 171,076	$ 29,161	$ 32,804
Service cost	4,784	4,847	1,002	1,223
Interest cost	10,094	9,805	1,581	1,882
Plan amendments	406	-	-	(7,047)
Actuarial (gain) loss	(10,469)	420	(2,941)	1,317
Plan participants' contributions		-	249	584
Benefits paid	(6,272)	(6,407)	(842)	(1,602)
Benefit obligation at December 31,	178,284	179,741	28,210	29,161
Change in plan assets:				
Fair value of plan assets at January 1,	117,671	115,292	18,942	16,606
Actual return on plan assets	8,757	7,790	933	675
Employer contributions	6,521	996	1,367	2,678
Benefits paid	(6,483)	(6,407)	(628)	(1,017)
Fair value of plan assets at December 31,	126,466	117,671	20,614	18,942
Funded status of plan:				
Funded status at December 31,	51,818	62,070	7,596	10,219
Unrecognized actuarial loss	-	(42,092)	-	(8,537)
Unrecognized prior service cost	-	(1,687)	-	7,517
Unrecognized net transition obligation	-	809	-	(5,624)
Net amount recognized	$ 51,818	$ 19,100	$ 7,596	$ 3,575

Company's pension plans had an accumulated benefit obligation of $150,999 and $148,629 at December 31, 2006 and 2005, respectively. The following table provides the net liability recognized on the Consolidated Balance Sheets at December 31:

	Pension Benefits		Other Postretirement Benefits	
	2006	2005	2006	2005
Current liability	$ (131)	$ -	$ -	$ -
Noncurrent liability	(51,687)	-	(7,596)	-
Prepaid benefits cost	-	-	-	555
Accrued benefit cost	-	(19,100)	-	(4,130)
Additional minimum liability	-	(12,726)	-	-
Intangible assets	-	1,817	-	-
Regulatory asset	-	6,167	-	-
Accumulated other comprehensive loss	-	4,742	-	-
Net liability recognized	$ (51,818)	$ (19,100)	$ (7,596)	$ (3,575)

At December 31, 2006 and 2005, the Company's pension plans had benefit obligations in excess of its plan assets. The following tables provide the projected benefit obligation, the accumulated benefit obligation and fair market value of the plan assets as of December 31,:

	Projected Benefit Obligation Exceeds the Fair Value of Plan Assets	
	2006	2005
Projected benefit obligation	$ 178,284	$ 179,741
Fair value of plan assets	126,466	117,671

	Accumulated Benefit Obligation Exceeds the Fair Value of Plan Assets	
	2006	2005
Accumulated benefit obligation	$ 150,999	$ 148,629
Fair value of plan assets	126,466	117,671

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

	Pension Benefits			Other Postretirement Benefits		
	2006	2005	2004	2006	2005	2004
Service cost	$ 4,783	$ 4,847	$ 4,312	$ 1,003	$ 1,223	$ 1,112
Interest cost	10,094	9,805	9,512	1,582	1,882	1,825
Expected return on plan assets	(9,397)	(9,536)	(9,169)	(1,299)	(1,261)	(1,086)
Amortization of transition obligation (asset)	(209)	(209)	(209)	104	803	803
Amortization of prior service cost	216	403	419	(281)	(57)	(57)
Amortization of actuarial (gain) loss	1,756	1,606	1,009	300	219	125
Amortization of regulatory asset	-	-	-	152	136	144
Capitalized costs & other	(1,826)	(1,847)	(1,021)	(757)	(739)	(629)
Net periodic benefit cost	$ 5,417	$ 5,069	$ 4,853	$ 804	$ 2,206	$ 2,237

Accounting for pensions and other postretirement benefits requires an extensive use of assumptions about the discount rate, expected return on plan assets, the rate of future compensation increases received by the Company's employees, mortality, turnover and medical costs. Each assumption is reviewed annually with assistance from the Company's actuarial consultant who provides guidance in establishing the assumptions. The assumptions are selected to represent the average expected experience over time and may differ in any one year from actual experience due to changes in capital markets and the overall economy. These differences will impact the amount of pension and other postretirement benefit expense that the Company recognizes.

The significant assumptions related to the Company's pension and other postretirement benefit plans are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2006	2005	2006	2005
Weighted-average Assumptions Used to Determine Benefit Obligations as of December 31,				
Discount rate	5.90%	5.65%	5.90%	5.65%
Rate of compensation increase	4.0-5.0%	4.0-5.0%	4.0%	4.0%
Assumed Health Care Cost Trend Rates Used to Determine Benefit Obligations as of December 31,				
Health care cost trend rate	n/a	n/a	9%	10%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	n/a	n/a	5%	5%
Year that the rate reaches the ultimate trend rate	n/a	n/a	2011	2011
Weighted-average Assumptions Used to Determine Net Periodic Benefit Costs for Years Ended December 31,				
Discount rate	5.65%	5.75%	5.65%	5.75%
Expected return on plan assets	8.0%	8.5%	5.33-8.0%	6.0-9.0%
Rate of compensation increase	4.0-5.0%	4.0-5.0%	4.0%	4.0%
Assumed Health Care Cost Trend Rates Used to Determine Net Periodic Benefit Costs for Years Ended December 31,				
Health care cost trend rate	n/a	n/a	10%	10%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	n/a	n/a	5%	5%
Year that the rate reaches the ultimate trend rate	n/a	n/a	2011	2010

n/a – Assumption is not applicable to pension benefits.

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

	1-Percentage-Point Increase	1-Percentage-Point Decrease
Effect on the health-care component of the accrued other postretirement benefit obligation	$ 1,516	$ (1,483)
Effect on total service and interest cost components of net periodic postretirement health-care benefit cost	$ 150	$ (150)

The Company's discount rate assumption was determined using a yield curve that was produced from a universe containing over 500 U.S.-issued Aa-graded corporate bonds, all of which were noncallable (or callable with make-whole provisions), and excluding the 10% of the bonds with the highest yields and the 10% with the lowest yields. The discount rate was then developed as the single rate that would produce the same present value as if the Company used spot rates, for various time periods, to discount the projected pension benefit payments. The Company's pension expense and liability (benefit obligations) increases as the discount rate is reduced. A 25 basis-point reduction in this assumption would have increased 2006 pension expense by $660 and the pension liabilities by $6,500.

The Company's expected return on assets is determined by evaluating the asset class return expectations with its advisors as well as actual, long-term, historical results of our asset returns. The Company's pension expense increases as the expected return on assets decreases. A 25 basis-point reduction in this assumption would have increased 2006 pension expense by $300. For 2006, the Company used an 8.0% expected return on assets assumption which will remain unchanged for 2007. The Company believes its actual long-term asset allocation on average will approximate the targeted allocation. The Company's investment strategy is to earn a reasonable rate of return while maintaining risk at acceptable levels through the diversification of investments across and within various asset categories. Investment returns are compared to benchmarks that include the S&P 500 Index, the Lehman Brothers Intermediate Government/Credit Index, and a combination of the two indices. The Pension Committee meets semi-annually to review plan investments and management monitors investment performance quarterly through a performance report prepared by an external consulting firm.

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

	2007 Target Allocation	Percentage of Plan Assets at December 31,	
		2006	2005
Asset Category:			
Equity securities	50 to 75%	63%	60%
Debt securities	25 to 50%	28%	24%
Cash	0%	7%	16%
Other	0%	2%	0%
Total	100%	100%	100%

Equity securities include Aqua America, Inc. common stock in the amounts of $9,460 or 7.5% of total plan assets and $11,121 or 9.5% of total plan assets as of December 31, 2006 and 2005, respectively.

The asset allocation for the Company's other postretirement benefit plans and the target allocation by asset category are as follows:

	2007 Target Allocation	Percentage of Plan Assets at December 31,	
		2006	2005
Asset Category:			
Cash	65%	66%	67%
Equity securities	35%	34%	33%
Total	100%	100%	100%

Minimum funding requirements for qualified defined benefit pension plans are determined by government regulations and not by accounting pronouncements. In accordance with funding rules and the Company's funding policy, during 2007 our pension contribution is expected to be $7,300. The Pension Protection Act of 2006 was signed into law in August 2006. The Company is currently evaluating this legislation and the effect it will have on its future pension contributions and does not expect its estimate for the 2007 funding amount to change. The Company's funding of its PBOP cost during 2007 is expected to approximate $2,960.

The Company has 401(k) savings plans that cover substantially all employees. The Company makes matching contributions that are invested in Aqua America, Inc. common stock based on a percentage of an employee's contribution, subject to certain

limitations. The Company's matching contribution, recorded as compensation expense, was $1,289, $1,236 and $1,160 for the years ended December 31, 2006, 2005 and 2004, respectively.

Water and Wastewater Rates

On June 22, 2006, the Pennsylvania Public Utility Commission ("PAPUC") granted the Company's operating subsidiary in Pennsylvania a $24,900 base water rate increase, on an annualized basis. The rates in effect at the time of the filing included $12,397 in Distribution System Improvement Charges ("DSIC") or 5.0% above the prior base rates. Consequently, the total base rates increased by $37,297 and the DSIC was reset to zero. On August 5, 2004, the PAPUC granted Aqua Pennsylvania, Inc. a $13,800 base rate increase. The rates in effect at the time of the filing included $11,200 in Distribution System Improvement Charges ("DSIC") or 5.0% above the prior base rates. Consequently, the total base rates increased by $25,000 and the DSIC was reset to zero.

In May 2004, the Company's operating subsidiary in Texas filed an application with the Texas Commission on Environmental Quality ("TCEQ") to increase rates, on an annualized basis, 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 TCEQ and several parties 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, in accordance with authorization from the TCEQ in July 2004. The additional revenue billed and collected prior to the final ruling is 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. In the event the Company's request is denied completely or in part, the Company could be required to refund some or all of the revenues billed to date, and write-off some or all of the regulatory asset for the expense deferral. In December 2006, the TCEQ held hearings and issued a rate schedule that provided further clarification and an indication of the expected outcome of the rate proceeding. Based on the Company's review of the present circumstances and as a result of the December 2006 hearings, the Company has revised its estimates of the final outcome of the TCEQ proceeding. During the fourth quarter of 2006, the revenue reserve was adjusted and additional revenues were recognized of $1,487 and the regulatory asset was increased resulting in lower expenses recognized of $1,199. As of December 31, 2006, we have deferred $12,382 of operating costs and $2,804 of rate case expenses and recognized $14,859 of revenue that is subject to refund based on the outcome of the final commission order.

The Company's other operating subsidiaries were allowed annual rate increases of $7,366 in 2006, $5,142 in 2005 and $6,673 in 2004, represented by thirty-two, twenty-three and fourteen rate decisions, respectively. Revenues from these increases realized in the year of grant were approximately $3,580, $3,144 and $3,995 in 2006, 2005 and 2004, respectively.

Six states in which the Company operates permit water utilities, and in two states wastewater utilities, to add a surcharge to their water or wastewater bills to offset the additional depreciation and capital costs related to infrastructure system replacement and rehabilitation projects completed and placed into service between base rate filings. Currently, Pennsylvania, Illinois, Ohio, New York, Indiana and Missouri allow for the use of infrastructure rehabilitation surcharges. These mechanisms typically adjust periodically based on additional qualified capital expenditures completed or anticipated in a future period. The infrastructure rehabilitation surcharge is capped as a percentage of base rates, generally at 5% to 9% of base rates, and is reset to zero when new base rates that reflect the costs of those additions become effective or when a utility's earnings exceed a regulatory benchmark. Infrastructure rehabilitation surcharges provided revenues in 2006, 2005 and 2004 of $7,873, $10,186 and $7,817, respectively.

Segment Information

The Company has identified fourteen operating segments and one reportable segment. Prior to the acquisition in 2006 of companies that provide on-site septic tank pumping and sludge hauling services, the Company's non-regulated operations were limited in scope and impact on its financial results and assets, and as a result the Company previously operated them as part of its regulated operating segments. The Company made this determination based on an evaluation of its operating segments during the fourth quarter of 2006.

The Regulated segment, the Company's single reportable segment, is comprised of thirteen operating segments representing our water and wastewater regulated utility companies which are organized by the states where we provide water and wastewater services. These operating segments are aggregated into one reportable segment since each of these operating segments has the following similarities: economic characteristics, nature of services, production processes, customers, water distribution or wastewater collection methods, and the nature of the regulatory environment.

One segment is included within the other category below. This segment is not quantitatively significant and is comprised of the Company's businesses that provide on-site septic tank pumping, sludge hauling services and other water and wastewater services. In addition to this segment, 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 certain general and administrative expenses, and interest expense for certain of the Company's regulated utility companies that do not have their own credit facilities.

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

	As of or For the Year Ended December 31, 2006			As of or For the Year Ended December 31, 2005		
	Regulated	Other	Consolidated	Regulated	Other	Consolidated
Operating revenues	$ 526,293	$ 7,198	$ 533,491	$ 493,456	$ 3,323	$ 496,779
Operations and maintenance expense	216,919	2,641	219,560	202,662	426	203,088
Depreciation	73,380	(2,485)	70,895	63,756	(3,009)	60,747
Operating income	199,224	6,323	205,547	191,419	5,088	196,507
Interest expense, net of AFUDC	43,348	11,143	54,491	41,857	7,758	49,615
Income tax	62,134	(1,888)	60,246	58,647	(1,734)	56,913
Net income	94,941	(2,937)	92,004	92,092	(936)	91,156
Capital expenditures	271,777	(71)	271,706	236,637	825	237,462
Total assets	2,819,385	58,518	2,877,903	2,699,941	(64,895)	2,635,046
Goodwill	18,537	4,043	22,580	20,078	102	20,180

	As of or For the Year Ended December 31, 2004		
	Regulated	Other	Consolidated
Operating revenues	$ 439,972	$ 2,067	$ 442,039
Operations and maintenance expense	179,332	(987)	178,345
Depreciation	57,840	(3,276)	54,564
Operating income	171,413	5,821	177,234
Interest expense, net of AFUDC	39,372	7,003	46,375
Income tax	52,816	(692)	52,124
Net income	80,094	(87)	80,007
Capital expenditures	195,299	437	195,736
Total assets	2,400,696	(45,322)	2,355,374
Goodwill	20,122	-	20,122

2006	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Operating revenues	$ 117,949	$ 131,749	$ 146,950	$ 136,843	$ 533,491
Operations and maintenance expense	51,316	55,433	59,127	53,684	219,560
Operating income	40,622	50,089	59,523	55,313	205,547
Net income	16,564	22,386	27,331	25,723	92,004
Basic net income per common share	0.13	0.17	0.21	0.19	0.70
Diluted net income per common share	0.13	0.17	0.21	0.19	0.70
Dividend paid per common share	0.1069	0.1069	0.1150	0.1150	0.4438
Dividend declared per common share	0.1069	0.1069	0.2300	-	0.4438
Price range of common stock					
- high	29.79	27.82	23.93	24.94	29.79
- low	26.50	20.13	21.13	21.54	20.13
2005					
Operating revenues	$ 113,988	$ 123,100	$ 136,783	$ 122,908	$ 496,779
Operations and maintenance expense	47,309	50,891	52,666	52,222	203,088
Operating income	42,771	48,593	59,091	46,052	196,507
Net income	18,871	22,218	27,917	22,150	91,156
Basic net income per common share	0.15	0.17	0.22	0.17	0.72
Diluted net income per common share	0.15	0.17	0.21	0.17	0.71
Dividend paid per common share	0.0975	0.0975	0.0975	0.1069	0.3994
Dividend declared per common share	0.0975	0.0975	0.2044	-	0.3994
Price range of common stock					
- high	19.37	23.24	29.15	29.22	29.22
- low	17.49	18.03	21.61	22.88	17.49

High and low prices of the Company's common stock are as reported on the New York Stock Exchange Composite Tape. The cash dividends paid in December 2006 of $0.115 and December 2005 of $0.1069 were declared in September 2006 and August 2005, respectively.

Summary of Selected Financial Data — Aqua America, Inc. and Subsidiaries

(in thousands of dollars, except per share amounts)

Years ended December 31,	2006	2005	2004 (a)	2003 (b)	2002
PER COMMON SHARE:					
Net income					
Basic	$0.70	$0.72	$0.64	$ 0.60	$ 0.59
Diluted	0.70	0.71	0.64	0.59	0.58
Cash dividends declared and paid	0.44	0.40	0.37	0.34	0.32
Return on average stockholders' equity	10.6%	11.7%	11.4%	12.3%	13.9%
Book value at year end	$6.96	$6.30	$5.88	$5.33	$4.35
Market value at year end	22.78	27.30	18.44	16.58	12.36
INCOME STATEMENT HIGHLIGHTS:					
Operating revenues	$533,491	$496,779	$442,039	$367,233	$322,028
Depreciation and amortization	75,041	65,488	58,864	51,463	44,322
Interest expense, net (c)	54,491	49,615	46,375	42,535	39,007
Income before income taxes	152,250	148,069	132,131	116,718	109,252
Provision for income taxes	60,246	56,913	52,124	45,923	42,046
Net income available to common stock	92,004	91,156	80,007	70,785	67,154
BALANCE SHEET HIGHLIGHTS:					
Total assets	$2,877,903	$2,635,046	$2,355,374	$2,071,252	$1,716,030
Property, plant and equipment, net	2,505,995	2,279,950	2,069,812	1,824,291	1,486,703
Common stockholders' equity	921,630	811,923	747,231	658,118	492,594
Long-term debt, including current portion	982,815	903,083	834,656	736,052	617,175
Total debt	1,101,965	1,041,588	909,466	832,511	732,288
ADDITIONAL INFORMATION:					
Net cash flows from operating activities	$170,726	$199,674	$173,603	$143,373	$121,560
Capital additions	271,706	237,462	195,736	163,320	136,164
Net cash expended for acquisitions of utility systems and other	11,848	11,633	54,300	192,331	8,914
Dividends on common stock	58,023	51,139	45,807	39,917	36,789
Number of utility customers served (d)	927,235	864,894	835,512	749,491	605,474
Number of shareholders of common stock	28,348	27,054	24,082	22,726	21,389
Common shares outstanding (000)	132,326	128,970	127,180	123,452	113,194
Employees (full-time)	1,540	1,489	1,442	1,260	971

(a) 2004 includes a partial year of financial results for the mid-year acquisition of Heater Utilities, Inc. and certain utility assets of Florida Water Services Corporation.

(b) 2003 includes five months of financial results for the AquaSource operations acquired in July 2003.

(c) Net of allowance for funds used during construction and interest income.

(d) 2006 includes 44,792 customers associated with the New York Water Service Corporation. The operating results of this acquisition will be reported in our consolidated financial statements beginning January 1, 2007.

Financial Reports and Investor Relations

Copies of the company's public financial reports, including annual reports and Forms 10–K and 10–Q, are available on line and can be downloaded from the investor relations section of our Web site at www.aquaamerica.com. You may also obtain these reports by writing to us at:

ATTN: Investor Relations
Aqua America, Inc.
762 W. Lancaster Avenue
Bryn Mawr, PA 19010-3489
www.aquaamerica.com

Corporate Governance

We are committed to maintaining high standards of corporate governance and are in compliance with the corporate governance rules of the Securities and Exchange Commission (SEC) and the New York Stock Exchange. Copies of our key corporate governance documents, including our Corporate Governance Guidelines, Code of Ethical Business Conduct, and the charters of each committee of our Board of Directors can be obtained from the corporate governance portion of the investor relations section of our Web site www.aquaamerica.com or requests may be directed to the address above. Amendments to the Code, and any grant of waiver from a provision of the Code requiring disclosure under applicable SEC rules will be disclosed on our Web site. As required under Section 302 of the Sarbanes–Oxley Act of 2002 and Rule 13a–14(a) under the Securities and Exchange Act of 1934, Aqua America's chief executive officer and chief financial officer have performed the required certification for 2006 without exception and their certifications were filed as Exhibits 31.1 and 31.2 to our Form 10-K for 2006. You may access this report and our other SEC filings from our Web site. In addition, in 2006 the company's chief executive officer provided to the New York Stock Exchange the Annual CEO certification regarding the company's compliance with the New York Stock Exchange's corporate governance listing standards.

Annual Meeting

10:00 a.m. Eastern Daylight Time
Thursday, May 24, 2007
Springfield Country Club
400 West Sproul Road
Springfield, PA 19064

Transfer Agent and Registrar

Computershare Trust Company, N.A.
P.O. Box 43078
Providence, RI 02940-3078
800.205.8314 or 781.575.3100
www.computershare.com

Independent Registered Public Accounting Firm

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

Stock Exchanges

The Common Stock of the company is listed on the New York Stock Exchange and the Philadelphia Stock Exchange under the ticker symbol WTR. The daily closing price is printed in The Wall Street Journal as AquaAmer. Listings might vary in other major newspapers.

Dividend Reinvestment and Direct Stock Purchase Plan

The company's Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") enables shareholders to reinvest all, or a designated portion of, dividends paid on up to 100,000 shares of Common Stock in additional shares of Common Stock at a five percent discount from a price based on the market value of the stock. In addition, shareholders may purchase additional shares of Aqua America Common Stock at any time with a minimum investment of $50, up to a maximum of $250,000 annually. Individuals may become shareholders by making an initial investment of at least $500. A Plan prospectus may be obtained by calling Computershare Trust Company at 800.205.8314 or by visiting www.computershare.com. **Please read the prospectus carefully before you invest.**

IRA, Roth IRA, Education IRA
An IRA, Roth IRA or Coverdell Education Savings Account may be opened through the Plan to hold shares of Common Stock of the company and to make contributions to the IRA to purchase shares of Common Stock. Participants in the Plan may roll over an existing IRA or other qualified plan distribution in cash into an IRA under the Plan to purchase the company's Common Stock. Participants may also transfer the company's Common Stock from an existing IRA into an IRA under the Plan. A prospectus, IRA forms and a disclosure statement may be obtained by calling Computershare Trust Company at 800.472.7428. Please read the prospectus carefully before you invest.

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

Delivery of voting materials to shareholders sharing an address
To reduce the expense of delivering duplicate voting materials to our shareholders who have more than one Aqua America stock account, we are delivering only one annual report and proxy statement to registered shareholders who share an address unless otherwise requested. A separate proxy card is included in the voting materials for each of these shareholders.

How to obtain a separate set of voting materials
If you are a registered shareholder who shares an address with another registered shareholder and have received only one set of voting materials for the 2006 annual meeting, you may write or call us to request a separate copy of this material at no cost to you at 610.645.1196 or Attn: Investor Relations, Aqua America, Inc., 762 W. Lancaster Avenue, Bryn Mawr, PA, 19010. For future annual meetings, you may request separate voting material by calling the Company's transfer agent at 800.205.8314.

Account Access
Aqua America shareholders may access their account by visiting www.computershare.com. Shareholders may view their account, purchase additional shares, and make changes to their account. To learn more, visit www.computershare.com or call 800.205.8314.

Dividends
Aqua America has paid dividends for 61 consecutive years. The normal Common Stock dividend dates for 2007 and the first six months of 2008 are:

Declaration Date	Ex-Dividend Date	Record Date	Payment Date
February 1, 2007	February 13, 2007	February 15, 2007	March 1, 2007
May 7, 2007	May 16, 2007	May 18, 2007	June 1, 2007
August 3, 2007	August 15, 2007	August 17, 2007	September 1, 2007
November 2, 2007	November 14, 2007	November 16, 2007	December 1, 2007
February 1, 2008	February 13, 2008	February 15, 2008	March 1, 2008
May 2, 2008	May 14, 2008	May 16, 2008	June 1, 2008

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

Only the Board of Directors may declare dividends and set record dates. Therefore, the payment of dividends and these dates may change at the discretion of the Board. Announcement of the dividend declaration is usually published in The Wall Street Journal and several other newspapers.

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

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

Safekeeping of Stock Certificates
Under the Direct Stock Purchase Plan, shareholders may have their stock certificates deposited with the transfer agent for safekeeping free of charge. Stock certificates and written instructions should be forwarded to: Computershare Trust Company, N.A., P.O. Box 43078, Providence, RI 02940-3078.

NOTES

experience | water

AQUA℠

Aqua America, Inc.
762 W. Lancaster Avenue
Bryn Mawr, PA 19010
www.aquaamerica.com

Pennsylvania

Ohio

North Carolina

Illinois

Texas

New Jersey

New York

Indiana

Florida

Virginia

Maine

Missouri

South Carolina

120 years of water. Pure and simple.

AQUA AMERICA, INC. • 2005 ANNUAL REPORT

AQUA America℠

Company Profile

Aqua America, Inc.

is the largest U.S.-based

publicly-traded water utility

serving more than 2.5 million

residents in Pennsylvania, Ohio,

North Carolina, Illinois, Texas,

New Jersey, Florida, Indiana,

Virginia, Maine, Missouri,

New York and South Carolina.

Aqua America is listed on the

New York and Philadelphia

Stock Exchanges under the

ticker symbol WTR.

Financial Highlights *(In thousands of dollars, except per share amounts)*

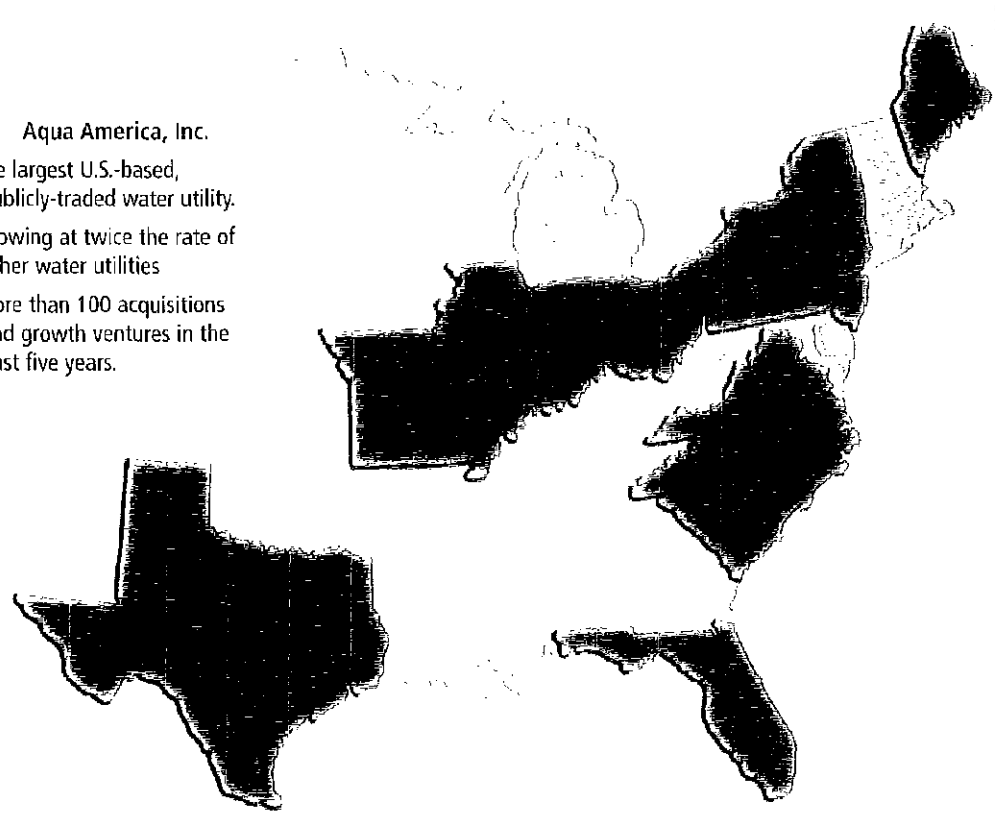
	2005	2004	% Change
• Operating revenues	$ 496,779	$ 442,039	12.4
• Net income available to common stock	91,156	80,007	13.9
• Diluted net income per common share (a)	0.71	0.64	10.9
• Annual dividend rate per common share (a)	0.4276	0.3900	9.6
• Dividends paid per common share (a)	0.3994	0.3675	8.7
• Common stockholders' equity per share (a)	6.30	5.88	7.1
• Common stockholders' equity	811,923	747,231	8.7
• Total assets	2,626,725	2,355,374	11.5
• Net cash flows from operating activities	199,674	173,603	15.0
• Capital additions (b)	237,462	195,736	21.3
• Number of customers served	864,894	835,512	3.5

(a) Restated for 2005 4-for-3 stock-split

(b) Excludes net payments for acquired water and wastewater systems: $11,633 in 2005 and $54,300 in 2004.

Aqua America, Inc.

- The largest U.S.-based, publicly-traded water utility.
- Growing at twice the rate of other water utilities
- More than 100 acquisitions and growth ventures in the past five years.



Chairman's Message

March 9, 2006

The year 2006 marks the 120 year anniversary of Aqua America.

Founded in 1886 in Springfield, Pennsylvania by a group of Swarthmore College professors, the company operated exclusively for 113 of the last 120 years in Southeastern Pennsylvania. In 1999, we made the strategic decision to acquire Consumers Water Company and take our first step outside of Southeastern Pennsylvania and enter four new states—New Jersey, Illinois, Ohio and Maine. In 2003, we took another strategic step and acquired the regulated water and wastewater operations of AquaSource, Inc., extending our reach to our current total of 13 states—adding Texas, Virginia, Florida, Indiana, South Carolina, Missouri and New York (the company first acquired a number of North Carolina systems in 2001 and expanded that number with the Heater Utilities Inc. and AquaSource acquisitions).

Our geographic expansion benefited shareholders by mitigating two of our key financial risks: regulatory environment and weather. When located only in Southeastern Pennsylvania, we were 100 percent beholden to the impact of regulatory decisions and weather patterns in one state. Now these risks are spread across our 13 states. However, even with our expansion, Pennsylvania still represents half of our growing company and has been a key part of our historical, long-term success.

The year 2005 brought well above-average stock performance with shareholders benefiting from this year's total return of more than 50 percent. This is well above our five, 10 and 15 year average total returns, which are closer to 20 percent annually. The company, our stock, and our industry benefited from increased media and investor attention during the year with feature articles appearing in *Forbes, The Wall Street Journal, The New York Times,* and various television segments on Bloomberg and CNBC.

The continuation of positive financial performance—with full year 2005 results producing 12 percent revenue growth and 14 percent net income growth over last year—allowed us to offer an above-historical-average dividend increase last year. In August, the company's board of directors approved a 10 percent increase in our shareholder dividend. The board also approved a four-for-three stock split in the form of a stock distribution at the same time. The new annualized dividend rate, adjusted for the split, is $.4276 per share. Both actions were effected on December 1, 2005.

Our growth strategy was once again in full swing this year, as we completed a record 30 acquisitions of water and wastewater systems in many of our states. Unlike our growth in 2004, which was primarily from the acquisition of two larger systems—Heater in North Carolina and Florida Water Services—this year's small system acquisitions were consistent with the type we consider our "bread and butter" and the foundation of our growth-through-acquisition program. We value these small systems because they bring new revenues, provide new platforms for future capital investment and future growth, and are also easily integrated into our operations.

We spent record amounts of capital in 2005, $237.5 million, fixing and expanding our water and wastewater systems around the country. These capital investments are critical to upgrading our infrastructure and meeting the national drinking water standards and providing quality drinking water to our customers. Capital investment is also the foundation of earnings growth using the regulated model. After making these investments, we are permitted to file for rate relief with the affected jurisdiction and request a fair, regulated return on our investment. These returns come to us in the form of new revenues and help to build our future earnings. We have earned credibility with the regulatory commissions in our states by consistently delivering on our promises. This has helped us receive a warm welcome in new states and fair treatment during the rate process.

In 2005, we were pleased to add two new directors to our board: Mr. Lon Greenberg, the CEO of UGI Corporation, and Dr. Constantine Papadakis, the President of Drexel University. We welcome the addition of both esteemed executives to our board and have already benefited from their contributions. With the entrance of our two newest directors, we also say goodbye to Mr. John Menario, former Chairman of Consumers Water Company and Mr. Jack McCaughn, former president of BetzDearborn, Inc.—both of whom retired after the March 7, 2006 board of directors meeting. Their wisdom through their combined 27 years of service offered invaluable guidance to the company through some key transitional and growth periods over the last decade. We thank them for their commitment and service.

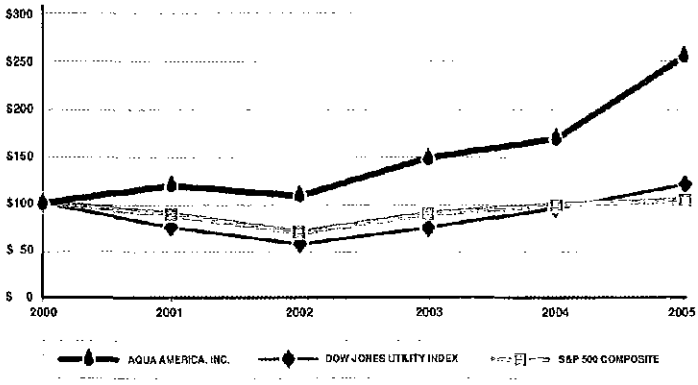
As we move forward into our 120th year, we do so with confidence in our long-term strategy and our future outlook. We believe our growth strategy has a strong foundation and, with more than 50,000 water systems and 16,000 wastewater systems in the U.S. today, plenty of future opportunity. We have completed 175 acquisitions and growth ventures over the past 10 years, giving us an expertise on which we believe we will continue to capitalize in the years to come.

Thanks to our shareholders, customers, employees and the communities we serve, we have an excellent network to support our continued success.

Nicholas DeBenedictis

Five Year Cumulative Total Return

COMPARISON OF FIVE YEAR CUMULATIVE TOTAL RETURN AMONG AQUA AMERICA, S&P 500 AND DOW JONES UTILITY INDEX

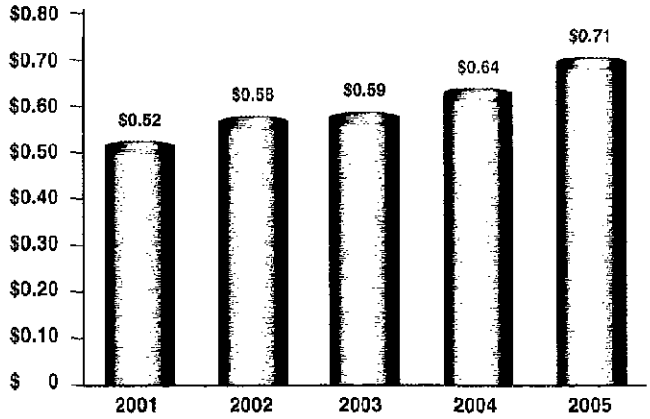


Common Stock and Dividend Highlights

- Increased cash dividend by 10 percent to $0.4276 on an annualized basis as of December 1, 2005
- 15 cash dividend increases in the last 14 years
- 4-for-3 stock split on December 1, 2005, the 6th stock split in 10 years
- Total return for 2005 more than 50 percent

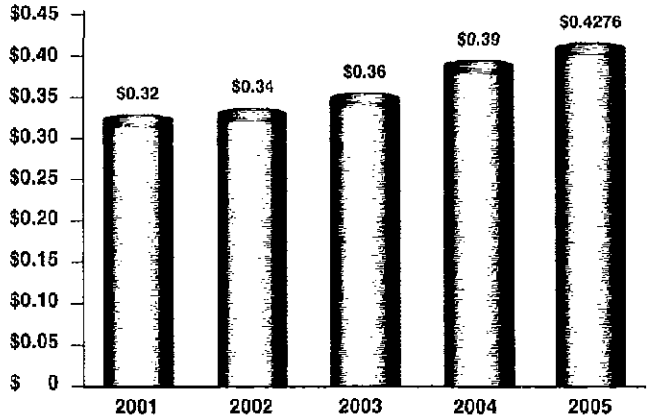
Earnings Per Share

(split-adjusted)

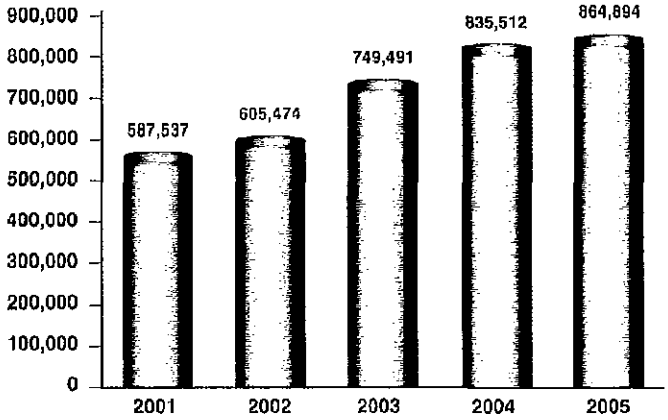


Dividends Per Share

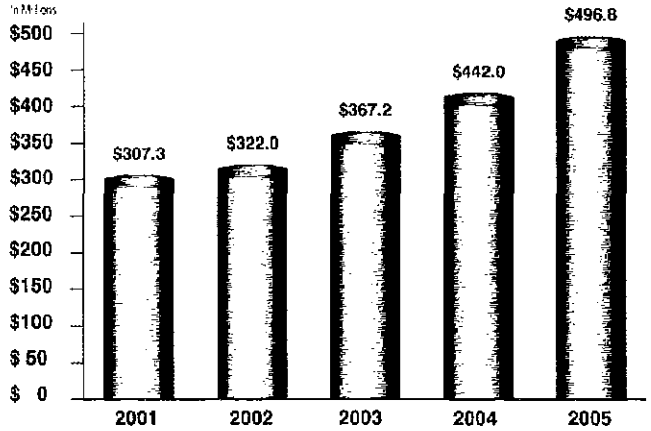
(split-adjusted)

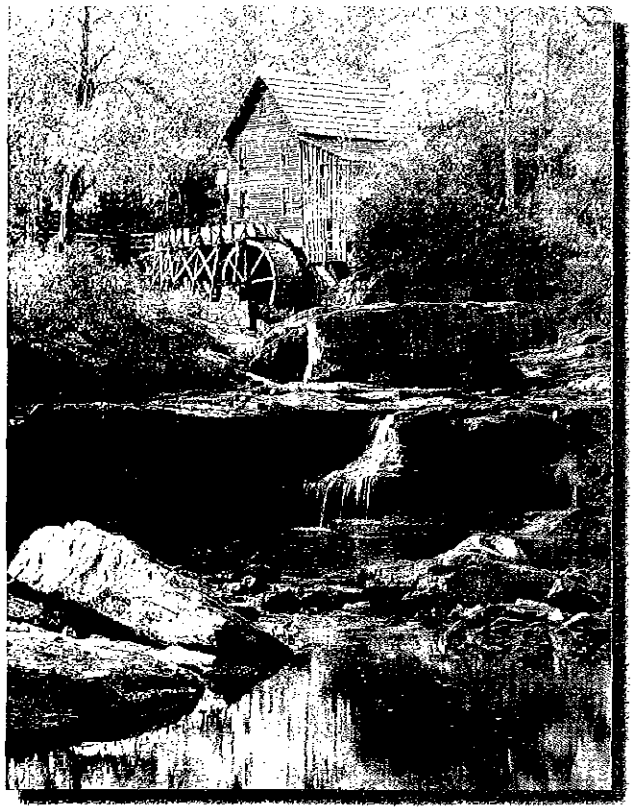


Customer Count



Operating Revenues





120 Years

At Aqua America, Inc. (Aqua) we take our responsibility to provide quality, reliable drinking water to our customers seriously. We've been doing so for the last 120 years. Since the first pipe was laid in 1886, we've been dedicated to improving infrastructure and water supply, whether it meant building reservoirs and plants to service a growing community, or replacing pipe to strengthen aging systems.

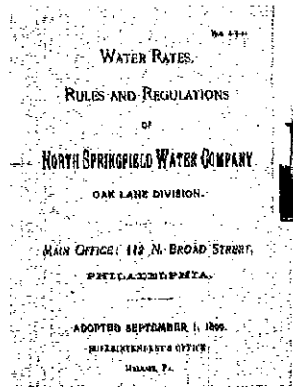
As our nation grew, so did our company. As early as the 1900s, Aqua established a growth strategy that is still the foundation of our company today. Our company is built on strength—strength of infrastructure, strength of service and strength to grow. Aqua's strength has remained during world wars, the Depression and massive storms that devastated parts of our service territory.

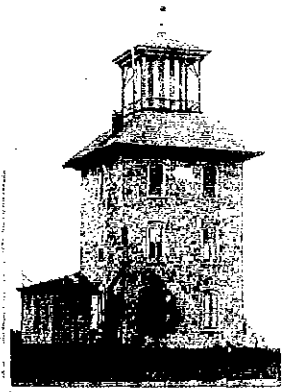
Over the years we've seen many changes, not only in our company name, but in our company's size and service territory. But no matter how much Aqua changes, we remain concerned citizens determined to provide our customers with quality water.

120 Years of Water. Pure and Simple.

1886 – 1900s

At a time when areas outside of Philadelphia (home to the nation's first municipal waterworks) began experimenting with their own waterworks, a group of concerned citizens in Delaware County decided to find an answer to their own water needs. These Swarthmore residents and engineering professors at Swarthmore College, who were worried about water quality, began operating a small water company in 1886. The citizens, whose names were lost in history, choose a local natural spring, build a pumping station and lay pipes to their homes. They share water privileges with their neighbors, and soon the operation grows too big to be run as a small association. So on January 4, 1886, the group incorporates and the Springfield Water Company is born.


WATER RATES.
RULES AND REGULATIONS
OF
NORTH SPRINGFIELD WATER COMPANY
OAK LANE DIVISION.
MAIN OFFICE: 112 N. BROAD STREET,
PHILADELPHIA.
ADOPTED SEPTEMBER 1, 1899.
SUPERINTENDENT'S OFFICE:
MEDIA, PA.

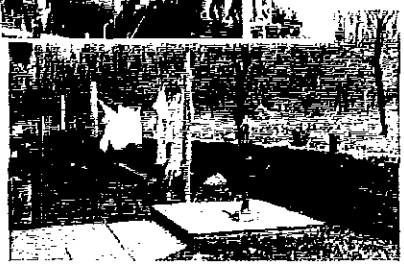


Soon after, the company contracts with a major pipe manufacturer and begins pumping from Whiskey Run, a creek one mile from Swarthmore. But just three short years later, the company outgrows the Whiskey Run supply, and Crum Creek is selected as a new source. Pumping Station No. 1 is operational, powered by water and steam.

Over the years, Springfield Water Company grows and acquires six companies to extend into Upper Darby, Ridley, Tinicum and Darby townships and Sharon Hill and Darby boroughs. This marks the start of an aggressive expansion strategy that becomes the foundation of the company's success.

Over the next 20 years, many local water companies consolidate with Springfield Water Company leading the way with its numerous acquisitions. The company acquires Lansdowne Water Company in 1899, which not only delivers water, but also turns a profit.

1920s

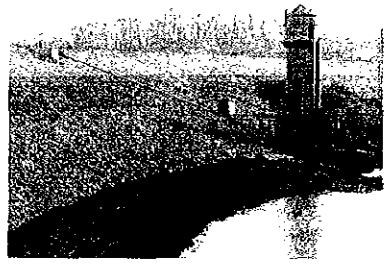


Early in this decade, Indiana farm boy Clarence Geist is making a name for himself in the utility industry in the Midwest. Geist's focus changes when he meets and falls in love with Philadelphia student Florence Hewitt. Geist follows Hewitt to Philadelphia and begins building his empire. He, along with Harold S. Schutt and Carleton E. Davis, are determined to provide fresh and safe water to the sprawling suburban Philadelphia area.

