

Notes -
Documents Incorporated by Reference

- (1) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 1992.
- (2) Indenture of Mortgage dated as of January 1, 1941 with supplements thereto through the Twentieth Supplemental Indenture dated as of August 1, 1983 were filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 1983.
- (3) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 1988.
- (4) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 1989.
- (5) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 1991.
- (6) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 1993.
- (7) Filed as an Exhibit to Quarterly Report on Form 10-Q for the quarter ended March 31, 1995.
- (8) Filed as an Exhibit to Quarterly Report on Form 10-Q for the quarter ended September 30, 1995.
- (9) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 1996.
- (10) Filed as an Exhibit to Quarterly Report on Form 10-Q for the quarter ended June 30, 1997.
- (11) Filed as an Exhibit to Form 8-K filed August 7, 1997.
- (12) Filed as an Exhibit to Quarterly Report on Form 10-Q for the quarter ended September 30, 1999.
- (13) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 1999.
- (14) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 2000.
- (15) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 2001.
- (16) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 2005.
- (17) Filed as an Exhibit to Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.
- (18) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 2002.
- (19) Filed as an Exhibit to Quarterly Report on Form 10-Q for the quarter ended September 30, 2003
- (20) Filed as an Exhibit to Form 8-K filed December 9, 2004.
- (21) Filed as an Exhibit to Quarterly Report on Form 10-Q for the quarter ended June 30, 2004.
- (22) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 2003.
- (23) Filed as Appendix C to definitive Proxy Statement dated April 2, 2004.
- (24) Filed as an Exhibit to Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.
- (25) Filed as an Exhibit to Annual Report on Form 10-K for the year ended December 31, 2004.
- (26) Filed as an Exhibit to Form 8-K filed December 12, 2005.
- (27) Filed as an Exhibit to Form 8-K filed March 7, 2005.
- (28) Filed as an Exhibit to Form 8-K filed March 13, 2006.
- (29) Filed as a Registration Statement on Form S-3 on February 18, 2005.

*Indicates management contract or compensatory plan or arrangement.

EIGHTH AMENDMENT TO CREDIT AGREEMENT

THIS EIGHTH AMENDMENT TO CREDIT AGREEMENT is made as of this 1st day of December, 2006, by and among AQUA PENNSYLVANIA, INC., a Pennsylvania corporation (formerly known as Pennsylvania Suburban Water Company, successor by merger to Philadelphia Suburban Water Company) ("Borrower"), the several banks which are parties to this Agreement (each a "Bank" and collectively, "Banks") and PNC BANK, NATIONAL ASSOCIATION in its capacity as agent for Banks (in such capacity, "Agent").

BACKGROUND

A. Borrower, Agent and Banks are parties to a Credit Agreement, dated as of December 22, 1999, as amended by a First Amendment to Credit Agreement dated as of November 28, 2000, a Second Amendment to Credit Agreement dated as of December 18, 2001, a Third Amendment to Credit Agreement dated as of December 16, 2002, a Fourth Amendment dated as of December 24, 2002, a Fifth Amendment to Credit Agreement dated as of December 14, 2003, a Sixth Amendment to Credit Agreement dated as of December 12, 2004 and a Seventh Amendment to Credit Agreement dated as of December 6, 2005 (as so amended, the "Credit Agreement"), pursuant to which Banks agreed to make revolving credit loans to Borrower in an aggregate outstanding amount of up to \$70,000,000 (the "Loans"). The Loans are evidenced by Borrower's Revolving Credit Notes in the aggregate principal face amount of \$70,000,000.

B. Borrower, Agent and Banks desire to extend the Termination Date of the facility, all on the terms and subject to the conditions herein set forth.

NOW THEREFORE, the parties hereto, intending to be legally bound hereby, agree as follows:

AGREEMENT

1. Terms. Capitalized terms used herein and not otherwise defined herein shall have the meanings given to such terms in the Credit Agreement.

2. Amendments to Credit Agreement. Effective on December 8, 2006 (the "Effective Date") the Credit Agreement is hereby amended as follows:

(a) The definition of Termination Date in Section 1.1 is hereby amended and restated to read in full as follows:

“ “Termination Date”: the earlier of (a) December 6, 2007 or any later date to which the Termination Date shall have been extended pursuant to subsection 2.8(d) hereof and (b) the date the Commitments are terminated as provided herein.”

