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

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.

(In thousands of dollars, except per share amounts)

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.

(In thousands of dollars, except per share amounts)

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.

(In thousands of dollars, except per share amounts)

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.

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.

Notes to Consolidated Financial Statements
(In thousands of dollars, except per share amounts)

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.

(In thousands of dollars, except per share amounts)

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

(In thousands of dollars, except per share amounts)

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.