And so, on January 1, 1925, Geist, also know as "Water Boy," purchases Springfield Consolidated Water Company (formerly Springfield Water Company). At this time, the company serves 45,396 customers. Later that year, the company changes its name to Philadelphia Suburban Water Company (PSW) to encapsulate the company's expansion strategy. The following year, the company installs its first steam-driven turbine and centrifugal pump at Crum Creek, which increases filter capacity to six million gallons per day.

1930s

Despite the Depression, the company continues to grow and offers its employees job security and the means to make ends meet in uncertain times.



A desperate need for additional emergency water supplies develops, driving the company to begin construction of the 3.5 billion gallon Geist Reservoir, later renamed the Springton Reservoir. Over the next several years, PSW adds 44 miles of main to its systems.

The Geist years end abruptly in 1938 when Geist dies at the age of 72. His protégé, Harold Schutt is named president. And even as war approaches, the company's financial standing stays strong and expansion plans move forward.

1940s

The nation is stunned by the Japanese attack on Peal Harbor on December 7, 1941. Between December 1941 and August 14, 1945, 16 million U.S. citizens are in uniform, and women hold jobs traditionally filled by men. At PSW, a lot of employees join the service or go to work at defense plants. So the company hires contractors, and soon women begin working as meter readers. In 1941, the company enters into an agreement with the International Brotherhood of Firemen, Oilers, Powerhouse Operators and Maintenance Men, Local 473, which represents 180 workers.

Four years later, the company honors long-time employees by organizing the 20-Year Club.

The year 1945 marks the beginning of the company's 60 consecutive years of paid dividends.

Though the war curtailed some expansion plans, the company continues to grow throughout this decade, and eventually introduces a modest advertising campaign to show how water was used throughout history.

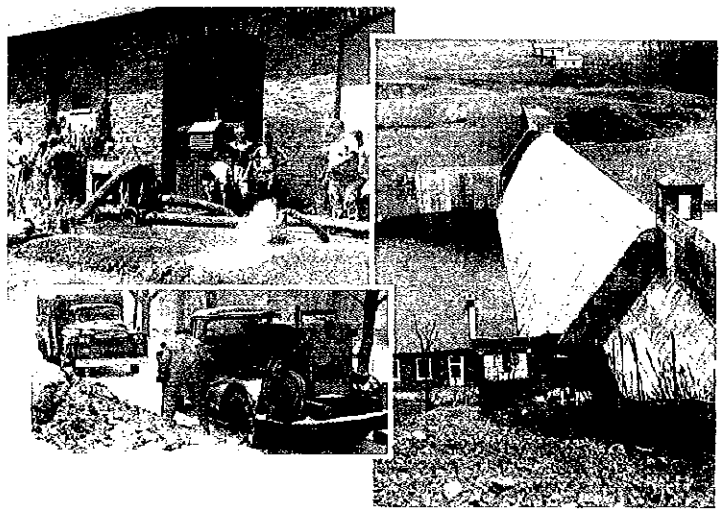
1950s

The company grows considerably during this decade, and even builds its largest reservoir to meet the increasing demand. The Green Lane reservoir is built to hold 4.4 billion gallons.

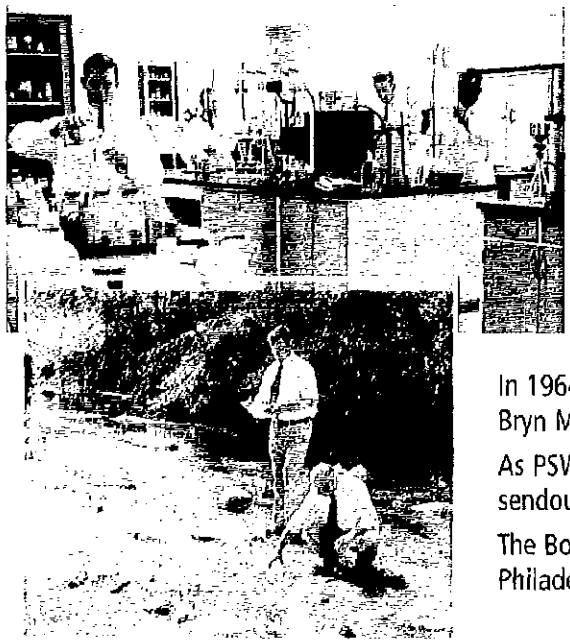
A massive storm hits the area in 1950, filling the Geist Reservoir that was dry after 17 months of almost no precipitation.

In 1951, the company adds nearly 8,000 new customers and needs to change to postcard billing to save time, money and materials. Roadside signs advertise the company's extensive infrastructure improvements.

In 1958, Margaret Hogan is named the company's first female officer. A year later, Harold Schutt retires, and James H. Clarke is named chairman. Thomas W. Moses is named PSW's new president.



1960s



PSW continues to grow while experiencing change in upper management. After only three years as president, Moses leaves PSW, and James M. Ballengee takes over as president. Ballengee renews the company's feeling of family among employees.

That same year, the customer count grows to 187,271 as infrastructure improvements continue and a new public relations plan is put into effect. The plan includes speeches, news releases and public tours that further enhance the company's community involvement. Customers receive their first-ever account numbers in 1963, as customer information is now stored on computers.

In 1964, the company opens the most modern laboratory in the water industry at its Bryn Mawr facility.

As PSW celebrates its 80th anniversary in 1966, new records are set including an annual sendout exceeding 24 billion gallons and operating revenues near $1 million.

The Board of Directors approves the plan to create a holding company called Philadelphia Suburban Corporation (PSC) in 1968.

1970s

James H. Clarke is named chairman of PSC, while Ballengee is appointed chairman and CEO of PSW. George H. Dann, a former meter reader, takes over as president of PSW.

On July 22, 1971, PSC appears for the first time on the New York Stock Exchange with the ticker symbol, PSC. One year later, Hurricane Agnes rips through the company's service territory causing severe flooding at its Pickering Creek plant. The plant is offline for nearly five days as a result of the storm that many call the 300-year flood.

Earl H. Graham, who joined the company as a laborer in 1947, is elected PSW's new president in 1974. He introduces the Employee Stock Purchase Plan, and is also credited with moving the company forward despite a less-than-favorable regulatory and business climate.

Two years later, John W. Boyer is appointed chairman of PSC, a position he holds until May 1993.

The federal government issues the Safe Drinking Water Act in 1974, and follows with new Federal Interim Primary Drinking Water Regulations in 1977. These regulations set chemical, physical and bacteriological standards, establish monitoring schedules and require certification of laboratories.

In 1979, the company unveils its new logo.

1980s

PSW renovates and expands its laboratory; is granted several rate increases, including a 13.3 percent increase in 1980; streamlines and automates its operations and installs a transmission system to help in droughts.

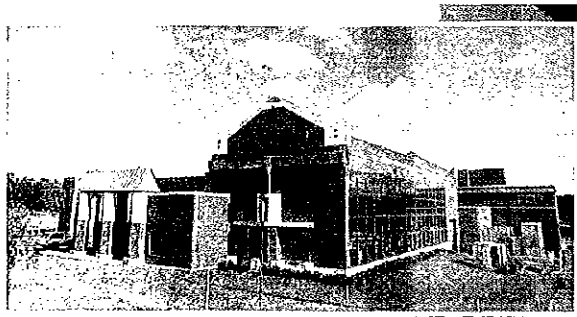
Throughout the decade, the company continues to improve its plants, and also opens a new building at its Bryn Mawr headquarters.

In 1986, the year of the company's centential celebration, PSW acquires Great Valley Water Company to add 20 wells and 145 miles of main to its system.

The company introduces a new computer system called Supervisory Control and Data Acquisition (SCADA) from which needs for adjustments in the distribution system are identified and made electronically from a distribution control center at the Bryn Mawr headquarters.

1990s

In 1991, the new state-of-the-art Pickering plant comes online.

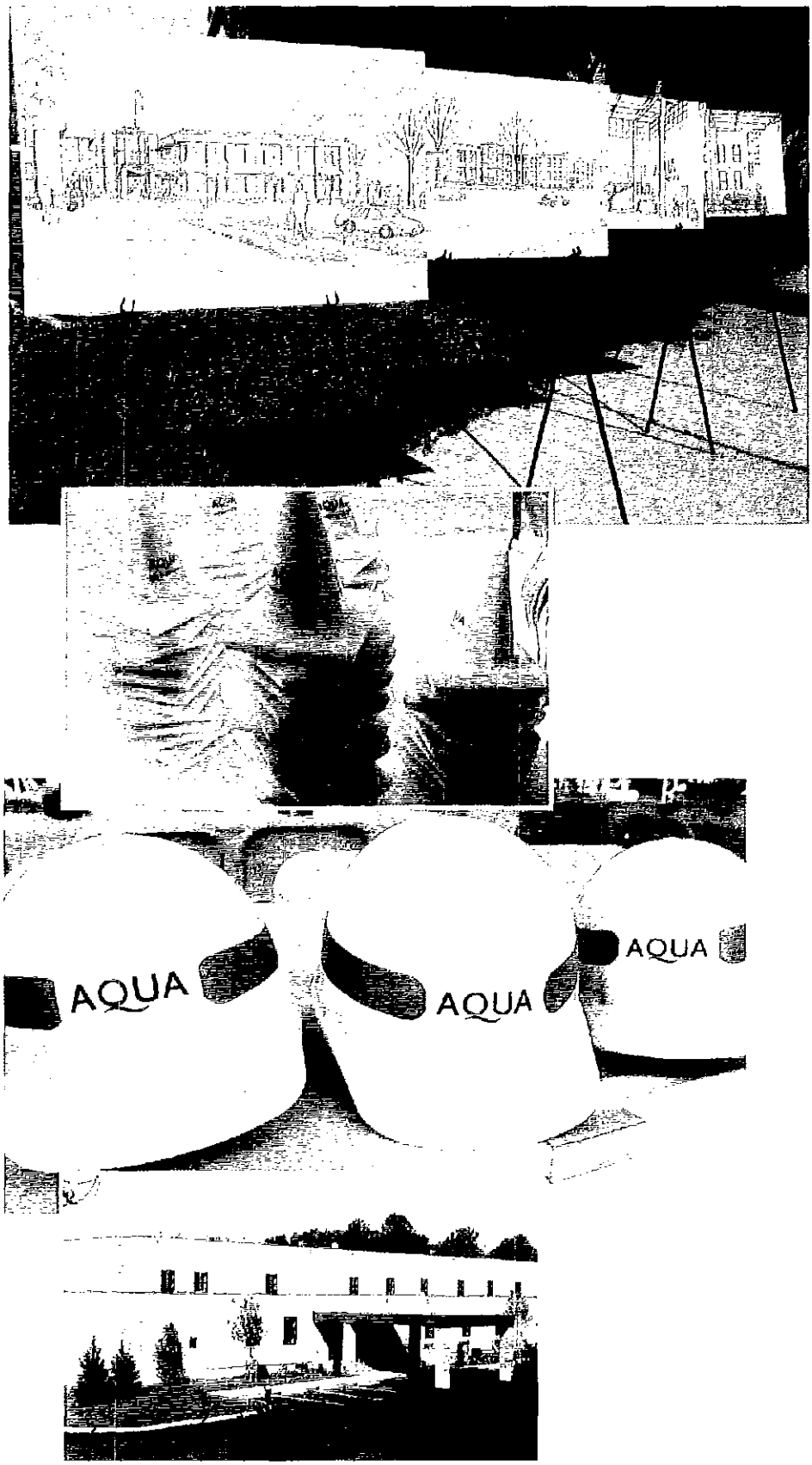


The company's current chairman and CEO Nicholas DeBenedictis, joins the company in 1992 and brings with him an aggressive growth-through-acquisition strategy. Within six months of his arrival, the company purchases the West Whiteland and Uwchlan water systems. He is named Chairman of PSC in 1993.

By the end of the decade, the company completes 46 growth ventures including the acquisition of the Bristol, West Chester and Bensalem water systems, which add more than 32,000 customer accounts.

In 1999, the company completes a major merger with Consumers Water Company, a company whose history also dates back to the late 1880s. This merger expands PSC's presence from one to five states and nearly doubles its customer count from 325,796 to 557,462.

2000s



Early in this decade (2002), the company receives news that long-time shareholder Vivendi Environnement (formerly Compaigne Generale de Eaux and now Veolia) intends to monetize its investment in PSC. Vivendi owns approximately 17 percent of PSC's outstanding common shares. PSC commits to buy two million shares, and a secondary offering of the remaining shares is a success. That same year, PSC announces another major acquisition. The company acquires AquaSource, which when closed in 2003, expands the company's footprint to 13 states.

Another big year follows. In 2004, PSC changes its name to Aqua America, Inc. (Aqua) and its ticker to WTR. The company's state subsidiaries also change their names to further unify this growing company. The company marks the event by ringing The Closing Bell™ at the New York Stock Exchange on January 14.

Later that year, the company announces two more major acquisitions—the operation of Florida Water Services Corporation and Heater Utilities. With the acquisition of Florida Water Services, the company adds 63 systems and more than 13,000 customers in the central part of Florida. Acquiring Heater Utilities in North Carolina makes the company the largest water provider in the state, serving more than 58,000 customers.

The company closes 2005 with a record number of acquisitions (30), increasing its 13-state customer base to approximately 865,000 accounts (2.6 million people).

Aqua receives much media attention in 2005. For the first time ever, the company is featured in *Forbes*, one of the country's leading financial magazines.

Other high profile media coverage included CNBC's *Squawk Box, The Wall Street Journal, Business Week, The New York Times* and *Kiplinger's*.

AQUA America℠

2005 FINANCIAL DATA

(This page intentionally left blank.)

FORWARD-LOOKING STATEMENTS

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

- recovery of capital expenditures and expenses in rates;
- projected capital expenditures and related funding requirements;
- dividend payment projections;
- future financing plans;
- future pension contributions;
- opportunities for future acquisitions, the success of pending acquisitions and the impact of future acquisitions;
- acquisition-related costs and synergies;
- the capacity of our water supplies, water facilities and wastewater facilities;
- general economic conditions;
- the impact of geographic diversity on our exposure to unusual weather; and
- the impact of accounting pronouncements.

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

- changes in general economic, business and financial market conditions;
- changes in government regulations and policies, including environmental and public utility regulations and policies;
- changes in environmental conditions, including those that result in water use restrictions;
- abnormal weather conditions;
- changes in, or unanticipated, capital requirements;
- changes in our credit rating;
- our ability to integrate businesses, technologies or services which we may acquire;
- our ability to manage the expansion of our business;
- the extent to which we are able to develop and market new and improved services;
- the effect of the loss of major customers;
- our ability to retain the services of key personnel and to hire qualified personnel as we expand;
- increasing difficulties in obtaining insurance and increased cost of insurance;
- cost overruns relating to improvements or the expansion of our operations;
- changes in accounting pronouncements; and
- civil disturbance or terroristic threats or acts.

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

OVERVIEW

The Company

Aqua America, Inc. is the holding company for regulated utilities providing water or wastewater services to approximately 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., accounts for approximately 56% of our operating revenues for 2005 and, as of December 31, 2005, 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.

Industry Mission

The mission of the investor-owned water utility industry is to provide quality and reliable water service at an affordable price for the customer with a fair return for shareholders. A number of challenges face the industry, including:

- strict environmental, health and safety standards;
- the need for substantial capital investment;
- economic regulation by state, and/or, in some cases, local government; and
- the impact of weather and drought conditions on water sales demand.

Rate Case Management Capability

We strive to achieve the industry mission by effective planning and efficient use of our resources. We maintain a rate case management capability to pursue timely and adequate returns on the capital investments that we make in improving or replacing water mains, treatment plants and other infrastructure. This capability is important in our continued profitability and in providing a fair return to our shareholders, and thus providing access to capital markets to help fund these investments. Often these utility investments are required by a changed federal or state environmental standard, to improve our ability to deliver quality customer service, or to assist in our ability to supply water in sufficient quantities for future demand or when experiencing drought conditions.

Economic Regulation - Most of our water and wastewater utility operations are subject to regulation by their respective state regulatory commissions, which have broad administrative power and authority to regulate rates and charges, determine franchise areas and conditions of service, approve acquisitions and authorize the issuance of securities. The regulatory commissions also establish uniform systems of accounts and approve the terms of contracts with affiliates and customers, business combinations with other utility systems, loans and other financings, and the franchise areas that we serve. A small number of our operations are subject to rate regulation by county or city government. The profitability of our utility operations is influenced to a great extent by the timeliness and adequacy of rate allowances in the various states in which we operate. Accordingly, we maintain a rate case management capability to provide that the tariffs of the utility operations reflect, to the extent practicable, the timely recovery of increases in costs of operations, capital, taxes, energy, materials and compliance with environmental regulations. In assessing our rate case strategy, we consider the amount of utility plant additions and replacements made since the previous rate decision, the changes in the cost of capital, changes in the capital structure and changes in other costs. Based on these assessments, our utility operations periodically file rate increase requests with their respective state regulatory commissions.

Some of the states in which we acquired operations in 2004 and 2003 require separate filings for each of our local systems, as compared to a single state-wide rate filing. Between August 2003 and December 2005, we have filed rate filings in over 25 jurisdictions. Due to the length of time since the last rate increase for some acquired systems and the large amount of capital improvements relative to the number of customers in some smaller systems, the proposed rate increase in some of these systems may be substantial. While each of these rate filings will proceed through the applicable regulatory process, we can provide no assurance that the rate increases will be granted in a timely or sufficient manner to cover the investments and expenses for which we initially sought the rate increases. Further, there remain 116 divisions within these recently acquired operations where we have not yet filed a rate request.

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

Effects of Inflation - As a regulated enterprise, our rates are established to provide recovery of costs and a return on our investment. Recovery of the effects of inflation through higher water rates is dependent upon receiving adequate and timely rate increases. However, rate increases are not retroactive and often lag increases in costs caused by inflation. During periods of moderate to low inflation, as has been experienced for the past several years, the effects of inflation on our operating results are not significant.

Customer and Business Services Projects - We are currently consolidating our customer service locations into three principal call centers, implementing a common customer information system, and upgrading our financial information systems. We expect to complete our primary customer service initiatives by the end of 2006. Consistent with prior practice, we have capitalized costs and services associated with these projects and expect to recover these costs in future rates. Certain information technology costs associated with these projects, such as software training, data conversion and business process reengineering costs, have been deferred in accordance with SFAS No. 71. Although we believe it is probable that the applicable public utility commissions will allow recovery of these costs, we can provide no assurances as to their full recoverability until the conclusion of the applicable rate proceeding. As of December 31, 2005, $3,952 of costs have been incurred and deferred as a regulatory asset since the last rate proceeding, and $251 has been expensed during the year ended December 31, 2005, in the jurisdictions where future recovery is unlikely.

Growth-Through-Acquisition Strategy

Part of our strategy to meet the industry challenges is to actively explore opportunities to expand our utility operations through acquisitions of water and wastewater utilities either in areas adjacent to our existing service areas or in new service areas. This growth-through-acquisition strategy allows us to operate more efficiently and provides an important source for possible future growth. The ability to successfully execute this strategy and meet the industry challenges is largely due to our qualified and trained workforce, which we strive to retain by treating employees fairly and providing our employees with development and growth opportunities. Please refer to the section captioned "Acquisitions" for an additional discussion of acquisitions.

We believe that acquisitions will continue to be an important source of growth for us. With approximately 50,000 community water systems in the U.S., 84% of which serve less than 3,300 customers, the water industry is the most fragmented of the major utility industries (telephone, natural gas, electric, water and wastewater). In the states where we operate, we believe there are over 22,000 public water systems of widely varying size, with the majority of the population being served by government-owned water systems.

Although not as fragmented as the water industry, the wastewater industry in the U.S. also presents opportunities for consolidation. According to the U.S. Environmental Protection Agency's (EPA) most recent survey of publicly-owned wastewater treatment facilities in 2000, there are approximately 16,000 such facilities in the nation serving approximately 72% of the U.S. population. The remaining population represents individual homeowners with their own treatment facilities; for example, community on-lot disposal systems and septic tank systems. The vast majority of wastewater facilities are government-owned rather than privately-owned. The EPA survey also indicated that there are approximately 6,600 wastewater facilities in operation or planned in the 13 states where we operate.

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

- the benefits of economies of scale;
- increasingly stringent environmental regulations;
- the need for capital investment; and
- the need for technological and managerial expertise.

We are actively exploring other opportunities to expand our water and wastewater utility operations through acquisitions or otherwise. We intend to continue to pursue acquisitions of municipally-owned and investor-owned water and wastewater systems of all sizes that provide services in areas adjacent to our existing service territories or in new service areas.

Sendout

"Sendout" represents the quantity of treated water delivered to our distribution systems. We use sendout as an indicator of customer demand. Weather conditions tend to impact water consumption, particularly in our northern service territories during the late spring and summer months when nonessential and recreational use of water is at its highest. Consequently, a higher proportion of annual operating revenues is realized in the second and third quarters. In general during this period, an extended period of dry weather increases water consumption, while above average rainfall decreases water consumption. Also, an increase in the average temperature generally causes an increase in water consumption. Conservation efforts, construction codes which require the use of low flow plumbing fixtures, as well as mandated water use restrictions in response to drought conditions, also affect water consumption.

The geographic diversity of our customer base helps reduce our exposure to extreme or unusual weather conditions in any one area of our service territory. Our geographic diversity has continued to widen as a result of the Heater and Florida Water acquisitions which closed in mid-year 2004 and the AquaSource acquisition which closed in 2003. During the year ended December 31, 2005, our operating revenues were derived principally from the following states: 56% in Pennsylvania, 8% in Ohio, 8% in Texas, 7% in Illinois, and 6% in North Carolina.

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

Selected Financial and Operating Statistics

Our selected five-year financial and operating statistics follow:

Years ended December 31,	2005	2004 (a)	2003 (b)	2002 (c)	2001
Customers:					
Residential water	724,954	702,367	624,355	535,506	526,776
Commercial water	33,975	33,720	33,015	30,355	29,745
Industrial water	1,356	1,365	1,397	1,423	1,454
Other water	15,584	15,700	20,483	16,466	9,947
Wastewater	89,025	82,360	70,241	21,724	19,615
Total	864,894	835,512	749,491	605,474	587,537
Operating revenues:					
Residential water	$ 295,473	$ 264,910	$ 218,487	$ 197,190	$ 188,303
Commercial water	73,455	65,605	61,343	55,962	53,103
Industrial water	18,364	17,377	17,675	17,221	16,141
Other water	50,827	44,593	40,048	36,255	35,681
Wastewater	42,176	35,931	17,874	8,210	6,960
Other	16,484	13,623	11,806	7,190	7,092
Total	$ 496,779	$ 442,039	$ 367,233	$ 322,028	$ 307,280
Operations and maintenance expense	$ 203,088	$ 178,345	$ 140,602	$ 117,735	$ 111,885
Net income available to common stock	$ 91,156	$ 80,007	$ 70,785	$ 67,154	$ 60,005
Capital expenditures	$ 237,462	$ 195,736	$ 163,320	$ 136,164	$ 124,088
Operating Statistics					
Selected operating results as a percentage of operating revenues:					
Operations and maintenance	40.9%	40.3%	38.3%	36.6%	36.4%
Depreciation and amortization	13.2%	13.3%	14.0%	13.8%	13.1%
Taxes other than income taxes	6.4%	6.2%	5.9%	6.0%	6.8%
Interest expense, net	10.4%	11.0%	12.2%	12.5%	11.9%
Net income available to common stock	18.3%	18.1%	19.3%	20.9%	19.5%
Effective tax rates	38.4%	39.4%	39.3%	38.5%	39.3%

(a) Net income available to common stock includes the gain of $1,522 ($2,342 pre-tax) realized on the sale of our Geneva, Ohio water system. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. 2004 includes a partial year of financial results for the mid-year acquisition of Heater Utilities, Inc. and certain utility assets of Florida Water Services Corporation.

(b) 2003 includes five months of financial results for the AquaSource operations acquired in July 2003.

(c) Net income available to common stock and net income includes the gain of $3,690 ($5,676 pre-tax) realized on the sale of a portion of our Ashtabula, Ohio water system.

Performance Measures Considered by Management

We consider the following nonfinancial measure and financial measures to be the fundamental basis by which we evaluate our performance: our number of customers, operating revenues, net income and dividend rate on common stock. In addition, we consider other key financial measures in evaluating our operating results: earnings per share, the ratio of operations and maintenance expense compared to operating revenues (this percentage is termed "operating expense ratio" or "efficiency ratio"); return on revenues (net income divided by operating revenues); and return on equity (net income divided by common stockholders' equity). We review these measurements regularly and compare them to historical periods as well as our operating budget as approved by the Aqua America, Inc. Board of Directors.

Our operating expense ratio is one measure that we use to evaluate our operating efficiency and management effectiveness. As reported in the table above, and as anticipated, our operating expense ratio increased for 2004 over 2003, and increased for 2003 over 2002 as a result of the additional operating costs associated with the AquaSource acquisition which closed in July 2003. Our 2004 results reflect a full twelve months of operating results for the acquisition, while our 2003 results reflect only five months of operating results for the acquisition. The business model of the acquired AquaSource operations, generally referred to as our Aqua South operations, is different from the rest of the Aqua America operations. The Aqua South operations are comprised of approximately 600 small systems, which are generally clustered in regions to achieve some level of operating efficiency. The small, separate systems of the Aqua South operations result in the operating revenues generated by the Aqua South operations being accompanied by a higher ratio of operations and maintenance expenses as compared to the rest of the pre-existing Aqua America operations. The Aqua South operations can be characterized as having relatively-higher fixed operating costs, in contrast to the rest of the Aqua America operations which generally consist of larger, interconnected systems, resulting in higher fixed capital costs (utility plant investment) and lower operating costs per customer. For the twelve-month period ended June 30, 2003, the last reporting period before the July 31, 2003 closing of AquaSource, our operating expense ratio declined to 36.5%, from 36.6% for the year ended December 31, 2002. To a lesser extent, the 2005 and 2004 efficiency ratios increased over the previous years due to the influence of the mid-year 2004 acquisitions of Heater Utilities, Inc. and Florida Water Services Corporation, which have similar operating characteristics as our Aqua South operations. Our efficiency ratio in 2004 was reduced by approximately 53 basis-points for a $2,342 gain realized on the sale of our Geneva, Ohio water system that was reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. Other factors that influence the efficiency ratio include regulatory lag, i.e., changes in operations and maintenance expenses without an immediate corresponding change in operating revenues, and operating revenues when accompanied by a dissimilar change in operations and maintenance expense, such as changes in water consumption as impacted by weather conditions. On January 1, 2006, we adopted SFAS No. 123R, "Share-Based Payment." As required, we began to record compensation expense for the fair value of stock options granted and the adoption of this accounting standard is expected to increase our 2006 operations and maintenance expense by approximately $3,500.

We continue to evaluate management initiatives to help control costs and improve efficiencies, but the effect of these acquisitions have been to increase our overall operating expense ratio from the levels experienced during the three years preceding the AquaSource acquisition. Consequently, our return on revenues in 2005 and 2004 was lower than 2003, 2002 and 2001 as a result of the impact of the higher cost of Aqua South's operations.

RESULTS OF OPERATIONS

Our net income has grown at an annual compound rate of approximately 11.5% during the five-year period ended December 31, 2005. During the past five years, operating revenues grew at a compound rate of 12.6% and total expenses, exclusive of income taxes, grew at a compound rate of 12.8%.

Operating Revenues

The growth in revenues over the past five years is a result of increases in both the customer base and in water rates. The number of customers increased at an annual compound rate of 8.9% in the past five years primarily as a result of acquisitions of water and wastewater systems, including the mid-year 2004 Heater and Florida Water Services acquisitions, and the AquaSource acquisition completed July 2003. Acquisitions made during the five-year period ended December 31, 2005 have provided water and wastewater revenues of approximately $114,176 in 2005, $87,919 in 2004 and $32,427 in 2003. Excluding the effect of acquisitions, our customer base increased at a five-year annual compound rate of 1.5%. Rate increases implemented during the past three years have provided additional operating revenues of approximately $25,500 in 2005, $15,800 in 2004 and $19,900 in 2003.

In November 2005, our Pennsylvania operating subsidiary filed an application with the Pennsylvania Public Utility Commission (PAPUC) requesting a $38,800 or 14.4% increase in annual revenues. The application is currently pending before the PAPUC and a final determination is anticipated by August 2006. On August 5, 2004, the PAPUC granted our Pennsylvania operating subsidiary a $13,800 base rate increase. The rates in effect at the time of the filing included $11,200 in Distribution System Improvement Charges ("DSIC") or 5.0% above the prior base rates. Consequently, the total base rates increased by $25,000 and the DSIC was reset to zero.

In May 2004, our operating subsidiary 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 our 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 parties have joined the proceeding to challenge our rate request. We commenced billing for the requested rates and implemented the deferral plan in August 2004, in accordance with authorization from the Texas Commission on Environmental Quality in July 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 us reflect an estimate of the final outcome of the ruling. As of December 31, 2005, we have deferred $9,486 of expenses and recognized $5,202 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. 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. Based on our review of the present circumstances, no additional reserve or change in estimate adjustments are required for the revenue recognized to date or for the impairment of our regulatory asset.

Our operating subsidiaries located in other states received rate increases representing estimated annualized revenues of $5,142 in 2005 resulting from twenty-three decisions, $6,673 in 2004 resulting from fourteen rate decisions, and $1,275 in 2003 resulting from eight rate decisions. Revenues from these increases realized in the year of grant were approximately $3,144 in 2005, $3,995 in 2004 and $839 in 2003. These operating subsidiaries currently have filed 18 rate requests which are being reviewed by the state regulatory commissions, proposing an aggregate increase of $9,202 in annual revenues. In addition, there were 14 rate awards received to date in 2006 for cases filed in 2005 in the amount of $1,961. During 2006, we intend to file 27 additional rate requests proposing an aggregate of approximately $17,029 of increased annual revenues.

Currently, Pennsylvania, Illinois, Ohio, Indiana and Missouri allow for the use of infrastructure rehabilitation surcharges. In Pennsylvania, this mechanism is referred to as a DSIC. These surcharge mechanisms typically adjust periodically based on additional qualified capital expenditures completed or anticipated in a future period. The infrastructure rehabilitation surcharge is capped as a percentage of base rates, generally at 5% to 9% of base rates, and is reset to zero when new base rates that reflect the costs of those additions become effective or when a utility's earnings exceed a regulatory benchmark. Infrastructure rehabilitation surcharges provided revenues of $10,186 in 2005, $7,817 in 2004 and $8,147 in 2003.

In addition to regulated water and wastewater operating revenues, we had other non-regulated revenues that were primarily associated with operating and maintenance contracts, and data processing service fees of $16,484 in 2005, $13,623 in 2004 and $11,806 in 2003. The increase in 2005 over 2004 resulted primarily from the additional revenues associated with the acquisition of an on-site septic tank pumping business, and increased revenues resulting from new and expanded contract operations. The increase in 2004 over the previous year resulted primarily from the additional revenues from contract operations associated with the July 2003 AquaSource acquisition.

Operations and Maintenance Expenses

Operations and maintenance expenses totaled $203,088 in 2005, $178,345 in 2004 and $140,602 in 2003. Most elements of operating costs are subject to the effects of inflation, and changes in the number of customers served, and several elements are subject to the effects of changes in water consumption, weather and the degree of water treatment required due to variations in the quality of the raw water. The principal elements of operating costs are labor and employee benefits, electricity, chemicals, maintenance expenses and insurance costs. Electricity and chemical expenses vary in relationship to water consumption, raw water quality, and to a lesser extent the competitive electric market in some of the states in which we operate. Maintenance expenses are sensitive to extremely cold weather, which can cause water mains to rupture. Operations and maintenance expenses increased in 2005 as compared to 2004 by $24,743 or 13.9% primarily due to the additional operating costs associated with acquisitions of $9,574, additional water production expenses of $3,856, increased postretirement costs of $2,430, higher insurance costs due to the absence in 2005 of the favorable claim settlements that had occurred in 2004 of $2,142, and the effect of the $2,342 gain on the sale of the Geneva water system which was recorded as a component of operations and maintenance expense in 2004.

Operations and maintenance expenses increased in 2004 as compared to 2003 by $37,743 or 26.8% primarily due to added operating costs associated with acquisitions of $36,123, additional postretirement costs of $2,110, increased accounting expense of $1,496 for assessing internal control effectiveness under the Sarbanes-Oxley Act and higher water production expenses. Partially offsetting these increases were lower insurance costs due to the favorable settlement of insurance claims during 2004, and the gain on the sale of the Geneva, Ohio water system of $2,342. In the consolidated statement of income for 2004, the gain on the sale of the Geneva water system is reported as a component of the line titled operations and maintenance expense. The impact of acquisitions is primarily the result of the effect of AquaSource for the full twelve-month period versus five months in 2003, and the mid-year 2004 acquisitions of Heater and the Florida Water Services systems.

Depreciation and Amortization Expenses

Depreciation expense was $60,747 in 2005, $54,564 in 2004 and $48,522 in 2003, and has increased principally as a result of the significant capital expenditures made to expand and improve our utility facilities, and as a result of acquisitions of water systems.

Amortization expense was $4,741 in 2005, $4,300 in 2004 and $2,941 in 2003. The increase in 2005 and 2004 is due to the amortization of the costs associated with, and other costs being recovered in, various rate filings. Expenses associated with filing rate cases are deferred and amortized over periods that generally range from one to three years.

Taxes Other than Income Taxes

Taxes other than income taxes increased by $4,100 or 14.9% in 2005 as compared to 2004 and $5,989 or 27.7% in 2004 as compared to 2003. The increase in both 2005 and 2004 is due to additional taxes associated with acquisitions and increases in state and local taxes. The other taxes associated with acquisitions resulted from the effect of the July 2003 AquaSource acquisition for a twelve-month period in 2004 as compared to the five-month period in 2003, and the mid-year 2004 acquisitions of Heater Utilities and the systems of Florida Water.

Interest Expense, net

Net interest expense was $52,062 in 2005, $48,679 in 2004 and $44,662 in 2003. Interest income of $3,040 in 2005, $1,762 in 2004 and $395 in 2003 was netted against interest expense. Interest expense increased in 2005 and 2004 primarily as a result of higher levels of borrowings, offset partially by the effects of decreased interest rates on borrowings. The higher level of average borrowings in 2004 was used to finance the acquisition of AquaSource in mid-year 2003, the Heater and Florida Water acquisitions in mid-year 2004, and capital expenditures. Interest income increased in 2005 due to additional investment income earned in 2005 on the proceeds from the issuance of tax-exempt bonds while being held by trustees pending completion of projects financed with the issues. Such interest income is capitalized by a reduction in our allowance for funds used during

construction. Interest income increased in 2004 due to $532 of interest income in connection with the arbitration award related to the final purchase price for the AquaSource acquisition received in 2004 and additional interest income associated with acquisitions. Interest expense during 2005 was favorably impacted by a reduction in the weighted cost of long-term debt from 6.00% at December 31, 2004 to 5.74% at December 31, 2005.

Allowance for Funds Used During Construction

The allowance for funds used during construction (AFUDC) was $2,447 in 2005, $2,304 in 2004 and $2,127 in 2003 and has varied over the years as a result of changes in the average balance of utility plant construction work in progress (CWIP), to which AFUDC is applied, and to changes in the AFUDC rate. The increase in 2005 is due to an increase in the average balance of CWIP to which AFUDC is applied, and additional AFUDC recorded as an adjustment in 2005 of $719 resulting from the identification in 2005 of a previously issued rate order which allowed the continuation of AFUDC on certain capital projects subsequent to being placed into utility service. This post-in-service AFUDC was not recognized in prior periods. These variances were partially offset by investment income earned during 2005, which reduced AFUDC. The increase in 2004 is due to an increase in the average balance of CWIP to which AFUDC is applied.

Gain on Sale of Other Assets

Gain on sale of other assets totaled $1,177 in 2005, $1,272 in 2004 and $5,692 in 2003 and consisted of gains on land and marketable securities sales. Gain on sale of land totaled $1,177 in 2005, $869 in 2004 and $5,153 in 2003. Gain on sale of marketable securities totaled $403 in 2004 and $539 in 2003.

Income Taxes

Our effective income tax rate was 38.4% in 2005, 39.4% in 2004 and 39.3% in 2003. The changes in the effective tax rates in 2005 and 2004 are due to differences between tax deductible expenses and book expenses and the recognition in 2005 of the American Jobs Creation Act tax deduction for qualified domestic production activities that reduced our tax provision by approximately $740.

Summary

Operating income was $196,507 in 2005, $177,234 in 2004 and $153,561 in 2003 and net income available to common stock was $91,156 in 2005, $80,007 in 2004 and $70,785 in 2003. Diluted income per share was $0.71 in 2005, $0.64 in 2004, and $0.59 in 2004. The changes in the per share income in 2005 and 2004 over the previous years were due to the aforementioned changes in income and impacted by a 2.8% increase in the average number of common shares outstanding during 2005 and a 5.6% increase in the average number of common shares outstanding during 2004, respectively. The increase in the number of shares outstanding in 2005 is primarily a result of the additional shares issued through our dividend reinvestment plan, employee stock purchase plan and equity compensation plan. The increase in the number of shares outstanding in 2004 is primarily a result of the additional shares issued in common share offerings and the aforementioned factors for 2005.

Although we have experienced increased income in the recent past, continued adequate rate increases reflecting increased operating costs and new capital investments are important to the future realization of improved profitability.

Fourth Quarter Results

Net income available to common stock was $22,150 in the fourth quarter of 2005 and $22,474 in the same period of 2004. The change in net income is due to increased operations and maintenance expense of $6,717, increased depreciation of $2,585 and increased other taxes of $1,522, offset partially by a $7,466 increase in operating revenues. The higher operations and maintenance expense is due primarily to the gain on the December 2004 sale of the Geneva water system of $2,342 which reduced operations and maintenance expense in 2004, additional operating cots associated with acquisitions, higher water production costs and increased postretirement costs. The increased depreciation expense reflects the utility plant placed in service since the fourth quarter of 2004. Other taxes increased due to higher property taxes and additional local taxes incurred in the fourth quarter of 2005. The increase in operating revenues was a result of additional revenues of $2,131 resulting from an increase in water rates granted to our operating subsidiaries, additional infrastructure rehabilitation surcharge revenue of $2,377, and the additional revenue from acquisitions.

FINANCIAL CONDITION

Cash Flow and Capital Expenditures

Net operating cash flow, dividends paid on common stock, capital expenditures, including allowances for funds used during construction, and expenditures for acquiring water and wastewater systems for the five years ended December 31, 2005 were as follows:

	Net Operating Cash Flow	Common Dividends	Capital Expenditures	Acquisitions of Utility Systems
2001	$ 102,165	$ 34,234	$ 124,088	$ 9,517
2002	121,560	36,789	136,164	8,914
2003	143,373	39,917	163,320	192,331
2004	173,603	45,807	195,736	54,300
2005	199,674	51,139	237,462	11,633
	$ 740,375	$ 207,886	$ 856,770	$ 276,695

Included in capital expenditures for the five-year period are: expenditures for the modernization and replacement of existing treatment plants, new water mains and customer service lines, rehabilitation of existing water mains and hydrants, and water meters. During this five-year period, we received $52,619 of customer advances and contributions in aid of construction to finance new water mains and related facilities which are not included in the capital expenditures presented in the above table. In addition, during this period, we have made sinking fund contributions and repaid debt in the amount of $242,849, retired $1,760 of preferred stock, and have refunded $23,701 of customer advances for construction. Common dividends increased during the past five years as a result of an annual increase in the common dividends declared and paid and an increase in the number of shares outstanding during the period.

Our planned 2006 capital program, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to be $255,200 of which $64,790 is for infrastructure rehabilitation surcharge-qualified projects. Our planned capital program includes spending for infrastructure rehabilitation in response to the infrastructure rehabilitation surcharge mechanisms, and should these mechanisms be discontinued for any reason, which is not anticipated, we would re-evaluate the magnitude of our capital program. Our 2006 capital program, along with $24,645 of sinking fund obligations and debt maturities, and $93,626 of other contractual cash obligations, as reported in the section captioned "Contractual Obligations", is expected to be financed through internally-generated funds, our revolving credit facilities, the issuance of equity and the issuance of new long-term debt.

Future utility construction in the period 2007 through 2010, including recurring programs, such as the ongoing replacement of water meters, water treatment plant upgrades, storage facility renovations, the rehabilitation of water mains and additional transmission mains to meet customer demands, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to require aggregate expenditures of approximately $950,000. We anticipate that less than one-half of these expenditures will require external financing of debt and the additional issuance of common stock through our dividend reinvestment and stock purchase plans and possible future public equity offerings. We expect to refinance $115,166 of sinking fund obligations and debt maturities during this period as they become due with new issues of long-term debt. The estimates discussed above do not include any amounts for possible future acquisitions of water systems or the financing necessary to support them.

Our primary source of liquidity is cash flows from operations, borrowings under various short-term lines of credit and other credit facilities, and customer advances and contributions in aid of construction. Our cash flow from operations, or internally-generated funds, is impacted by the timing of rate relief and water consumption. We fund our capital and acquisition programs through internally-generated funds, supplemented by short-term borrowings. Over time, we refinance our short-term borrowings with long-term debt and proceeds from the issuance of common stock. The ability to finance our future construction programs, as well as our acquisition activities, depends on our ability to attract the necessary external financing and maintain internally-generated funds. Rate orders permitting compensatory rates of return on invested capital and timely

rate adjustments will be required by our operating subsidiaries to achieve an adequate level of earnings and cash flow to enable them to secure the capital they will need to operate and to maintain satisfactory debt coverage ratios.

Acquisitions

During the past five years, we have expended cash of $276,695 and issued 816,019 shares of common stock, valued at $8,781 at the time of the acquisition, related to the acquisitions of utility systems, primarily water utilities and some wastewater utilities. We included the operating results of these acquisitions in our consolidated financial statements beginning on the respective acquisition date.

During 2005, we completed 30 acquisitions for $11,633 in cash and the issuance of 24,684 shares of common stock. The acquisitions completed in 2005 included both water and wastewater systems in seven of the states in which we operate. Pursuant to our strategy to grow through acquisitions, on June 1, 2004, we acquired the capital stock of Heater Utilities, Inc. for $48,000 in cash and the assumption of long-term debt of $19,219 and short-term debt of $8,500. The acquired operation provides water and wastewater service to over 50,000 water and wastewater customers primarily in the areas of suburban Raleigh, Charlotte, Gastonia and Fayetteville, North Carolina. For the fiscal year ended December 31, 2003, Heater had operating revenues of $19,489. The acquisition was accounted for as a purchase and accordingly, we recorded goodwill of $18,842. In 2004, as part of the North Carolina Utilities Commission approval process for this acquisition, the Commission approved a mechanism through which we could recover up to two-thirds of the goodwill through customer rates in the future upon achieving certain objectives. We intend to pursue these objectives to facilitate recognition of this premium in customer rates. However, there can be no assurance that we will be able to achieve these objectives and recover such amount of goodwill, if any.

On June 30, 2004, we acquired certain utility assets of Florida Water Services Corporation, comprised of 63 water and wastewater systems located in central Florida for $14,747 in cash. In accordance with Florida Public Service Commission procedures, the acquisition was approved by the Commission and rate base was determined on December 20, 2005. Under the terms of the purchase agreement, the Commission's rate base determination will result in a reduction of the final purchase price that could be as much as approximately $2,000, which is not expected to result in the recognition of goodwill.