3. Loan Documents . Except where the context clearly requires otherwise, all references to the Credit Agreement in any of the Loan Documents or any other document delivered to Banks or Agent in connection therewith shall be to the Credit Agreement as amended by this Agreement.

4. Borrower's Ratification . Borrower agrees that it has no defenses or set-offs against Banks or Agent or their respective officers, directors, employees, agents or attorneys, with respect to the Loan Documents, all of which are in full force and effect, and that all of the terms and conditions of the Loan Documents not inconsistent herewith shall remain in full force and effect unless and until modified or amended in writing in accordance with their terms. Borrower hereby ratifies and confirms its obligations under the Loan Documents as amended hereby and agrees that the execution and delivery of this Agreement does not in any way diminish or invalidate any of its obligations thereunder.

5. Representations and Warranties . Borrower hereby represents and warrants to Agent and Banks that:

(a) Except as otherwise previously disclosed to Agent and Banks, the representations and warranties made in the Credit Agreement, as amended by this Agreement, are true and correct as of the date hereof;

(b) No Default or Event of Default under the Credit Agreement exists on the date hereof; and

(c) This Agreement has been duly authorized, executed and delivered so as to constitute the legal, valid and binding obligations of Borrower, enforceable in accordance with its terms.

All of the above representations and warranties shall survive the making of this Agreement.

6. Conditions Precedent . The effectiveness of the amendments set forth herein is subject to the fulfillment, to the satisfaction of Agent and its counsel, of the following conditions precedent on or before the Effective Date:

(a) Borrower shall have delivered to Agent, with copies or counterparts for each Bank as appropriate, the following, all of which shall be in form and substance satisfactory to Agent and shall be duly completed and executed:

(i) This Agreement;

(ii) Copies, certified by the Secretary or an Assistant Secretary of Borrower as of a recent date, of resolutions of the board of directors of Borrower in effect on the date hereof authorizing the execution, delivery and performance of this Agreement and the other documents and transactions contemplated hereby;

- (iii) Copies, certified by its corporate secretary as of a recent date, of the articles of incorporation, certificate of formation, and by-laws of Borrower as in effect, or a certificate stating that there have been no changes to any such documents since the most recent date, true and correct copies thereof were delivered to Agent; and
- (iv) Such additional documents, certificates and information as Agent or Banks may require pursuant to the terms hereof or otherwise reasonably request.

(b) The representations and warranties set forth in the Credit Agreement shall be true and correct on and as of the date hereof.

(c) No Default or Event of Default shall have occurred and be continuing as of the date hereof.

(d) Borrower shall have paid to Agent for the benefit of Banks an extension fee of \$84,000 to be distributed pro rata to Banks.

7. Miscellaneous.

(a) All terms, conditions, provisions and covenants in the Loan Documents and all other documents delivered to Agent and Banks in connection therewith shall remain unaltered and in full force and effect except as modified or amended hereby. To the extent that any term or provision of this Agreement is or may be deemed expressly inconsistent with any term or provision in any Loan Document or any other document executed in connection therewith, the terms and provisions hereof shall control.

(b) The execution, delivery and effectiveness of this Agreement shall neither operate as a waiver of any right, power or remedy of Agent or Banks under any of the Loan Documents nor constitute a waiver of any Default or Event of Default or default thereunder.

(c) In consideration of Agent's and Banks' agreement to amend the existing credit facility, Borrower hereby waives and releases Agent and Banks and their respective officers, attorneys, agents and employees from any liability, suit, damage, claim, loss or expense of any kind or failure whatsoever and howsoever arising that it ever had up until, or has as of, the date of this Agreement.

(d) This Agreement constitutes the entire agreement of the parties with respect to the subject matter hereof and supersedes all prior and contemporaneous understandings and agreements.

(e) In the event any provisions of this Agreement shall be held invalid or unenforceable by any court of competent jurisdiction, such holding shall not invalidate or render unenforceable any other provision hereof.

(f) This Agreement shall be governed by and construed according to the laws of the Commonwealth of Pennsylvania.

(g) This Agreement shall inure to the benefit of, and be binding upon, the parties hereto and their respective successors and assigns and may be executed in one or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

(h) The headings used in this Agreement are for convenience of reference only, do not form a part of this Agreement and shall not affect in any way the meaning or interpretation of this Agreement.