The acquisition of Heater and the Florida Water Systems were initially funded by a portion of the proceeds from the issuance by Aqua America of an unsecured short-term note in May 2004. A portion of the short-term note was subsequently repaid by Aqua America with the proceeds from a November 2004 secondary equity offering, and a portion of the short-term note was refinanced through the February 2005 issuance of $30,000 of unsecured notes. In November 2004, we sold 2,606,667 shares of common stock in a public offering for proceeds of $42,600, net of expenses. In February 2005, Aqua America issued $18,000 of notes due in 2015 with an interest rate of 5.01% and $12,000 of notes due in 2020 with an interest rate of 5.20%.

Pursuant to our growth strategy, in July 2003, we completed the acquisition of four operating water and wastewater subsidiaries of AquaSource, Inc., a subsidiary of DQE, Inc., including selected, integrated operating and maintenance contracts and related assets (individually and collectively the acquisition is referred to as "AquaSource") for $190,717 in cash, as adjusted pursuant to the purchase agreement based on working capital at closing. In August 2004, we were awarded and received $12,289 plus interest in an arbitration related to the calculation of the final purchase price under the terms of the purchase agreement, which resulted in a final purchase price of $178,428. In the consolidated statement of cash flow for 2004, the $12,289 award has been reported as proceeds on the line titled acquisitions of water and wastewater systems, net. The acquisition was initially funded by a portion of the proceeds from the July 2003 issuance of $135,000 of unsecured notes due 2023, with an interest rate of 4.87%, and the issuance of a $90,000 unsecured note by Aqua America. In August 2003, the $90,000 unsecured note was repaid with the proceeds from the issuance of 6,666,667 shares of common stock through a shelf registration. The acquired operations of AquaSource serve over 130,000 water and wastewater customer accounts in 11 states (including the Connecticut and Kentucky operations which were subsequently sold to other parties). Please refer to the section captioned "Dispositions" for a discussion of the AquaSource operations located in Connecticut and Kentucky. The acquisition provides an expanded platform from which to extend our growth-through-acquisition strategy of acquiring water and wastewater systems that are near or adjacent to our existing service territories. The AquaSource operations are comprised of approximately 600 small systems, which are generally clustered in regions to achieve some level of operating efficiency.

We continue to hold acquisition discussions with several water and wastewater systems. Generally acquisitions are expected to be financed through the issuance of equity (for the acquisition of some investor-owned systems) or funded initially with short-term debt with subsequent repayment from the proceeds of long-term debt or proceeds from equity offerings.

Dispositions

In December 2004, as a result of the settlement of a condemnation action, our Ohio operating subsidiary sold its water utility assets within the municipal boundaries of the City of Geneva in Ashtabula County, Ohio for net proceeds of approximately $4,716, which was in excess of the book value for these assets. The proceeds were used to pay-down short-term debt and the sale resulted in the recognition in the fourth quarter of 2004 of a gain on the sale of these assets, net of expenses, of $2,342. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. We continue to operate this water system for the City of Geneva under an operating contract that began upon the closing of the sale for a period through December 2006. These water utility assets represented less than 1% of Aqua America's total assets, and the total number of customers included in the water system sold represented less than 1% of our total customer base.

We reviewed and evaluated areas of our business and operating divisions that were acquired in July 2003 with the AquaSource operations and have completed the following sale transactions of operating divisions acquired as part of the AquaSource transaction:

- In July 2004, we sold our only operation in Kentucky. The sale price approximated our investment in this operation. The operation represented approximately 0.2% of the operations acquired from AquaSource, Inc.
- In October 2003, we completed the sale of our only operation in Connecticut. The sale price of $4,000 approximated our investment in this operation. The operation represented approximately 2% of the operations acquired from AquaSource, Inc.

In December 2002, as a result of the settlement of a condemnation action, our Ohio operating subsidiary sold to Ashtabula County, Ohio the water utility assets in the unincorporated areas of Ashtabula County and the area within the Village of Geneva on the Lake for net proceeds of $12,118, which was in excess of the book value for these assets. The proceeds were used to pay down short-term debt, and the sale resulted in the recognition in 2002 of a gain on the sale of these assets, net of expenses, of $5,676. We continue to operate this water system for Ashtabula County under a multi-year operating contract that expires in December 2008. The water utility assets sold represented less than 1% of our total assets, and the total number of customers included in the water system sold represented less than 1% of our total customer base.

The City of Fort Wayne, Indiana has authorized the acquisition, by eminent domain or otherwise, of a portion of the utility assets of one of the operating subsidiaries that we acquired in connection with the AquaSource acquisition. We have challenged whether the City is following the correct legal procedures in connection with the City's attempted condemnation and we have challenged the City's valuation of this portion of our system. The portion of the system under consideration represents approximately 1% of our total customer base. While we continue to discuss this matter with officials from the City of Fort Wayne, we continue to protect our interests in this proceeding. We believe that we will be entitled to fair market value for our assets if they are condemned, and that the fair market value will be in excess of the book value for such assets.

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

Sources of Capital

Since net operating cash flow plus advances and contributions in aid of construction have not been sufficient to fully fund cash requirements, we issued approximately $659,214 of long-term debt and obtained other short-term borrowings during the past five years. During the past five years, the Trustees held an aggregate $64,664 of the proceeds from certain long-term debt issuances pending completion of the projects financed with the issues. At December 31, 2005, we had short-term lines of credit and other credit facilities of $217,000, of which $78,495 was available. Our short-term lines of credit and other credit facilities are either payable on demand or have a 364-day term.

In December 2005, we filed a universal shelf registration with the SEC to allow for the potential future sale by us, from time to time, in one or more public offerings, of an indeterminant amount of our common stock, preferred stock, debt securities and other securities specified therein at indeterminant prices. No issuances have been completed to date under this shelf registration. During the last three years, we completed the following offerings of equity:

- In November 2004, we sold 2,606,667 shares of common stock in a public offering for proceeds of $42,600, net of expenses. The net proceeds were used to repay a portion of our short-term debt. The short-term debt was incurred by Aqua America in connection with the Heater and Florida Water acquisitions.

- In August 2003, we sold 6,666,667 shares of common stock in a public offering for proceeds of $90,100, net of expenses. The net proceeds were used to repay an unsecured note of $90,000. The indebtedness was incurred by Aqua America in connection with the acquisition of the operations that were purchased from AquaSource, Inc.
- In May 2003, we sold 2,491,667 shares of common stock in a public offering for proceeds of $33,100, net of expenses. The net proceeds were used to repay short-term debt, including the repayment of $22,000 of indebtedness incurred in connection with our repurchase of 2,017,700 shares of our common stock from affiliates of Veolia Environnement, S.A., formerly Vivendi Environnement, S.A., in October 2002.

In addition, we have a shelf registration statement filed with the SEC to permit the offering from time to time of shares of common stock and shares of preferred stock in connection with acquisitions. During 2005, we issued 24,684 shares of common stock totaling $675 to acquire a water system. During 2004 and 2003, we did not issue any shares under the acquisition shelf registration. During 2002, we issued 238,219 shares of common stock totaling $2,745 to acquire water and wastewater systems. The balance remaining available for use under the acquisition shelf registration as of December 31, 2005 is 2,194,262 shares. We will determine the form and terms of any securities issued under these shelf registrations at the time of issuance.

We offer a Dividend Reinvestment and Direct Stock Purchase Plan (Plan) that provides a convenient and economical way to purchase shares of Aqua America, Inc. Under the direct stock purchase portion of the Plan, shares are sold throughout the year. The dividend reinvestment portion of the Plan offers a 5% discount on the purchase of shares of common stock with reinvested dividends. As of the December 2005 dividend payment, holders of 16.7% of the common shares outstanding participated in the dividend reinvestment portion of the Plan. The shares issued under the Plan are either original issue shares or shares purchased by the Company's transfer agent in the open-market. During the past five years, we have sold 2,484,207 original issue shares of common stock for net proceeds of $35,711 through the dividend reinvestment portion of the Plan and we used the proceeds to invest in our operating subsidiaries, to repay short-term debt, and for general corporate purposes.

Other Capital Transactions

In May 2002, Veolia Environnement, S.A., formerly Vivendi Environnement, S.A., which through its affiliates (collectively "VE") owned approximately 16.8% of our outstanding common stock, advised us of its decision to sell its investment in Aqua America. VE announced that its decision was part of its overall strategy to divest non-core assets and focus on other business strategies. In September 2002, in order to facilitate the orderly re-distribution of the shares held by VE into the market, we completed a secondary offering of 16,475,427 shares of Aqua America common stock held by VE. The number of outstanding shares of common stock was not changed and we did not receive any proceeds as a result of this secondary offering. In addition, in October 2002 we repurchased 2,017,700 shares of Aqua America common stock representing the remainder of the shares of Aqua America common stock held by VE. The repurchase of shares was funded with proceeds of $22,000 from a short-term credit facility. In May 2003, this $22,000 short-term credit facility was repaid with funds from the issuance of 2,491,667 shares of common stock through a shelf registration, providing proceeds of approximately $33,100, net of expenses. The balance of the net proceeds were used to repay other short-term debt.

The Board of Directors has authorized us to purchase our common stock, from time to time, in the open market or through privately negotiated transactions. We have not purchased any shares under this authorization since 2000. As of December 31, 2005, 548,278 shares remain available for repurchase. Funding for future stock purchases, if any, is not expected to have a material impact on our financial position.

Off-Balance Sheet Financing Arrangements

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

Contractual Obligations

The following table summarizes our contractual cash obligations as of December 31, 2005:

	Payments Due By Period						
	2006	2007	2008	2009	2010	Thereafter	Total
Long-term debt (a)	$ 24,645	$ 30,959	$ 23,651	$ 6,672	$ 53,884	$ 763,272	$ 903,083
Interest on fixed-rate, long-term debt (b)	51,661	49,419	47,558	46,922	44,287	568,828	808,675
Operating leases (c)	3,482	3,033	2,559	1,218	969	15,264	26,525
Unconditional purchase obligations (d)	12,184	11,763	11,358	11,009	11,778	75,559	133,651
Other purchase obligations (e)	13,552	-	-	-	-	-	13,552
Postretirement benefit plans' obligations (f)	9,282	-	-	-	-	-	9,282
Other obligations (g)	3,465	400	400	257	-	-	4,522
Total	$ 118,271	$ 95,574	$ 85,526	$ 66,078	$ 110,918	$ 1,422,923	$ 1,899,290

(a) Represents sinking fund obligations and debt maturities.
(b) Represents interest payable on fixed-rate, long-term debt. Amounts reported may differ from actual due to future refinancing of debt.
(c) Represents operating leases that are noncancelable, before expiration, for the lease of motor vehicles, buildings, land and other equipment.
(d) Represents our commitment to purchase minimum quantities of water as stipulated in agreements with other water purveyors. We use purchased water to supplement our water supply, particularly during periods of peak customer demand.
(e) Represents an approximation of the open purchase orders as of the period end for goods and services purchased in the ordinary course of business.
(f) Represents contributions expected to be made to postretirement benefit plans. The amount of required contributions in 2007 and thereafter is not determinable.
(g) Represents capital expenditures estimated to be required under legal and binding contractual obligations.

In addition to these obligations, we pay refunds on Customers' Advances for Construction over a specific period of time based on operating revenues related to developer-installed water mains or as new customers are connected to and take service from such mains. After all refunds are paid, any remaining balance is transferred to Contributions in Aid of Construction. The refund amounts are not included in the above table because the refund amounts and timing are dependent upon several variables, including new customer connections, customer consumption levels and future rate increases, which cannot be accurately estimated. Portions of these refund amounts are payable annually through 2020 and amounts not paid by the contract expiration dates become non-refundable.

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

Market Risk

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. The exposure to changes in interest rates is a result of financings through the issuance of fixed-rate, long-term debt. Such exposure is typically related to financings between utility rate increases, because generally our rate increases provide a revenue level to allow recovery of our current cost of capital. Interest rate risk is managed through the use of a combination of long-term debt, which is at fixed interest rates and short-term debt, which is at floating interest rates. As of December 31, 2005, the debt maturities by period and the weighted average interest rate for fixed-rate, long-term debt are as follows:

	2006	2007	2008	2009	2010	Thereafter	Total	Fair Value
Long-term debt (fixed rate)	$ 24,645	$ 30,959	$ 23,651	$ 6,672	$ 53,884	$ 763,272	$ 903,083	$ 950,479
Weighted average interest rate	5.74%	5.64%	5.63%	5.72%	5.44%	5.35%	5.74%	

From time to time, we make investments in marketable equity securities. As a result, we are exposed to the risk of changes in equity prices for the "available for sale" marketable equity securities. As of December 31, 2005, we owned no marketable equity securities as we sold the balance of our securities during 2004.

Capitalization

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

December 31,	2005	2004	2003	2002	2001
Long-term debt*	52.7%	52.8%	52.8%	55.6%	52.9%
Preferred stock	0.0%	0.0%	0.0%	0.0%	0.1%
Common stockholders' equity	47.3%	47.2%	47.2%	44.4%	47.0%
	100.0%	100.0%	100.0%	100.0%	100.0%

*Includes current portion.

The changes in the capitalization ratios primarily resulted from the issuance of common stock over the past five years, and the issuance of debt to finance our acquisitions and capital program and the previously mentioned repurchase of common stock from Veolia Environnement in 2002. It is our goal to maintain an equity ratio adequate to support the current Standard and Poors corporate credit rating of "A+" and its senior secured debt rating of "AA-" for Aqua Pennsylvania, our largest operating subsidiary.

Dividends on Common Stock

We have paid common dividends consecutively for 61 years. Effective December 1, 2005, our Board of Directors authorized an increase of 9.6% in the dividend rate over the amount we paid in the previous quarter. As a result of this authorization, beginning with the dividend payment in December 2005, the annual dividend rate increased to $0.4276 per share. We presently intend to pay quarterly cash dividends in the future, on March 1, June 1, September 1 and December 1, subject to our earnings and financial condition, regulatory requirements and such other factors as our Board of Directors may deem relevant. During the past five years, our common dividends paid have averaged 56.3% of net income.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our financial condition and results of operations are impacted by the methods, assumptions, and estimates used in the application of critical accounting policies. The following accounting policies are particularly important to our financial condition or results of operations, and require estimates or other judgments of matters of uncertainty. Changes in the estimates or other judgments included within these accounting policies could result in a significant change to the financial statements. We believe our most critical accounting policies include revenue recognition, the use of regulatory assets and liabilities as

permitted by Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation," the review for impairment of our long-lived assets which consist primarily of Utility Plant in Service and regulatory assets, our accounting for pensions and other postretirement benefits and our accounting for income taxes. We have discussed the selection and development of our critical accounting policies and estimates with the Audit Committee of the Board of Directors.

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

In some operating divisions, we commence the billing of our utility customers, under new rates, upon authorization from the respective regulatory commission and before the final commission rate order is issued. The revenue recognized reflects an estimate based on our judgment of the final outcome of the ruling. We monitor the facts and circumstances regularly, and revise the estimate as required. The revenue billed and collected prior to the final ruling is subject to refund based on the final ruling. Please refer to the section named "Operating Revenues" for a discussion of revenue currently being recognized under rate filings that are not final.

Regulatory Assets and Liabilities—SFAS No. 71 stipulates generally accepted accounting principles for companies whose rates are established by or are subject to approval by an independent third-party regulator. In accordance with SFAS No. 71, we defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that these costs and credits will be recognized in the rate-making process in a period different from when the costs and credits were incurred. These deferred amounts, both assets and liabilities, are then recognized in the income statement in the same period that they are reflected in our rates charged for water and wastewater service. In the event that our assessment as to the probability of the inclusion in the rate-making process is incorrect, the associated regulatory asset or liability would be adjusted to reflect the change in our assessment or change in regulatory approval.

Impairment of Long-Lived Assets—In accordance with the requirements of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", we review for impairment of our long-lived assets, including Utility Plant in Service. We also review regulatory assets for the continued application of SFAS No. 71. Our review determines whether there have been changes in circumstances or events that have occurred that require adjustments to the carrying value of these assets. In accordance with SFAS No. 71, adjustments to the carrying value of these assets would be made in instances where the inclusion in the rate-making process is unlikely.

Accounting for Postretirement Benefits—We maintain a qualified defined benefit pension plan and plans that provide for certain postretirement benefits other than pensions. Accounting for pensions and other postretirement benefits requires an extensive use of assumptions about the discount rate, expected return on plan assets, the rate of future compensation increases received by our employees, mortality, turnover and medical costs. Each assumption is reviewed annually with assistance from our actuarial consultant who provides guidance in establishing the assumptions. The assumptions are selected to represent the average expected experience over time and may differ in any one year from actual experience due to changes in capital markets and the overall economy. These differences will impact the amount of pension and other postretirement benefit expense that we recognize. During 2005, we undertook a comprehensive study of the key demographic assumptions which impact the obligations and expense for these plans. Based on the study, we updated the assumed retirement and turnover rates for the plans to better reflect the recent experience combined with our expectations of future patterns. In addition, we have updated the mortality assumptions to reflect a more recent actuarial study of mortality experience and an expectation of future mortality improvements. The net effect of the changes in these assumptions was a decrease of $1,600 in our pension and postretirement benefit obligation measured as of December 31, 2005.

Our discount rate assumption was determined using a yield curve that was produced from a universe containing over 500 U.S.-issued Aa-graded corporate bonds, all of which were noncallable (or callable with make-whole provisions), and excluding the 10% of the bonds with the highest yields and the 10% with the lowest yields. The discount rate was then developed as the single rate that would produce the same present value as if we used spot rates, for various time periods, to discount the projected pension benefit payments. Our pension expense and liability (benefit obligations) increases as the discount rate is reduced. A 25 basis-point reduction in this assumption would have increased 2005 pension expense by $660 and the pension liabilities by $7,000. The present values of Aqua America's future pension and other postretirement obligations were determined using discount rates of 5.65% at December 31, 2005 and 5.75% at December 31, 2004. Our expense under these

plans is determined using the discount rate as of the beginning of the year, which was 5.75% for 2005, and will be 5.65% for 2006.

Our expected return on assets is determined by evaluating the asset class return expectations with our advisors as well as actual, long-term, historical results of our asset returns. Our pension expense increases as the expected return on assets decreases. A 25 basis-point reduction in this assumption would have increased 2005 pension expense by $280. For 2005, we used an 8.5% expected return on assets assumption, and will lower this assumption to 8.0% for the calculation of pension expense for 2006. This change was made to reflect a change in our expectations of long-term market returns given the recent decrease in bond yields. The expected return on assets is based on a targeted allocation of 65% equities and 35% fixed income. We believe that our actual long-term asset allocation on average will approximate the targeted allocation. Our targeted allocation is driven by the investment strategy to earn a reasonable rate of return while maintaining risk at acceptable levels through the diversification of investments across and with various asset categories.

As of December 31, 2005, we have an additional minimum liability of $10,909 associated with our defined benefit pension plans. The additional minimum liability is a result of the accumulated benefit obligation exceeding the fair value of plan assets. The portion of the additional minimum liability related to our employees in one of our rate jurisdictions results in the establishment of a regulatory asset of $6,167, as we expect recovery of the future, increased pension expense through customer rates. Since the balance of the additional minimum liability of $4,742 may not be recovered through rates, the accounting requirements for recording a regulatory asset are not met and as a result this amount is recorded as accumulated other comprehensive loss through aggregate charges to accumulated other comprehensive income in 2004 and 2005, net of income tax benefits of $1,660. The change in the additional minimum liability from December 31, 2004 of $6,820 to December 31, 2005 of $10,909 resulted from the effect of a decreased discount rate, offset partially by an increase in the pension plan assets during 2005 due to positive equity market performance and pension contributions. Although additional minimum liability does not directly impact net income or cash flow, in future years, our pension expense and cash funding requirements are anticipated to increase as a result of the decline in the plans' funded status. Funding requirements for qualified defined benefit pension plans are determined by government regulations and not by accounting pronouncements. In accordance with our funding policy, during 2006 our required pension contribution is expected to be approximately $6,400. We do not expect our estimate for the 2006 funding amount to change as a result of the pending pension funding reform. Pension funding reform will impact future contributions, though we expect future changes in the amount of contributions and expense recognized will be generally included in customer rates.

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

IMPACT OF RECENT ACCOUNTING PRONOUNCEMENTS

On October 22, 2004, the American Jobs Creation Act ("AJCA") was signed into law. Among other provisions, the AJCA creates a new deduction for qualified domestic production activities. Certain of our activities, such as our water treatment activity, are considered as qualifying production activities for purposes of determining the deduction for qualified production activities. In December 2004, the Financial Accounting Standards Board ("FASB") issued FSP 109-1, "Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004." In accordance with FSP 109-1, we treat the deduction for qualified domestic production activities as a reduction of the income tax provision in the period realized. We adopted this statement in the first quarter of 2005 and have recorded an estimate for the effect of the statement which reduced the provision for Federal and state income taxes by approximately $740 for the year ended December 31, 2005.

In November 2004, the FASB approved Statement of Financial Accounting Standards ("SFAS") No. 151, "Inventory Costs – An Amendment of ARB No. 43, Chapter 4." SFAS No. 151 requires the exclusion of certain costs from inventories and the allocation of fixed production overheads to inventories to be based on the normal capacity of the production facilities. The

standard is effective for Aqua America for costs incurred after December 31, 2005. We believe this statement will not have a material impact on our results of operations or financial position.

In November 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29." SFAS No. 153 eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. We adopted this standard and it did not have a material impact on our results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," which revises SFAS No. 123, "Accounting for Stock-based Compensation," and supersedes APB No. 25, "Accounting for Stock Issued to Employees." As noted in the footnotes to our consolidated financial statements, we currently provide pro forma disclosure of our compensation costs associated with the fair value of stock options that have been granted. We currently account for stock-based compensation associated with stock options using the intrinsic method, and accordingly, no compensation costs have been recognized in our consolidated financial statements. 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. We adopted this standard as required on January 1, 2006. We adopted this standard using the modified prospective method in which stock option awards that are granted, modified or cancelled after the date of adoption are measured and accounted for in accordance with SFAS No. 123R. Awards that are granted prior to the effective date will continue to be accounted for in accordance with SFAS No. 123 except that the stock option expense for unvested options will be recognized in the income statement. We intend to use the Black-Scholes option-pricing model as permitted under SFAS No. 123R. The impact of adoption of SFAS No. 123R on our earnings depends on a number of variables including the level of share-based payments granted in the future, the fair value of the options granted and the associated income tax benefits that we receive. Assuming we grant a comparable number of stock options in 2006 as compared to 2005 and the fair value approximates the value of recent stock option grants reported in the notes to our consolidated financial statements, the after-tax impact of SFAS No. 123R is expected to approximate $3,000 during the year ending December 31, 2006. We believe the adoption of this standard will have no impact on our overall financial position or cash flow, but will result in the reclassification of related tax benefits from operating cash flow to financing cash flow to the extent these tax benefits exceed the associated compensation cost recognized in the income statement.

In March 2005, the FASB issued FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations," which clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. We adopted this standard as required on December 15, 2005 and it did not have a material effect on our results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 requires retrospective application to prior periods' financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle should be recognized in the period of the accounting change. SFAS No. 154 further requires that a change in depreciation, amortization or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. Aqua America intends to adopt this standard as required in 2006.

AQUA AMERICA, INC. AND SUBSIDIARIES

Management's Report On Internal Control Over Financial Reporting

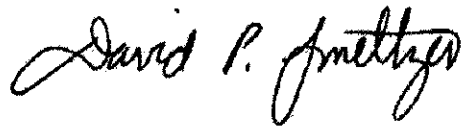
Management of Aqua America, Inc. (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the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

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

In assessing the effectiveness of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. As a result of management's assessment and based on the criteria in the framework, management has concluded that, as of December 31, 2005, the Company's internal control over financial reporting was effective.

The Company's independent registered public accounting firm, PricewaterhouseCoopers LLP, has audited management's assessment of the effectiveness of the Company's internal control over financial reporting, as stated in their report which appears herein.

Nicholas DeBenedictis
Chairman, President and Chief Executive Officer



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

March 13, 2006

Report of Independent Registered Public Accounting Firm

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

We have completed integrated audits of Aqua America, Inc.'s 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005 and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated Financial Statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income and comprehensive income, of capitalization, of common stockholders' equity and of cash flows present fairly, in all material respects, the financial position of Aqua America, Inc. and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal Control over Financial Reporting

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control – Integrated Framework issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

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

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Philadelphia, PA
March 13, 2006

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(In thousands, except per share amounts)
Years ended December 31, 2005, 2004 and 2003

	2005	2004	2003
Operating revenues	$ 496,779	$ 442,039	$ 367,233
Costs and expenses:			
Operations and maintenance	203,088	178,345	140,602
Depreciation	60,747	54,564	48,522
Amortization	4,741	4,300	2,941
Taxes other than income taxes	31,696	27,596	21,607
	300,272	264,805	213,672
Operating income	196,507	177,234	153,561
Other expense (income):			
Interest expense, net	52,062	48,679	44,662
Allowance for funds used during construction	(2,447)	(2,304)	(2,127)
Gain on sale of other assets	(1,177)	(1,272)	(5,692)
Income before income taxes	148,069	132,131	116,718
Provision for income taxes	56,913	52,124	45,923
Net income	91,156	80,007	70,795
Dividends on preferred stock	-	-	10
Net income available to common stock	$ 91,156	$ 80,007	$ 70,785
Net income	$ 91,156	$ 80,007	$ 70,795
Other comprehensive income (loss), net of tax:			
Minimum pension liability adjustment	(1,340)	(1,742)	-
Unrealized gains on securities	-	59	455
Reclassification adjustment for gains reported in net income	-	(230)	(347)
	(1,340)	(1,913)	108
Comprehensive income	$ 89,816	$ 78,094	$ 70,903
Net income per common share:			
Basic	$ 0.72	$ 0.64	$ 0.60
Diluted	$ 0.71	$ 0.64	$ 0.59
Average common shares outstanding during the period:			
Basic	127,364	124,329	117,700
Diluted	129,206	125,710	118,993

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands of dollars, except per share amounts)
December 31, 2005 and 2004

	2005	2004
Assets		
Property, plant and equipment, at cost	$ 2,900,585	$ 2,626,151
Less: accumulated depreciation	620,635	556,339
Net property, plant and equipment	2,279,950	2,069,812
Current assets:		
Cash and cash equivalents	11,872	14,192
Accounts receivable and unbilled revenues, net	62,690	64,538
Inventory, materials and supplies	7,798	6,903
Prepayments and other current assets	7,596	5,570
Total current assets	89,956	91,203
Regulatory assets	130,953	122,935
Deferred charges and other assets, net	37,061	34,106
Funds restricted for construction activity	68,625	17,196
Goodwill	20,180	20,122
	$ 2,626,725	$ 2,355,374
Liabilities and Stockholders' Equity		
Common stockholders' equity:		
Common stock at $.50 par value, authorized 300,000,000 shares, issued 129,658,806 and 127,866,524 in 2005 and 2004	$ 64,829	$ 48,036
Capital in excess of par value	478,508	468,524
Retained earnings	285,132	245,115
Treasury stock, at cost, 688,625 and 686,747 shares in 2005 and 2004	(12,914)	(12,702)
Accumulated other comprehensive income	(3,082)	(1,742)
Unearned compensation	(550)	-
Total common stockholders' equity	811,923	747,231
Minority interest	1,551	1,237
Long-term debt, excluding current portion	878,438	784,461
Commitments	-	-
Current liabilities:		
Current portion of long-term debt	24,645	50,195
Loans payable	138,505	74,810
Accounts payable	55,455	34,915
Accrued interest	13,052	12,029
Accrued taxes	1,111	8,975
Other accrued liabilities	30,571	33,506
Total current liabilities	263,339	214,430
Deferred credits and other liabilities:		
Deferred income taxes and investment tax credits	250,346	223,887
Customers' advances for construction	74,828	73,095
Regulatory liabilities	11,751	11,942
Other	31,969	21,283
Total deferred credits and other liabilities	368,894	330,207
Contributions in aid of construction	302,580	277,808
	$ 2,626,725	$ 2,355,374

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CAPITALIZATION
(In thousands of dollars, except per share amounts)
December 31, 2005 and 2004

	2005	2004
Common stockholders' equity:		
Common stock, $.50 par value	$ 64,829	$ 48,036
Capital in excess of par value	478,508	468,524
Retained earnings	285,132	245,115
Treasury stock, at cost	(12,914)	(12,702)
Accumulated other comprehensive income	(3,082)	(1,742)
Unearned compensation	(550)	-
Total common stockholders' equity	811,923	747,231
Long-term debt:		
Long-term debt of subsidiaries (substantially secured by utility plant):		
Interest Rate Range		
0.00% to 2.49%	21,574	20,051
2.50% to 2.99%	28,684	29,924
3.00% to 3.49%	17,380	17,546
3.50% to 3.99%	6,748	7,123
4.00% to 4.99%	30,695	9,435
5.00% to 5.49%	262,588	165,615
5.50% to 5.99%	79,000	89,260
6.00% to 6.49%	88,504	110,360
6.50% to 6.99%	32,000	42,000
7.00% to 7.49%	15,878	45,105
7.50% to 7.99%	25,012	25,231
8.00% to 8.49%	26,507	26,714
8.50% to 8.99%	9,000	9,000
9.00% to 9.49%	46,764	53,244
9.50% to 9.99%	40,933	42,088
10.00% to 10.50%	6,000	6,000
	737,267	698,696
Unsecured notes payable, 4.87%, maturing in various installments 2010 - 2023	135,000	135,000
Unsecured notes payable, 5.01%, due 2015	18,000	-
Unsecured notes payable, 5.20%, due 2020	12,000	-
Notes payable, 6.05%, maturing in 2006 through 2008	816	960
	903,083	834,656
Current portion of long-term debt	24,645	50,195
Long-term debt, excluding current portion	878,438	784,461
Total capitalization	$ 1,690,361	$ 1,531,692

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMMON STOCKHOLDERS' EQUITY

(In thousands of dollars, except per share amounts)

	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Accumulated Other Comprehensive Loss	Unearned Compensation on Restricted Stock	Total
Balance at December 31, 2002	$ 35,034	$ 317,871	$ 180,047	$ (40,421)	$ 63	$ -	$ 492,594
Net income	-	-	70,785	-	-	-	70,785
Other comprehensive income: unrealized gains on securities, net of income tax of $244	-	-	-	-	455	-	455
Reclassification adjustment for gains reported in net income, net of income tax of $186	-	-	-	-	(347)	-	(347)
Dividends	-	-	(39,917)	-	-	-	(39,917)
Stock split	9,244	(9,244)	-	-	-	-	-
Sale of stock (9,745,160 shares)	2,168	99,031	-	29,163	-	-	130,362
Repurchase of stock (60,646 shares)	-	-	-	(1,353)	-	-	(1,353)
Equity Compensation Plan (26,875 shares)	8	344	-	-	-	-	352
Exercise of stock options (579,777 shares)	181	4,283	-	-	-	-	4,464
Employee stock plan tax benefits	-	723	-	-	-	-	723
Balance at December 31, 2003	46,635	413,008	210,915	(12,611)	171	-	658,118
Net income	-	-	80,007	-	-	-	80,007
Other comprehensive income (loss):							
Minimum pension liability adjustment, net of income tax of $938	-	-	-	-	(1,742)	-	(1,742)
Unrealized gain on securities, net of income tax of $32	-	-	-	-	59	-	59
Less: reclassification adjustment for gains reported in net income, net of income tax of $173	-	-	-	-	(230)	-	(230)
Dividends	-	-	(45,807)	-	-	-	(45,807)
Sale of stock (3,181,203 shares)	1,170	48,971	-	991	-	-	51,132
Repurchase of stock (51,808 shares)	-	-	-	(1,082)	-	-	(1,082)
Equity Compensation Plan (45,535 shares)	17	692	-	-	-	-	709
Exercise of stock options (570,064 shares)	214	4,847	-	-	-	-	5,061
Employee stock plan tax benefits	-	1,006	-	-	-	-	1,006
Balance at December 31, 2004	48,036	468,524	245,115	(12,702)	(1,742)	-	747,231
Net income	-	-	91,156	-	-	-	91,156
Other comprehensive loss: minimum pension liability adjustment, net of income tax of $722	-	-	-	-	(1,340)	-	(1,340)
Dividends	-	-	(51,139)	-	-	-	(51,139)
Stock issued for acquisitions (24,684 shares)	12	663	-	-	-	-	675
Stock split	16,095	(16,095)	-	-	-	-	-
Sale of stock (471,682 shares)	161	7,943	-	1,537	-	-	9,641
Repurchase of stock (56,930 shares)	-	-	-	(1,749)	-	-	(1,749)
Equity Compensation Plan (37,751 shares)	14	708	-	-	-	(722)	-
Exercise of stock options (1,327,717 shares)	511	11,264	-	-	-	-	11,775
Employee stock plan tax benefits	-	5,501	-	-	-	-	5,501
Amortization of unearned compensation	-	-	-	-	-	172	172
Balance at December 31, 2005	$ 64,829	$ 478,508	$ 285,132	$ (12,914)	$ (3,082)	$ (550)	$ 811,923

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED CASH FLOW STATEMENTS
(In thousands of dollars)
Years ended December 31, 2005, 2004 and 2003

	2005	2004	2003
Cash flows from operating activities:			
Net income	$ 91,156	$ 80,007	$ 70,795
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	65,488	58,864	51,463
Deferred income taxes	26,027	40,577	26,741
Gain on sale of water system	-	(2,342)	-
Gain on sale of other assets	(1,177)	(1,272)	(5,692)
Net decrease (increase) in receivables, inventory and prepayments	7,572	(2,766)	(314)
Net increase in payables, accrued interest, accrued taxes and other accrued liabilities	12,933	863	7,777
Other	(2,325)	(328)	(7,397)
Net cash flows from operating activities	199,674	173,603	143,373
Cash flows from investing activities:			
Property, plant and equipment additions, including allowance for funds used during construction of $2,447, $2,304 and $2,127	(237,462)	(195,736)	(163,320)
Acquisitions of water and wastewater systems, net	(11,633)	(54,300)	(192,331)
Release of funds previously restricted for construction activity	56,137	14,015	16,339
Additions to funds restricted for construction activity	(107,566)	(2,772)	(1,025)
Net proceeds from the sale of water systems	-	4,716	4,000
Net proceeds from the sale of other assets	1,300	2,098	6,496
Other	102	(517)	(312)
Net cash flows used in investing activities	(299,122)	(232,496)	(330,153)
Cash flows from financing activities:			
Customers' advances and contributions in aid of construction	14,728	14,269	8,181
Repayments of customers' advances	(4,792)	(4,930)	(4,257)
Net proceeds (repayments) of short-term debt	63,695	(30,150)	(18,654)
Proceeds from long-term debt	147,012	130,258	154,537
Repayments of long-term debt	(83,235)	(55,928)	(44,204)
Change in cash overdraft position	(8,808)	(2,190)	5,200
Redemption of preferred stock	-	-	(172)
Proceeds from issuing common stock	21,416	56,193	134,826
Repurchase of common stock	(1,749)	(1,082)	(1,353)
Dividends paid on preferred stock	-	-	(10)
Dividends paid on common stock	(51,139)	(45,807)	(39,917)
Other	-	179	-
Net cash flows from financing activities	97,128	60,812	194,177
Net increase (decrease) in cash and cash equivalents	(2,320)	1,919	7,397
Cash and cash equivalents at beginning of year	14,192	12,273	4,876
Cash and cash equivalents at end of year	$ 11,872	$ 14,192	$ 12,273
Cash paid during the year for:			
Interest, net of amounts capitalized	$ 48,278	$ 45,261	$ 40,572
Income taxes	$ 30,734	$ 22,322	$ 19,168

See Summary of Significant Accounting Policies-Customers' Advances for Construction, Acquisitions and Employee Stock and and Incentive Plans footnotes for description of non-cash activities.
See accompanying notes to consolidated financial statements.

Summary of Significant Accounting Policies

Nature of Operations—Aqua America, Inc. ("Aqua America" or the "Company") is the holding company for regulated utilities providing water or wastewater services 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., accounts for approximately 56% of our operating revenues for 2005 and provides water or wastewater services to customers in the suburban areas north and west of the City of Philadelphia and in 22 other counties in Pennsylvania. The Company's other subsidiaries provide similar services in 12 other states. In addition, the Company provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to our operating companies' service territories. The company has identified thirteen operating segments that are based on the thirteen states where we provide water or wastewater services. These operating segments are aggregated into one reportable segment since each of the Company's operating segments has the following similarities: economic characteristics, nature of services, production processes, customers, water distribution or wastewater collection methods, and the nature of the regulatory environment.

Regulation—Most of the operating companies that are regulated public utilities are subject to regulation by the public utility commissions of the states in which they operate. The respective public utility commissions have jurisdiction with respect to rates, service, accounting procedures, issuance of securities, acquisitions and other matters. Some of the operating companies that are regulated public utilities are subject to rate regulation by county or city government. Regulated public utilities follow Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 provides for the recognition of regulatory assets and liabilities as allowed by regulators for costs or credits that are reflected in current rates or are considered probable of being included in future rates. The regulatory assets or liabilities are then relieved as the cost or credit is reflected in rates.

Consolidation—The consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany accounts and transactions have been eliminated where appropriate.

Recognition of Revenues—Revenues include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the latest billing to the end of the accounting period. Nonregulated revenues are recognized when services are performed and are primarily associated with operating and maintenance contracts and data processing service fees. Nonregulated revenues totaled $16,484 in 2005, $13,623 in 2004 and $11,806 in 2003.

Property, Plant and Equipment and Depreciation—Property, plant and equipment consist primarily of utility plant. The cost of additions includes contracted cost, direct labor and fringe benefits, materials, overheads and, for certain utility plant, allowance for funds used during construction. Water systems acquired are recorded at estimated original cost of utility plant when first devoted to utility service and the applicable depreciation is recorded to accumulated depreciation. The difference between the estimated original cost, less applicable accumulated depreciation, and the purchase price is recorded as an acquisition adjustment within utility plant. At December 31, 2005, utility plant includes a net credit acquisition adjustment of $64,165, which is generally being amortized from 0 to 20 years. Amortization of the acquisition adjustments totaled $3,674 in 2005, $3,961 in 2004 and $1,649 in 2003.

Utility expenditures for maintenance and repairs, including major maintenance projects and minor renewals and betterments, are charged to operating expenses when incurred in accordance with the system of accounts prescribed by the public utility commissions of the states in which the company operates. The cost of new units of property and betterments are capitalized. Utility expenditures for water main cleaning and relining of pipes are deferred and recorded in net property, plant and equipment in accordance with SFAS No. 71. As of December 31, 2005, $15,788 of costs has been incurred since the last rate proceeding and the Company expects to recover these costs in future rates.

The cost of software upgrades and enhancements are capitalized if they result in added functionality which enable the software to perform tasks it was previously incapable of performing. Certain information technology costs associated with major system installations, conversions and improvements, such as software training, data conversion and business process reengineering costs, are deferred as a regulatory asset if the Company expects to recover these costs in future rates. If these costs are not deferred in accordance with SFAS No. 71, then these costs are charged to operating expenses when incurred. As of December 31, 2005, $3,952 of costs have been incurred and deferred, since the last rate proceeding, as a regulatory asset, and the deferral is reported as a component of net property, plant and equipment.

When units of utility property are replaced, retired or abandoned, the recorded value thereof is credited to the asset account and such value, together with the net cost of removal, is charged to accumulated depreciation. To the extent the Company recovers cost of removal or other retirement costs through rates after the retirement costs are incurred, a regulatory asset is recorded. In some cases, the Company recovers retirement costs through rates during the life of the associated asset and before the costs are incurred. These amounts result in a regulatory liability being reported based on the amounts previously recovered through customer rates.

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

In accordance with the requirements of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the long-lived assets of the Company, which consist primarily of Utility Plant in Service and regulatory assets, are reviewed for impairment when changes in circumstances or events occur. There has been no change in circumstances or events that have occurred that require adjustments to the carrying values of these assets.

Allowance for Funds Used During Construction—The allowance for funds used during construction ("AFUDC") is a non-cash credit which represents the estimated cost of funds used to finance the construction of utility plant. In general, AFUDC is applied to construction projects requiring more than one month to complete. No AFUDC is applied to projects funded by customer advances for construction or contributions in aid of construction. AFUDC includes the net cost of borrowed funds and a rate of return on other funds when used, and is recovered through water rates as the utility plant is depreciated. The amount of AFUDC related to equity funds in 2005 was $1. There was no AFUDC related to equity funds in 2004 and 2003. No interest was capitalized by our nonregulated businesses.

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

The Company had a book overdraft for certain of its disbursement cash accounts of $2,573 and $11,381 at December 31, 2005 and 2004, respectively. A book overdraft represents transactions that have not cleared the bank accounts at the end of the period. The Company transfers cash on an as-needed basis to fund these items as they clear the bank in subsequent periods. The balance of the book overdraft is reported as accounts payable and the change in the book overdraft balance is reported as cash flows from financing activities.

Accounts Receivable—Accounts receivable are recorded at the invoiced amounts. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in our existing accounts receivable, and is determined based on historical write-off experience and the aging of account balances. The Company reviews the allowance for doubtful accounts quarterly. Account balances are written off against the allowance when it is probable the receivable will not be recovered.

Deferred Charges and Other Assets—Deferred charges and other assets consist of financing expenses, other costs and marketable securities. Deferred bond issuance expenses are amortized by the straight-line method over the life of the related issues. Call premiums related to the early redemption of long-term debt, along with the unamortized balance of the related issuance expense, are deferred and amortized over the life of the long-term debt used to fund the redemption. Other costs, for which the Company has received or expects to receive prospective rate recovery, are deferred and amortized over the period of rate recovery in accordance with SFAS No. 71.

Marketable securities are considered "available-for-sale" and accordingly, are carried on the balance sheet at fair market value. Unrecognized gains are included in other comprehensive income.

Goodwill—Goodwill represents the excess cost over the fair value of net tangible and identifiable intangible assets acquired, and a substantial portion of the goodwill balance is associated with the acquisition of Heater Utilities, Inc. in June 2004. Goodwill is not amortized but is tested for impairment annually, or more often, if certain circumstances indicate a possible impairment may exist. In accordance with the requirements of SFAS No. 142, "Goodwill and Other Intangible Assets," the Company tested the goodwill attributable to each of our reporting units for impairment as of July 31, 2005, in conjunction with the timing of our annual strategic business plan. Based on the Company's comparison of the estimated fair value of each reporting unit to their respective carrying amounts, the impairment test concluded that none of its goodwill was impaired.

Income Taxes—The Company accounts for certain income and expense items in different time periods for financial reporting than for tax reporting purposes. Deferred income taxes are provided on the temporary differences between the tax basis of the assets and liabilities, and the amounts at which they are carried in the consolidated financial statements. The income tax effect of temporary differences not allowed currently in rates is recorded as deferred taxes with an offsetting regulatory asset or liability. These deferred income taxes are based on the enacted tax rates expected to be in effect when such temporary differences are projected to reverse. Investment tax credits are deferred and amortized over the estimated useful lives of the related properties.

Customers' Advances for Construction and Contributions in Aid of Construction—Water mains or, in some instances, cash advances to reimburse the Company for its costs to construct water mains, are contributed to the Company by customers, real estate developers and builders in order to extend water service to their properties. The value of these contributions is recorded as Customers' Advances for Construction. Non-cash property, in the form of water mains, has been received, generally from developers, as advances or contributions of $15,729, $9,273 and $9,991 in 2005, 2004 and 2003, respectively. The Company makes refunds on these advances over a specific period of time based on operating revenues related to the main or as new customers are connected to and take service from the main. After all refunds are made, any remaining balance is transferred to Contributions in Aid of Construction. Contributions in aid of construction include direct non-refundable contributions and the portion of customers' advances for construction that become non-refundable. Contributed property is generally not depreciated. Certain of the subsidiaries do depreciate contributed property and amortize contributions in aid of construction at the composite rate of the related property.

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

Stock-Based Compensation—The Company currently accounts for stock-based compensation using the intrinsic value method in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees". Accordingly, no compensation expense related to granting of stock options has been recognized in the financial statements for stock options that have been granted. Please refer to the Recent Accounting Pronouncements section of this footnote for information concerning changes to the Company's accounting for stock-based compensation, including the expected after-tax impact of adopting SFAS No. 123R, "Share-Based Payment." Pursuant to the current disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, pro forma net income available to common stock and earnings per share are presented in the following table as if compensation cost for stock options was determined as of the grant date under the fair value method:

	Years Ended December 31,		
	2005	2004	2003
Net income available to common stock, as reported	$ 91,156	$ 80,007	$ 70,785
Add: stock-based employee compensation expense included in reported net income, net of tax	290	266	224
Less: pro forma expense related to stock options granted, net of tax effects	(2,054)	(1,990)	(1,793)
Pro forma	$ 89,392	$ 78,283	$ 69,216
Basic net income per share:			
As reported	$ 0.72	$ 0.64	$ 0.60
Pro forma	0.70	0.63	0.59
Diluted net income per share:			
As reported	$ 0.71	$ 0.64	$ 0.59
Pro forma	0.69	0.62	0.58

The per share weighted-average fair value at the date of grant for stock options granted during 2005, 2004 and 2003 was $4.23, $4.07 and $3.50 per option, respectively. The fair value of options at the date of grant was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2005	2004	2003
Expected life (years)	6.0	4.5	5.6
Interest rate	4.1%	4.0%	3.7%
Volatility	23.4%	29.9%	32.4%
Dividend yield	2.4%	2.2%	2.6%

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

Reclassifications and Revisions—Certain prior year amounts have been changed to conform with current year's presentation. The changes include the presentation of regulatory assets and cash overdrafts. Regulatory assets were previously reported on a net basis. This presentation was changed to report regulatory assets and liabilities on a gross basis and regulatory liabilities have been reclassified to deferred credits and other liabilities. Cash overdrafts were previously reported as components of cash or loans payable. This presentation was changed to classify cash overdrafts as accounts payable. Accordingly, applicable historic 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 impacted the Company's net cash flows from financing activities from that which was previously reported, by a $440 decrease for the year ended December 31, 2004, and an increase of $2,555 for the year ended December 31, 2003.

Recent Accounting Pronouncements—On October 22, 2004, the American Jobs Creation Act ("AJCA") was signed into law. Among other provisions, the AJCA creates a new deduction for qualified domestic production activities. Certain activities of the Company, such as our water treatment activity, are considered as qualifying production activities for purposes of determining the deduction for qualified production activities. In December 2004, the Financial Accounting Standards Board ("FASB") issued FSP 109-1, "Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004." In accordance with FSP 109-1, the Company will treat the deduction for qualified domestic production activities as a reduction of the income tax provision in the period realized. The Company adopted this statement in the first quarter of 2005 and has recorded an estimate for the effect of the statement which reduced the provision for Federal and state income taxes by approximately $740 for the year ended December 31, 2005.

In November 2004, the FASB approved Statement of Financial Accounting Standards ("SFAS") No. 151, "Inventory Costs – An Amendment of ARB No. 43, Chapter 4." SFAS No. 151 requires the exclusion of certain costs from inventories and the allocation of fixed production overheads to inventories to be based on the normal capacity of the production facilities. The standard is effective for the Company for costs incurred after December 31, 2005. The Company believes this statement will not have a material impact on its results of operations or financial position.

In November 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29." SFAS No. 153 eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. The Company adopted this statement and it did not have a material impact on the Company's results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," which revises SFAS No. 123, "Accounting for Stock-based Compensation," and supersedes APB No. 25, "Accounting for Stock Issued to Employees." As noted in the section captioned "Stock-based Compensation" in the Summary of Significant Accounting Policies footnote, the Company currently provides pro forma disclosure of its compensation costs associated with the fair value of stock options that have been granted. The Company currently accounts for stock-based compensation associated with stock options using the intrinsic method, and accordingly, no compensation costs have been recognized in its consolidated financial statements. 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. The Company adopted this standard as required on January 1, 2006. The Company adopted this standard using the modified prospective method in which stock option awards that are granted, modified or cancelled after the date of adoption are measured and accounted for in accordance with SFAS No. 123R. Awards that are granted prior to the effective date will continue to be accounted for in accordance with SFAS No. 123 except that the stock option expense for unvested options will be recognized in the income statement. The Company intends to use the Black-Scholes option-pricing model as permitted under SFAS No. 123R. The impact of adoption of SFAS No. 123R on the Company's earnings depends on a number of variables including the level of share-based payments granted in the future, the fair value of the options granted and the associated income tax benefits that the Company receives. Assuming the Company grants a comparable number of stock options in 2006 as compared to 2005 and the fair value approximates the value of recent stock option grants reported in the notes to our consolidated financial statements, the after-tax impact of SFAS No. 123R is expected to approximate $3,000 during the year ending December 31, 2006. The Company believes that the adoption of this standard will have no impact on our overall financial position or cash flow, but will result in the reclassification of related tax benefits from operating cash flow to financing cash flow to the extent these tax benefits exceed the associated compensation cost recognized in the income statement.

In March 2005, the FASB issued FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations," which clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. The Company adopted this standard as required on December 15, 2005 and it did not have a material effect on its results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 requires retrospective application to prior periods' financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle should be recognized in the period of the accounting change. SFAS No. 154 further requires that a change in depreciation, amortization or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. The Company intends to adopt this standard as required in 2006.

Acquisitions

Heater—Pursuant to our strategy to grow through acquisitions, on June 1, 2004 the Company acquired the capital stock of Heater Utilities, Inc. for $48,000 in cash and the assumption of long-term debt of $19,219 and short-term debt of $8,500. The acquired operation provides water and wastewater service to over 50,000 water and wastewater customers primarily in the areas of suburban Raleigh, Charlotte, Gastonia and Fayetteville, North Carolina. For the fiscal year ended December 31, 2003, Heater had operating revenues of $19,489. The acquisition was accounted for as a purchase and accordingly, the purchase price is allocated to the net tangible and intangible assets based upon their estimated fair values at the date of the acquisition. The Company obtained a third-party valuation of these assets and liabilities, and it resulted in the recording of a purchase accounting fair value adjustment of $3,141 to increase the carrying-value of long-term debt assumed. The purchase price allocation is as follows:

	June 1, 2004
Property, plant and equipment, net	$ 96,779
Current assets	4,133
Other long-term assets	6,005
Goodwill	18,842
Total assets acquired	125,759
Current liabilities	3,063
Loans payable	8,500
Long-term debt	22,360
Other long-term liabilities	43,836
Total liabilities assumed	77,759
Net assets acquired	$ 48,000

The Company has recorded goodwill of $18,842, and a substantial portion of the goodwill is expected to be deductible for tax purposes. The purchase price was arrived at through arms-length negotiations with the seller and is consistent with the multiples paid in other comparable transactions. Aqua America considered important regulatory, strategic and valuation considerations in arriving at the final purchase price. During 2004, through the North Carolina Utilities Commission approval process, a mechanism has been developed through which the Company could recover up to two-thirds of the goodwill through customer rates in the future upon achieving certain objectives. The Company intends to pursue these objectives to facilitate recognition of this premium in customer rates. However, there can be no assurance that the Company will be able to achieve these objectives and recover such amount of goodwill, if any.

Florida Water—On June 30, 2004, the Company acquired certain utility assets of Florida Water Services Corporation, comprised of 63 water and wastewater systems located in central Florida for $14,747 in cash. In accordance with Florida Public Service Commission procedures, the acquisition was approved by the Commission and rate base was determined on December 20, 2005. Under the terms of the purchase agreement, the Commission's rate base determination will result in a reduction of the final purchase price that could be as much as approximately $2,000, which is not expected to result in the recognition of goodwill.

AquaSource—Pursuant to our strategy to grow through acquisitions, on July 31, 2003, the Company completed its acquisition of four operating water and wastewater subsidiaries of AquaSource, Inc. (a subsidiary of DQE, Inc.), including selected, integrated operating and maintenance contracts and related assets (individually and collectively the acquisition is referred to as "AquaSource") for $190,717 in cash, as adjusted pursuant to the purchase agreement based on working capital at closing. On August 27, 2004, we were awarded and received $12,289 plus interest in an arbitration related to the calculation of the final purchase price under the terms of the purchase agreement, which resulted in a final purchase price of $178,428. In the

consolidated statement of cash flow for 2004, the $12,289 award has been reported as proceeds on the line titled acquisitions of water and wastewater systems, net.

The results of AquaSource have been included in the Company's consolidated financial statements beginning August 1, 2003. The acquired operations of AquaSource serve over 130,000 water and wastewater customer accounts in 11 states (including the Connecticut and Kentucky operations which were subsequently sold to other parties). Please refer to the Dispositions footnote for a discussion of the AquaSource operations located in Connecticut and Kentucky. The AquaSource acquisition was initially funded by a portion of the proceeds from the July 2003 issuance of $135,000 of unsecured notes due 2023, with an interest rate of 4.87%, and the issuance of a $90,000 unsecured note by Aqua America. In August 2003, the $90,000 unsecured note was repaid with the proceeds from the issuance of 6,666,667 shares of common stock through a shelf registration.

Under the purchase method of accounting, the purchase price is allocated to AquaSource's net tangible and intangible assets based upon their estimated fair values at the date of the acquisition. The purchase price allocation, which reflects the effects of the August 2004 purchase price arbitration proceeding, is as follows:

	July 31, 2003
Property, plant and equipment, net	$ 197,719
Current assets	9,687
Other long-term assets	14,204
Assets held for sale, net	4,096
Total assets acquired	225,706
Current liabilities	8,214
Long-term debt	7,170
Other long-term liabilities	31,894
Total liabilities assumed	47,278
Net assets acquired	$ 178,428

The following supplemental pro forma information is presented to illustrate the effects of the AquaSource acquisition, which was completed on July 31, 2003, on the historical operating results for the year ended December 31, 2003 as if the acquisition had occurred at the beginning of the period (unaudited):

Operating revenues	$ 407,628
Net income	$ 74,436
Net income per common share:	
Basic	$ 0.61
Diluted	$ 0.60

The supplemental information is not necessarily representative of the actual results that may have occurred for this period or of the results that may occur in the future. This information does not reflect the effects of recent rate increases or cost savings that may result from the acquisition, such as the effects of a reduction in administrative costs. This information is based upon the historical operating results of AquaSource for periods prior to the acquisition date of July 31, 2003 as provided to the Company by AquaSource, Inc. and DQE, Inc. management.

Other Acquisitions— During 2005, the Company completed 30 acquisitions or other growth ventures in various states. The total purchase price of $12,308 for the systems acquired in 2005 consisted of $11,633 in cash and the issuance of 24,684 shares of the Company's common stock. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company were $2,145.

During 2004, in addition to the Heater and Florida Water acquisitions, the Company completed 27 acquisitions or other growth ventures in the various states in which the Company operates for an aggregate purchase price of $3,842 in cash. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company were $1,281 in 2005 and $617 in 2004.

During 2003, in addition to the AquaSource acquisition, the Company completed 17 acquisitions or other growth ventures in the various states in which the Company operates for an aggregate purchase price of $1,614 in cash. Operating revenues included in the consolidated financial statements of the Company related to these systems were $976 in 2005, $860 in 2004 and $312 in 2003.

Dispositions

In December 2004, as a result of the settlement of a condemnation action, the Company's Ohio operating subsidiary sold its water utility assets within the municipal boundaries of the City of Geneva in Ashtabula County, Ohio for net proceeds of approximately $4,716, which was in excess of the book value for these assets. The proceeds were used to pay-down short-term debt and the sale resulted in the recognition in the fourth quarter of 2004 of a gain on the sale of these assets, net of expenses, of $2,342. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. We continue to operate this water system for the City of Geneva under an operating contract that began upon the closing of the sale for a period through December 2006. The operating contract provides for an annual base operating fee of $135 and allows for additional fees to be earned commensurate with the services provided. These water utility assets represent less than 1% of Aqua America's total assets, and the total number of customers included in the water system sold represents less than 1% of our total customer base.

In July 2004, the Company sold its only operations in Kentucky. The sale price approximates our investment in this operation. The operation represented approximately 0.2% of the operations acquired from AquaSource, Inc. In October 2003, the Company sold its only operation in Connecticut. The sale price of $4,000 approximates our investment in this operation. The operation represented approximately 2% of the operations acquired from AquaSource, Inc.

The City of Fort Wayne, Indiana has authorized the acquisition, by eminent domain or otherwise, of a portion of the utility assets of one of the operating subsidiaries that the Company acquired in connection with the AquaSource acquisition in 2003. The Company has challenged whether the City is following the correct legal procedures in connection with the City's attempted condemnation and the Company has challenged the City's valuation of this portion of its system. The portion of the system under consideration represents approximately 1% of the Company's total customer base. While the Company continues to discuss this matter with officials from the City of Fort Wayne, the Company continues to protect its interests in this proceeding. The Company believes that it will be entitled to fair market value for its assets if they are condemned, and it is believed that the fair market value will be in excess of the book value for such assets.

Property, Plant and Equipment

	December 31, 2005	December 31, 2004	Approximate range of remaining lives
Utility plant and equipment:			
Mains and accessories	$ 1,187,597	$ 1,087,712	10 to 85 years
Services, hydrants, treatment plants and reservoirs	660,279	607,331	5 to 85 years
Operations structures and water tanks	222,107	218,888	15 to 77 years
Miscellaneous pumping and purification equipment	376,599	342,985	10 to 50 years
Meters, data processing, transportation and operating equipment	341,550	298,015	5 to 50 years
Land and other non-depreciable assets	73,346	67,260	-
Utility Plant and equipment	2,861,478	2,622,191	
Utility construction work in progress	98,898	63,754	-
Net utility plant acquisition adjustment	(64,165)	(63,347)	0 to 20 years
Non-utility plant and equipment	4,374	3,553	2 to 40 years
Total property, plant and equipment	$ 2,900,585	$ 2,626,151	

Accounts Receivable

	December 31, 2005	December 31, 2004
Billed utility revenue	$ 42,541	$ 39,783
Unbilled utility revenue	21,419	27,927
Other	3,136	1,677
	67,096	69,387
Less allowance for doubtful accounts	4,406	4,849
Net accounts receivable	$ 62,690	$ 64,538

The Company's customers are located principally in the following states: 48% in Pennsylvania, 10% in Ohio, 9% in North Carolina, 8% in Illinois, 6% in Texas, 6% in New Jersey, 4% in Florida, and 4% in Indiana. No single customer accounted for more than one percent of the Company's operating revenues during the years ended December 31, 2005, 2004 or 2003. The following table summarizes the changes in the Company's allowance for doubtful accounts:

	2005	2004	2003
Balance at January 1,	$ 4,849	$ 5,851	$ 3,580
Amounts charged to expense	3,116	3,695	2,643
Accounts written off	(4,113)	(5,460)	(2,715)
Recoveries of accounts written off	554	701	253
Allowance acquired through acquisitions	-	62	2,090
Balance at December 31,	$ 4,406	$ 4,849	$ 5,851

Regulatory Assets and Liabilities

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

	December 31, 2005		December 31, 2004	
	Regulatory Assets	Regulatory Liabilities	Regulatory Assets	Regulatory Liabilities
Income taxes	$ 69,531	$ 2,203	$ 68,990	$ 3,283
Utility plant retirement costs	17,421	8,368	14,729	8,184
Postretirement benefits	10,871	-	11,403	-
Texas rate filing expense deferral	9,486	-	3,365	-
CTC payment	5,733	-	6,879	-
Water tank painting	4,292	267	4,593	130
Fair value of long-term debt assumed in acquisition	2,804	-	3,015	-
Merger costs	1,641	-	2,170	-
Rate case filing expenses & other	9,174	913	7,791	345
	$ 130,953	$ 11,751	$ 122,935	$ 11,942

Items giving rise to deferred state income taxes, as well as a portion of deferred Federal income taxes related to certain differences between tax and book depreciation expense, are recognized in the rate setting process on a cash or flow-through basis and will be recovered as they reverse.

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

Postretirement benefits include pension and other postretirement benefits. The pension costs include deferred net pension expense in excess of amounts funded which the Company believes will be recoverable in future years as pension funding is required, and in addition includes an additional minimum liability for pensions as a result of a decline in the discount rate assumed for pension obligations and a change in the fair market value of plan assets. The additional minimum liability equals the excess of the accumulated benefit obligation over the fair value of plan assets. The regulatory asset related to postretirement benefits other than pensions represents costs that were deferred between the time that the accrual method of accounting for these benefits was adopted in 1993 and the recognition of the accrual method in the Company's rates as prescribed in subsequent rate filings. Amortization of the amount deferred for postretirement benefits other than pensions began in 1994 and is currently being recovered in rates.

The regulatory asset for the Texas rate filing of 2004 results from a multi-year plan to increase annual revenues in phases, and to defer and amortize a portion of the Company's depreciation, operating and other tax expense over a similar multi-year period.

The regulatory asset associated with the Competitive Transition Charge ("CTC") payment represents the full payoff in 2001, net of amortization, of the allocable share of a CTC as negotiated by Aqua Pennsylvania, Inc. from an electric distribution company. The Pennsylvania Electricity Generation Customer Choice and Competition Act permitted electric distribution utilities to recover their stranded costs from its customers in the form of a CTC. Rate recovery of the $11,465 CTC payment began in 2000 and is expected to conclude in 2010. Expenses associated with water tank painting are deferred and amortized over a period of time as approved in the regulatory process.

As a requirement of purchase accounting, the Company recorded a fair value adjustment for fixed-rate, long-term debt assumed in the Heater Utilities, Inc. acquisition in 2004. The regulatory asset results from the rate setting process continuing to recognize the historical interest cost of the assumed debt.

The regulatory asset related to the recovery of merger costs represents the portion of the Consumers Water Company merger costs that will be recovered in rates as a result of a rate settlement in 2000 and is being amortized over the recovery period. The regulatory asset related to rate case filing expenses represents the costs associated with filing for rate increases that are deferred and amortized over periods that generally range from one to five years.

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

Income Taxes

The provision for income taxes consists of:

	Years Ended December 31,		
	2005	2004	2003
Current:			
Federal	$ 24,417	$ 2,042	$ 11,933
State	6,586	7,553	7,249
	31,003	9,595	19,182
Deferred:			
Federal	22,294	41,414	25,521
State	3,616	1,115	1,220
	25,910	42,529	26,741
Total tax expense	$ 56,913	$ 52,124	$ 45,923

The statutory Federal tax rate is 35% and for states with a corporate net income tax, the state corporate net income tax rates range from 5.00% to 9.99% for all years presented. The Company's Federal income tax returns for all years through 2001 have been closed, and 2002 was closed as a result of the conclusion of a tax audit.

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

	Years Ended December 31,		
	2005	2004	2003
Computed Federal tax expense at statutory rate	$ 51,824	$ 46,245	$ 40,852
Increase in tax expense for depreciation expense to be recovered in future rates	806	1,376	1,125
Domestic Production Credit	(656)	-	-
Deduction for Aqua America common dividends paid under employee benefit plan	(321)	(245)	(241)
Amortization of deferred investment tax credits	(359)	(285)	(285)
Prior year rate reductions	(437)	(538)	(431)
State income taxes, net of federal tax benefit	6,631	5,634	5,505
Other, net	(575)	(63)	(602)
Actual income tax expense	$ 56,913	$ 52,124	$ 45,923

The tax effects of temporary differences between book and tax accounting that give rise to the deferred tax assets and deferred tax liabilities are as follows:

	December 31,	
	2005	2004
Deferred tax assets:		
Customers' advances for construction	$ 17,549	$ 17,057
Costs expensed for book not deducted for tax, principally accrued expenses	1,803	1,989
Utility plant acquisition adjustment basis differences	29,429	30,920
Minimum pension liability adjustment	1,660	938
Total gross deferred tax assets	50,441	50,904
Deferred tax liabilities:		
Utility plant, principally due to depreciation and differences in the basis of fixed assets due to variation in tax and book accounting	267,835	243,953
Deferred taxes associated with the gross-up of revenues necessary to recover, in rates, the effect of temporary differences	25,796	23,670
Deferred investment tax credit	6,066	6,328
Unrealized gain on marketable securities	-	-
Other	1,090	840
Total gross deferred tax liabilities	300,787	274,791
Net deferred tax liability	$ 250,346	$ 223,887

On October 22, 2004, the American Jobs Creation Act ("AJCA") was signed into law. Among other provisions, the AJCA creates a new deduction for qualified domestic production activities. Certain activities of the Company, such as our water treatment activity, are considered as qualifying production activities for purposes of determining the deduction for qualified production activities. In December 2004, the FASB issued FSP 109-1, "Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004." In accordance with FSP 109-1, the Company will treat the deduction for qualified domestic production activities as a reduction of the income tax provision in the period realized. The Company adopted this statement in 2005 and has recorded an estimate for the effect of the statement which reduced the provision for Federal and state income taxes by approximately $740 for the year ended December 31, 2005.

Commitments

The Company maintains agreements with other water purveyors for the purchase of water to supplement its water supply, particularly during periods of peak demand. The agreements stipulate purchases of minimum quantities of water to the year 2026. The estimated annual commitments related to such purchases through 2010 are expected to approximate $11,618 and $75,559 thereafter. The Company purchased approximately $10,603, $8,724 and $8,014 of water under these agreements during the years ended December 31, 2005, 2004 and 2003, respectively.

The Company leases motor vehicles, buildings and other equipment under operating leases that are noncancelable. The future annual minimum lease payments due are: $2,934 in 2006, $2,488 in 2007, $2,012 in 2008, $670 in 2009, $430 in 2010 and $256 thereafter. The Company leases parcels of land on which treatment plants and other facilities are situated and adjacent parcels that are used for watershed protection. The operating leases are noncancelable, expire between 2012 and 2052 and contain certain renewal provisions. Certain leases are subject to an adjustment every five years based on changes in the Consumer Price

Index. Subject to the aforesaid adjustment, during each of the next five years, approximately $545 of annual lease payments for land are due, and $15,009 thereafter. The Company leases treatment plants to other parties under lease agreements that require payments to the Company of $567 in 2006, $267 in 2007, $308 in 2008, $246 in 2009, $246 in 2010 and $3,430 thereafter.

Rent expense was $3,390, $3,267 and $2,993 for the years ended December 31, 2005, 2004 and 2003, respectively.

Long-term Debt and Loans Payable

The Consolidated Statements of Capitalization provide a summary of long-term debt as of December 31, 2005 and 2004. The supplemental indentures with respect to certain issues of the First Mortgage Bonds restrict the ability of Aqua Pennsylvania, Inc. and certain other operating subsidiaries of the Company to declare dividends, in cash or property, or repurchase or otherwise acquire the stock of these companies. As of December 31, 2005, approximately $281,000 of Aqua Pennsylvania's retained earnings and $69,000 of the retained earnings of certain other subsidiaries were free of these restrictions. Certain supplemental indentures also prohibit Aqua Pennsylvania and certain other subsidiaries of the Company from making loans to, or purchasing the stock of, the Company.

Sinking fund payments are required by the terms of certain issues of long-term debt. The future sinking fund payments and debt maturities of the Company's long-term debt are as follows:

Interest Rate Range	2006	2007	2008	2009	2010	Thereafter
0.00% to 2.49%	$ 1,320	$ 1,340	$ 1,354	$ 1,378	$ 1,395	$ 14,787
2.50% to 2.99%	6,502	1,489	1,534	1,583	1,657	15,919
3.00% to 3.49%	265	12,270	278	288	298	3,981
3.50% to 3.99%	675	685	695	706	717	3,270
4.00% to 4.99%	50	50	50	55	27,055	138,435
5.00% to 5.49%	-	-	-	-		292,588
5.50% to 5.99%	-	-	-	-	-	79,000
6.00% to 6.49%	144	644	10,172	-	-	78,360
6.50% to 6.99%	10,000	10,000	-	-	-	12,000
7.00% to 7.49%	2,499	2,540	2,585	634	687	6,933
7.50% to 7.99%	194	210	227	245	264	23,872
8.00% to 8.49%	139	152	167	184	202	25,663
8.50% to 8.99%	-	-	-	-	-	9,000
9.00% to 9.49%	663	584	594	604	20,615	23,704
9.50% to 9.99%	2,194	995	5,995	995	994	29,760
10.00% to 10.50%	-	-	-	-	-	6,000
Total	$ 24,645	$ 30,959	$ 23,651	$ 6,672	$ 53,884	$ 763,272

In February 2005, the Company issued $30,000 of unsecured notes of which $18,000 are due in 2015 with an interest rate of 5.01% and $12,000 are due in 2020 with an interest rate of 5.20%. The proceeds of this financing were used to refinance existing short-term debt. In May 2005, Aqua Pennsylvania issued $72,000 of tax-exempt bonds secured by a supplement to its first mortgage indenture at the following terms: $22,000 at 4.87% due 2036, $25,000 at 4.88% due 2037 and $25,000 at 4.89% due 2038. Of the $72,000 in proceeds, $22,000 was used to retire previously issued tax-exempt bonds in August 2005 and the balance of proceeds are restricted to funding the costs of certain capital projects during the period 2005 through 2007. In December 2005, Aqua Pennsylvania issued $25,000 of tax-exempt bonds at 4.82% due 2035, which were secured by a supplement to its first mortgage indenture. The proceeds are restricted to funding certain capital projects during the period 2006 through 2008. At various times during 2005, Aqua Pennsylvania and other operating subsidiaries issued other notes payable, first mortgage bonds and tax-exempt bonds aggregating $24,677 at a weighted-average interest rate of 4.10% due at various times ranging from 2019 to 2035. The proceeds from these issuances were used to reduce a portion of the balance of short-term debt at each of the respective operating subsidiaries and to redeem $10,260 of first mortgage bonds of an operating subsidiary with an interest rate of 5.60%. As of December 31, 2005, the Trustees for 12 issues held $68,625 pending

construction of the projects to be financed with the issues and are reported in the consolidated balance sheet as funds restricted for construction activity.

In May 2004, Aqua Pennsylvania issued $87,000 of First Mortgage Bonds secured by a supplement to its first mortgage indenture with a weighted-average interest rate of approximately 5.1% and a weighted-average maturity of 13.7 years. The proceeds from this issuance were used to refinance short-term debt and to fund long-term debt maturities. In May 2004, an unsecured note of $70,000 was issued by the Company. Interest under this note is based, at the borrower's option, on either a defined base rate or an adjusted London Interbank Offered Rate corresponding to the interest period selected. The proceeds of this financing were used to fund acquisitions and to refinance existing debt. In November 2004, $34,000 of the $70,000 unsecured note was repaid with the proceeds from an equity offering. The remaining balance of the note of $36,000 was repaid in May 2005. In connection with the acquisition of Heater Utilities, Inc. in 2004, the Company assumed $22,360 of long-term debt at interest rates ranging from 7.05% to 8.24% due 2012 to 2025, which includes the purchase accounting fair value adjustment of $3,141, increasing the carrying-value of long-term debt. In November 2004, Aqua Pennsylvania issued $14,000 tax-exempt bonds due 2039 at a rate of 5.05% and secured by a supplement to its first mortgage indenture. The proceeds from the bonds issued were used to retire previously issued tax-exempt bonds. At various times during 2004, Aqua Pennsylvania and other operating subsidiaries issued other notes payable and first mortgage bonds aggregating $31,239 at a weighted-average interest rate of 3.76% due at various times ranging from 2006 to 2037. The proceeds from these issuances were used to reduce a portion of the balance of the short-term debt at each of the respective operating subsidiaries and to redeem $6,000 of first mortgage bonds with a weighted-average interest rate of 9.19%. The weighted average cost of long-term debt at December 31, 2005 and 2004 was 5.74% and 6.00%, respectively.

Aqua Pennsylvania has a $70,000 364-day revolving credit facility with four banks and the Company has a $20,000 364-day bank revolving credit facility. Funds borrowed under these agreements are classified as loans payable and are used to provide working capital. As of December 31, 2005 and 2004, funds borrowed under the Aqua Pennsylvania revolving credit agreements were $65,000 and $29,000, respectively, and $17,000 and $0 were borrowed under the Company's revolving credit agreement, respectively. Interest under these facilities is based, at the borrower's option, on the prime rate, an adjusted federal funds rate, an adjusted London Interbank Offered Rate corresponding to the interest period selected, an adjusted Euro-Rate corresponding to the interest period selected or at rates offered by the banks. These agreements restrict short-term borrowings of Aqua Pennsylvania and the Company. A commitment fee of 1/10 of 1% is charged on the total commitment amount of Aqua Pennsylvania's revolving credit agreement. The average cost of borrowing under these facilities was 3.8% and 1.4%, and the average borrowing was $63,355 and $50,115, during 2005 and 2004, respectively. The maximum amount outstanding at the end of any one month was $85,000 in 2005 and $89,519 in 2004.

At December 31, 2005 and 2004, the Company had combined short-term lines of credit of $127,000 and $108,000, respectively. Funds borrowed under these lines are classified as loans payable and are used to provide working capital. As of December 31, 2005 and 2004, funds borrowed under the short-term lines of credit were $56,505 and $9,810, respectively. The average borrowing under the lines was $35,610 and $34,711 during 2005 and 2004, respectively. The maximum amount outstanding at the end of any one month was $56,505 in 2005 and $51,288 in 2004. Interest under the lines is based at the Company's option, depending on the line, on the prime rate, an adjusted Euro-Rate, an adjusted federal funds rate or at rates offered by the banks. The average cost of borrowings under all lines during 2005 and 2004 was 3.9% and 2.3%, respectively.

Interest income of $3,040, $1,762 and $395 was netted against interest expense on the consolidated statements of income for the years ended December 31, 2005, 2004 and 2003, respectively. The total interest cost was $55,102, $50,441 and $45,057 in 2005, 2004 and 2003, including amounts capitalized of $2,447, $2,304 and $2,127, respectively.

Fair Value of Financial Instruments

The carrying amount of current assets and liabilities that are considered financial instruments approximates their fair value as of the dates presented. The carrying amount and estimated fair value of the Company's long-term debt are as follows:

	December 31,	
	2005	2004
Carrying amount	$ 903,083	$ 834,656
Estimated fair value	950,479	863,247

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. The Company's customers' advances for construction and related tax deposits have a carrying value of $74,828 and $73,095 at December 31, 2005 and 2004, respectively. Their relative fair values cannot be accurately estimated because future refund payments depend on several variables, including new customer connections, customer consumption levels and future rate increases. Portions of these non-interest bearing instruments are payable annually through 2020 and amounts not paid by the contract expiration dates become non-refundable. The fair value of these amounts would, however, be less than their carrying value due to the non-interest bearing feature.

Stockholders' Equity

At December 31, 2005, the Company had 300,000,000 shares of common stock authorized; par value $0.50. Shares outstanding at December 31, 2005, 2004 and 2003 were 128,970,181, 127,179,777 and 123,452,053, respectively. Treasury shares held at December 31, 2005, 2004 and 2003 were 688,625, 686,747 and 681,384, respectively. At December 31, 2005, the Company had 1,770,819 shares of authorized but unissued Series Preferred Stock, $1.00 par value.

In August 2005, the Company's Board of Directors declared a 4-for-3 common stock split to be effected in the form of a 33 1/3% stock distribution for all common shares outstanding, to shareholders of record on November 17, 2005. Common shares outstanding do not include shares held by the Company in treasury. The new shares were distributed on December 1, 2005. The Company's par value of $0.50 per share remained unchanged and $16,095 was transferred from Capital in Excess of Par Value to Common Stock to record the split. All common share and per common share data for all periods presented have been restated to give effect to the stock split.

In December 2005, the Company filed a universal shelf registration with the Securities and Exchange Commission to allow for the potential future sale by us, from time to time, in one or more public offerings, of an indeterminant amount of our common stock, preferred stock, debt securities and other securities specified therein at indeterminant prices. No issuances have been completed to date under this shelf registration. During the last three years, the Company completed the following offerings of equity:

- In November 2004, the Company issued 2,606,667 shares of common stock in a public offering for proceeds of $42,600, net of expenses. The net proceeds were used to repay a portion of our short-term debt. The indebtedness was incurred by Aqua America in connection with acquisitions.
- In August 2003, the Company issued 6,666,667 shares of common stock in a public offering for proceeds of $90,100, net of expenses. The net proceeds were used to repay an unsecured note of $90,000. The indebtedness was incurred by Aqua America in connection with the acquisition of the operations that were purchased from AquaSource, Inc.
- In May 2003, the Company issued 2,491,667 shares of common stock in a public offering for proceeds of $33,100, net of expenses. The net proceeds were used to repay short-term debt, including the repayment of $22,000 of indebtedness incurred in connection with the Company's repurchase of 2,017,700 shares of common stock from affiliates of Veolia Environnement, S.A. (formerly Vivendi Environnement, S.A.) in October 2002.

In addition, the Company has a shelf registration statement filed with the Securities and Exchange Commission to permit the offering from time to time of shares of common stock and shares of preferred stock in connection with acquisitions. During 2005, 24,684 shares of common stock totaling $675 were issued by the Company to acquire water and wastewater systems. The balance remaining available for use under the acquisition shelf registration as of December 31, 2005 is 2,194,262 shares. The form and terms of any securities issued under these shelf registrations will be determined at the time of issuance.

The Board of Directors has authorized the Company to purchase its common stock, from time to time, in the open market or through privately negotiated transactions. The Company has not repurchased any shares under this authorization since 2000. As of December 31, 2005, 548,278 shares remain available for repurchase.

The Company has a Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") that allows reinvested dividends to be used to purchase shares of common stock at a five percent discount from the current market value. Under the direct stock purchase program, shares are purchased by investors at market price. The shares issued under the Plan are either original issue shares or shares purchased by the Company's transfer agent in the open-market. During 2005, 2004 and 2003, under the dividend reinvestment portion of the Plan, 401,503, 512,609 and 527,473 original issue shares of common stock were sold providing the Company with proceeds of $8,516, $7,808 and $7,000, respectively.

The Company reports comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income." Accordingly, the Company's accumulated other comprehensive income is reported in the Common Stockholders' Equity section of the Consolidated Balance Sheets, the Consolidated Statements of Common Stockholders' Equity and the related other comprehensive income is reported in the Consolidated Statements of Income and Comprehensive Income. The Company reports its unrealized gains on securities and minimum pension liability adjustments as other comprehensive income or loss and accumulated other comprehensive income or loss.

Net Income per Common Share and Equity per Common Share

Basic net income per share is based on the weighted average number of common shares outstanding. Diluted net income per share is based on the weighted average number of common shares outstanding and potentially dilutive shares. The dilutive effect of employee stock options is included in the computation of Diluted net income per share. The following table summarizes the shares, in thousands, used in computing Basic and Diluted net income per share:

	Years ended December 31,		
	2005	2004	2003
Average common shares outstanding during the period for Basic computation	127,364	124,329	117,700
Dilutive effect of employee stock options	1,842	1,381	1,293
Average common shares outstanding during the period for Diluted computation	129,206	125,710	118,993

For the years ended December 31, 2005 and 2003, there were no outstanding employee stock options excluded from the calculation of diluted net income per share as the average market price of the Company's common stock was greater than the options' exercise price. For the year ended December 31, 2004, employee stock options outstanding to purchase 759,867 shares of common stock were excluded from the calculation of diluted net income per share as the options' exercise price was greater than the average market price of the Company's common stock.

Equity per common share was $6.30 and $5.88 at December 31, 2005 and 2004, respectively. These amounts were computed by dividing common stockholders' equity by the number of shares of common stock outstanding at the end of each year.

Shareholder Rights Plan

The Company has a Shareholder Rights Plan designed to protect the Company's shareholders in the event of an unsolicited unfair offer to acquire the Company. Each outstanding common share is entitled to one Right which is evidenced by the common share certificate. In the event that any person acquires 20% or more of the outstanding common shares or commences a tender or exchange offer which, if consummated, would result in a person or corporation owning at least 20% of the outstanding common shares of the Company, the Rights will begin to trade independently from the common shares and, if certain circumstances occur, including the acquisition by a person of 20% or more of the outstanding common shares, each Right would then entitle its holder to purchase a number of common shares of the Company at a substantial discount. If the Company is involved in a merger or other business combination at any time after the Rights become exercisable, the Rights will entitle the holder to acquire a certain number of shares of common stock of the acquiring company at a substantial discount. The Rights are redeemable by the Company at a redemption price of $.01 per Right at any time before the Rights become exercisable. The Rights will expire on March 1, 2008, unless previously redeemed.

Employee Stock and Incentive Plan

In May 2004, the 2004 Equity Compensation Plan ("the 2004 Plan") was approved by the shareholders to replace the 1994 Equity Compensation Plan ("the 1994 Plan"), the Company may grant qualified and non-qualified stock options to officers, key employees and consultants. 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 ("Board"). 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, and awards under the 1994 plan were, made by a committee of the Board of Directors.

Options under the plans were issued at the market price of the stock on the day of the grant. Options are exercisable in installments of 33% annually, starting one year from the date of the grant and expire 10 years from the date of the grant. The following table summarizes stock option transactions for the plans:

	As of or For the Years Ended December 31,					
	2005		2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options:						
Outstanding, beginning of year	4,066,983	$ 11.22	3,991,228	$ 9.98	3,773,511	$ 9.04
Granted	816,997	18.33	776,867	16.15	818,205	12.74
Terminated	(63,900)	15.22	(131,048)	12.47	(20,711)	11.09
Exercised	(1,327,717)	8.88	(570,064)	8.96	(579,777)	7.71
Outstanding, end of year	3,492,363	$ 13.70	4,066,983	$ 11.22	3,991,228	$ 9.98
Exercisable, end of year	1,957,079	$ 11.31	2,549,073	$ 9.32	2,341,733	$ 8.26

Options exercised during 2005 ranged in price from $3.42 per share to $16.15 per share. At December 31, 2005, 4,093,297 options under the 2004 Plan were still available for grant, 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 1994 Plan may be re-issued under the 2004 Plan. The following table summarizes the price ranges of the options outstanding and options exercisable as of December 31, 2005:

	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Remaining Life (years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Range of prices:					
$ 4.30 - 7.99	290,026	3.1	$ 6.40	290,026	$ 6.40
$ 8.00 - 9.99	250,963	2.8	8.35	250,963	8.35
$10.00 - 12.99	1,301,947	6.4	12.20	1,109,069	12.15
$13.00 - 15.99	160,270	7.4	13.75	106,102	13.76
$16.00 - 16.99	680,491	8.3	16.15	200,919	16.15
$17.00 - 18.33	808,666	9.2	18.33	-	-
	3,492,363	6.9	$ 13.70	1,957,079	$ 11.31

Under SFAS No. 123 "Accounting for Stock-Based Compensation" and SFAS No. 148 "Accounting for Stock-Based Compensation – Transition and Disclosure", the Company applied the provisions of APB Opinion No. 25 and provided the pro forma disclosure provisions of this statement. Accordingly, no compensation cost was recognized in the financial

statements for stock options that have been granted. Pursuant to the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, pro forma net income available to common stock and earnings per share are presented in the Summary of Significant Accounting Policies - Stock-Based Compensation as if compensation cost for stock options was determined as of the grant date under the fair value method. On January 1, 2006, the Company adopted SFAS No. 123R, "Share-Base Payment" which changes the accounting for the compensation costs for its stock options granted as described in the Summary of Significant Accounting Policies - Recent Accounting Pronouncements.

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. During 2005, 2004 and 2003, 37,751, 45,535 and 26,875 shares of restricted stock were granted with a restriction period ranging from six to 36 months. The value of restricted stock awards, which are "compensatory", is equal to the fair market value of the stock on the date of the grant and is amortized ratably over the restriction period. The company recorded compensation expense related to restricted stock awards of $495, $439 and $369 during 2005, 2004 and 2003, respectively.

Pension Plans and Other Postretirement Benefits

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

In addition to providing pension benefits, the Company offers certain Postretirement Benefits other than Pensions ("PBOPs") to employees hired before April 1, 2003 and retiring with a minimum level of service. These PBOPs include continuation of medical and prescription drug benefits for eligible retirees and life insurance benefits for certain eligible retirees. The Company funds its gross PBOP cost through various trust accounts. The benefits of retired officers and certain other retirees are paid by the Company and not from plan assets due to limitations imposed by the Internal Revenue Code.

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

Years:	Pension Benefits	Other Postretirement Benefits
2006	$ 6,866	$ 1,829
2007	7,076	1,950
2008	7,415	2,095
2009	7,911	2,261
2010	8,383	2,442
2011 - 2015	52,787	14,802

In May 2004, the FASB issued FASB Staff Position ("FSP") No. 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." FSP 106-2 supersedes FSP 106-1, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003," which was issued in January 2004 and permitted a sponsor of a postretirement health care plan that provides a prescription drug benefit to make a one-time election to defer accounting for the effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") until more authoritative guidance on the accounting for the federal subsidy was issued. The Company had elected the one-time deferral allowed under FSP 106-1 and as a result adopted FSP 106-2

as required in the third quarter of 2004 and it did not have a material impact on our results of operations or financial position.

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

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Change in benefit obligation:				
Benefit obligation at January 1,	$ 171,076	$ 150,098	$ 32,804	$ 29,134
Service cost	4,847	4,312	1,223	1,112
Interest cost	9,805	9,512	1,882	1,825
Plan amendments	-	567	(7,047)	6
Actuarial loss	420	12,742	1,317	1,676
Plan participants' contributions	-	-	584	631
Benefits paid	(6,407)	(6,155)	(1,602)	(1,580)
Benefit obligation at December 31,	179,741	171,076	29,161	32,804
Change in plan assets:				
Fair value of plan assets at January 1,	115,292	108,731	16,606	14,391
Actual return on plan assets	7,790	8,535	675	641
Employer contributions	996	4,181	2,678	2,522
Benefits paid	(6,407)	(6,155)	(1,017)	(948)
Fair value of plan assets at December 31,	117,671	115,292	18,942	16,606
Funded status of plan:				
Funded status at December 31,	62,070	55,784	10,219	16,198
Unrecognized actuarial loss	(42,092)	(41,531)	(8,537)	(6,853)
Unrecognized prior service cost	(1,687)	(2,090)	7,517	527
Unrecognized net transition obligation	809	1,017	(5,624)	(6,428)
Net amount recognized	$ 19,100	$ 13,180	$ 3,575	$ 3,444

The Company's pension plans had an accumulated benefit obligation of $148,629 and $136,851 at December 31, 2005 and 2004, respectively. The following table provides the net liability recognized on the Consolidated Balance Sheets at December 31,:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Prepaid benefits cost	$ -	$ -	$ 555	$ 762
Accrued benefit cost	(19,100)	(13,180)	(4,130)	(4,206)
Additional minimum liability	(12,726)	(8,928)	-	-
Intangible assets	1,817	2,108	-	-
Regulatory asset	6,167	4,140	-	-
Accumulated other comprehensive loss	4,742	2,680	-	-
Net liability recognized	$ (19,100)	$ (13,180)	$ (3,575)	$ (3,444)

At December 31, 2005 and 2004, the Company's pension plans had benefit obligations in excess of its plan assets. The following tables provide the projected benefit obligation, the accumulated benefit obligation and fair market value of the plan assets as of December 31,:

	Projected Benefit Obligation Exceeds the Fair Value of Plan Assets	
	2005	2004
Projected benefit obligation	$ 179,741	$ 171,076
Fair value of plan assets	117,671	115,292

	Accumulated Benefit Obligation Exceeds the Fair Value of Plan Assets	
	2005	2004
Accumulated benefit obligation	$ 148,629	$ 136,851
Fair value of plan assets	117,671	115,292

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

	Pension Benefits			Other Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Service cost	$ 4,847	$ 4,312	$ 3,627	$ 1,223	$ 1,112	$ 987
Interest cost	9,805	9,512	8,999	1,882	1,825	1,703
Expected return on plan assets	(9,536)	(9,169)	(7,775)	(1,261)	(1,086)	(917)
Amortization of transition obligation (asset)	(209)	(209)	(209)	803	803	803
Amortization of prior service cost	403	419	395	(57)	(57)	(57)
Amortization of actuarial (gain) loss	1,606	1,009	1,282	219	125	62
Amortization of regulatory asset	-	-	-	136	144	136
Capitalized costs	(1,847)	(1,021)	(205)	(739)	(629)	(598)
Net periodic benefit cost	$ 5,069	$ 4,853	$ 6,114	$ 2,206	$ 2,237	$ 2,119

Accounting for pensions and other postretirement benefits requires an extensive use of assumptions about the discount rate, expected return on plan assets, the rate of future compensation increases received by the Company's employees, mortality, turnover and medical costs. Each assumption is reviewed annually with assistance from the Company's actuarial consultant who provides guidance in establishing the assumptions. The assumptions are selected to represent the average expected experience over time and may differ in any one year from actual experience due to changes in capital markets and the overall economy. These differences will impact the amount of pension and other postretirement benefit expense that the Company recognizes. During 2005, the Company undertook a comprehensive study of the key demographic assumptions which impact the obligations and expense for its plans. Based on the study, the Company updated the assumed retirement and turnover rates for the plans to better reflect the recent experience combined with our expectations of future patterns. In addition, the Company has updated the mortality assumptions to reflect a more recent actuarial study of mortality experience and an expectation of future mortality improvements. The net effect of the changes in these assumptions was a decrease of $1,600 in the Company's pension and postretirement benefit obligation measured as of December 31, 2005.

The significant assumptions related to the Company's pension and other postretirement benefit plans are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Weighted-average Assumptions Used to Determine Benefit Obligations as of December 31,				
Discount rate	5.65%	5.75%	5.65%	5.75%
Rate of compensation increase	4.0-5.0%	4.0-5.0%	4.0%	4.0%
Assumed Health Care Cost Trend Rates Used to Determine Benefit Obligations as of December 31,				
Health care cost trend rate	n/a	n/a	10%	10%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	n/a	n/a	5%	5%
Year that the rate reaches the ultimate trend rate	n/a	n/a	2011	2010
Weighted-average Assumptions Used to Determine Net Periodic Benefit Costs for Years Ended December 31,				
Discount rate	5.75%	6.25%	5.75%	6.25%
Expected return on plan assets	8.50%	8.50%	6.0-9.0%	6.0-9.0%
Rate of compensation increase	4.0-5.0%	4.0-5.0%	4.0%	4.0%
Assumed Health Care Cost Trend Rates Used to Determine Net Periodic Benefit Costs for Years Ended December 31,				
Health care cost trend rate	n/a	n/a	10%	10%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	n/a	n/a	5%	5%
Year that the rate reaches the ultimate trend rate	n/a	n/a	2010	2009

n/a – Assumption is not applicable to pension benefits.

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

	1-Percentage-Point Increase	1-Percentage-Point Decrease
Effect on the health-care component of the accrued other postretirement benefit obligation	$ 614	$ (689)
Effect on total service and interest cost components of net periodic postretirement health-care benefit cost	$ 70	$ (104)

The Company's discount rate assumption was determined using a yield curve that was produced from a universe containing over 500 U.S.-issued Aa-graded corporate bonds, all of which were noncallable (or callable with make-whole provisions), and excluding the 10% of the bonds with the highest yields and the 10% with the lowest yields. The discount rate was then developed as the single rate that would produce the same present value as if the Company used spot rates, for various time periods, to discount the projected pension benefit payments. The Company's pension expense and liability (benefit obligations) increases as the discount rate is reduced. A 25 basis-point reduction in this assumption would have increased 2005 pension expense by $660 and the pension liabilities by $7,000.

The Company's expected return on assets is determined by evaluating the asset class return expectations with its advisors as well as actual, long-term, historical results of our asset returns. The Company's pension expense increases as the expected return on assets decreases. A 25 basis-point reduction in this assumption would have increased 2005 pension expense by $280. For 2005, the Company used an 8.5% expected return on assets assumption, and will lower this assumption to 8.0% for the calculation of pension expense for 2006. This change was made to reflect a change in the Company's expectations of long-term market returns given the recent decrease in bond yields. The Company believes its actual long-term asset allocation on average will approximate the targeted allocation. The Company's investment strategy is to earn a reasonable rate of return while maintaining risk at acceptable levels through the diversification of investments across and within various asset categories. Investment returns are compared to benchmarks that include the S&P 500 Index, the Lehman Brothers Intermediate Government/Credit Index, and a combination of the two indices. The Pension Committee meets semi-annually to review plan investments and management monitors investment performance quarterly through a performance report prepared by an external consulting firm.

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

	2006 Target Allocation	Percentage of Plan Assets at December 31,	
		2005	2004
Asset Category:			
Equity securities	65%	60%	62%
Debt securities	35%	24%	27%
Cash	0%	16%	11%
Total	100%	100%	100%

Equity securities include Aqua America, Inc. common stock in the amounts of $11,121 or 9.5% of total plan assets and $7,373 or 6.4% of total plan assets as of December 31, 2005 and 2004, respectively.

The asset allocation for the Company's other postretirement benefit plans and the target allocation by asset category are as follows:

	2006 Target Allocation	Percentage of Plan Assets at December 31,	
		2005	2004
Asset Category:			
Cash	65%	67%	60%
Equity securities	35%	33%	40%
Total	100%	100%	100%

Minimum funding requirements for qualified defined benefit pension plans are determined by government regulations and not by accounting pronouncements. In accordance with funding rules and the Company's funding policy, during 2006 our pension contribution is expected to be $6,400. The Company's funding of its PBOP cost during 2006 is expected to approximate $2,882.

As of December 31, 2005, the Company has an additional minimum liability of $10,909 associated with our defined benefit plan. The additional minimum liability is a result of the accumulated benefit obligation exceeding the fair value of plan assets.

The portion of the additional minimum liability related to our employees in one of our rate jurisdictions results in the establishment of a regulatory asset of $6,167, as the Company expects recovery of the future, increased pension expense through customer rates. Since the balance of the additional minimum liability of $4,742 may not be recovered through rates, the accounting requirements for recording a regulatory asset are not met and as a result this amount is recorded as accumulated other comprehensive loss through aggregate charges to accumulated other comprehensive income in 2004 and 2005, net of income tax benefits of $1,660. The change in the additional minimum liability from December 31, 2004 to December 31, 2005 resulted from the effect of a decreased discount rate, offset partially by an increase in the pension plan assets during 2005 due to positive equity market performance and pension contributions.

The Company has 401(k) savings plans that cover substantially all employees. The Company makes matching contributions that are invested in Aqua America, Inc. common stock based on a percentage of an employee's contribution, subject to certain limitations. The Company's matching contribution, recorded as compensation expense, was $1,236, $1,160 and $921 for the years ended December 31, 2005, 2004 and 2003, respectively.

Water and Wastewater Rates

In November 2005, the Company's Pennsylvania operating subsidiary, Aqua Pennsylvania, Inc., filed an application with the Pennsylvania Public Utility Commission ("PAPUC") requesting a $38,800 or 14.4% increase in annual revenues. The application is currently pending before the PAPUC and a final determination is anticipated by August 2006. On August 5, 2004, the PAPUC granted Aqua Pennsylvania, Inc. a $13,800 base rate increase. The rates in effect at the time of the filing included $11,200 in Distribution System Improvement Charges ("DSIC") or 5.0% above the prior base rates. Consequently, the total base rates increased by $25,000 and the DSIC was reset to zero.

In May 2004, the Company's operating subsidiary 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 parties 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, in accordance with authorization from the Texas Commission on Environmental Quality in July 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 December 31, 2005, we have deferred $9,486 of expenses and recognized $5,202 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.

The Company's other operating subsidiaries were allowed annual rate increases of $5,142 in 2005, $6,673 in 2004 and $1,275 in 2003, represented by twenty-three, fourteen and eight rate decisions, respectively. Revenues from these increases realized in the year of grant were approximately $3,144, $3,995 and $839 in 2005, 2004 and 2003, respectively.

Five states in which the Company operates permit water utilities, and in some states wastewater utilities, to add a surcharge to their water or wastewater bills to offset the additional depreciation and capital costs related to infrastructure system replacement and rehabilitation projects completed and placed into service between base rate filings. Currently, Pennsylvania, Illinois, Ohio, Indiana and Missouri allow for the use of infrastructure rehabilitation surcharges. These mechanisms typically adjust periodically based on additional qualified capital expenditures completed or anticipated in a future period. The infrastructure rehabilitation surcharge is capped as a percentage of base rates, generally at 5% to 9% of base rates, and is reset to zero when new base rates that reflect the costs of those additions become effective or when a utility's earnings exceed a regulatory benchmark. Infrastructure rehabilitation surcharges provided revenues in 2005, 2004 and 2003 of $10,186, $7,817 and $8,147, respectively.

(In thousands of dollars, except per share amounts)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
2005					
Operating revenues	$ 113,988	$ 123,100	$ 136,783	$ 122,908	$ 496,779
Operations and maintenance expense	47,309	50,891	52,666	52,222	203,088
Operating income	42,771	48,593	59,091	46,052	196,507
Net income	18,871	22,218	27,917	22,150	91,156
Basic net income per common share	0.15	0.17	0.22	0.17	0.72
Diluted net income per common share	0.15	0.17	0.21	0.17	0.71
Dividend paid per common share	0.0975	0.0975	0.0975	0.1069	0.3994
Dividend declared per common share	0.0975	0.0975	0.2044	-	0.3994
Price range of common stock					
- high	19.37	23.24	29.15	29.22	29.22
- low	17.49	18.03	21.61	22.88	17.49
2004					
Operating revenues	$ 99,768	$ 106,524	$ 120,305	$ 115,442	$ 442,039
Operations and maintenance expense	41,831	44,483	46,526	45,505	178,345
Operating income	36,444	40,473	50,997	49,320	177,234
Net income	15,575	17,871	24,087	22,474	80,007
Basic net income per common share	0.13	0.14	0.19	0.18	0.64
Diluted net income per common share	0.12	0.14	0.19	0.18	0.64
Dividend paid per common share	0.09	0.09	0.09	0.0975	0.3675
Dividend declared per common share	0.09	0.09	0.1875	-	0.3675
Price range of common stock					
- high	17.14	16.47	16.67	18.48	18.48
- low	15.00	14.24	14.18	15.58	14.18

All per share data as presented has been adjusted for the 2005 4-for-3 common stock split effected in the form of a 33 1/3% stock distribution. High and low prices of the Company's common stock are as reported on the New York Stock Exchange Composite Tape. The cash dividends paid in December 2005 of $0.1069 and December 2004 of $0.0975 were declared in August 2005 and August 2004, respectively.

Summary of Selected Financial Data

Aqua America, Inc. and Subsidiaries

(in thousands of dollars, except per share amounts)

Years ended December 31,	2005	2004 (a)	2003 (b)	2002	2001
PER COMMON SHARE:					
Net income					
Basic	$0.72	$0.64	$ 0.60	$ 0.59	$ 0.53
Diluted	0.71	0.64	0.59	0.58	0.52
Cash dividends declared and paid	0.40	0.37	0.34	0.32	0.30
Return on average stockholders' equity	11.7%	11.4%	12.3%	13.9%	13.3%
Book value at year end	$6.30	$5.88	$5.33	$4.35	$4.14
Market value at year end	27.30	18.44	16.58	12.36	13.53
INCOME STATEMENT HIGHLIGHTS:					
Operating revenues	$496,779	$442,039	$367,233	$322,028	$307,280
Depreciation and amortization	65,488	58,864	51,463	44,322	40,168
Interest expense, net (c)	49,615	46,375	42,535	39,007	38,637
Income before income taxes	148,069	132,131	116,718	109,252	99,087
Provision for income taxes	56,913	52,124	45,923	42,046	38,976
Net income available to common stock	91,156	80,007	70,785	67,154	60,005
BALANCE SHEET HIGHLIGHTS:					
Total assets	$2,626,725	$2,355,374	$2,071,252	$1,716,030	$1,554,483
Property, plant and equipment, net	2,279,950	2,069,812	1,824,291	1,486,703	1,364,282
Common stockholders' equity	811,923	747,231	658,118	492,594	471,930
Long-term debt, including current portion	903,083	834,656	736,052	617,175	531,455
Total debt	1,041,588	909,466	832,511	732,288	641,123
ADDITIONAL INFORMATION:					
Net cash flows from operating activities	$199,674	$173,603	$143,373	$121,560	$102,165
Capital additions	237,462	195,736	163,320	136,164	124,088
Net cash expended for acquisitions of utility systems	11,633	54,300	192,331	8,914	9,517
Dividends on common stock	51,139	45,807	39,917	36,789	34,234
Number of customers served	864,894	835,512	749,491	605,474	587,537
Number of shareholders of common stock	27,054	24,082	22,726	21,389	20,920
Common shares outstanding (000)	128,970	127,180	123,452	113,194	113,977
Employees (full-time)	1,489	1,442	1,260	971	951

All per share data as presented has been adjusted for the 2005 4-for-3 common stock split effected in the form of a 33 1/3% stock distribution.

(a) 2004 includes a partial year of finanical results for the mid-year acquisition of Heater Utilities, Inc. and certain utility assets of Florida Water Services Corporation.

(b) 2003 includes five months of financial results for the AquaSource operations acquired in July 2003.

(c) Net of allowance for funds used during construction and interest income.

AQUA AMERICA, INC. AND SUBSIDIARIES
INVESTOR RELATIONS INFORMATION

Financial Reports and Investor Relations

Copies of the company's public financial reports, including annual reports and Forms 10–K and 10–Q, are available on line and can be downloaded from the investor relations section of our Web site at www.aquaamerica.com. You may also obtain these reports by writing to us at:

ATTN: Investor Relations
Aqua America, Inc.
762 W. Lancaster Avenue
Bryn Mawr, PA 19010-3489
www.aquaamerica.com

Corporate Governance

We are committed to maintaining high standards of corporate governance and have implemented the corporate governance rules of the Securities and Exchange Commission (SEC) and the New York Stock Exchange. Copies of our key corporate governance documents, including our Corporate Governance Guidelines, Code of Ethical Business Conduct, and the charters of each committee of our Board of Directors can be obtained from the corporate governance portion of the investor relations section of our Web site www.aquaamerica.com or requests may be directed to the address above. Amendments to the Code, and any grant of waiver from a provision of the Code requiring disclosure under applicable SEC rules will be disclosed on our Web site. As required under Section 302 of the Sarbanes–Oxley Act of 2002 and Rule 13a–14(a) under the Securities and Exchange Act of 1934, Aqua America's chief executive officer and chief financial officer have performed the required certification for 2005 without exception and their certifications were filed as Exhibits 31.1 and 31.2 to our Form 10-K for 2005. You may access this report and our other SEC filings from our Web site. In addition, in 2005 the company's chief executive officer provided to the New York Stock Exchange the Annual CEO certification regarding the company's compliance with the New York Stock Exchange's corporate governance listing standards.

Annual Meeting

10:00 A.M. Eastern Daylight Time
Wednesday, May 17, 2006
Drexelbrook Banquet Facility and Corporate Events Center
Drexelbrook Drive and Valley Road
Drexel Hill, PA 19026

Transfer Agent and Registrar

Computershare Trust Company, N.A.
P.O. Box 43010
Providence, RI 02940-3010
800.205.8314 or 781.575.3100
www.computershare.com/equiserve

Independent Registered Public Accounting Firm

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

Stock Exchanges

The Common Stock of the company is listed on the New York Stock Exchange and the Philadelphia Stock Exchange under the ticker symbol WTR. The daily closing price is printed in *The Wall Street Journal* as AquaAmer. Listings might vary in other major newspapers.

Dividend Reinvestment and Direct Stock Purchase Plan

The company's Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") enables shareholders to reinvest all, or a designated portion of, dividends paid on up to 100,000 shares of Common Stock in additional shares of Common Stock at a five percent discount from a price based on the market value of the stock. In addition, shareholders may purchase additional shares of Aqua America Common Stock at any time with a minimum investment of $50, up to a maximum of $250,000 annually. Individuals may become shareholders by making an initial investment of at least $500. A Plan prospectus may be obtained by calling Computershare Trust Company at 800.205.8314 or by visiting www.computershare.com/equiserve. **Please read the prospectus carefully before you invest.**

IRA, Roth IRA, Education IRA

An IRA, Roth IRA or Coverdell Education Savings Account may be opened through the Plan to hold shares of Common Stock of the company and to make contributions to the IRA to purchase shares of Common Stock. Participants in the Plan may roll over an existing IRA or other qualified plan distribution in cash into an IRA under the Plan to purchase the company's Common Stock. Participants may also transfer the company's Common Stock from an existing IRA into an IRA under the Plan. A prospectus, IRA forms and a disclosure statement may be obtained by calling Computershare Trust Company at 800.472.7428. **Please read the prospectus carefully before you invest.**

Direct Deposit

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

Delivery of voting materials to shareholders sharing an address

To reduce the expense of delivering duplicate voting materials to our shareholders who have more than one Aqua America stock account, we are delivering only one annual report and proxy statement to registered shareholders who share an address unless otherwise requested. A separate proxy card is included in the voting materials for each of these shareholders.

How to obtain a separate set of voting materials

If you are a registered shareholder who shares an address with another registered shareholder and have received only one set of voting materials for the 2006 annual meeting, you may write or call us to request a separate copy of this material at no cost to you at 610.645.1196 or Attn: Investor Relations, Aqua America, Inc., 762 W. Lancaster Avenue, Bryn Mawr, PA, 19010. For future annual meetings, you may request separate voting material by calling the Company's transfer agent at 800.205.8314.

Account Access

Aqua America shareholders may access their account by visiting www.computershare.com/equiserve. Shareholders may view their account, purchase additional shares, and make changes to their account. To learn more, visit www.computershare.com/equiserve or call 800.205.8314.

Dividends

Aqua America has paid dividends for 60 consecutive years. The normal Common Stock dividend dates for 2006 and the first six months of 2007 are:

Declaration Date	Ex-Dividend Date	Record Date	Payment Date
February 2, 2006	February 12, 2006	February 14, 2006	March 1, 2006
May 5, 2006	May 16, 2006	May 18, 2006	June 1, 2006
August 1, 2006	August 16, 2006	August 18, 2006	September 1, 2006
November 6, 2006	November 15, 2006	November 17, 2006	December 1, 2006
January 30, 2007	February 13, 2007	February 15, 2007	March 1, 2007
May 7, 2007	May 16, 2007	May 18, 2007	June 1, 2007

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

Only the Board of Directors may declare dividends and set record dates. Therefore, the payment of dividends and these dates may change at the discretion of the Board. Announcement of the dividend declaration is usually published in *The Wall Street Journal* and several other newspapers.

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

Lost Dividend Checks and Stock Certificates

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

Safekeeping of Stock Certificates

Under the Direct Stock Purchase Plan, shareholders may have their stock certificates deposited with the transfer agent for safekeeping free of charge. Stock certificates and written instructions should be forwarded to: Computershare Trust Company, N.A., P.O. Box 43010, Providence, RI 02940-3010.

Notes

Board of Directors

Nicholas DeBenedictis, 60
Chairman, President and CEO
Aqua America, Inc.
Director since 1992

Mary C. Carroll, 65
Consultant and
Community Volunteer
Director since 1981

Richard Glanton, 59
Senior Vice President
Exelon Corporation
Director since 1995

Lon R. Greenberg, 55
Chairman and CEO
UGI Corporation
Director since 2005

William P. Hankowsky, 54
Chairman, President and CEO
Liberty Property Trust
Director since 2004

***John F. McCaughan, 70**
Chairman (Retired)
Betz Laboratories, Inc.
Director since 1984

***John E. Menario, 70**
Assistant to the President (Retired)
Banknorth Group, Inc.
Director since 1999

Constantine Papadakis, 60
President, Drexel University
Director since 2005

Richard L. Smoot, 65
Regional Chairman,
Advisory Board (Retired)
PNC Financial Services Group
Philadelphia and
Southern New Jersey
Director since 1997

** Retired from Board March 2006*

Officers

Nicholas DeBenedictis, 60
Chairman, President and CEO

Richard D. Hugus, 56
Regional President
Aqua America – Southern Operations

Karl M. Kyriss, 55
Regional President
Aqua America – Mid-Atlantic Operations

Robert G. Liptak, 58
Regional President
Aqua America – Northern Operations

Richard R. Riegler, 59
Vice President
Engineering and
Environmental Affairs

David P. Smeltzer, 47
Senior Vice President
Finance and CFO

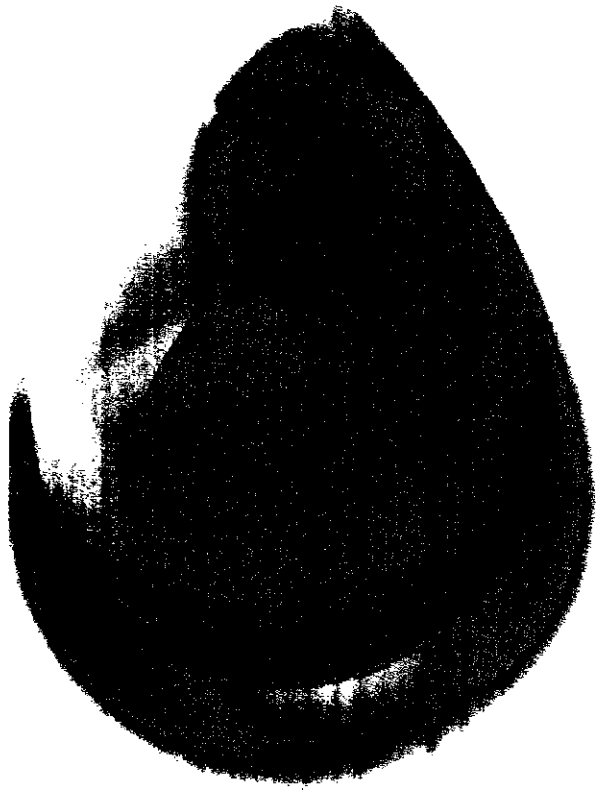
Roy H. Stahl, Esq., 53
Executive Vice President,
General Counsel
and Corporate Secretary

Photo: Sarah Wray

AQUA America

762 West Lancaster Avenue • Bryn Mawr, PA 19010-3489 • T: 610.525.1400 • F: 610.645.1061

www.aquaamerica.com



2004

ANNUAL REPORT

AQUA America

AQUA America

Company Profile

Aqua America, Inc. is the largest U.S.-based publicly-traded water utility serving more than 2.5 million residents in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, Florida, Indiana, Virginia, Maine, Missouri, New York and South Carolina. Aqua America is listed on both the New York and Philadelphia Stock Exchanges under the ticker symbol WTR.

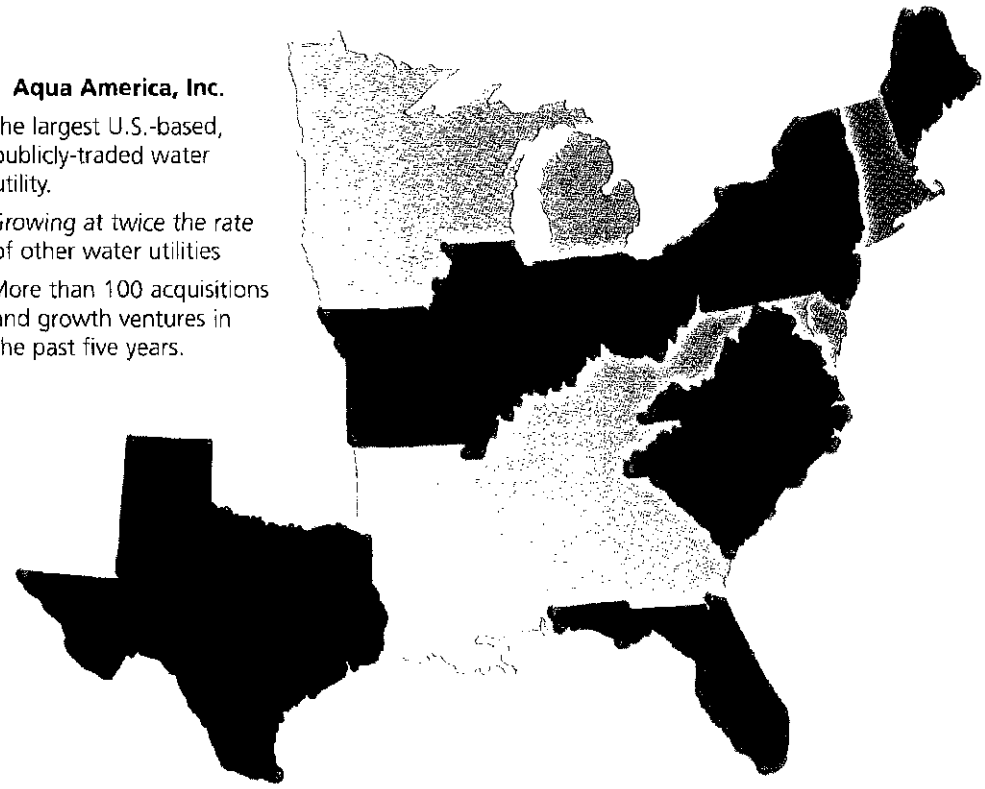
Financial Highlights *(In thousands of dollars, except per share amounts)*

	2004	2003	% Change
• Operating revenues	$ 442,039	$ 367,233	20.4
• Net income available to common stock	80,007	70,785	13.0
• Diluted net income per common share	0.85	0.79	7.6
• Annual dividend rate per common share	0.52	0.48	8.3
• Dividends paid per common share	0.490	0.456	7.5
• Common stockholders' equity per share	7.83	7.11	10.1
• Stockholders' equity	748,468	659,030	13.6
• Total assets	2,340,248	2,069,736	13.1
• Net cash flows from operating activities	173,603	143,373	21.1
• Capital additions (a)	195,736	163,320	19.8
• Number of customers served	835,512	749,491	11.5

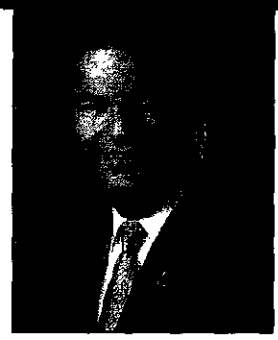
(a) Excludes net payments for acquired water and wastewater systems: $54,300 in 2004 and $192,331 in 2003.

Aqua America, Inc.

- The largest U.S.-based, publicly-traded water utility.
- *Growing at twice the rate* of other water utilities
- More than 100 acquisitions and growth ventures in the past five years.



CHAIRMAN'S MESSAGE



March 14, 2005

Dear Shareholder:

Growth remained the theme of our 2004 performance.

This past year was another exciting year of double-digit customer growth, with the addition of more than 85,000 customers through a combination of acquisitions and organic growth. Customer growth facilitates earnings growth, as new customers generate additional revenues, improve economies of scale, and provide increased opportunities for us to invest capital to improve and upgrade our utility systems.

Shareholders of Aqua America once again experienced double-digit growth in the return on their investment during 2004, with our stock price appreciating 11 percent and shareholders who reinvested their dividends reaping a total return of 13 percent. Additionally, the Board approved an **8.3 percent increase in the dividend** effective with the December 1, 2004 dividend payment. Our Board remains committed to enhancing shareholder value having increased our dividend 14 times in the last 13 years.

We are pleased to report **record financial results for 2004,** including 20 percent revenue growth and a 13 percent increase in net income. Revenues grew from $367 million in 2003 to $442 million for the full year 2004. Net income grew to $80 million this year from $70 million in 2003 and corresponding diluted earnings per share grew to $0.85 from $0.79 in 2003. These increases were aided by the mid-year acquisitions of Heater Utilities in North Carolina and the 63 systems from Florida Water Services in Florida, which collectively added more than 65,000 customers to our base. Additional growth was achieved with 27 other "tuck-in" acquisitions in many of our other states.

This year was also one of successful rate increases with more than $27 million in annualized revenue awarded in 2004, contributing to our financial performance. We are pleased with the fair treatment we have received from the regulatory commissions that govern our operations and believe we have earned a reputation as a responsible, accountable water utility focused on water quality, infrastructure improvement and customer service.

Standard and Poors confirmed the **A+ corporate credit rating** on our largest subsidiary Aqua Pennsylvania, and a AA- rating on our first mortgage bonds. As a result of our excellent credit rating, we were able to refinance existing debt and issue new debt at low interest rates, borrowing $132.2 million at an average interest rate of 4.8 percent during 2004. Through our refinancing and low-interest borrowing efforts, we were able to reduce the overall weighted average cost on our $834.7 million of long-term debt from 6.2 percent to 6.0 percent during the year. Our ability to borrow at such low rates provides a direct benefit to our customers, as it allows us to partially mitigate needed rate increases.

In November, we completed an underwritten secondary offering of 1.955 million shares of common stock at a public offering price of $22.70. The shares were distributed to a diverse group of predominantly retail shareholders. The proceeds of the offering were used to repay a portion of our short-term debt with the balance used for working capital and other general corporate purposes.

Operating efficiency has been a consistent theme in our core strategy. Operating expenses had experienced upward pressure after the acquisition of AquaSource (2003) and our recent acquisitions of Heater and Florida Water, which all have smaller, more geographically dispersed systems and operate with a higher expense structure than our traditional operations. This year we worked diligently to improve the operating efficiency of these newly-acquired properties. While we made considerable progress, we have more opportunity for improvement and anticipate making greater progress over the coming years. We remain committed to managing our business as efficiently as is prudent.

The Sarbanes-Oxley Act has changed the face of public company accountability and corporate governance standards. Being a regulated entity and providing a product that has a public health impact, we have always had a history and culture of compliance with regulatory standards. In 2004, we completed the new audit of internal control over financial reporting for the first time. We are pleased to report that our assessment concluded that our controls are effective and that we have no material weaknesses. Our auditors reached a similar conclusion.

This year we mourned the passing of one of our esteemed board members, G. Fred DiBona, Jr. Mr. DiBona, who served as the CEO of Independence Blue Cross, joined our board in 1993. His contribution over the years was significant as we have grown from a small, regional, regulated water utility to one of the water industry's leading companies. His wit and wisdom will be sorely missed.

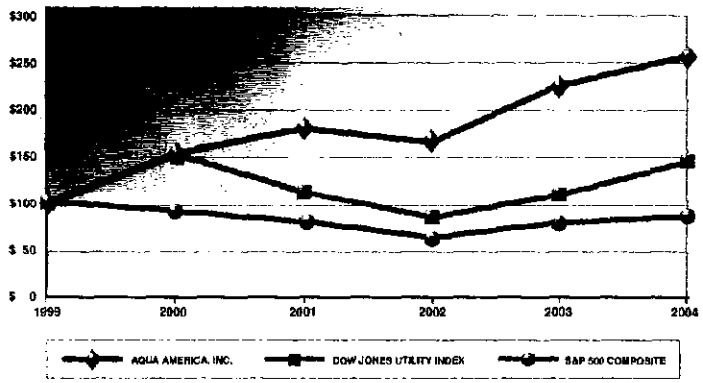
As we move forward, we firmly believe that our **consolidation strategy** remains sustainable in the fragmented water service industry. With more than 50,000 water systems in the U.S., there is no shortage of acquisition opportunities. As the largest US-based, publicly-traded company in our sector with a reputation for excellence, we believe that we are uniquely positioned to capitalize on the industry's consolidation.

Aqua America's success is built on the foundation of a four-legged stool supported by our customers, shareholders, employees and the communities we serve. Thanks to the commitment of each of these constituents, we are pleased to report that Aqua America has delivered another record year.

Sincerely,

Nicholas DeBenedictis

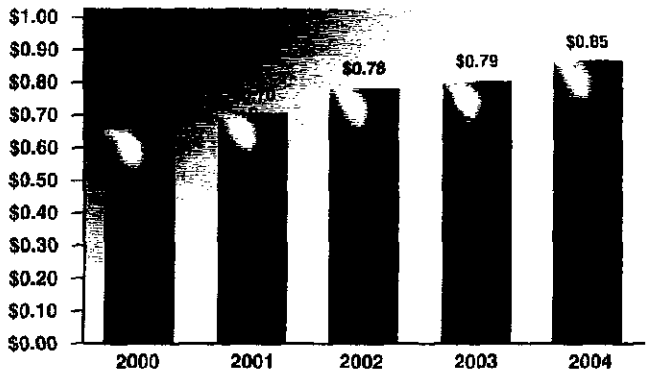
Five Year Cumulative Total Return



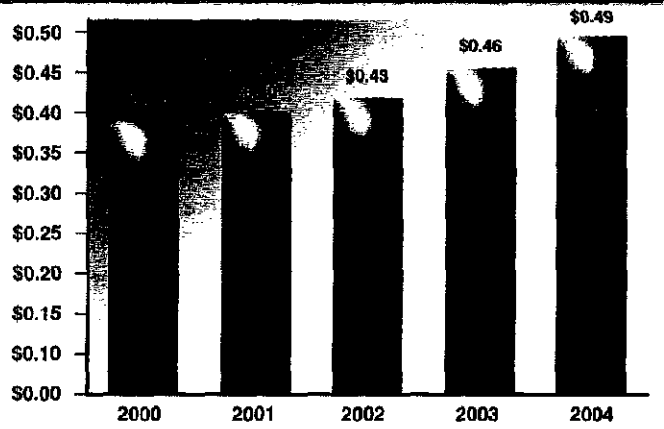
Dividend Highlights

- Increased cash dividend by 8.3 percent to $0.52 on an annualized basis as of December 1, 2004
- 14 cash dividend increases in the last 13 years
- Dividends paid for 60 consecutive years
- Issued five stock splits in the last nine years

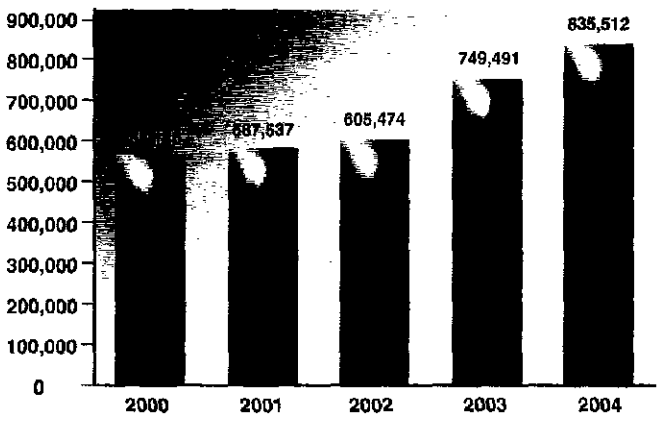
Earnings Per Share



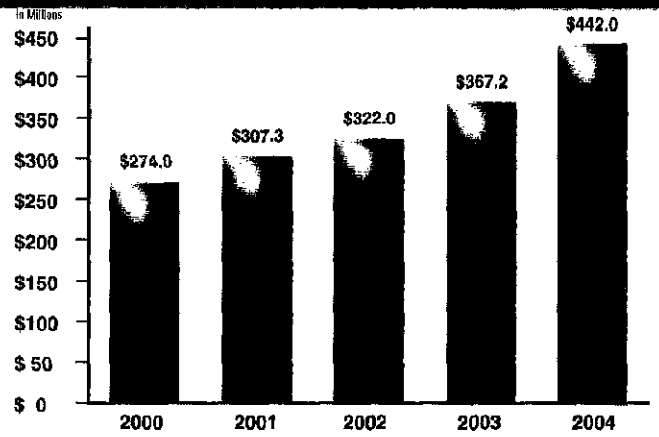
Dividends Paid Per Share



Customers



Operating Revenues



2004

ncial Data

AQUA America

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(In thousands of dollars, except per share amounts)

FORWARD-LOOKING STATEMENTS

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

- recovery of capital expenditures and expenses in rates;
- projected capital expenditures and related funding requirements;
- dividend payment projections;
- future financing plans;
- future pension contributions;
- opportunities for future acquisitions, the success of pending acquisitions and the impact of future acquisitions;
- acquisition-related costs and synergies;
- the capacity of our water supplies and facilities;
- general economic conditions;
- The impact of geographic diversity on our exposure to unusual weather; and
- The impact of accounting pronouncements.

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

- changes in general economic, business and financial market conditions;
- changes in government regulations and policies, including environmental and public utility regulations and policies;
- changes in environmental conditions, including those that result in water use restrictions;
- abnormal weather conditions;
- changes in capital requirements;
- changes in our credit rating;
- our ability to integrate businesses, technologies or services which we may acquire;
- our ability to manage the expansion of our business;
- the extent to which we are able to develop and market new and improved services;

- the effect of the loss of major customers;
- unanticipated capital requirements;
- our ability to retain the services of key personnel and to hire qualified personnel as we expand;
- increasing difficulties in obtaining insurance and increased cost of insurance;
- cost overruns relating to improvements or the expansion of our operations; and
- civil disturbance or terroristic threats or acts.

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

GENERAL INFORMATION

Name Change

On January 16, 2004, we changed our name to Aqua America, Inc. from Philadelphia Suburban Corporation. In addition, we changed our ticker symbol to WTR from PSC on the New York Stock Exchange and Philadelphia Stock Exchange on January 20, 2004.

Overview

Aqua America, Inc. is the holding company for regulated utilities providing water or wastewater services to 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. - formerly Pennsylvania Suburban Water Company, accounts for approximately 57% of our operating revenues and provides water or wastewater services to approximately 1.3 million residents in the suburban areas north and west of the City of Philadelphia and in 21 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.

The mission of the investor-owned water utility industry is to provide quality and reliable water service at an affordable price for the customer, and provide a fair return to its shareholders. A number of challenges face the industry, including:

- strict environmental, health and safety standards;
- the need for substantial capital investment;
- economic regulation by state, and/or in some cases local, government; and
- the impact of weather and drought conditions on water sales demand.

Aqua America, Inc. strives to achieve the industry mission by effective planning and efficient use of its resources to meet the industry challenges. We maintain a rate case management capability to pursue timely and adequate returns on the capital investments that we make in improving or replacing water mains, treatment plants

and other infrastructure. This factor is important in our continued profitability and in providing a fair return to our shareholders, and thus providing access to capital markets to help fund these investments. Often these utility investments are required by a changed federal or state environmental standard, to improve our ability to deliver quality customer service, or to assist in our ability to supply water in sufficient quantities for future demand or when experiencing drought conditions. A strategy to meet the above challenges is to actively explore opportunities to expand our utility operations through acquisitions of water and wastewater utilities either in areas adjacent to our existing service areas or in new service areas. This growth-through-acquisition strategy allows us to operate more efficiently and provides an important source for possible future growth. The ability to successfully execute this strategy and meet the industry challenges is largely due to our qualified and trained workforce, which we strive to retain by treating employees fairly and providing our employees with development and growth opportunities.

We believe that acquisitions will continue to be an important source of growth for us. With more than 50,000 community water systems in the U.S., 84% of which serve less than 3,300 customers, the water industry is the most fragmented of the major utility industries (telephone, natural gas, electric, water and wastewater). In the states where we operate, we believe there are over 22,000 public water systems of widely varying size, with the majority of the population being served by government-owned water systems.

Although not as fragmented as the water industry, the wastewater industry in the U.S. also presents opportunities for consolidation. According to the U.S. Environmental Protection Agency's (EPA) most recent survey of publicly-owned wastewater treatment facilities in 2000, there are approximately 16,000 such facilities in the nation serving approximately 72% of the U.S. population. The remaining population represents individual homeowners with their own treatment facilities; for example, community on-lot disposal systems and septic tank systems. The vast majority of wastewater facilities are government-owned rather than privately-owned. The EPA survey also indicated that there are approximately 6,600 wastewater facilities in operation or planned in the 13 states where we operate.

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

- the benefits of economies of scale;
- increasingly stringent environmental regulations;
- the need for capital investment; and
- the need for technological and managerial expertise.

On June 1, 2004, we acquired the capital stock of Heater Utilities, Inc. for $48,000 in cash and the assumption of long-term debt of $19,219 and short-term debt of $8,500. The acquired operation provides water and wastewater service to over 50,000 water and wastewater customers primarily in the areas of suburban Raleigh, Charlotte, Gastonia and Fayetteville, North Carolina. On June 30, 2004, we acquired certain utility assets of Florida Water Services Corporation, comprised of 63 water and wastewater systems located in central Florida for $14,747 in cash. In accordance with Florida procedures, the acquisition remains subject to regulatory approval by the Florida Public Service Commission. This process is not expected to be completed prior to September 2005. The operating results of these acquisitions have been included in our consolidated financial statements beginning on the respective acquisition dates. Under the terms of the purchase agreement, the Commission's review process may result in an adjustment of the final purchase price based on the Commission's determination of plant investment for the systems. The final purchase price is not expected to result in the recognition of goodwill.

On July 31, 2003, we completed the acquisition of four operating water and wastewater subsidiaries of AquaSource, Inc., a subsidiary of DQE, Inc., including selected, integrated operating and maintenance contracts and related assets, for $178,428 in cash, as adjusted for a purchase price reduction received in August 2004 of $12,289

pursuant to the purchase agreement. The acquired operations of AquaSource serve over 130,000 water and wastewater customer accounts in 11 states; including the Connecticut and Kentucky operations which were subsequently sold to other parties. The operating results of AquaSource have been included in our consolidated financial statements beginning August 1, 2003. Please refer to the section captioned "Acquisitions" for an expanded discussion of acquisitions.

We are actively exploring other opportunities to expand our water and wastewater utility operations through acquisitions or otherwise. We intend to continue to pursue acquisitions of municipally-owned and investor-owned water and wastewater systems of all sizes that provide services in areas adjacent to our existing service territories or in new service areas.

Following are our selected five-year financial statistics:

Years ended December 31,	2004 (a)	2003 (b)	2002 (c)	2001	2000 (d)
Operating revenues	$ 442,039	$ 367,233	$ 322,028	$ 307,280	$ 274,014
Operations and maintenance expense	$ 178,345	$ 140,602	$ 117,735	$ 111,885	$ 101,741
Net income available to common stock	$ 80,007	$ 70,785	$ 67,154	$ 60,005	$ 52,784
Capital expenditures	$ 195,736	$ 163,320	$ 136,164	$ 124,088	$ 129,740
Operating Statistics					
Selected operating results as a percentage of operating revenues:					
Operations and maintenance	40.3%	38.3%	36.6%	36.4%	37.1%
Depreciation and amortization	13.3%	14.0%	13.8%	13.1%	12.4%
Taxes other than income taxes	6.2%	5.9%	6.0%	6.8%	8.2%
Interest expense, net	11.0%	12.2%	12.5%	11.9%	12.9%
Net income available to common stock	18.1%	19.3%	20.9%	19.5%	19.3%
Effective tax rates	39.4%	39.3%	38.5%	39.3%	39.2%

(a) Net income available to common stock and net income includes the gain of $1,522 ($2,342 pre-tax) realized on the sale of our Geneva, Ohio water system. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense.
(b) 2003 includes five months of financial results for the AquaSource operations acquired in July 2003.
(c) Net income available to common stock and net income includes the gain of $3,690 ($5,676 pre-tax) realized on the sale of a portion of our Ashtabula, Ohio water system.
(d) Net income available to common stock and net income includes the gain of $2,236 ($4,041 pre-tax) for the partial recovery of the merger costs related to the merger with Consumers Water Company.

We consider the following nonfinancial measure and financial measures to be the fundamental basis by which we evaluate our performance: number of customers, operating revenues, net income and our dividend rate on common stock. In addition, we consider other key financial measures in evaluating our operating results: the ratio of operations and maintenance expense compared to operating revenues (this percentage is termed "operating expense ratio"); return on revenues (net income divided by operating revenues); and earnings before interest, taxes, depreciation and amortization ("EBITDA"). These measurements are reviewed regularly and compared to historical periods as well as our operating budget as approved by the Aqua America, Inc. Board of Directors.

Our operating expense ratio is one measure that we use to evaluate our operating efficiency and management effectiveness. As reported in the above table and as anticipated, our operating expense ratio increased for 2004 over 2003, and 2003 as compared to 2002 as a result of the additional operating costs associated with the AquaSource acquisition which closed on July 31, 2003. Our 2004 results reflect a full twelve months of operating results for this acquisition and only five months in 2003. The business model of the acquired AquaSource operations, generally referred to as our Aqua South operations, are different from the rest of the Aqua America operations. The Aqua South operations are comprised of approximately 600 small systems, which are generally clustered in regions to achieve some level of operating efficiency. However, the small, separate systems of the Aqua South operations results in the additional operating revenues generated by the Aqua South operations being accompanied by a higher ratio of operations and maintenance expenses than the level Aqua America experiences in the rest of the Aqua America operations. The Aqua South operations can be characterized as having relatively-higher fixed costs to operate in contrast to the rest of the Aqua America operations which generally consist of larger, interconnected systems resulting in higher fixed capital costs (utility plant investment) and lower operating costs per customer. For the twelve-month period ending June 30, 2003, the last reporting period before the July 31, 2003 closing of AquaSource, our operating expense ratio declined to 36.5%, from 36.6% for the year ended December 31, 2002. We are implementing management systems over time that will allow us to further control costs and improve efficiencies, but the effect of this acquisition will be to increase our overall operating expense ratio from the levels experienced during the preceding five years. Consequently, as anticipated our return on revenues, net income divided by operating revenues, in 2004 was lower than in the previous four years as a result of the impact of the higher cost of Aqua South's operations.

Following are our selected five-year operating and sales statistics:

Years ended December 31,		2004	2003	2002	2001	2000
Customers	Residential water	702,367	624,355	535,506	526,776	512,442
	Commercial water	33,720	33,015	30,355	29,745	29,317
	Industrial water	1,365	1,397	1,423	1,454	1,446
	Other water	15,700	20,483	16,466	9,947	9,500
	Wastewater	82,360	70,241	21,724	19,615	12,441
	Total	835,512	749,491	605,474	587,537	565,146
Operating Revenues (a)	Residential water	$ 264,910	$ 218,487	$ 197,190	$ 188,303	$ 170,597
	Commercial water	65,605	61,343	55,962	53,103	47,109
	Industrial water	17,377	17,675	17,221	16,141	14,943
	Other water	44,593	40,048	36,255	35,681	29,582
	Wastewater	35,931	17,874	8,210	6,960	5,414
	Other	13,623	11,806	7,190	7,092	6,369
	Total	$ 442,039	$ 367,233	$ 322,028	$ 307,280	$ 274,014

(a) 2003 includes five months of financial results for the operations acquired in the AquaSource acquisition.

RESULTS OF OPERATIONS

Our net income has grown at an annual compound rate of approximately 17.1% during the five-year period ended December 31, 2004. The five year annual compound growth rate is higher than the rate typically experienced due to the base year 1999 results including the after-tax merger costs of $8,596 associated with the Consumers Water Company merger. As a comparison, our net income for the periods ended December 31, 2004 has grown at annual compound rate of approximately 10.1% during the past six years, 11.0% during the past four years, and 10.0% during the past three years. During the past five years, operating revenues grew at a compound rate of 11.5% and total expenses, exclusive of income taxes, grew at a compound rate of 11.0%.

Operating Revenues

The growth in revenues over the past five years is a result of increases in both the customer base and in water rates. The number of customers increased at an annual compound rate of 8.8% in the past five years primarily as a result of acquisitions of water and wastewater systems, including the mid-year 2004 Heater and Florida Water Services acquisitions, and the AquaSource acquisition completed July 2003. Acquisitions made during the five-year period ended December 31, 2004 have provided water and wastewater revenues of approximately $90,187 in 2004, $34,960 in 2003 and $8,758 in 2002. Excluding the effect of acquisitions, our customer base increased at a five-year annual compound rate of 1.2%. Rate increases implemented during the past three years have provided additional operating revenues of approximately $15,800 in 2004, $19,900 in 2003 and $14,700 in 2002. In addition to regulated water and wastewater operating revenues, we had other non-regulated revenues that were primarily associated with operating and maintenance contracts, and data processing service fees of $13,623 in 2004, $11,806 in 2003 and $7,190 in 2002. The increases in 2004 and 2003 over the previous year resulted primarily from the additional revenues from contract operations associated with the July 2003 AquaSource acquisition.

Economic Regulation – Most of our water and wastewater utility operations are subject to regulation by their respective state regulatory commissions, which have broad administrative power and authority to regulate rates and charges, determine franchise areas and conditions of service, approve acquisitions and authorize the issuance of securities. A small number of our operations are subject to rate regulation by county or city government. The profitability of our utility operations is influenced a great extent by the timeliness and adequacy of rate allowances in the various states in which we operate. Accordingly, we maintain a rate case management capability to provide that the tariffs of the utility operations reflect, to the extent practicable, the timely recovery of increases in costs of operations, capital, taxes, energy, materials and compliance with environmental regulations. In assessing our rate case strategy, we consider the amount of utility plant additions and replacements made since the previous rate decision, the changes in the cost of capital, changes in the capital structure and changes in other costs. Based on these assessments, our utility operations periodically file rate increase requests with their respective state regulatory commissions.

On August 5, 2004, the Pennsylvania Public Utility Commission (PAPUC) granted our Pennsylvania operating subsidiary a $13,800 base rate increase. The rates in effect at the time of the filing included $11,200 in Distribution System Improvement Charges ("DSIC") or 5.0% above the prior base rates. Consequently, the total base rates increased by $25,000 and the DSIC was reset to zero. On August 1, 2002, the PAPUC granted our Pennsylvania operating subsidiary a $21,226 base rate increase. The rates in effect at the time of the filing included $9,400 in DSIC at 5.0%. Consequently, the total base rates increased by $30,626 and the DSIC was reset to zero.

In May 2004, our operating subsidiary 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 our depreciation, operating and other tax expense over a similar multi-year period, such that the annual impact on operating income approximates the requested amount. The application is currently pending before the Commission. We

commenced billing for the requested rates and implemented the deferral plan in August 2004, in accordance with authorization from the Texas Commission on Environmental Quality in July 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 us reflect an estimate of the final outcome of the ruling.

Our operating subsidiaries located in other states received rate increases representing estimated annualized revenues of $6,673 in 2004 resulting from fourteen rate decisions, $1,275 in 2003 resulting from eight rate decisions and $3,024 in 2002 resulting from thirteen rate decisions. Revenues from these increases realized in the year of grant were approximately $3,995 in 2004, $839 in 2003 and $1,403 in 2002. These operating subsidiaries currently have eleven rate requests in process requesting a $6,513 increase in annual revenues. These requests are currently under review by the respective state regulatory commissions. During 2005, we intend to file twenty-two rate requests requesting an aggregate of approximately $18,682 of increased annual revenues.

Revenue Surcharges - Four states in which we operate permit water utilities, and in some states wastewater utilities, to add a surcharge to their water or wastewater bills to offset the additional depreciation and capital costs associated with certain capital expenditures related to replacing and rehabilitating infrastructure systems. Prior to these mechanisms being approved, water and wastewater utilities absorbed all of the depreciation and capital costs of these projects between base rate increases without the benefit of additional revenues. The gap between the time that a capital project is completed and the recovery of its costs in rates is known as regulatory lag. The infrastructure rehabilitation surcharge mechanism is intended to substantially reduce regulatory lag which often acted as a disincentive to water and wastewater utilities to rehabilitate their infrastructure. In addition, our subsidiaries in certain states use a surcharge or credit on their bill to reflect certain allowable changes in costs until such time as these costs are fully incorporated in base rates.

Currently, Pennsylvania, Illinois, Ohio and Indiana allow for the use of infrastructure rehabilitation surcharges. In Pennsylvania, this mechanism is referred to as a DSIC. These mechanisms typically adjust periodically based on additional qualified capital expenditures completed or anticipated in a future period. The infrastructure rehabilitation surcharge is capped as a percentage of base rates, generally 5% of base rates, and is reset to zero when new base rates that reflect the costs of those additions become effective or when a utility's earnings exceed a regulatory benchmark. Infrastructure rehabilitation surcharges provided revenues of $7,817 in 2004, $8,147 in 2003 and $5,518 in 2002.

Sendout – "Sendout" represents the quantity of treated water delivered to our distribution systems. We use sendout as an indicator of customer demand. Weather conditions tend to impact water consumption, particularly in our northern service territories during the late spring and summer months when nonessential and recreational use of water is at its highest. Consequently, a higher proportion of annual operating revenues is realized in the second and third quarters. In general during this period, an extended period of dry weather increases water consumption, while above average rainfall decreases water consumption. Also, an increase in the average temperature generally causes an increase in water consumption. Conservation efforts, construction codes which require the use of low flow plumbing fixtures, as well as mandated water use restrictions in response to drought conditions, also affect water consumption.

The geographic diversity of our customer base helps reduce our exposure to extreme or unusual weather conditions in any one area of our service territory. Our geographic diversity has continued to widen as a result of the Heater and Florida Water acquisitions which closed in mid-year 2004 and the AquaSource acquisition which closed in July 2003. During the year ended December 31, 2004, which included only the partial year operating revenues from the Heater and Florida Water acquisitions, our operating revenues were derived principally from the following states: 57% in Pennsylvania, 9% in Ohio, 7% in Illinois, 7% in Texas, 5% in New Jersey, and 4% in North Carolina.

On occasion, drought warnings and water use restrictions are issued by governmental authorities for portions of our service territories in response to extended periods of dry weather conditions. The timing and duration of the warnings and restrictions can have an impact on our water revenues and net income. In general, water consumption in the summer months is affected by drought warnings and restrictions to a higher degree because nonessential and recreational use of water is highest during the summer months, particularly in our northern service territories. At other times of the year, warnings and restrictions generally have less of an effect on water consumption. During the period from November 2001 to December 2002, at various times in specific counties and to varying degrees, drought warnings or drought emergencies were declared by the Commonwealth of Pennsylvania for substantial portions of our Pennsylvania service territories. A drought warning calls for a 10 to 15 percent voluntary reduction of water use, particularly non-essential uses of water. A drought emergency imposes a ban on nonessential water use. Water use restrictions were also imposed and relaxed at various times during 2002 in our service territories in New Jersey. Currently there are no drought warnings or restrictions in any of the areas we serve.

Operations and Maintenance Expenses

Operations and maintenance expenses totaled $178,345 in 2004, $140,602 in 2003 and $117,735 in 2002. Most elements of operating costs are subject to the effects of inflation, and changes in the number of customers served, and several elements are subject to the effects of changes in water consumption, weather and the degree of water treatment required due to variations in the quality of the raw water. The principal elements of operating costs are labor and employee benefits, electricity, chemicals, maintenance expenses and insurance costs. Electricity and chemical expenses vary in relationship to water consumption, raw water quality, and to a lesser extent the competitive electric market in some of the states in which we operate. Maintenance expenses are sensitive to extremely cold weather, which can cause water mains to rupture. Operations and maintenance expenses increased in 2004 as compared to 2003 by $37,743 or 26.8% due to added operating costs associated with acquisitions of $36,123, additional postretirement costs of $2,110, increased accounting expense of $1,496 for assessing internal control effectiveness under the Sarbanes-Oxley Act and higher water production expenses. Partially offsetting these increases were lower insurance costs due to the favorable settlement of insurance claims during 2004, and the gain on the sale of the Geneva, Ohio water system of $2,342. In the consolidated statement of income for 2004, the gain on the sale of the Geneva water system is reported as a component of the line titled operations and maintenance expense. The impact of acquisitions is primarily the result of the effect of AquaSource for the full twelve-month period versus five months in 2003, and the mid-year 2004 acquisitions of Heater and the Florida Water Services systems.

Operations and maintenance expenses increased in 2003 as compared to 2002 by $22,867 or 19.4% due to additional operating costs associated with acquisitions of $18,526, primarily from AquaSource, higher postretirement costs, and additional maintenance costs, offset in part by reduced bad debt expense. The postretirement benefits expense increase resulted principally from higher pension costs and increased retiree medical costs. The increased maintenance expenses are primarily a result of additional main break repairs resulting from the relatively harsh winter weather experienced in early 2003 in our northern service territory.

Depreciation and Amortization Expenses

Depreciation expense was $54,564 in 2004, $48,522 in 2003 and $41,424 in 2002, and has increased principally as a result of the significant capital expenditures made to expand and improve our utility facilities, and as a result of acquisitions of water systems.

Amortization expense was $4,300 in 2004, $2,941 in 2003 and $2,898 in 2002. The increase in 2004 and 2003 is due to the amortization of the costs associated with, and other costs being recovered in, various rate filings. Expenses associated with filing rate cases are deferred and amortized over periods that generally range from one to three years.

Taxes Other than Income Taxes

Taxes other than income taxes increased by $5,989 or 27.7% in 2004 as compared to 2003 and $2,140 or 11.0% in 2003 as compared to 2002. The increase in both 2004 and 2003 is due to additional taxes associated with acquisitions and increases in state taxes. The other taxes associated with acquisitions resulted from the effect of the July 2003 AquaSource acquisition for a twelve-month period in 2004 as compared to the five-month period in 2003, and the mid-year 2004 acquisitions of Heater Utilities and the systems of Florida Water.

Interest Expense, net

Net interest expense was $48,679 in 2004, $44,662 in 2003 and $40,396 in 2002. Interest income of $1,762 in 2004, $395 in 2003 and $287 in 2002 was netted against interest expense. Interest expense increased in 2004 and in 2003 primarily as a result of higher levels of borrowings, offset partially by the effects of decreased interest rates on borrowings. The higher level of average borrowings in 2004 and 2003 was used to finance the acquisition of AquaSource in July 2003, the Heater and Florida Water acquisitions in mid-year 2004, and capital expenditures. Interest income increased in 2004 due to $532 of interest income in connection with the arbitration award related to the final purchase price for the AquaSource acquisition received in 2004 and additional interest income associated with acquisitions. Interest expense during 2004 was favorably impacted by a reduction in the weighted cost of long-term debt from 6.19% at December 31, 2003 to 6.00% at December 31, 2004.

Allowance for Funds Used During Construction

The allowance for funds used during construction (AFUDC) was $2,304 in 2004, $2,127 in 2003 and $1,389 in 2002 and has varied over the years as a result of changes in the average balance of utility plant construction work in progress (CWIP), to which AFUDC is applied, and to changes in the AFUDC rate. The increase in 2004 is due to an increase in the average balance of CWIP to which AFUDC is applied. The increase in 2003 is due to an increase in the AFUDC rate as a result of tax-exempt borrowings for our multi-year infrastructure rehabilitation plan and an increase in the average balance of CWIP.

Gain on Sale of Water System

Gain on sale of water system represents the gain realized on the December 2002 sale of a portion of the Ashtabula, Ohio water system to the county government. The sale provided $12,118 of net proceeds and resulted in 2002 pre-tax gain of $5,676. The gain realized on the December 2004 sale of the Geneva, Ohio water system to the City of Geneva of $2,342 is reported in the consolidated statement of income as a component of the line titled operations and maintenance expense.

Gain on Sale of Other Assets

Gain on sale of other assets totaled $1,272 in 2004, $5,692 in 2003 and $2,079 in 2002 and consisted of gains on land and marketable securities sales. Gain on sale of land totaled $869 in 2004, $5,153 in 2003 and $900 in 2002. Gain on sale of marketable securities totaled $403 in 2004, $539 in 2003 and $1,179 in 2002.

Income Taxes

Our effective income tax rate was 39.4% in 2004, 39.3% in 2003 and 38.5% in 2002. The changes in the effective tax rates in 2004 and 2003 are due to differences between tax deductible expenses and book expenses.

Summary

Operating income was $177,234 in 2004, $153,561 in 2003 and $140,504 in 2002 and net income available to common stock was $80,007 in 2004, $70,785 in 2003 and $67,154 in 2002. Diluted income per share was $0.85 in 2004, $0.79 in 2003 and $0.78 in 2002. The changes in the per share income in 2004 and 2003 over the previous years were due to the aforementioned changes in income and impacted by a 5.6% increase in the average number of common shares outstanding during 2004 and a 3.1% increase in the average number of common shares outstanding during 2003, respectively. The increase in the number of shares outstanding in 2004 and 2003 is primarily a result of the additional shares issued in common share offerings and through our dividend reinvestment plan, employee stock purchase plan and equity compensation plan.

Although we have experienced increased income in the recent past, continued adequate rate increases reflecting increased operating costs and new capital investments are important to the future realization of improved profitability.

Fourth Quarter Results

Net income available to common stock was $22,474 in the fourth quarter of 2004 and $18,606 in the same period of 2003. The change in net income is due to a $14,230 increase in operating revenues, offset by increased operations and maintenance expense of $3,373, increased interest expense of $1,418, a lower gain on sales of other assets of $973 and increased amortization expense of $514. The increase in operating revenues was a result of additional revenues of $9,006 resulting from an increase in water rates granted to our operating subsidiaries, and the additional revenues from acquisitions, offset partially by reduced infrastructure rehabilitation surcharge revenue of $2,036. The reduction in infrastructure rehabilitation surcharge revenues is due to the August 2004 Pennsylvania rate increase which resulted in the DSIC being reset to zero concurrent with the increase in base water rates. The higher operations and maintenance expense is due primarily to the additional operating costs associated with acquisitions, offset partially by the gain on the December 2004 sale of the Geneva water system of $2,342, and reduced insurance costs.

Effects of Inflation

As a regulated enterprise, our rates are established to provide recovery of costs and a return on our investment. Recovery of the effects of inflation through higher water rates is dependent upon receiving adequate and timely rate increases. However, rate increases are not retroactive and often lag increases in costs caused by inflation. During periods of moderate to low inflation, as has been experienced for the past several years, the effects of inflation on our operating results are not significant.

Security

In light of concerns regarding security in the wake of the September 11, 2001 terrorist attacks, we have increased security measures at our facilities. These increased security measures were not made in response to any specific threat. We are in contact with federal, state and local authorities and industry trade associations regarding information on possible threats and security measures for water utility operations. The cost of the increased security measures, including capital expenditures, is expected to be recoverable in water rates and is not expected to have a material impact on our results from operations or financial condition.

FINANCIAL CONDITION

Cash Flow and Capital Expenditures

Net operating cash flow, dividends paid on common stock, capital expenditures, including allowances for funds used during construction, and expenditures for acquiring water and wastewater systems for the five years ended December 31, 2004 were as follows:

	Net Operating Cash Flow	Common Dividends	Capital Expenditures	Acquisitions of Utility Systems
2000	$ 86,972	$ 30,406	$ 129,740	$ 3,546
2001	102,165	34,234	124,088	9,517
2002	121,560	36,789	136,164	8,914
2003	143,373	39,917	163,320	192,331
2004	173,603	45,807	195,736	54,300
	$ 627,673	$ 187,153	$ 749,048	$ 268,608

Included in capital expenditures for the five-year period are: expenditures for the modernization and replacement of existing treatment plants, new water mains and customer service lines, rehabilitation of existing water mains and hydrants, and water meters. During this five-year period, we received $45,494 of customer advances and contributions in aid of construction to finance new water mains and related facilities which are not included in the capital expenditures presented in the above table. In addition, during this period, we have made sinking fund contributions and retired debt in the amount of $163,689, retired $1,760 of preferred stock, and have refunded $23,550 of customer advances for construction. Common dividends increased during the past five years as a result of an annual increase in the common dividends declared and paid and an increase in the shares outstanding during the period.

Our planned 2005 capital program, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to be $262,400 of which $66,400 is for infrastructure rehabilitation surcharge-qualified projects. We have increased our capital spending for infrastructure rehabilitation in response to the infrastructure rehabilitation surcharge mechanisms, and should these mechanisms be discontinued for any reason, which is not anticipated, we would re-evaluate the magnitude our capital program. Our 2005 capital program, along with $50,195 of sinking fund obligations and debt maturities, and $33,444 of other contractual cash obligations, as reported in the section captioned "Contractual Obligations", is expected to be financed through internally-generated funds, our revolving credit facilities, the issuance of equity and the issuance of new long-term debt.

Future utility construction in the period 2006 through 2009, including recurring programs, such as the ongoing replacement of water meters, water treatment plant upgrades, storage facility renovations, the rehabilitation of water mains and additional transmission mains to meet customer demands, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to require aggregate expenditures of approximately $700,000. We anticipate that less than one-half of these expenditures will require external financing of debt and the additional issuance of common stock through our dividend reinvestment and stock purchase plans and possible future public equity offerings. We expect to refinance $86,263 of sinking fund obligations and debt maturities during this period as they become due with new issues of long-term debt. The estimates discussed above do not include any amounts for possible future acquisitions of water systems or the financing necessary to support them.

Our primary source of liquidity is cash flows from operations, borrowings under various short-term lines of credit and other credit facilities, and customer advances and contributions in aid of construction. Our cash flow from operations, or internally-generated funds, is impacted by the timing of rate relief and water consumption. We fund our capital and acquisition programs through internally-generated funds, supplemented by short-term borrowings. Over time, we refinance our short-term borrowings with long-term debt and proceeds from the issuance of common stock. The ability to finance our future construction programs, as well as our acquisition activities, depends on our ability to attract the necessary external financing and maintain internally-generated funds. Rate orders permitting compensatory rates of return on invested capital and timely rate adjustments will be required by our operating subsidiaries to achieve an adequate level of earnings and cash flow to enable them to secure the capital they will need and to maintain satisfactory debt coverage ratios.

Acquisitions

During the past five years, we have expended cash of $268,608 and issued 1,317,017 shares of common stock, valued at $16,400 at the time of the acquisition, related to the acquisitions of utility systems, primarily water utilities and some wastewater utilities. The operating results of these acquisitions have been included in our consolidated financial statements beginning on the respective acquisition date.

Pursuant to our strategy to grow through acquisitions, on June 1, 2004, we acquired the capital stock of Heater Utilities, Inc. for $48,000 in cash and the assumption of long-term debt of $19,219 and short-term debt of $8,500. The acquired operation provides water and wastewater service to over 50,000 water and wastewater customers primarily in the areas of suburban Raleigh, Charlotte, Gastonia and Fayetteville, North Carolina. For the fiscal year ended December 31, 2003, Heater had operating revenues of $19,489. The acquisition was accounted for as a purchase and accordingly, we recorded goodwill of $18,842. In 2004, as part of the North Carolina Utilities Commission approval process for this acquisition, the Commission approved a mechanism through which we could recover up to two-thirds of the goodwill through customer rates in the future upon achieving certain objectives. We intend to pursue these objectives to facilitate recognition of this premium in customer rates. However, there can be no assurance that we will be able to achieve these objectives and recover such amount of goodwill, if any.

On June 30, 2004, we acquired certain utility assets of Florida Water Services Corporation, comprised of 63 water and wastewater systems located in central Florida for $14,747 in cash, which is less than the depreciated original cost of these assets. In accordance with Florida procedures, the acquisition remains subject to regulatory approval by the Florida Public Service Commission and this process is not expected to be completed prior to September 2005. Under the terms of the purchase agreement, the Commission's review process may result in an adjustment of the final purchase price, which would be settled in cash, based on the Commission's determination of plant investment for the systems. Since the purchase price adjusts by the change in the determined plant investment or rate base, effectively the rate base adjustment is directly offset by the change in purchase price. The final purchase price is not expected to result in the recognition of goodwill.

The acquisition of Heater and the Florida Water Systems were initially funded by a portion of the proceeds from the issuance by Aqua America of an unsecured short-term note in May 2004. A portion of the short-term note was subsequently repaid by Aqua America with the proceeds from a November 2004 secondary equity offering, and a portion of the short-term note was refinanced through the February 2005 issuance of $30,000 of unsecured notes. In November 2004, we sold 1,955,000 shares of common stock in a public offering for proceeds of $42,600, net of expenses. In February 2005, Aqua America issued $18,000 of notes due in 2015 with an interest rate of 5.01% and $12,000 of notes due in 2020 with an interest rate of 5.20%.

Pursuant to our growth strategy, on July 31, 2003, we completed the acquisition of four operating water and wastewater subsidiaries of AquaSource, Inc., a subsidiary of DQE, Inc., including selected, integrated operating and maintenance contracts and related assets (individually and collectively the acquisition is referred to as "AquaSource") for $190,717 in cash, as adjusted pursuant to the purchase agreement based on working capital at closing. On August 27, 2004, we were awarded and received $12,289 plus interest in an arbitration related to the calculation of the final purchase price under the terms of the purchase agreement, which resulted in a final purchase price of $178,428. In the consolidated statement of cash flow for 2004, the $12,289 award has been reported as proceeds on the line titled acquisitions of water and wastewater systems, net. The acquisition was initially funded by a portion of the proceeds from the July 2003 issuance of $135,000 of unsecured notes due 2023, with an interest rate of 4.87%, and the issuance of a $90,000 unsecured note by Aqua America. In August 2003, the $90,000 unsecured note was repaid with the proceeds from the issuance of 5,000,000 shares of common stock through a shelf registration. The acquired operations of AquaSource serve over 130,000 water and wastewater customer accounts in 11 states (including the Connecticut and Kentucky operations which were subsequently sold to other parties). Please refer to the section captioned "Dispositions" for a discussion of the AquaSource operations located in Connecticut, Kentucky and New York. The acquisition provides an expanded platform from which to extend our growth-through-acquisition strategy of acquiring water and wastewater systems that are near or adjacent to our existing service territories. The AquaSource operations are comprised of approximately 600 small systems, which are generally clustered in regions to achieve some level of operating efficiency.

We continue to hold acquisition discussions with several water and wastewater systems. Generally acquisitions are expected to be financed through the issuance of equity (for the acquisition of some investor-owned systems) or funded initially with short-term debt with subsequent repayment from the proceeds of long-term debt or proceeds from equity offerings.

Dispositions

In December 2004, as a result of the settlement of a condemnation action, our Ohio operating subsidiary sold its water utility assets within the municipal boundaries of the City of Geneva in Ashtabula County, Ohio for net proceeds of approximately $4,716, which was in excess of the book value for these assets. The proceeds were used to pay-down short-term debt and the sale resulted in the recognition in the fourth quarter of 2004 of a gain on the sale of these assets, net of expenses, of $2,342. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. We continue to operate this water system for the City of Geneva under an operating contract that began upon the closing of the sale for a period through December 2006. The operating contract provides for an annual base operating fee of $135 and allows for additional fees to be earned commensurate with the services provided. These water utility assets represent less than 1% of Aqua America's total assets, and the total number of customers included in the water system sold represents less than 1% of our total customer base.

We continue to review and evaluate for possible sale selected areas of our business and operating divisions that were acquired in July 2003 with the AquaSource operations. To date, we have completed the following sale transactions of operating divisions acquired as part of the AquaSource transaction:

- In July 2004, we sold our only operation in Kentucky. The sale price approximates our investment in this operation. The operation represented approximately 0.2% of the operations acquired from AquaSource, Inc.
- In October 2003, we completed the sale of our only operation in Connecticut. The sale price of $4,000 approximates our investment in this operation. The operation represented approximately 2% of the operations acquired from AquaSource, Inc.

In May 2003, we announced an agreement for the sale of the AquaSource regulated operation located in New York to a New England-based water company. In January 2005, after the expiration of the sale

agreement, we did not renew the sale agreement. The New York operations represented approximately 1% of the operations acquired from AquaSource, Inc.

In December 2002, as a result of the settlement of a condemnation action, our Ohio operating subsidiary sold to Ashtabula County, Ohio the water utility assets in the unincorporated areas of Ashtabula County and the area within the Village of Geneva on the Lake for net proceeds of $12,118, which was in excess of the book value for these assets. The proceeds were used to pay down short-term debt, and the sale resulted in the recognition in the fourth quarter of 2002 of a gain on the sale of these assets, net of expenses, of $5,676. We continue to operate this water system for Ashtabula County, beginning after the closing of the sale, under a multi-year operating contract. The water utility assets sold represented less than 1% of our total assets, and the total number of customers included in the water system sold represented less than 1% of our total customer base.

The City of Fort Wayne, Indiana has authorized the acquisition, by eminent domain or otherwise, of a portion of the utility assets of one of the operating subsidiaries that we acquired in connection with the AquaSource acquisition in 2003. We have challenged whether the City is following the correct legal procedures in connection with the City's attempted condemnation and we have challenged the City's valuation of this portion of our system. The portion of the system under consideration represents approximately 1% of our total customer base. While we continue to discuss this matter with officials from the City of Fort Wayne, we continue to protect our interests in this proceeding. We believe that we will be entitled to fair market value for our assets if they are condemned, and that the fair market value will be in excess of the book value for such assets.

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

Sources of Capital

Since net operating cash flow plus advances and contributions in aid of construction have not been sufficient to fully fund cash requirements, we issued approximately $564,000 of long-term debt and obtained other short-term borrowings during the past five years. At December 31, 2004, we had short-term lines of credit and other credit facilities of $198,000, of which $159,190 was available. Our short-term lines of credit and other credit facilities are either payable on demand or have a 364-day term.

In April 2003, we filed a universal shelf registration with the SEC to allow for the sale, over time, of up to $250,000 of various debt and equity securities, including common stock. To date, we have completed three issuances under the universal shelf registration:

- In November 2004, we sold 1,955,000 shares of common stock in a public offering for proceeds of $42,600, net of expenses. The net proceeds were used to repay a portion of our short-term debt. The short-term debt was incurred by Aqua America in connection with the Heater and Florida Water acquisitions.
- In August 2003, we sold 5,000,000 shares of common stock in a public offering for proceeds of $90,100, net of expenses. The net proceeds were used to repay an unsecured note of $90,000. The indebtedness was incurred by Aqua America in connection with the acquisition of the operations that were purchased from AquaSource, Inc.
- In May 2003, we sold 1,868,750 shares of common stock in a public offering for proceeds of $33,100, net of expenses. The net proceeds were used to repay short-term debt, including the repayment of $22,000 of indebtedness incurred in connection with our repurchase of 1,513,275 shares of our common stock from affiliates of Veolia Environnement, S.A., formerly Vivendi Enivironnement, S.A., in October 2002.

The balance remaining available for use under the universal shelf registration as of December 31, 2004 is $77,517. In addition, we have a shelf registration statement filed with the SEC to permit the offering from time to time of shares of common stock and shares of preferred stock for acquisitions. During 2004 and 2003, no shares were issued from the acquisition shelf registration. During 2002, 178,664 shares of common stock totaling $2,745, were issued to acquire water and wastewater systems. The balance remaining available for use under the acquisition shelf registration as of December 31, 2004 is 2,218,947 shares. The form and terms of such securities shall be determined when and if these securities are issued under these shelf registrations.

In September 2000, we sold 2,583,008 shares of common stock in a public offering for net proceeds of $29,689. The proceeds of this offering were used to make an equity contribution to our Pennsylvania operating subsidiary.

We offer a Dividend Reinvestment and Direct Stock Purchase Plan (Plan) that provides a convenient and economical way to purchase shares of Aqua America, Inc. Under the direct stock purchase portion of the Plan, shares are sold throughout the year. The dividend reinvestment portion of the Plan offers a 5% discount on the purchase of shares of common stock with reinvested dividends. As of the December 2004 dividend payment, holders of 16.9% of the common shares outstanding participated in the dividend reinvestment portion of the Plan. The shares issued under the Plan are either original issue shares or shares purchased by the Company's transfer agent in the open-market. During the past five years, we have sold 2,086,736 original issue shares of common stock for net proceeds of $32,677 through the dividend reinvestment portion of the Plan and the proceeds were used to invest in our operating subsidiaries, to repay short-term debt, and for general corporate purposes.

Other Capital Transactions

In May 2002, Veolia Environnement, S.A., formerly Vivendi Environnement, S.A., which through its affiliates (collectively "VE") owned approximately 16.8% of our outstanding common stock, advised us of its decision to sell its investment in Aqua America. VE announced that its decision was part of its overall strategy to divest non-core assets and focus on other business strategies. In September 2002, in order to facilitate the orderly re-distribution of the shares held by VE into the market, we completed a secondary offering of 12,356,570 shares of Aqua America common stock held by VE. The number of outstanding shares of common stock was not changed and we did not receive any proceeds as a result of this secondary offering. In addition, in October 2002 we repurchased 1,513,275 shares of Aqua America common stock representing the remainder of the shares of Aqua America common stock held by VE. The repurchase of shares was funded with proceeds of $22,000 from a short-term credit facility. In May 2003, this $22,000 short-term credit facility was repaid with funds from the issuance of 1,868,750 shares of common stock through a shelf registration, providing proceeds of approximately $33,100, net of expenses. The balance of the net proceeds were used to repay other short-term debt.

The Board of Directors has authorized us to purchase our common stock, from time to time, in the open market or through privately negotiated transactions. We have not purchased any shares under this authorization since 2000. As of December 31, 2004, 411,209 shares remain available for repurchase. Funding for future stock purchases, if any, is not expected to have a material impact on our financial position.

Contractual Obligations

The following table summarizes our contractual cash obligations as of December 31, 2004:

	Payments Due By Period						
	2005	2006	2007	2008	2009	Thereafter	Total
Long-term debt (a)	$ 50,195	$ 24,623	$ 31,068	$ 23,756	$ 6,816	$ 698,198	$ 834,656
Operating leases (b)	2,926	2,309	1,669	1,336	969	15,907	25,116
Unconditional purchase obligations (c)	10,840	10,760	11,325	11,103	10,594	82,388	137,010
Other purchase obligations (d)	6,244	-	-	-	-	-	6,244
Postretirement benefit plans' obligations (e)	10,082	-	-	-	-	-	10,082
Other obligations (f)	3,352	400	400	267	130	-	4,549
Total	$ 83,639	$ 38,092	$ 44,462	$ 36,462	$ 18,509	$ 796,493	$ 1,017,657

(a) Represents sinking fund obligations and debt maturities.
(b) Represents operating leases that are noncancelable, before expiration, for the lease of motor vehicles, buildings, land and other equipment.
(c) Represents our commitment to purchase minimum quantities of water as stipulated in agreements with other water purveyors. We use purchased water to supplement our water supply, particularly during periods of peak customer demand.
(d) Represents an approximation of the open purchase orders as of the period end for goods and services purchased in the ordinary course of business.
(e) Represents contributions expected to be made to postretirement benefit plans. The amount of required contributions in 2006 and thereafter is not determinable.
(f) Represents capital expenditures estimated to be required under legal and binding contractual obligations.

In addition to these obligations, we make refunds on Customers' Advances for Construction over a specific period of time based on operating revenues related to developer-installed water mains or as new customers are connected to and take service from such mains. After all refunds are made, any remaining balance is transferred to Contributions in Aid of Construction. The refund amounts are not included in the above table because the refund amounts and timing cannot be accurately estimated because future refund payments depend on several variables, including new customer connections, customer consumption levels and future rate increases. Portions of these refund amounts are payable annually through 2017 and amounts not paid by the contract expiration dates become non-refundable.

These contractual obligations will be funded from cash flows from operations and liquidity sources held by or available to Aqua America.

Market Risk

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. The exposure to changes in interest rates is a result of financings through the issuance of fixed-rate, long-term debt. Such exposure is typically related to financings between utility rate increases, because generally our rate increases provide a revenue level to allow recovery of our current cost of capital. Interest rate risk is managed through the use of a combination of long-term debt, which is at fixed interest rates and short-term debt, which is at floating interest rates. As of December 31, 2004, the debt maturities by period and the weighted average interest rate for fixed-rate, long-term debt are as follows:

	2005	2006	2007	2008	2009	Thereafter	Total	Fair Value
Long-term debt (fixed rate)	$ 50,195	$ 24,623	$ 31,068	$ 23,756	$ 6,816	$ 698,198	$ 834,656	$ 863,247
Weighted average interest rate	7.19%	5.69%	5.10%	6.66%	4.89%	5.93%	6.00%	

From time to time, we make investments in marketable equity securities. As a result, we are exposed to the risk of changes in equity prices for the "available for sale" marketable equity securities. As of December 31, 2004, we owned no marketable equity securities as we sold the balance of our securities during 2004. As a result, the market risks to which we are exposed are less than the risks to which we were exposed in the prior year.

Capitalization

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

December 31,	2004	2003	2002	2001	2000
Long-term debt*	52.8%	52.8%	55.6%	52.9%	52.4%
Preferred stock	0.0%	0.0%	0.0%	0.1%	0.2%
Common stockholders' equity	47.2%	47.2%	44.4%	47.0%	47.4%
	100.0%	100.0%	100.0%	100.0%	100.0%

*Includes current portion.

The changes in the capitalization ratios primarily result from the issuance of common stock over the past five years, and the issuance of debt to finance our acquisitions and capital program and the previously mentioned repurchase of common stock from Veolia Environnement (formerly Vivendi, S.A.) in 2002. It is our goal to maintain an equity ratio adequate to support our current Standard and Poors corporate credit rating of "A+" and its senior secured debt rating of "AA-" for Aqua Pennsylvania, our largest operating subsidiary.

Dividends on Common Stock

We have paid common dividends consecutively for 60 years. Effective December 1, 2004, our Board of Directors authorized an increase of 8.3% in the dividend rate over the amount we paid in the previous quarter. As a result of this authorization, beginning with the dividend payment in December 2004, the annual dividend rate increased to $0.52 per share. We presently intend to pay quarterly cash dividends in the future, on March 1, June 1, September 1 and December 1, subject to our earnings and financial condition, regulatory requirements and such other factors as our Board of Directors may deem relevant. During the past five years, our common dividends paid have averaged 56.6% of net income.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our financial condition and results of operations are impacted by the methods, assumptions, and estimates used in the application of critical accounting policies. The following accounting policies are particularly important to our financial condition or results of operations, and require estimates or other judgements of matters of uncertainty. Changes in the estimates or other judgements included within these accounting policies could result in a significant change to the financial statements. We believe our most critical accounting policies include revenue recognition, the use of regulatory assets and liabilities as permitted by Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation," the review for impairment of our long-lived assets which consist primarily of Utility Plant in Service and regulatory assets, and our accounting for pensions and other postretirement benefits.

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

Regulatory Assets and Liabilities - SFAS No. 71 stipulates generally accepted accounting principles for companies whose rates are established by or are subject to approval by an independent third-party regulator. In accordance with SFAS No. 71, we defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that these costs and credits will be recognized in the rate-making process in a period different from when the costs and credits were incurred. These deferred amounts, both assets and liabilities, are then recognized in the income statement in the same period that they are reflected in our rates charged for water and wastewater service. In the event that our assessment as to the probability of the inclusion in the rate-making process is incorrect, the associated regulatory asset or liability would be adjusted to reflect the change in our assessment or change in regulatory approval.

Impairment of Long-Lived Assets - In accordance with the requirements of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", we review for impairment of our long-lived assets, including Utility Plant in Service. We also review regulatory assets for the continued application of SFAS No. 71. Our review determines whether there have been changes in circumstances or events that have occurred that require adjustments to the carrying value of these assets. In accordance with SFAS No. 71, adjustments to the carrying value of these assets would be made in instances where the inclusion in the rate-making process is unlikely.

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

Our discount rate is based on a market rate for a recognized-rating agency's high-quality long-term bond portfolio with durations matching the expected payouts under our retirement plans. Our pension expense and liability (benefit obligations) increases as the discount rate is reduced. A 25 basis-point reduction in this assumption would have increased 2004 pension expense by $550 and the pension liabilities by $6,500. The present values of Aqua America's future pension and other postretirement obligations were determined using discount rates of 5.75% at December 31, 2004 and 6.25% at December 31, 2003. Our expense under

these plans is determined using the discount rate as of the beginning of the year, which was 6.25% for 2004, and will be 5.75% for 2005.

Our expected return on assets is determined by evaluating the asset class return expectations with our advisors as well as actual, long-term, historical results of our asset returns. Our pension expense increases as the expected return on assets decreases. A 25 basis-point reduction in this assumption would have increased 2004 pension expense by $270. For 2004, we used an 8.5% expected return on assets assumption which will remain unchanged for 2005. The expected return on assets is based on a targeted allocation of 65% equities and 35% fixed income. We believe that our actual long-term asset allocation on average will approximate the targeted allocation. Our targeted allocation is driven by the investment strategy to earn a reasonable rate of return while maintaining risk at acceptable levels through the diversification of investments across and with various asset categories.

As of December 31, 2004, we have an additional minimum liability of $6,820 associated with our defined benefit pension plans. The additional minimum liability is a result of the accumulated benefit obligation exceeding the fair value of plan assets. The portion of the additional minimum liability related to our employees in one of our rate jurisdictions results in the establishment of a regulatory asset of $4,140, as we expect recovery of the future, increased pension expense through customer rates. Since the balance of the additional minimum liability of $2,680 may not be recovered through rates, the accounting requirements for recording a regulatory asset are not met and as a result this amount is recorded as an other comprehensive loss for 2004 through a charge to accumulated other comprehensive income, net of income tax benefits of $938. The change in the additional minimum liability from December 31, 2003 of $41 to December 31, 2004 of $6,820 resulted from the effect of a decreased discount rate, offset partially by an increase in the pension plan assets during 2004 due to positive equity market performance and pension contributions. Although additional minimum liability does not directly impact net income or cash flow, in future years, our pension expense and cash funding requirements are anticipated to increase as a result of the decline in the plans' funded status. Funding requirements for qualified defined benefit pension plans are determined by government regulations and not by accounting pronouncements. In accordance with our funding policy, during 2005 our required pension contribution is expected to be approximately $7,278. We expect future changes in the amount of contributions and expense recognized will be generally included in customer rates.

IMPACT OF RECENT ACCOUNTING PRONOUNCEMENTS

In May 2004, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") No. 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." FSP 106-2 supersedes FSP 106-1, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003," which was issued in January 2004 and permitted a sponsor of a postretirement health care plan that provides a prescription drug benefit to make a one-time election to defer accounting for the effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") until more authoritative guidance on the accounting for the federal subsidy was issued. We had elected the one-time deferral allowed under FSP 106-1 and as a result we adopted FSP 106-2 as required in the third quarter of 2004 and it did not have a material impact on our results of operation or financial position.

In November 2004, the FASB approved Statement of Financial Accounting Standards ("SFAS") No. 151, "Inventory Costs – An Amendment of ARB No. 43, Chapter 4." SFAS No. 151 requires the exclusion of certain costs from inventories and the allocation of fixed production overheads to inventories to be based on the normal capacity of the production facilities. The standard is effective for Aqua America for costs incurred after December 31, 2005. We believe this statement will not have a material impact on our results of operations or financial position.

In November 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29." SFAS No. 153 eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. We believe this statement will not have a material impact on our results of operations or financial position.

On October 22, 2004, the American Jobs Creation Act ("AJCA") was signed into law. Among other provisions, the AJCA creates a new deduction for qualified domestic production activities. Certain of our activities, such as our water treatment activity, are considered as qualifying production activities for purposes of determining the deduction for qualified production activities. In December 2004, the FASB issued FSP 109-1, "Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004." In accordance with FSP 109-1, we will treat the deduction for qualified domestic production activities as a reduction of the income tax provision in future years as realized. The AJCA and FSP 109-1 did not impact our 2004 consolidated financial statements. We are currently assessing the impact, if any, of the AJCA and FSP 109-1 on our consolidated financial statements in future periods. We believe the deduction could impact our future effective income tax rate and it is not expected to have a material impact on our results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," which is effective for reporting periods beginning after June 15, 2005 (our third quarter 2005 period). This standard revises SFAS No. 123, "Accounting for Stock-based Compensation," and supersedes APB No. 25, "Accounting for Stock Issued to Employees." As noted in the footnotes to our consolidated financial statements, we currently provide pro forma disclosure of compensation costs associated with the fair value of stock options that have been granted. We currently account for stock-based compensation associated with stock options using the intrinsic method, and accordingly, no compensation costs have been recognized in our consolidated financial statements. 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. The fair value of the option grant will be estimated using an option-pricing model. We are currently evaluating this standard to determine the impact on our consolidated financial statements, including the selection of an appropriate option-pricing model as permitted under SFAS No. 123R, and the method by which we will adopt SFAS No. 123R. We are currently evaluating the requirements of SFAS No. 123R and we expect the adoption of this standard will have a material impact on our results of operations and earnings per share.

AQUA AMERICA, INC. AND SUBSIDIARIES

Management's Report On Internal Control Over Financial Reporting

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

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

In assessing the effectiveness of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. As a result of management's assessment and based on the criteria in the framework, management has concluded that, as of December 31, 2004, the Company's internal control over financial reporting was effective.

Management evaluated the Company's internal control over financial reporting as of December 31, 2004. In conducting this assessment, management has excluded Heater Utilities, Inc. from its assessment because it was acquired by the Company in a purchase business combination during 2004. Heater Utilities, Inc., is a wholly-owned subsidiary, whose total assets and total revenues represent approximately 5% and 3%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2004.

The Company's independent registered public accounting firm, PricewaterhouseCoopers LLP, has audited management's assessment of the effectiveness of the Company's internal control over financial reporting, as stated in their report which appears herein.

Nicholas DeBenedictis
Chairman &
President

David P. Smeltzer
Senior Vice President - Finance

March 14, 2005

Report of Independent Registered Public Accounting Firm

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

We have completed an integrated audit of Aqua America, Inc.'s 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income and comprehensive income, of capitalization and of cash flows present fairly, in all material respects, the financial position of Aqua America, Inc. and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting, appearing in the 2004 Annual Report to Shareholders, that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

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

As described in Management's Report on Internal Control Over Financial Reporting, management has excluded Heater Utilities, Inc. from its assessment of internal control over financial reporting as of December 31, 2004 because it was acquired by the Company in a purchase business combination during 2004. We have also excluded Heater Utilities, Inc. from our audit of internal control over financial reporting. Heater Utilities, Inc., is a wholly-owned subsidiary, whose total assets and total revenues represent approximately 5% and 3%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2004.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Philadelphia, PA
March 14, 2005

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(In thousands, except per share amounts)
Years ended December 31, 2004, 2003 and 2002

	2004	2003	2002
Operating revenues	$ 442,039	$ 367,233	$ 322,028
Costs and expenses:			
Operations and maintenance	178,345	140,602	117,735
Depreciation	54,564	48,522	41,424
Amortization	4,300	2,941	2,898
Taxes other than income taxes	27,596	21,607	19,467
	264,805	213,672	181,524
Operating income	177,234	153,561	140,504
Other expense (income):			
Interest expense, net	48,679	44,662	40,396
Allowance for funds used during construction	(2,304)	(2,127)	(1,389)
Gain on sale of water system	-	-	(5,676)
Gain on sale of other assets	(1,272)	(5,692)	(2,079)
Income before income taxes	132,131	116,718	109,252
Provision for income taxes	52,124	45,923	42,046
Net income	80,007	70,795	67,206
Dividends on preferred stock	-	10	52
Net income available to common stock	$ 80,007	$ 70,785	$ 67,154
Net income	$ 80,007	$ 70,795	$ 67,206
Other comprehensive income (loss), net of tax:			
Minimum pension liability adjustment	(1,742)	-	-
Unrealized gains on securities	59	455	104
Reclassification adjustment for gains reported in net income	(230)	(347)	(767)
	(1,913)	108	(663)
Comprehensive income	$ 78,094	$ 70,903	$ 66,543
Net income per common share:			
Basic	$ 0.86	$ 0.80	$ 0.78
Diluted	$ 0.85	$ 0.79	$ 0.78
Average common shares outstanding during the period:			
Basic	93,247	88,275	85,674
Diluted	94,282	89,244	86,538

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands of dollars, except per share amounts)
December 31, 2004 and 2003

	2004	2003
Assets		
Property, plant and equipment, at cost	$ 2,626,151	$ 2,302,304
Less accumulated depreciation	556,339	478,013
Net property, plant and equipment	2,069,812	1,824,291
Current assets:		
Cash and cash equivalents	13,116	10,757
Accounts receivable and unbilled revenues, net	64,538	62,320
Inventory, materials and supplies	6,903	5,841
Prepayments and other current assets	5,570	5,051
Total current assets	90,127	83,969
Regulatory assets	110,993	98,761
Deferred charges and other assets, net	31,998	34,277
Funds restricted for construction activity	17,196	28,438
Goodwill	20,122	-
	$ 2,340,248	$ 2,069,736
Liabilities and Stockholders' Equity		
Stockholders' equity:		
Common stock at $.50 par value, authorized 300,000,000 shares, issued 96,071,580 and 93,270,424 in 2004 and 2003	$ 48,036	$ 46,635
Capital in excess of par value	468,524	413,008
Retained earnings	245,115	210,915
Minority interest	1,237	912
Treasury stock, at cost, 686,747 and 681,384 shares in 2004 and 2003	(12,702)	(12,611)
Accumulated other comprehensive income	(1,742)	171
Total stockholders' equity	748,468	659,030
Long-term debt, excluding current portion	784,461	696,666
Commitments	-	-
Current liabilities:		
Current portion of long-term debt	50,195	39,386
Loans payable	85,115	96,459
Accounts payable	23,534	32,321
Accrued interest	12,029	11,126
Accrued taxes	8,975	16,779
Other accrued liabilities	37,534	35,930
Total current liabilities	217,382	232,001
Deferred credits and other liabilities:		
Deferred income taxes and investment tax credits	223,887	190,395
Customers' advances for construction	73,095	72,500
Other	15,147	9,419
Total deferred credits and other liabilities	312,129	272,314
Contributions in aid of construction	277,808	209,725
	$ 2,340,248	$ 2,069,736

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CAPITALIZATION
(In thousands of dollars, except per share amounts)
December 31, 2004 and 2003

	2004	2003
Stockholders' equity:		
Common stock, $.50 par value	$ 48,036	$ 46,635
Capital in excess of par value	468,524	413,008
Retained earnings	245,115	210,916
Minority interest	1,237	912
Treasury stock, at cost	(12,702)	(12,612)
Accumulated other comprehensive income	(1,742)	171
Total stockholders' equity	748,468	659,030
Long-term debt:		
Long-term debt of subsidiaries (substantially secured by utility plant):		
Interest Rate Range		
0.00% to 2.49%	20,051	16,868
2.50% to 2.99%	29,924	18,913
3.00% to 3.49%	17,546	5,618
3.50% to 3.99%	7,123	2,800
4.00% to 4.99%	9,435	8,135
5.00% to 5.49%	165,615	110,875
5.50% to 5.99%	89,260	76,260
6.00% to 6.49%	110,360	119,360
6.50% to 6.99%	42,000	42,000
7.00% to 7.49%	45,105	46,716
7.50% to 7.99%	25,231	23,000
8.00% to 8.49%	26,714	17,500
8.50% to 8.99%	9,000	9,000
9.00% to 9.49%	53,244	53,805
9.50% to 9.99%	42,088	43,242
10.00% to 10.50%	6,000	6,000
	698,696	600,092
Note payable, 6.05%, due 2006	960	960
Unsecured notes payable, 4.87%, due 2023	135,000	135,000
	834,656	736,052
Current portion of long-term debt	50,195	39,386
Long-term debt, excluding current portion	784,461	696,666
Total capitalization	$ 1,532,929	$ 1,355,696

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMMON STOCKHOLDERS' EQUITY
(In thousands of dollars, except per share amounts)

	Common Stock	Capital in excess of par value	Retained earnings	Treasury Stock	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2001	$ 34,650	$ 304,039	$ 149,682	$ (17,167)	$ 726	$ 471,930
Net income	-	-	67,154	-	-	67,154
Other comprehensive income: unrealized gains on securities, net of income tax of $56	-	-	-	-	104	104
Reclassification adjustment for gains reported in net income, net of income tax of $412	-	-	-	-	(767)	(767)
Dividends	-	-	(36,789)	-	-	(36,789)
Stock issued for acquisitions (178,864 shares)	71	2,674	-	-	-	2,745
Sale of stock (448,593 shares)	161	6,220	-	855	-	7,236
Repurchase of stock (1,274,680 shares)	-	-	-	(24,109)	-	(24,109)
Equity Compensation Plan (37,031 shares)	15	598	-	-	-	613
Exercise of stock options (339,178 shares)	137	3,237	-	-	-	3,374
Employee stock plan tax benefits	-	1,103	-	-	-	1,103
Balance at December 31, 2002	35,034	317,871	180,047	(40,421)	63	492,594
Net income	-	-	70,785	-	-	70,785
Other comprehensive income: unrealized gains on securities, net of income tax of $244	-	-	-	-	455	455
Reclassification adjustment for gains reported in net income, net of income tax of $186	-	-	-	-	(347)	(347)
Dividends	-	-	(39,917)	-	-	(39,917)
Stock split	9,244	(9,244)	-	-	-	-
Sale of stock (7,308,870 shares)	2,168	99,031	-	29,163	-	130,362
Repurchase of stock (60,646 shares)	-	-	-	(1,353)	-	(1,353)
Equity Compensation Plan (20,156 shares)	8	344	-	-	-	352
Exercise of stock options (434,833 shares)	181	4,283	-	-	-	4,464
Employee stock plan tax benefits	-	723	-	-	-	723
Balance at December 31, 2003	46,635	413,008	210,915	(12,611)	171	658,118
Net income	-	-	80,007	-	-	80,007
Other comprehensive income (loss):						
Minimum pension liability adjustment, net of income tax of $938	-	-	-	-	(1,742)	(1,742)
Unrealized gain on securities, net of income tax of $32	-	-	-	-	59	59
Less: Reclassification adjustment for gains reported in net income, net of income tax of $173	-	-	-	-	(230)	(230)
Dividends	-	-	(45,807)	-	-	(45,807)
Sale of stock (2,385,902 shares)	1,170	48,971	-	991	-	51,132
Repurchase of stock (51,808 shares)	-	-	-	(1,082)	-	(1,082)
Equity Compensation Plan (34,151 shares)	17	692	-	-	-	709
Exercise of stock options (427,548 shares)	214	4,847	-	-	-	5,061
Employee stock plan tax benefits	-	1,006	-	-	-	1,006
Balance at December 31, 2004	$ 48,036	$ 468,524	$ 245,115	$ (12,702)	$ (1,742)	$ 747,231

See accompanying notes to consolidated financial statements.

AQUA AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED CASH FLOW STATEMENTS
(In thousands of dollars)
Years ended December 31, 2004, 2003 and 2002

	2004	2003	2002
Cash flows from operating activities:			
Net income	$ 80,007	$ 70,795	$ 67,206
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	58,864	51,463	44,322
Deferred income taxes	40,577	26,741	18,470
Gain on sale of water system	(2,342)	-	(5,676)
Gain on sale of other assets	(1,272)	(5,692)	(2,079)
Net increase in receivables, inventory and prepayments	(2,766)	(314)	(742)
Net increase in payables, accrued interest, accrued taxes and other accrued liabilities	863	7,777	1,346
Other	(328)	(7,397)	(1,287)
Net cash flows from operating activities	173,603	143,373	121,560
Cash flows from investing activities:			
Property, plant and equipment additions, including allowance for funds used during construction of $2,304, $2,127 and $1,389	(195,736)	(163,320)	(136,164)
Acquisitions of water and wastewater systems, net	(54,300)	(192,331)	(8,914)
Net decrease (increase) in funds restricted for construction activity	11,243	15,314	(23,986)
Net proceeds from the sale of water systems	4,716	4,000	12,118
Net proceeds from the sale of other assets	2,098	6,496	6,258
Other	(517)	(312)	(362)
Net cash flows used in investing activities	(232,496)	(330,153)	(151,050)
Cash flows from financing activities:			
Customers' advances and contributions in aid of construction	14,269	8,181	10,266
Repayments of customers' advances	(4,930)	(4,257)	(5,070)
Net proceeds (repayments) of short-term debt	(31,900)	(18,654)	5,445
Proceeds from long-term debt	130,258	154,537	119,350
Repayments of long-term debt	(55,928)	(44,204)	(43,279)
Redemption of preferred stock	-	(172)	(944)
Proceeds from issuing common stock	56,193	134,826	10,611
Repurchase of common stock	(1,082)	(1,353)	(24,109)
Dividends paid on preferred stock	-	(10)	(52)
Dividends paid on common stock	(45,807)	(39,917)	(36,789)
Other	179	2,645	(1,034)
Net cash flows from financing activities	61,252	191,622	34,395
Net increase in cash and cash equivalents	2,359	4,842	4,905
Cash and cash equivalents at beginning of year	10,757	5,915	1,010
Cash and cash equivalents at end of year	$ 13,116	$ 10,757	$ 5,915
Cash paid during the year for:			
Interest, net of amounts capitalized	$ 45,261	$ 40,572	$ 38,040
Income taxes	$ 22,322	$ 19,168	$ 24,165

See Summary of Significant Accounting Policies-Customers' Advances for Construction, Acquisitions and Employee Stock and and Incentive Plans footnotes for description of non-cash activities.
See accompanying notes to consolidated financial statements.

Summary of Significant Accounting Policies

Name Change – On January 16, 2004, Philadelphia Suburban Corporation changed its corporate name to Aqua America, Inc. In addition, we changed our ticker symbol from PSC to WTR on the New York Stock Exchange and Philadelphia Stock Exchange effective on January 20, 2004.

Nature of Operations - Aqua America, Inc. ("Aqua America" or the "Company") is the holding company for regulated utilities providing water or wastewater services 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. - formerly Pennsylvania Suburban Water Company, accounts for approximately 57% of our operating revenues and provides water or wastewater service to customers in the suburban areas north and west of the City of Philadelphia and in 21 other counties in Pennsylvania. The Company's other subsidiaries provide similar services in 12 other states. In addition, the Company provides water and wastewater service through operating and maintenance contracts with municipal authorities and other parties close to our operating companies' service territories.

Regulation - Most of the operating companies that are regulated public utilities are subject to regulation by the public utility commissions of the states in which they operate. The respective public utility commissions have jurisdiction with respect to rates, service, accounting procedures, issuance of securities, acquisitions and other matters. Some of the operating companies that are regulated public utilities are subject to rate regulation by county or city government. Regulated public utilities follow Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 provides for the recognition of regulatory assets and liabilities as allowed by regulators for costs or credits that are reflected in current rates or are considered probable of being included in future rates. The regulatory assets or liabilities are then relieved as the cost or credit is reflected in rates.

Consolidation - The consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany accounts and transactions have been eliminated where appropriate.

Recognition of Revenues - Revenues include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the latest billing to the end of the accounting period. Nonregulated revenues are recognized when services are performed and are primarily associated with operating and maintenance contracts and data processing service fees. Nonregulated revenues totaled $13,623 in 2004, $11,806 in 2003 and $7,190 in 2002.

Property, Plant and Equipment and Depreciation - Property, plant and equipment consist primarily of utility plant. The cost of additions includes contracted cost, direct labor and fringe benefits, materials, overheads and, for certain utility plant, allowance for funds used during construction. Water systems acquired are recorded at estimated original cost of utility plant when first devoted to utility service and the applicable depreciation is recorded to accumulated depreciation. The difference between the estimated original cost, less applicable accumulated depreciation, and the purchase price is recorded as an acquisition adjustment within utility plant. At December 31, 2004, utility plant includes a net credit acquisition adjustment of $63,347, which is generally being amortized from 0 to 20 years. Amortization of the acquisition adjustments totaled $3,961 in 2004, $1,649 in 2003 and $633 during 2002.

Utility expenditures for maintenance and repairs, including major maintenance projects and minor renewals and betterments, are charged to operating expenses when incurred in accordance with the system of accounts prescribed by the public utility commissions of the states in which the company operates. The cost of new units of property and betterments are capitalized.

When units of utility property are replaced, retired or abandoned, the recorded value thereof is credited to the asset account and such value, together with the net cost of removal, is charged to accumulated depreciation. To the extent the Company recovers cost of removal or other retirement costs through rates after the retirement costs are incurred, a regulatory asset is recorded. In some cases, the Company recovers retirement costs through rates during the life of the associated asset and before the costs are incurred. These amounts result in a regulatory liability being reported based on the amounts previously recovered through customer rates.

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

In accordance with the requirements of Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the long-lived assets of the Company, which consist primarily of Utility Plant in Service and regulatory assets, are reviewed for impairment when changes in circumstances or events occur. There has been no change in circumstances or events that have occurred that require adjustments to the carrying values of these assets.

Allowance for Funds Used During Construction - The allowance for funds used during construction ("AFUDC") is a non-cash credit which represents the estimated cost of funds used to finance the construction of utility plant. In general, AFUDC is applied to construction projects requiring more than one month to complete. No AFUDC is applied to projects funded by customer advances for construction or contributions in aid of construction. AFUDC includes the net cost of borrowed funds and a rate of return on other funds when used, and is recovered through water rates as the utility plant is depreciated. The amount of AFUDC related to equity funds in 2002 was $9. There was no AFUDC related to equity funds in 2004 and 2003. No interest was capitalized by our nonregulated businesses.

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

Accounts Receivable – Accounts receivable are recorded at the invoiced amounts. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in our existing accounts receivable, and is determined based on historical write-off experience. The Company reviews the allowance for doubtful accounts quarterly. Account balances are written off against the allowance when it is probable the receivable will not be recovered.

Deferred Charges and Other Assets - Deferred charges and other assets consist of financing expenses, other costs and marketable securities. Deferred bond issuance expenses are amortized by the straight-line method over the life of the related issues. Call premiums related to the early redemption of long-term debt, along with the unamortized balance of the related issuance expense, are deferred and amortized over the life of the long-term debt used to fund the redemption. Other costs, for which the Company has received or expects to receive prospective rate recovery, are deferred and amortized over the period of rate recovery in accordance with SFAS No. 71.

Marketable securities are considered "available-for-sale" and accordingly, are carried on the balance sheet at fair market value. Unrecognized gains are included in other comprehensive income.

Goodwill – Goodwill represents the excess cost over the fair value of net tangible and identifiable intangible assets acquired, and a substantial portion of the goodwill balance is associated with the acquisition of Heater Utilities, Inc. in June 2004. Goodwill is not amortized but is tested for impairment annually, or more often, if certain circumstances indicate a possible impairment may exist. In accordance with the requirements of SFAS No. 142, "Goodwill and Other Intangible Assets," the Company tested the goodwill attributable to each of our reporting units for impairment as of June 30, 2004, in conjunction with the timing of our annual strategic business plan. Based on the Company's comparison of the estimated fair value of each reporting unit to their respective carrying amounts, the impairment test concluded that none of its goodwill was impaired.

Income Taxes - The Company accounts for certain income and expense items in different time periods for financial reporting than for tax reporting purposes. Deferred income taxes are provided on the temporary differences between the tax basis of the assets and liabilities, and the amounts at which they are carried in the consolidated financial statements. The income tax effect of temporary differences not allowed currently in rates is recorded as deferred taxes with an offsetting regulatory asset or liability. These deferred income taxes are based on the enacted tax rates expected to be in effect when such temporary differences are projected to reverse. Investment tax credits are deferred and amortized over the estimated useful lives of the related properties.

Customers' Advances for Construction - Water mains or, in some instances, cash advances to reimburse the Company for its costs to construct water mains, are contributed to the Company by customers, real estate developers and builders in order to extend water service to their properties. The value of these contributions is recorded as Customers' Advances for Construction. The Company makes refunds on these advances over a specific period of time based on operating revenues related to the main or as new customers are connected to and take service from the main. After all refunds are made, any remaining balance is transferred to Contributions in Aid of Construction. Non-cash property, in the form of water mains, has been received, generally from developers, as advances or contributions of $9,273, $9,991 and $17,271 in 2004, 2003 and 2002, respectively.

Contributions in Aid of Construction - Contributions in aid of construction include direct non-refundable contributions and the portion of customers' advances for construction that become non-refundable.

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

Stock-Based Compensation - The Company currently accounts for stock-based compensation using the intrinsic value method in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees". Accordingly, no compensation expense related to granting of stock options has been recognized in the financial statements for stock options that have been granted. Please refer to the Recent Accounting Pronouncements section of this footnote for information concerning changes to the Company's accounting for stock-based compensation. Pursuant to the current disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, pro forma net income available to common stock and earnings per share are presented in the following table as if compensation cost for stock options was determined as of the grant date under the fair value method:

	Years Ended December 31,		
	2004	2003	2002
Net income available to common stock, as reported	$ 80,007	$ 70,785	$ 67,154
Add: stock-based employee compensation expense included in reported net income, net of tax	266	224	473
Less: pro forma expense related to stock options granted, net of tax effects	(1,990)	(1,793)	(1,741)
Pro forma	$ 78,283	$ 69,216	$ 65,886
Basic net income per share:			
As reported	$ 0.86	$ 0.80	$ 0.78
Pro forma	0.84	0.78	0.77
Diluted net income per share:			
As reported	$ 0.85	$ 0.79	$ 0.78
Pro forma	0.83	0.78	0.76

The per share weighted-average fair value at the date of grant for stock options granted during 2004, 2003 and 2002 was $5.43, $4.67 and $5.15 per option, respectively. The fair value of options at the date of grant was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2004	2003	2002
Expected life (years)	4.5	5.6	5.5
Interest rate	4.0%	3.7%	4.9%
Volatility	29.9%	32.4%	34.2%
Dividend yield	2.2%	2.6%	2.6%

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

Recent Accounting Pronouncements – In May 2004, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") No. 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." FSP 106-2 supersedes FSP 106-1, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003," which was issued in January 2004 and permitted a sponsor of a postretirement health care plan that provides a prescription drug benefit to make a one-time election to defer accounting for the effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") until more authoritative guidance on the accounting for the federal subsidy was issued. The Company had elected the one-time deferral allowed under FSP 106-1 and as a result adopted FSP 106-2 as required in the third quarter of 2004 and it did not have a material impact on our results of operations or financial position.

In November 2004, the FASB approved Statement of Financial Accounting Standards ("SFAS") No. 151, "Inventory Costs – An Amendment of ARB No. 43, Chapter 4." SFAS No. 151 requires the exclusion of certain costs from inventories and the allocation of fixed production overheads to inventories to be based on the normal capacity of the production facilities. The standard is effective for the Company for costs incurred after December 31, 2005. The Company believes this statement will not have a material impact on its results of operations or financial position.

In November 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29." SFAS No. 153 eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. The Company believes this statement will not have a material impact on its results of operations or financial position.

On October 22, 2004, the American Jobs Creation Act ("AJCA") was signed into law. Among other provisions, the AJCA creates a new deduction for qualified domestic production activities. Certain activities of the Company, such as our water treatment activity, are considered as qualifying production activities for purposes of determining the deduction for qualified production activities. In December 2004, the FASB issued FSP 109-1, "Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004." In accordance with FSP 109-1, the Company will treat the deduction for qualified domestic production activities as a reduction of the income tax provision in future years as realized. The AJCA and FSP 109-1 did not impact the Company's 2004 consolidated

financial statements. Thus, the Company is currently assessing the impact, if any, of the AJCA and FSP 109-1 on its consolidated financial statements in future periods. The Company believes the deduction could impact the Company's future effective income tax rate and it is not expected to have a material impact on its results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," which is effective for reporting periods beginning after June 15, 2005 (our third quarter 2005 period). This standard revises SFAS No. 123, "Accounting for Stock-based Compensation," and supersedes APB No. 25, "Accounting for Stock Issued to Employees." As noted in the section captioned "Stock-based Compensation" in the Summary of Significant Accounting Policies footnote, the Company currently provides pro forma disclosure of its compensation costs associated with the fair value of stock options that have been granted. The Company currently accounts for stock-based compensation associated with stock options using the intrinsic method, and accordingly, no compensation costs have been recognized in its consolidated financial statements. 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. The fair value of the option grant will be estimated using an option-pricing model. The Company is currently evaluating this standard to determine the impact on its consolidated financial statements, including the selection of an appropriate option-pricing model as permitted under SFAS No. 123R, and the method by which we will adopt SFAS No. 123R. The Company is currently evaluating the requirements of SFAS No. 123R and it expects that the adoption of this standard will have a material impact on its results of operations and earnings per share.

Acquisitions

Heater – Pursuant to our strategy to grow through acquisitions, on June 1, 2004 the Company acquired the capital stock of Heater Utilities, Inc. for $48,000 in cash and the assumption of long-term debt of $19,219 and short-term debt of $8,500. The acquired operation provides water and wastewater service to over 50,000 water and wastewater customers primarily in the areas of suburban Raleigh, Charlotte, Gastonia and Fayetteville, North Carolina. For the fiscal year ended December 31, 2003, Heater had operating revenues of $19,489. The acquisition was accounted for as a purchase and accordingly, the purchase price is allocated to the net tangible and intangible assets based upon their estimated fair values at the date of the acquisition. The Company obtained a third-party valuation of these assets and liabilities, and it resulted in the recording of a purchase accounting fair value adjustment of $3,141 to increase the carrying-value of long-term debt assumed. The purchase price allocation is as follows:

	June 1, 2004
Property, plant and equipment, net	$ 96,779
Current assets	4,133
Other long-term assets	6,005
Goodwill	18,842
Total assets acquired	125,759
Current liabilities	3,063
Loans payable	8,500
Long-term debt	22,360
Other long-term liabilities	43,836
Total liabilities assumed	77,759
Net assets acquired	$ 48,000

The Company has recorded goodwill of $18,842, and a substantial portion of the goodwill is expected to be deductible for tax purposes. The purchase price was arrived at through arms-length negotiations with the seller and is consistent with the multiples paid in other comparable transactions. Aqua America considered important regulatory, strategic and valuation considerations in arriving at the final purchase price. During 2004, through the North Carolina Utilities Commission approval process, a mechanism has been developed through which the Company could recover up to two-thirds of the goodwill through customer rates in the future upon achieving certain objectives. The Company intends to pursue these objectives to facilitate recognition of this premium in customer rates. However, there can be no assurance that the Company will be able to achieve these objectives and recover such amount of goodwill, if any.

Florida Water - On June 30, 2004, the Company acquired certain utility assets of Florida Water Services Corporation, comprised of 63 water and wastewater systems located in central Florida for $14,747 in cash, which is less than the depreciated original cost of these assets. In accordance with Florida procedures, the acquisition remains subject to regulatory approval by the Florida Public Service Commission. This process is not expected to be completed prior to September 2005. Under the terms of the purchase agreement, the Commission's review process may result in an adjustment of the final purchase price, which would be settled in cash, based on the Commission's determination of plant investment for the systems. Since the purchase price adjusts by the change in the determined plant investment or rate base, effectively the rate base adjustment is directly offset by the change in purchase price. The final purchase price is not expected to result in the recognition of goodwill.

AquaSource - Pursuant to our strategy to grow through acquisitions, on July 31, 2003, the Company completed its acquisition of four operating water and wastewater subsidiaries of AquaSource, Inc. (a subsidiary of DQE, Inc.), including selected, integrated operating and maintenance contracts and related assets (individually and collectively the acquisition is referred to as "AquaSource") for $190,717 in cash, as adjusted pursuant to the purchase agreement based on working capital at closing. On August 27, 2004, we were awarded and received $12,289 plus interest in an arbitration related to the calculation of the final purchase price under the terms of the purchase agreement, which resulted in a final purchase price of $178,428. In the consolidated statement of cash flow for 2004, the $12,289 award has been reported as proceeds on the line titled acquisitions of water and wastewater systems, net.

The results of AquaSource have been included in the Company's consolidated financial statements beginning August 1, 2003. The acquired operations of AquaSource serve over 130,000 water and wastewater customer accounts in 11 states (including the Connecticut and Kentucky operations which were subsequently sold to other parties). Please refer to the Dispositions footnote for a discussion of the AquaSource operations located in Connecticut, Kentucky and New York. The AquaSource acquisition was initially funded by a portion of the proceeds from the July 2003 issuance of $135,000 of unsecured notes due 2023, with an interest rate of 4.87%, and the issuance of a $90,000 unsecured note by Aqua America. In August 2003, the $90,000 unsecured note was repaid with the proceeds from the issuance of 5,000,000 shares of common stock through a shelf registration.

Under the purchase method of accounting, the purchase price is allocated to AquaSource's net tangible and intangible assets based upon their estimated fair values at the date of the acquisition. The purchase price allocation, which reflects the effects of the August 2004 purchase price arbitration proceeding, is as follows:

	July 31, 2003
Property, plant and equipment, net	$ 197,719
Current assets	9,687
Other long-term assets	14,204
Assets held for sale, net	4,096
Total assets acquired	225,706
Current liabilities	8,214
Long-term debt	7,170
Other long-term liabilities	31,894
Total liabilities assumed	47,278
Net assets acquired	$ 178,428

The following supplemental pro forma information is presented to illustrate the effects of the AquaSource acquisition, which was completed on July 31, 2003, on the historical operating results for the year ended December 31, 2003 and 2002 as if the acquisition had occurred at the beginning of the respective periods (unaudited):

	Years Ended December 31,	
	2003	2002
Operating revenues	$ 407,628	$ 391,569
Net income	$ 74,436	$ 72,420
Net income per common share:		
Basic	$ 0.81	$ 0.80
Diluted	$ 0.81	$ 0.79

The supplemental information is not necessarily representative of the actual results that may have occurred for these periods or of the results that may occur in the future. This information does not reflect the effects of recent rate increases or cost savings that may result from the acquisition, such as the effects of a reduction in administrative costs. This information is based upon the historical operating results of AquaSource for periods prior to the acquisition date of July 31, 2003 as provided to the Company by AquaSource, Inc. and DQE, Inc. management.

Other Acquisitions - During 2004, in addition to the Heater and Florida Water acquisitions, the Company completed 27 acquisitions or other growth ventures in the various states in which the Company operates for an aggregate purchase price of $3,842 in cash. The operating revenues included in the consolidated financial statements of the Company during the period owned by the Company were $617.

During 2003, in addition to the AquaSource acquisition, the Company completed 17 acquisitions or other growth ventures in the various states in which the Company operates for an aggregate purchase price of $1,614 in cash. Operating revenues included in the consolidated financial statements of the Company related to these systems were $860 in 2004 and $312 in 2003.

During 2002, the Company completed 25 acquisitions or other growth ventures in various states. The total purchase price of $11,659 for the systems acquired in 2002 consisted of $8,914 in cash and the issuance of 178,864 shares of the Company's common stock. Operating revenues included in the consolidated financial statements of the Company related to the systems acquired in 2002 were $2,932 in 2004, $2,920 in 2003 and $1,341 in 2002.

Dispositions

In December 2004, as a result of the settlement of a condemnation action, the Company's Ohio operating subsidiary sold its water utility assets within the municipal boundaries of the City of Geneva in Ashtabula County, Ohio for net proceeds of approximately $4,716, which was in excess of the book value for these assets. The proceeds were used to pay-down short-term debt and the sale resulted in the recognition in the fourth quarter of 2004 of a gain on the sale of these assets, net of expenses, of $2,342. The gain is reported in the 2004 consolidated statement of income as a reduction to operations and maintenance expense. We continue to operate this water system for the City of Geneva under an operating contract that began upon the closing of the sale for a period through December 2006. The operating contract provides for an annual base operating fee of $135 and allows for additional fees to be earned commensurate with the services provided. These water utility assets represent less than 1% of Aqua America's total assets, and the total number of customers included in the water system sold represents less than 1% of our total customer base.

In July 2004, the Company sold it only operations in Kentucky. The sale price approximates our investment in this operation. The operation represented approximately 0.2% of the operations acquired from AquaSource, Inc. In October 2003, the Company sold its only operation in Connecticut. The sale price of $4,000 approximates our investment in this operation. The operation represented approximately 2% of the operations acquired from AquaSource, Inc. In May 2003, the Company announced an agreement for the sale of the AquaSource regulated operation located in New York to a New England-based water company. In January 2005, after the expiration of the sale agreement, the Company did not renew the sale agreement. The New York operations represented approximately 1% of the operations acquired from AquaSource, Inc.

In December 2002, as a result of the settlement of a condemnation action, the Company's Ohio operating subsidiary sold to Ashtabula County, Ohio the water utility assets in the unincorporated areas of Ashtabula County and the area within the Village of Geneva on the Lake for $12,118, net of certain closing costs. The sale was in excess of the book value for these assets and the sale generated a gain of $5,676 (or an after-tax

gain of $3,690 and $0.04 per share) recorded in the fourth quarter of 2002. We continue to operate this water system for Ashtabula County, beginning after the closing of the sale, under a multi-year operating contract. The water utility assets sold represent less than 1% of our total assets, and the total number of customers included in the water system sold represents less than 1% of our total customer base.

The City of Fort Wayne, Indiana has authorized the acquisition, by eminent domain or otherwise, of a portion of the utility assets of one of the operating subsidiaries that the Company acquired in connection with the AquaSource acquisition in 2003. The Company has challenged whether the City is following the correct legal procedures in connection with the City's attempted condemnation and the Company has challenged the City's valuation of this portion of its system. The portion of the system under consideration represents approximately 1% of the Company's total customer base. While the Company continues to discuss this matter with officials from the City of Fort Wayne, the Company continues to protect its interests in this proceeding. The Company believes that it will be entitled to fair market value for its assets if they are condemned, and it is believed that the fair market value will be in excess of the book value for such assets.

Property, Plant and Equipment

	December 31, 2004	December 31, 2003	Approximate range of remaining lives
Utility plant and equipment:			
Mains and accessories	$ 1,087,712	$ 962,439	15 to 85 years
Services, hydrants, treatment plants and reservoirs	607,331	547,622	5 to 56 years
Operations structures and water tanks	218,888	175,663	15 to 61 years
Miscellaneous pumping and purification equipment	342,985	259,468	10 to 50 years
Meters, data processing, transportation and operating equipment	298,015	251,721	5 to 50 years
Land and other non-depreciable assets	67,260	58,223	-
Utility Plant and equipment	2,622,191	2,255,136	
Utility construction work in progress	63,754	92,106	-
Net utility plant acquisition adjustment	(63,347)	(48,054)	0 to 20 years
Non-utility plant and equipment	3,553	3,116	2 to 40 years
Total property, plant and equipment	$ 2,626,151	$ 2,302,304	

Accounts Receivable

	December 31, 2004	December 31, 2003
Billed utility revenue	$ 39,783	$ 41,843
Unbilled utility revenue	27,927	23,876
Other	1,677	2,452
	69,387	68,171
Less allowance for doubtful accounts	4,849	5,851
Net accounts receivable	$ 64,538	$ 62,320

The Company's customers are located principally in the following states: 49% in Pennsylvania, 10% in Ohio, 8% in North Carolina, 8% in Illinois, 6% in Texas, 5% in New Jersey, 4% in Florida, and 4% in Indiana. No single

customer accounted for more than one percent of the Company's operating revenues during the years ended December 31, 2004, 2003 or 2002. The following table summarizes the changes in the Company's allowance for doubtful accounts:

	2004	2003	2002
Balance at January 1,	$ 5,851	$ 3,580	$ 2,482
Amounts charged to expense	2,621	2,643	3,182
Accounts written off	(4,255)	(2,715)	(2,375)
Recoveries of accounts written off	556	253	291
Allowance acquired through acquisitions	76	2,090	-
Balance at December 31,	$ 4,849	$ 5,851	$ 3,580

Regulatory Assets and Liabilities

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

	December 31,	
	2004	2003
Income taxes, asset	$ 68,990	$ 68,917
Income taxes, liability	(3,283)	(3,434)
CTC payment	6,879	8,026
Postretirement benefits	11,403	6,698
Merger costs	2,170	2,700
Water tank painting	4,593	3,240
Utility plant retirement costs, asset	14,729	13,699
Utility plant retirement costs, liability	(8,184)	(7,484)
Rate case filing expenses & other	13,696	6,399
	$ 110,993	$ 98,761

Items giving rise to deferred state income taxes, as well as a portion of deferred Federal income taxes related to certain differences between tax and book depreciation expense, are recognized in the rate setting process on a cash or flow-through basis and will be recovered as they reverse. The regulatory asset associated with the Competitive Transition Charge ("CTC") payment represents the full payoff in 2001, net of amortization, of the allocable share of a CTC as negotiated by Aqua Pennsylvania, Inc. from its electric distribution company, PECO Energy Company. The Pennsylvania Electricity Generation Customer Choice and Competition Act permitted electric distribution utilities to recover their stranded costs from its customers in the form of a CTC. Rate recovery of the $11,465 CTC payment began in 2000 and is expected to conclude in 2010.

Postretirement benefits include pension and other postretirement benefits. The pension costs include deferred net pension expense in excess of amounts funded which the Company believes will be recoverable in future years as pension funding is required, and in addition includes an additional minimum liability for pensions as a result of a decline in the discount rate assumed for pension obligations and a change in the fair market value of plan assets. The additional minimum liability equals the excess of the accumulated benefit obligation over the fair value of plan assets. The regulatory asset related to postretirement benefits other than pensions represents costs that were deferred between the time that the accrual method of accounting for these benefits was adopted in 1993 and the recognition of the accrual method in the Company's rates as prescribed in subsequent rate filings. Amortization of the amount deferred for postretirement benefits other than pensions began in 1994 and is currently being recovered in rates.

The regulatory asset related to the recovery of merger costs represents the portion of the Consumers Water Company merger costs that will be recovered in rates as a result of a rate settlement in 2000 and is being amortized over the recovery period. Expenses associated with water tank painting are deferred and amortized over a period of time as approved in the regulatory process. The regulatory asset for utility plant retirement costs, including cost of removal, represents costs already incurred that are expected to be recovered in future rates over a five year recovery period. The regulatory liability for utility plant retirement costs represents amounts recovered through rates during the life of the associated asset and before the costs are incurred. The regulatory asset related to rate case filing expenses represents the costs associated with filing for rate increases that are deferred and amortized over periods that generally range from one to five years.

Income Taxes

The provision for income taxes consists of:

	Years Ended December 31,		
	2004	2003	2002
Current:			
Federal	$ 2,042	$ 11,933	$ 16,619
State	7,553	7,249	6,647
	9,595	19,182	23,266
Deferred:			
Federal	41,414	25,521	17,921
State	1,115	1,220	859
	42,529	26,741	18,780
Total tax expense	$ 52,124	$ 45,923	$ 42,046

The statutory Federal tax rate is 35% and for states with a corporate net income tax, the state corporate net income tax rates range from 5.00% to 9.99% for all years presented. The Company's Federal income tax returns for all years through 2000 have been closed, and 2002 was closed as a result of the conclusion of a tax audit.

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

	Years Ended December 31,		
	2004	2003	2002
Computed Federal tax expense at statutory rate	$ 46,245	$ 40,852	$ 38,238
Increase in tax expense for depreciation expense to be recovered in future rates	1,376	1,125	558
Merger transaction costs	(24)	(96)	(680)
Charitable contribution	-	(424)	(98)
Deduction for Aqua America common dividends paid under employee benefit plan	(245)	(241)	(207)
Amortization of deferred investment tax credits	(285)	(285)	(283)
Prior year rate reductions	(538)	(431)	(315)
State income taxes, net of federal tax benefit	5,634	5,505	4,879
Other, net	(39)	(82)	(46)
Actual income tax expense	$ 52,124	$ 45,923	$ 42,046

The tax effects of temporary differences between book and tax accounting that give rise to the deferred tax assets and deferred tax liabilities are as follows:

	December 31,	
	2004	2003
Deferred tax assets:		
Customers' advances for construction	$ 17,057	$ 17,133
Costs expensed for book not deducted for tax, principally accrued expenses	1,989	6,525
Utility plant acquisition adjustment basis differences	30,920	21,784
Minimum pension liability adjustment	938	-
Total gross deferred tax assets	50,904	45,442
Deferred tax liabilities:		
Utility plant, principally due to depreciation and differences in the basis of fixed assets due to variation in tax and book accounting	243,953	203,706
Deferred taxes associated with the gross-up of revenues necessary to recover, in rates, the effect of temporary differences	23,670	24,634
Deferred investment tax credit	6,328	6,618
Unrealized gain on marketable securities	-	141
Other	840	738
Total gross deferred tax liabilities	274,791	235,837
Net deferred tax liability	$ 223,887	$ 190,395

On October 22, 2004, the American Jobs Creation Act ("AJCA") was signed into law. Among other provisions, the AJCA creates a new deduction for qualified domestic production activities. Certain activities of the Company, such as our water treatment activity, are considered as qualifying production activities for purposes of determining the deduction for qualified production activities. The AJCA did not impact the Company's 2004 consolidated financial statements. Thus, the Company is currently assessing the impact, if any, of the AJCA on its consolidated financial statements in future periods. See Summary of Significant Accounting Policies – Recent Accounting Pronouncements for a discussion of the AJCA.

Commitments

The Company maintains agreements with other water purveyors for the purchase of water to supplement its water supply, particularly during periods of peak demand. The agreements stipulate purchases of minimum quantities of water to the year 2026. The estimated annual commitments related to such purchases are expected to approximate $10,924 through 2009 and $82,388 thereafter. The Company purchased approximately $8,724, $8,014 and $7,079 of water under these agreements during the years ended December 31, 2004, 2003 and 2002, respectively.

The Company leases motor vehicles, buildings and other equipment under operating leases that are noncancelable. The future annual minimum lease payments due are: $2,452 in 2005, $1,833 in 2006, $1,192 in 2007, $857 in 2008, $488 in 2009 and $692 thereafter. The Company leases parcels of land on which treatment plants and other facilities are situated and adjacent parcels that are used for watershed protection. The operating leases are noncancelable, expire between 2012 and 2052 and contain certain renewal provisions. Certain leases are subject to an adjustment every five years based on changes in the Consumer Price Index. Subject to the aforesaid adjustment, during each of the next five years, approximately $477 of annual lease payments for land are due, and $15,215 thereafter. The Company leases treatment plants to other parties under lease agreements that require payments to the Company of $567 in 2005, $567 in 2006, $267 in 2007, $308 in 2008, $246 in 2009 and $3,676 thereafter.

Rent expense was $3,267, $2,993 and $2,182 for the years ended December 31, 2004, 2003 and 2002, respectively.

Long-term Debt and Loans Payable

The Consolidated Statements of Capitalization provides a summary of long-term debt and loans outstanding as of December 31, 2004 and 2003. The supplemental indentures with respect to certain issues of the First Mortgage Bonds restrict the ability of Aqua Pennsylvania, Inc. and certain other operating subsidiaries of the Company to declare dividends, in cash or property, or repurchase or otherwise acquire the stock of these companies. As of December 31, 2004, approximately $249,000 of Aqua Pennsylvania's retained earnings and $62,000 of the retained earnings of certain other subsidiaries were free of these restrictions. Certain supplemental indentures also prohibit Aqua Pennsylvania and certain other subsidiaries of the Company from making loans to, or purchasing the stock of, the Company.

Annual sinking fund payments are required for certain issues of First Mortgage Bonds by the supplemental indentures. The future sinking fund payments and debt maturities of the Company's long-term debt are as follows:

Interest Rate Range	2005	2006	2007	2008	2009	Thereafter
0.00% to 2.49%	$ 1,267	$ 1,337	$ 1,351	$ 1,364	$ 1,388	$ 13,344
2.50% to 2.99%	1,453	6,495	1,529	1,572	1,619	17,256
3.00% to 3.49%	267	266	12,273	280	290	4,170
3.50% to 3.99%	679	689	700	710	722	3,623
4.00% to 4.99%	-	50	50	50	55	144,230
5.00% to 5.49%	-	-	-	-	-	165,615
5.50% to 5.99%	-	-	-	-	-	89,260
6.00% to 6.49%	-	144	644	10,172	-	100,360
6.50% to 6.99%	10,000	10,000	10,000	-	-	12,000
7.00% to 7.49%	28,500	2,539	2,580	2,625	714	8,147
7.50% to 7.99%	180	194	210	227	245	24,175
8.00% to 8.49%	126	138	152	167	184	25,947
8.50% to 8.99%	-	-	-	-	-	9,000
9.00% to 9.49%	6,568	576	584	594	604	44,318
9.50% to 9.99%	1,155	2,195	995	5,995	995	30,753
10.00% to 10.50%	-	-	-	-	-	6,000
Total	$ 50,195	$ 24,623	$ 31,068	$ 23,756	$ 6,816	$ 698,198

Aqua Pennsylvania had a five-year $300,000 medium-term note program that expired in December 2004 that provided for the issuance of long-term debt with maturities ranging between one and 35 years at fixed rates of interest, as determined at the time of issuance. The bonds issued under this program were secured by the Thirty-Third Supplement to the trust indenture relating to Aqua Pennsylvania's First Mortgage Bonds. In May 2004, Aqua Pennsylvania issued $87,000 of First Mortgage Bonds through the program with a weighted-average interest rate of approximately 5.1% and a weighted-average maturity of 13.7 years. The proceeds from this issuance were used to refinance short-term debt and to fund long-term debt maturities.

In May 2004, an unsecured note of $70,000 was issued by the Company. Interest under this note is based, at the borrower's option, on either a defined base rate or an adjusted London Interbank Offered Rate corresponding to the interest period selected. The proceeds of this financing were used to fund acquisitions and to refinance existing debt. In November 2004, $34,000 of the $70,000 unsecured note was repaid with the proceeds from an equity offering. The remaining balance of the note of $36,000 is classified as loans payable. In connection with the acquisition of Heater Utilities, Inc. in June 2004, the Company assumed $22,360 of long-term debt at interest rates ranging from 7.05% to 8.24% due 2012 to 2025, which includes the purchase accounting fair value adjustment of $3,141, increasing the carrying-value of long-term debt. In November 2004, Aqua Pennsylvania issued $14,000 tax-exempt bonds due 2039 at a rate of 5.05% and secured by a supplement to the trust indenture relating to Aqua Pennsylvania's First Mortgage Bonds. The proceeds from the bonds issued were used to retire previously issued tax-exempt bonds. At various times during 2004, Aqua Pennsylvania and other operating subsidiaries issued other notes payable and first mortgage bonds in aggregate of $31,239 at a weighted-average interest rate of 3.76% due at various times ranging from 2006 to 2037. The proceeds from these issuances were used to reduce a portion of the balance of the short-term debt at each of the respective operating subsidiaries and to redeem $6,000 of first mortgage bonds with a weighted-average interest rate of 9.19%. As of December 31, 2004, the Trustees for eight issues held $17,196 pending completion of the projects financed with the issues and are reported in the consolidated balance sheet as funds restricted for construction activity.

In July 2003, the Company issued $135,000 of unsecured notes due 2023 and with an interest rate of 4.87%. The proceeds of this financing were used to fund the acquisition of the AquaSource operations and to refinance existing debt. In July 2003, the Company also issued a $90,000 unsecured note payable and the proceeds were also used to fund the acquisition of the AquaSource operations. In August 2003, the $90,000 note payable was repaid with the proceeds from an equity offering. At various times during 2003, Aqua Pennsylvania, other operating subsidiaries and the Company issued other notes payable and first mortgage bonds in aggregate of $27,894 at a weighted average interest rate of 4.50% due at various times ranging from 2013 to 2032. The proceeds from these issuances were used to reduce a portion of the balance of the short-term debt at each of the respective operating subsidiaries, to redeem $7,000 of first mortgage bonds of operating subsidiaries with a weighted average interest rate of 6.35% and redeem the Company's preferred stock of $172. In connection with the acquisition of the AquaSource operations in July 2003, the Company assumed $8,131 of long-term debt of which $7,415 was retired during 2003. The weighted average cost of long-term debt at December 31, 2004 and 2003 was 6.00% and 6.19%, respectively.

Aqua Pennsylvania has a $70,000 364-day revolving credit facility with four banks and the Company has a $20,000 364-day bank revolving credit facility. Funds borrowed under these agreements are classified as loans payable and are used to provide working capital. As of December 31, 2004 and 2003, funds borrowed under the Aqua Pennsylvania revolving credit agreements were $29,000 and $52,068, respectively, and $0 and $19,801 were borrowed under the Company's revolving credit agreement, respectively. Interest under these facilities is based, at the borrower's option, on the prime rate, an adjusted federal funds rate, an adjusted London Interbank Offered Rate corresponding to the interest period selected, an adjusted Euro-Rate corresponding to the interest period selected or at rates offered by the banks. These agreements restrict the total amount of short-term borrowings of Aqua Pennsylvania and the Company. A commitment fee ranging from 1/4 to 1/10 of 1% is charged on the unused portion of the revolving credit agreements. The average cost of borrowing under these facilities was 1.4% and 1.6%, and the average borrowing was $50,115 and $62,528, during 2004 and 2003,

respectively. The maximum amount outstanding at the end of any one month was $89,519 in 2004 and $73,079 in 2003.

At December 31, 2004 and 2003, the Company had combined short-term lines of credit of $108,000 and $88,000, respectively. Funds borrowed under these lines are classified as loans payable and are used to provide working capital. As of December 31, 2004 and 2003, funds borrowed under the short-term lines of credit were $9,810 and $24,590, respectively. The average borrowing under the lines was $34,711 and $50,353 during 2004 and 2003, respectively. The maximum amount outstanding at the end of any one month was $51,288 in 2004 and $73,700 in 2003. Interest under the lines is based at the Company's option, depending on the line, on the prime rate, an adjusted Euro-Rate, an adjusted federal funds rate or at rates offered by the banks. The average cost of borrowings under all lines during 2004 and 2003 was 2.3% and 2.4%, respectively.

Interest income of $1,762, $395 and $287 was netted against interest expense on the consolidated statements of income for the years ended December 31, 2004, 2003 and 2002, respectively. The total interest cost was $50,441, $45,057 and $40,683 in 2004, 2003 and 2002, including amounts capitalized of $2,304, $2,127 and $1,389, respectively.

Fair Value of Financial Instruments

The carrying amount of current assets and liabilities that are considered financial instruments approximates their fair value as of the dates presented. The carrying amount and estimated fair value of the Company's long-term debt are as follows:

	December 31,	
	2004	2003
Carrying amount	$ 834,656	$ 736,052
Estimated fair value	863,247	781,502

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. The Company's customers' advances for construction and related tax deposits have a carrying value of $73,095 and $72,500 at December 31, 2004 and 2003, respectively. Their relative fair values cannot be accurately estimated because future refund payments depend on several variables, including new customer connections, customer consumption levels and future rate increases. Portions of these non-interest bearing instruments are payable annually through 2017 and amounts not paid by the contract expiration dates become non-refundable. The fair value of these amounts would, however, be less than their carrying value due to the non-interest bearing feature.

Preferred Stock

At December 31, 2004, the Company had 1,770,819 shares of Series Preferred Stock with a $1.00 par value authorized, of which 100,000 shares are designated as Series A Preferred Stock. During 1996, the Company designated and issued in connection with an acquisition 32,200 shares as Series B Preferred Stock, $1.00 par value. The Series B Preferred Stock was recorded on the consolidated balance sheet at its liquidation value of $100 per share. In December 2003, the remaining shares of Series B Preferred Stock were redeemed as provided under the provisions of the issue through the issuance of debt of $960 with a five-year maturity at an interest rate of 6.05% per annum. The Series A Preferred Stock, as well as the undesignated shares of Series Preferred Stock, remains unissued. As of December 31, 2004, the Company did not have any preferred stock outstanding.

Stockholders' Equity

At December 31, 2004, the Company had 300,000,000 shares of common stock authorized; par value $0.50. Shares outstanding at December 31, 2004, 2003 and 2002 were 95,384,833, 92,589,040 and 84,895,543, respectively. Treasury shares held at December 31, 2004, 2003 and 2002 were 686,747, 681,384 and 2,151,350, respectively.

The Company has a universal shelf registration with the Securities and Exchange Commission to allow for the sale, over time, of up to $250,000 of various debt and equity securities, including common stock. The Company has issued common stock in these transactions under the universal shelf registration:

- In November 2004, the Company issued 1,955,000 shares of common stock in a public offering for proceeds of $42,600, net of expenses. The net proceeds were used to repay a portion of our short-term debt. The indebtedness was incurred by Aqua America in connection with acquisitions.

- In August 2003, the Company issued 5,000,000 shares of common stock in a public offering for proceeds of $90,100, net of expenses. The net proceeds were used to repay an unsecured note of $90,000. The indebtedness was incurred by Aqua America in connection with the acquisition of the operations that were purchased from AquaSource, Inc.

- In May 2003, the Company issued 1,868,750 shares of common stock in a public offering for proceeds of $33,100, net of expenses. The net proceeds were used to repay short-term debt, including the repayment of $22,000 of indebtedness incurred in connection with the Company's repurchase of 1,513,275 shares of common stock from affiliates of Veolia Environnement, S.A. (formerly Vivendi Environnement, S.A.) in October 2002.

The balance remaining available for use under the universal shelf registration as of December 31, 2004 is $77,517. In addition, the Company has a shelf registration statement filed with the Securities and Exchange Commission to permit the offering from time to time of shares of common stock and shares of preferred stock for acquisitions. During 2002, 178,664 shares of common stock totaling $2,745 were issued by the Company to acquire water and wastewater systems. The balance remaining available for use under the acquisition shelf registration as of December 31, 2004 is 2,218,947 shares. The form and terms of such securities shall be determined when and if these securities are issued under these shelf registrations.

In May 2002, Veolia Environnement, S.A. which through its affiliates (collectively "VE") owned approximately 16.8% of our outstanding common stock, advised the Company of their decision to sell its investment in Aqua America, Inc. VE announced that its decision was part of its overall strategy to divest non-core assets and focus on other business strategies. In September 2002, in order to facilitate the orderly re-distribution of the shares held by VE into the market, the Company completed a secondary offering of 12,356,570 shares of Aqua America common stock held by VE. The number of outstanding shares of common stock was not changed and the Company did not receive any proceeds as a result of this secondary offering. In addition, in October 2002 the Company repurchased 1,513,275 shares of Aqua America, Inc. common stock representing the remainder of the shares of Aqua America, Inc. common stock held by VE. The repurchase of shares was funded with proceeds of $22,000 from a short-term credit facility. In May 2003, this $22,000 short-term credit facility was repaid with a portion of the funds from the issuance of 1,868,750 shares of common stock through a shelf registration as described above.

In addition, the Board of Directors has authorized the Company to purchase its common stock, from time to time, in the open market or through privately negotiated transactions. The Company has not repurchased any shares under this authorization since 2000. As of December 31, 2004, 411,209 shares remain available for purchase by the Company.

The Company has a Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") that allows reinvested dividends to be used to purchase shares of common stock at a five percent discount from the current market value. Under the direct stock purchase program, shares are purchased by investors at market price. The shares issued under the Plan are either original issue shares or shares purchased by the Company's transfer agent in the open-market. During 2004, 2003 and 2002, under the dividend reinvestment portion of the Plan, 384,457, 395,605 and 402,084 original issue shares of common stock were sold providing the Company with proceeds of $7,808, $7,000 and $6,407, respectively.

The Company reports comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income." Accordingly, the Company's accumulated other comprehensive income is reported in the Stockholders' Equity section of the Consolidated Balance Sheets, the Consolidated Statements of Stockholders' Equity and the related other comprehensive income is reported in the Consolidated Statements of Income and Comprehensive Income. The Company reports its unrealized gains on securities and minimum pension liability adjustments as other comprehensive income or loss and accumulated other comprehensive income or loss.

Net Income per Common Share and Equity per Common Share

Basic net income per share is based on the weighted average number of common shares outstanding. Diluted net income per share is based on the weighted average number of common shares outstanding and potentially dilutive shares. The dilutive effect of employee stock options is included in the computation of Diluted net income per share. The following table summarizes the shares, in thousands, used in computing Basic and Diluted net income per share:

	Years ended December 31,		
	2004	2003	2002
Average common shares outstanding during the period for Basic computation	93,247	88,275	85,674
Dilutive effect of employee stock options	1,035	969	864
Average common shares outstanding during the period for Diluted computation	94,282	89,244	86,538

For the year ended December 31, 2004, employee stock options outstanding to purchase 569,900 shares of common stock were excluded from the calculation of diluted net income per share as the options' exercise price was greater than the average market price of the Company's common stock. For the years ended December 31, 2003 and 2002, there were no outstanding employee stock options excluded from the calculation of diluted net income per share as the average market price of the Company's common stock was greater than the options' exercise price.

Equity per common share was $7.83 and $7.11 at December 31, 2004 and 2003, respectively. These amounts were computed by dividing common stockholders' equity by the number of shares of common stock outstanding at the end of each year.

Shareholder Rights Plan

The Company has a Shareholder Rights Plan designed to protect the Company's shareholders in the event of an unsolicited unfair offer to acquire the Company. Each outstanding common share is entitled to one Right which is evidenced by the common share certificate. In the event that any person acquires 20% or more of the outstanding common shares or commences a tender or exchange offer which, if consummated, would result in a person or corporation owning at least 20% of the outstanding common shares of the Company, the Rights will begin to trade independently from the common shares and, if certain circumstances occur, including the acquisition by a person of 20% or more of the outstanding common shares, each Right would then entitle its holder to purchase a number of common shares of the Company at a substantial discount. If the Company is involved in a merger or other business combination at any time after the Rights become exercisable, the Rights will entitle the holder to acquire a certain number of shares of common stock of the acquiring company at a substantial discount. The Rights are redeemable by the Company at a redemption price of $.01 per Right at any time before the Rights become exercisable. The Rights will expire on March 1, 2008, unless previously redeemed.

Employee Stock and Incentive Plan

In May 2004, the 2004 Equity Compensation Plan ("the 2004 Plan") was approved by the shareholders to replace the 1994 Equity Compensation Plan ("the 1994 Plan"), the Company may grant qualified and non-qualified stock options to officers, key employees and consultants. 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 ("Board"). The 2004 Plan authorizes 3,675,000 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 150,000. Awards under the 2004 Plan are, and awards under the 1994 plan were, made by a committee of the Board of Directors.

Options under the plans were issued at the market price of the stock on the day of the grant. Options are exercisable in installments of 33% annually, starting one year from the date of the grant and expire 10 years from the date of the grant. The following table summarizes stock option transactions for the plans:

	As of or For the Years Ended December 31,					
	2004		2003		2002	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options:						
Outstanding, beginning of year	2,993,421	$ 13.31	2,830,133	$ 12.06	2,559,763	$ 10.66
Granted	582,650	21.53	613,654	16.98	617,813	16.64
Terminated	(98,286)	16.63	(15,533)	14.78	(8,265)	12.99
Exercised	(427,548)	11.95	(434,833)	10.28	(339,178)	9.82
Outstanding, end of year	3,050,237	$ 14.96	2,993,421	$ 13.31	2,830,133	$ 12.06
Exercisable, end of year	1,911,805	$ 12.43	1,756,300	$ 11.01	1,555,483	$ 9.70

Options exercised during 2004 ranged in price from $4.56 per share to $21.53 per share. At December 31, 2004, 3,678,584 options under the 2004 Plan were still available for grant, 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 1994 Plan may be re-issued under the 2004 Plan. The following table summarizes the price ranges of the options outstanding and options exercisable as of December 31, 2004:

	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Remaining Life (years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Range of prices:					
$ 4.56 - 7.99	342,302	1.4	$ 6.25	342,302	$ 6.25
$ 8.00 - 9.99	245,471	5.3	9.39	245,471	9.39
$10.00 - 12.99	396,510	3.9	11.10	396,510	11.10
$13.00 - 15.99	433,175	6.3	15.28	433,175	15.28
$16.00 - 16.99	941,578	7.9	16.65	454,295	16.65
$17.00 - 21.53	691,201	9.1	20.97	40,052	18.33
	3,050,237	6.5	$ 14.96	1,911,805	$ 12.43

Under SFAS No. 123 "Accounting for Stock-Based Compensation" and SFAS No. 148 "Accounting for Stock-Based Compensation – Transition and Disclosure", the Company currently applies the provisions of APB Opinion No. 25 and provides the pro forma disclosure provisions of this statement. Accordingly, no compensation cost has been recognized in the financial statements for stock options that have been granted. Pursuant to the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, pro forma net income available to common stock and earnings per share are presented in the Summary of Significant Accounting Policies - Stock-Based Compensation as if compensation cost for stock options was determined as of the grant date under the fair value method. In December 2004, the FASB issued SFAS No. 123R, "Share-Base Payment" which will change the Company's accounting for the compensation costs for its stock options granted as described in the Summary of Significant Accounting Policies - Recent Accounting Pronouncements.

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. During 2004, 2003 and 2002, 34,151, 20,156 and 37,031 shares of restricted stock were granted with a restriction period ranging from six to 36 months. The value of restricted stock awards, which are "compensatory", is equal to the fair market value of the stock on the date of the grant and is amortized ratably over the restriction period. The company recorded compensation expense related to restricted stock awards of $439, $369 and $769 during 2004, 2003 and 2002, respectively.

Pension Plans and Other Postretirement Benefits

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

In addition to providing pension benefits, the Company offers certain Postretirement Benefits other than Pensions ("PBOPs") to employees hired before April 1, 2003 and retiring with a minimum level of service. These PBOPs include continuation of medical and prescription drug benefits for eligible retirees and life insurance benefits for certain eligible retirees. The Company funds its gross PBOP cost through various trust accounts. The benefits of retired officers and certain other retirees are paid by the Company and not from plan assets due to limitations imposed by the Internal Revenue Code.

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

Years:	Pension Benefits	Other Postretirenent Benefits
2005	$ 6,453	$ 1,852
2006	6,541	1,950
2007	6,747	2,047
2008	7,129	2,176
2009	7,452	2,310
2010 - 2014	47,220	14,012

In May 2004, the FASB issued FASB Staff Position ("FSP") No. 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." FSP 106-2 supersedes FSP 106-1, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003," which was issued in January 2004 and permitted a sponsor of a postretirement health care plan that provides a prescription drug benefit to make a one-time election to defer accounting for the effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") until more authoritative guidance on the accounting for the federal subsidy was issued. The Company had elected the one-time deferral allowed under FSP 106-1 and as a result adopted FSP 106-2 as required in the third quarter of 2004 and it did not have a material impact on our results of operations or financial position.

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

	Pension Benefits		Other Postretirement Benefits	
	2004	2003	2004	2003
Change in benefit obligation:				
Benefit obligation at January 1,	$ 150,098	$ 131,059	$ 29,134	$ 25,436
Service cost	4,312	3,627	1,112	987
Interest cost	9,512	8,999	1,825	1,703
Plan amendments	567	-	6	-
Actuarial loss	12,742	12,222	1,676	1,978
Plan participants' contributions	-	-	631	513
Benefits paid	(6,155)	(5,809)	(1,580)	(1,483)
Benefit obligation at December 31,	171,076	150,098	32,804	29,134
Change in plan assets:				
Fair value of plan assets at January 1,	108,731	94,438	14,391	12,200
Actual return on plan assets	8,535	20,021	641	816
Employer contributions	4,181	81	2,522	2,345
Benefits paid	(6,155)	(5,809)	(948)	(970)
Fair value of plan assets at December 31,	115,292	108,731	16,606	14,391
Funded status of plan:				
Funded status at December 31,	55,784	41,367	16,198	14,743
Unrecognized actuarial loss	(41,531)	(29,164)	(6,853)	(4,857)
Unrecognized prior service cost	(2,090)	(1,942)	527	590
Unrecognized net transition obligation	1,017	1,227	(6,428)	(7,231)
Net amount recognized	$ 13,180	$ 11,488	$ 3,444	$ 3,245

The Company's pension plans had an accumulated benefit obligation of $136,851 and $121,521 at December 31, 2004 and 2003, respectively. The following table provides the net liability recognized on the Consolidated Balance Sheets at December 31,:

	Pension Benefits		Other Postretirement Benefits	
	2004	2003	2004	2003
Prepaid benefits cost	$ -	$ -	$ 762	$ 937
Accrued benefit cost	(13,180)	(11,488)	(4,206)	(4,182)
Additional minimum liability	(8,928)	(2,003)	-	-
Intangible assets	2,108	1,962	-	-
Regulatory asset	4,140	41	-	-
Accumulated other comprehensive loss	2,680	-	-	-
Net liability recognized	$ (13,180)	$ (11,488)	$ (3,444)	$ (3,245)

At December 31, 2004 and 2003, the Company's pension plans had benefit obligations in excess of its plan assets. The following tables provide the projected benefit obligation, the accumulated benefit obligation and fair market value of the plan assets as of December, 31:

	Projected Benefit Obligation Exceeds the Fair Value of Plan Assets	
	2004	2003
Projected benefit obligation	$ 171,076	$ 150,098
Fair value of plan assets	115,292	108,731

	Accumulated Benefit Obligation Exceeds the Fair Value of Plan Assets	
	2004	2003
Accumulated benefit obligation	$ 136,851	$ 121,521
Fair value of plan assets	115,292	108,731

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

	Pension Benefits			Other Postretirement Benefits		
	2004	2003	2002	2004	2003	2002
Service cost	$ 4,312	$ 3,627	$ 3,205	$ 1,112	$ 987	$ 840
Interest cost	9,512	8,999	8,501	1,825	1,703	1,620
Expected return on plan assets	(9,169)	(7,775)	(9,945)	(1,086)	(917)	(953)
Amortization of transition obligation (asset)	(209)	(209)	(209)	803	803	803
Amortization of prior service cost	419	395	414	(57)	(57)	(57)
Amortization of actuarial (gain) loss	1,009	1,282	(2)	125	62	(5)
Amortization of regulatory asset	-	-	-	144	136	136
Capitalized costs	(1,021)	(205)	(66)	(629)	(598)	(520)
Net periodic benefit cost	$ 4,853	$ 6,114	$ 1,898	$ 2,237	$ 2,119	$ 1,864

Accounting for pensions and other postretirement benefits requires an extensive use of assumptions about the discount rate, expected return on plan assets, the rate of future compensation increases received by the Company's employees, mortality, turnover and medical costs. Each assumption is reviewed annually with assistance from the Company's actuarial consultant who provides guidance in establishing the assumptions. The assumptions are selected to represent the average expected experience over time and may differ in any one year from actual experience due to changes in capital markets and the overall economy. These differences will impact the amount of pension and other postretirement benefit expense that the Company recognizes.

The significant assumptions related to the Company's pension and other postretirement benefit plans are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2004	2003	2004	2003
Weighted-average Assumptions Used to Determine Benefit Obligations as of December 31,				
Discount rate	5.75%	6.25%	5.75%	6.25%
Rate of compensation increase	4.0-5.0%	4.0-5.0%	4.0%	4.0%
Assumed Health Care Cost Trend Rates Used to Determine Benefit Obligations as of December 31,				
Health care cost trend rate	n/a	n/a	10%	10%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	n/a	n/a	5%	5%
Year that the rate reaches the ultimate trend rate	n/a	n/a	2010	2009
Weighted-average Assumptions Used to Determine Net Periodic Benefit Costs for Years Ended December 31,				
Discount rate	6.25%	6.75%	6.25%	6.75%
Expected return on plan assets	8.50%	8.50%	6.0-9.0%	6.0-9.0%
Rate of compensation increase	4.0-5.0%	4.0-5.0%	4.0%	4.0%
Assumed Health Care Cost Trend Rates Used to Determine Net Periodic Benefit Costs for Years Ended December 31,				
Health care cost trend rate	n/a	n/a	10%	10%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	n/a	n/a	5%	5%
Year that the rate reaches the ultimate trend rate	n/a	n/a	2009	2006

n/a – Assumption is not applicable to pension benefits.

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

	1-Percentage-Point Increase	1-Percentage-Point Decrease
Effect on the health-care component of the accrued other postretirement benefit obligation	$ 863	$ (910)
Effect on total service and interest cost components of net periodic postretirement health-care benefit cost	$ 92	$ (102)

The discount rate is based on a market rate for a recognized-rating agency's high-quality long-term bond portfolio with durations matching the expected payouts under our retirement plans. The Company's pension expense and liability (benefit obligations) increases as the discount rate is reduced.

The Company's expected return on assets is determined by evaluating the asset class return expectations with its advisors as well as actual, long-term, historical results of our asset returns. The Company's pension expense increases as the expected return on assets decreases. The Company believes its actual long-term asset allocation on average will approximate the targeted allocation. The Company's investment strategy is to earn a reasonable rate of return while maintaining risk at acceptable levels through the diversification of investments across and within various asset categories. Investment returns are compared to benchmarks that include the S&P 500 Index, the Lehman Brothers Intermediate Government/Credit Index, and a combination of the two indices. The Pension Committee meets semi-annually to review plan investments and management monitors investment performance quarterly through a performance report prepared by an external consulting firm.

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

	2005 Target Allocation	Percentage of Plan Assets at December 31,	
		2004	2003
Asset Category:			
Equity securities	65%	62%	66%
Debt securities	35%	27%	32%
Cash	0%	11%	2%
Total	100%	100%	100%

Equity securities include Aqua America, Inc. common stock in the amounts of $7,373 or 6.4% of total plan assets and $6,469 or 5.9% of total plan assets as of December 31, 2004 and 2003, respectively.

The asset allocation for the Company's other postretirement benefit plans and the target allocation by asset category are as follows:

	2005 Target Allocation	Percentage of Plan Assets at December 31,	
		2004	2003
Asset Category:			
Cash	65%	60%	64%
Equity securities	35%	40%	36%
Total	100%	100%	100%

Minimum funding requirements for qualified defined benefit pension plans are determined by government regulations and not by accounting pronouncements. In accordance with funding rules and the Company's funding policy, during 2005 our pension contribution is expected to be $7,278. The Company's funding of its PBOP cost during 2005 is expected to approximate $2,804.

As of December 31, 2004, the Company has an additional minimum liability of $6,820 associated with our defined benefit plan. The additional minimum liability is a result of the accumulated benefit obligation exceeding the fair value of plan assets. The portion of the additional minimum liability related to our employees in one of our rate jurisdictions results in the establishment of a regulatory asset of $4,140, as the Company expects recovery of the future, increased pension expense through customer rates. Since the balance of the additional minimum liability of $2,680 may not be recovered through rates, the accounting requirements for recording a regulatory asset are not met and as a result this amount is recorded as an other comprehensive loss for 2004 through a charge to accumulated other comprehensive income, net of income tax benefits of $938. The change in the additional minimum liability

from December 31, 2003 to December 31, 2004 resulted from the effect of a decreased discount rate, offset partially by an increase in the pension plan assets during 2004 due to positive equity market performance and pension contributions.

The Company has 401(k) savings plans that cover substantially all employees. The Company makes matching contributions that are invested in Aqua America, Inc. common stock based on a percentage of an employee's contribution, subject to certain limitations. The Company's matching contribution, recorded as compensation expense, was $1,160, $921 and $859 for the years ended December 31, 2004, 2003 and 2002, respectively.

Water and Wastewater Rates

On August 5, 2004, the Pennsylvania Public Utility Commission ("PAPUC") granted Aqua Pennsylvania, Inc. a $13,800 base rate increase. The rates in effect at the time of the filing included $11,200 in Distribution System Improvement Charges ("DSIC") or 5.0% above the prior base rates. Consequently, the total base rates increased by $25,000 and the DSIC was reset to zero. On August 1, 2002, the PAPUC granted Aqua Pennsylvania, Inc. a $21,226 or 10.2% base rate increase. The rates in effect at the time of the filing included $9,400 in DSIC at 5.0%. Consequently, the total base rates increased by $30,626 and the DSIC was reset to zero.

In May 2004, the Company's operating subsidiary 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 annual impact on operating income approximates the requested amount. The application is currently pending before the Commission. The Company commenced billing for the requested rates and implemented the deferral plan in August 2004, in accordance with authorization from the Texas Commission on Environmental Quality in July 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.

The Company's other operating subsidiaries were allowed annual rate increases of $6,673 in 2004, $1,275 in 2003 and $3,024 in 2002, represented by fourteen, eight and thirteen rate decisions, respectively. Revenues from these increases realized in the year of grant were approximately $3,995, $839 and $1,403 in 2004, 2003 and 2002, respectively.

Four states in which the Company operates permit water utilities, and in some states wastewater utilities, to add a surcharge to their water or wastewater bills to offset the additional depreciation and capital costs related to infrastructure system replacement and rehabilitation projects completed and placed into service between base rate filings. Currently, Pennsylvania, Illinois, Ohio and Indiana allow for the use of infrastructure rehabilitation surcharges. These mechanisms typically adjust periodically based on additional qualified capital expenditures completed or anticipated in a future period. The infrastructure rehabilitation surcharge is capped as a percentage of base rates, generally 5% of base rates, and is reset to zero when new base rates that reflect the costs of those additions become effective or when a utility's earnings exceed a regulatory benchmark. Infrastructure rehabilitation surcharges provided revenues in 2004, 2003 and 2002 of $7,817, $8,147 and $5,518, respectively.

Selected Quarterly Financial Data (Unaudited)
(in thousands of dollars, except per share amounts)

Aqua America, Inc. and Subsidiaries

2004	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Operating revenues	$ 99,768	$ 106,524	$ 120,305	$ 115,442	$ 442,039
Operations and maintenance expense	41,831	44,483	46,526	45,505	178,345
Operating income	36,444	40,473	50,997	49,320	177,234
Net income available to common stock	15,575	17,871	24,087	22,474	80,007
Basic net income per common share	0.17	0.19	0.26	0.24	0.86
Diluted net income per common share	0.17	0.19	0.26	0.24	0.85
Dividend paid per common share	0.12	0.12	0.12	0.13	0.49
Dividend declared per common share	0.12	0.12	0.25	-	0.49
Price range of common stock					
- high	22.85	21.96	22.22	24.64	24.64
- low	20.00	18.98	18.90	20.77	18.90

2003					
Operating revenues	$ 80,489	$ 83,379	$ 102,153	$ 101,212	$ 367,233
Operations and maintenance expense	30,664	31,029	36,777	42,132	140,602
Operating income	32,446	35,290	46,302	39,523	153,561
Net income available to common stock	13,324	15,235	23,620	18,606	70,785
Basic net income per common share	0.16	0.18	0.26	0.20	0.80
Diluted net income per common share	0.16	0.18	0.26	0.20	0.79
Dividend paid per common share	0.112	0.112	0.112	0.120	0.456
Dividend declared per common share	0.112	0.112	0.232	-	0.456
Price range of common stock					
- high	17.83	19.85	20.07	22.40	22.40
- low	15.77	17.22	18.28	18.71	15.77

High and low prices of the Company's common stock are as reported on the New York Stock Exchange Composite Tape. The cash dividends paid in December 2004 of $0.13 and December 2003 of $0.12 were declared in August 2004 and August 2003, respectively.

Beginning August 1, 2003, the financial results for the operations acquired in the AquaSource acquisition have been included in the Company's consolidated financial statements.

Summary of Selected Financial Data

Aqua America, Inc. and Subsidiaries

(in thousands of dollars, except per share amounts)

Years ended December 31,	2004	2003 (a)	2002	2001	2000
PER COMMON SHARE:					
Net income					
Basic	$0.86	0.80	0.78	0.71	0.65
Diluted	0.85	0.79	0.78	0.70	0.65
Cash dividends declared and paid	0.49	0.46	0.43	0.40	0.38
Return on average stockholders' equity	11.4%	12.3%	13.9%	13.3%	13.2%
Book value at year end	$7.83	$7.11	$5.80	$5.52	$5.10
Market value at year end	24.59	22.10	16.48	18.04	15.68
INCOME STATEMENT HIGHLIGHTS:					
Operating revenues	$442,039	$367,233	$322,028	$307,280	$274,014
Depreciation and amortization	58,864	51,463	44,322	40,168	34,100
Interest expense, net (b)	46,375	42,535	39,007	38,637	37,775
Income before income taxes	132,131	116,718	109,252	99,087	86,995
Provision for income taxes	52,124	45,923	42,046	38,976	34,105
Net income available to common stock	80,007	70,785	67,154	60,005	52,784
BALANCE SHEET HIGHLIGHTS:					
Total assets	$2,340,248	$2,069,736	$1,717,069	$1,555,108	$1,413,723
Property, plant and equipment, net	2,069,812	1,824,291	1,486,703	1,364,282	1,249,652
Stockholders' equity	748,468	659,030	493,097	472,717	430,587
Long-term debt, including current portion	834,656	736,052	617,175	531,455	472,712
Total debt	919,771	832,511	732,288	641,123	573,706
ADDITIONAL INFORMATION:					
Net cash flows from operating activities	$173,603	$143,373	$121,560	$102,165	$86,972
Capital additions	195,736	163,320	136,164	124,088	129,740
Net cash expended for acquisitions of utility systems	54,300	192,331	8,914	9,517	3,546
Dividends on common stock	45,807	39,917	36,789	34,234	30,406
Number of customers served	835,512	749,491	605,474	587,537	565,146
Number of shareholders of common stock	24,082	22,726	21,389	20,920	20,978
Common shares outstanding (000)	95,385	92,589	84,896	85,483	83,869
Employees (full-time)	1,442	1,260	971	951	943

(a) Beginning August 1, 2003, the financial results for the operations acquired in the AquaSource acquisition have been included in Aqua America's consolidated financial statements.

(b) Includes dividends on preferred stock of subsidiary and minority interest; net of allowance for funds used during construction.

AQUA AMERICA, INC. AND SUBSIDIARIES
INVESTOR RELATIONS INFORMATION

Financial Reports and Investor Relations

Copies of the company's public financial reports, including annual reports and Forms 10–K and 10–Q, are available on line and can be downloaded from the investor relations section of our Web site at www.aquaamerica.com. You may also obtain these reports by writing to us at:

ATTN: Investor Relations
Aqua America, Inc.
762 W. Lancaster Avenue
Bryn Mawr, PA 19010-3489
www.aquaamerica.com

Corporate Governance

We are committed to maintaining high standards of corporate governance and have implemented the corporate governance rules of the Securities and Exchange Commission (SEC) and the New York Stock Exchange. Copies of our key corporate governance documents, including our Corporate Governance Guidelines, Code of Ethical Business Conduct, and the charters of each committee of our Board of Directors can be obtained from the corporate governance portion of the investor relations section of our Web site—www.aquaamerica.com—or requests may be directed to the address above. Amendments to the Code, and any grant of waiver from a provision of the Code requiring disclosure under applicable SEC rules will be disclosed on our Web site. The certifications of the company's chief executive officer and chief financial officer required by the Sarbanes-Oxley Act have been included as Exhibits 31.1 and 31.2 in the company's Form 10-K. In addition, in 2004 the company's chief executive officer provided to the New York Stock Exchange the Annual CEO certification regarding the company's compliance with the New York Stock Exchange's corporate governance listing standards.

Annual Meeting

10:00 A.M. Eastern Daylight Time
Thursday, May 19, 2005
Springfield Country Club
400 West Sproul Road
Springfield, PA 19064

Transfer Agent and Registrar

EquiServe Trust Company, N.A.
P.O. Box 43010
Providence, RI 02940-3010
800-205-8314 or 781-575-3100
www.equiserve.com

Independent Registered Public Accounting Firm

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

Stock Exchanges

The Common Stock of the company is listed on the New York Stock Exchange and the Philadelphia Stock Exchange under the ticker symbol WTR. The daily closing price is printed in *The Wall Street Journal* as AquaAmer. Listings might vary in other major newspapers.

Dividend Reinvestment and Direct Stock Purchase Plan

The company's Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") enables shareholders to reinvest all, or a designated portion of, dividends paid on up to 100,000 shares of Common Stock in additional shares of Common Stock at a five percent discount from a price based on the market value of the stock. In addition, shareholders may purchase additional shares of Aqua America Common Stock at any time with a minimum investment of $50, up to a maximum of $250,000 annually. Individuals may become shareholders by making an initial investment of at least $500. A Plan prospectus may be obtained by calling EquiServe Trust Company at 800-205-8314 or by visiting www.equiserve.com. **Please read the prospectus carefully before you invest.**

IRA, Roth IRA, Education IRA

An IRA, Roth IRA or Education IRA may be opened through the Plan to hold shares of Common Stock of the company and to make contributions to the IRA to purchase shares of Common Stock. Participants in the Plan may roll over an existing IRA or other qualified plan distribution in cash into an IRA under the Plan to purchase the company's Common Stock. Participants may also transfer the company's Common Stock from an existing IRA into an IRA under the Plan. A prospectus, IRA forms and a disclosure statement may be obtained by calling EquiServe Trust Company at 800-472-7428. **Please read the prospectus carefully before you invest.**

Direct Deposit

With direct deposit, Aqua America cash dividends are deposited automatically on the dividend payment date of each quarter. Shareholders will receive confirmation of their deposit in the mail. Shareholders interested in direct deposit should call the Company's transfer agent at 800-205-8314.

Delivery of voting materials to shareholders sharing an address

To reduce the expense of delivering duplicate voting materials to our shareholders who have more than one Aqua America stock account, we are delivering only one annual report and proxy statement to registered shareholders who share an address unless otherwise requested. A separate proxy card is included in the voting materials for each of these shareholders.

How to obtain a separate set of voting materials

If you are a registered shareholder who shares an address with another registered shareholder and have received only one set of voting materials for the 2005 annual meeting, you may write or call us to request a separate copy of this material at no cost to you at 610-645-1196 or Attn: Investor Relations, Aqua America, Inc., 762 W. Lancaster Avenue, Bryn Mawr, PA, 19010. For future annual meetings, you may request separate voting material by calling the Company's transfer agent at 800-205-8314.

Account Access

Aqua America shareholders may access their account by visiting www.equiserve.com. Shareholders may view their account, purchase additional shares, and make changes to their account. To learn more, visit www.equiserve.com or call 800-205-8314.

Dividends

Aqua America has paid dividends since 1946. The normal Common Stock dividend dates for 2005 and the first six months of 2006 are:

Declaration Date	Ex-Dividend Date	Record Date	Payment Date
January 28, 2005	February 10, 2005	February 14, 2005	March 1, 2005
May 5, 2005	May 16, 2005	May 18, 2005	June 1, 2005
August 5, 2005	August 16, 2005	August 18, 2005	September 1, 2005
November 4, 2005	November 15, 2005	November 17, 2005	December 1, 2005
February 2, 2006	February 13, 2006	February 15, 2006	March 1, 2006
May 5, 2006	May 16, 2006	May 18, 2006	June 1, 2006

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

Only the Board of Directors may declare dividends and set record dates. Therefore, the payment of dividends and these dates may change at the discretion of the Board. Announcement of the dividend declaration is usually published in *The Wall Street Journal* and several other newspapers.

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

Lost Dividend Checks and Stock Certificates

Dividend checks lost by shareholders, or those that might be lost in the mail, will be replaced upon notification of the lost or missing check. All inquiries concerning lost or missing dividend checks should be made to the Company's transfer agent at 800-205-8314. Shareholders should call or write the Company's transfer agent to report a lost certificate. Appropriate documentation will be prepared and sent to the shareholder with instructions.

Safekeeping of Stock Certificates

Under the Direct Stock Purchase Plan, shareholders may have their stock certificates deposited with the transfer agent for safekeeping free of charge. Stock certificates and written instructions should be forwarded to: EquiServe Trust Company, N.A., P.O. Box 43010, Providence, RI 02940-3010.

AQUA America

Board of Directors

Nicholas DeBenedictis, 59
Chairman, President and CEO
Aqua America, Inc.
Director since 1992

Mary C. Carroll, 64
Consultant and
Community Volunteer
Director since 1981

G. Fred DiBona, Jr., 54
President and CEO
Independence Blue Cross
Director since 1993

Richard Glanton, 58
Senior Vice President
Exelon Corporation
Director since 1995

William P. Hankowsky, 53
Chairman, President and CEO
Liberty Property Trust
Director since 2004

John F. McCaughan, 69
Chairman (Retired)
Betz Laboratories, Inc.
Director since 1984

John E. Menario, 69
Assistant to the President (Retired)
Banknorth Group, Inc.
Director since 1999

Richard L. Smoot, 64
Regional Chairman,
Advisory Board (Retired)
PNC Financial Services Group
Philadelphia and
Southern New Jersey
Director since 1997

Officers

Nicholas DeBenedictis, 59
Chairman, President and CEO

Richard D. Hugus, 55
Regional President
Aqua America – South

Karl M. Kyriss, 54
President
Aqua Pennsylvania, Inc.

Robert G. Liptak, 57
Regional President
Aqua America – North

Richard R. Riegler, 58
Senior Vice President
Engineering and
Environmental Affairs

David P. Smeltzer, 46
Senior Vice President
Finance and CFO

Roy H. Stahl, Esq., 52
Executive Vice President,
General Counsel
and Corporate Secretary

In Memoriam

Aqua America honors the life and legacy of its friend and long-time board member,

G. Fred DiBona, Jr.

We thank him for helping us grow into the nation's largest publicly-traded water utility.

AQUA America

AQUA America

762 West Lancaster Avenue
Bryn Mawr, PA 19010-3489
T: 610.525.1400 • F: 610.645.1061

www.aquaamerica.com

Annual Report 4959-AR-05