IN WITNESS WHEREOF, Borrower, Agent and Banks have caused this Agreement to be executed by their duly authorized officers as of the date first above written.

AQUA PENNSYLVANIA, INC.

By: Kathy L. Pape
Title: Vice President and Treasurer

PNC BANK, NATIONAL ASSOCIATION, as a Bank and as Agent

By: Forrest B. Patterson, Jr.
Title: Senior Vice President

CITIZENS BANK OF PENNSYLVANIA

By: Leslie Broderick
Title: Senior Vice President

BANK OF AMERICA, N.A. (formerly Fleet National Bank)

By: Katherine Osele
Title: Assistant Vice President

NATIONAL CITY BANK

By: David Dobstaff
Title: Senior Vice President

AQUA AMERICA, INC.
and SUBSIDIARIES
2007 ANNUAL CASH INCENTIVE COMPENSATION PLAN

BACKGROUND

In 1989, the Company and its compensation consultant conducted a feasibility study to determine whether the Company should implement an incentive compensation plan. The study was prompted by the positive experience of other investor-owned water companies with incentive compensation.

The study included interviews with executives and an analysis of competitive compensation levels. Based on the results, the compensation consultant recommended that the Company's objectives and competitive practice supported the adoption of an annual incentive plan (the "Plan"). The Company has had a cash incentive compensation plan in place since 1990 and management and the Board of Directors believe it has had a positive effect on the Company's operations, aiding employees, shareholders (higher earnings) and customers (better service and controlling expenses).

The Plan has two components — a Management Incentive Program and an Employee Recognition ("Chairman's Award") Program.

The Plan is designed to provide an appropriate incentive to the officers, managers and certain other key employees of the Company. The 2007 Management Incentive Program will cover officers, managers and certain key employees of Aqua America, Inc., and its subsidiaries.

All incentive awards under the Plan shall be paid by March 15 of the calendar year following the calendar year in which such awards are earned, or as soon as administratively practicable thereafter.

MANAGEMENT INCENTIVE PROGRAM**Performance Measures**

- Annual incentive bonus awards are calculated by multiplying an individual's Target Bonus by a Company Factor based on the applicable company's performance and an Individual Factor based on the individual employee's performance.
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The approach of having a plan tied to the applicable company's income performance is appropriate as the participants' assume some of the same risks and rewards as the shareholders who are investing in the company and making its capital construction and acquisition programs possible. Customers also benefit from the participants' individual objectives being met, as improvements in performance are accomplished by controlling costs, improving efficiencies and enhancing customer service. For these reasons, future rate relief should be lessened and less frequent, which directly benefits all customers.

- The applicable company's actual after-tax net income from continuing operations or earnings before interest, taxes and depreciation ("EBITD") relative to its annual budget will be the primary measure for the company's performance. The measurement to be used as the Company Factor (financial factor, thresholds and weighting by applicable business unit) for each participant will be established by the Chairman of the Company and, for the senior executives of the Company, approved individually by the Executive Compensation and Employee Benefits Committee. Each year a "Target Net Income or EBITD" level will be established. Portions of the Company Rating Factor may be tied to the financial targets of more than one company for some participants whose responsibilities involve more than one company. For purposes of the Plan, the Target Net Income or EBITD may differ from the budgeted net income or EBITD level. For 2007, the Target Net Income or EBITD will exclude the impact of any unbudgeted extraordinary gains or losses as a result of changes in accounting principles.
 - Based on a review of historic performance, the minimum or threshold level of performance is set at 90 percent of the Target Net Income or EBITD. That is, no bonus awards will be made if actual net income is less than 90 percent of the Target Net Income or EBITD for the year. No additional bonus will be earned for results exceeding 110 percent of the Target Net Income or EBITD.
 - Each individual's performance and achievement of his or her objectives will also be evaluated and factored into the bonus calculation (the "Individual Factor"). Performance objectives for each participant are established each year and are primarily directed toward customer growth, improving customer service, controlling costs and improving efficiencies and productivity. Each objective has specific performance measures that are used to determine the level of achievement for each objective. A participant's target Individual Factor should be no more than 90 points, with the possibility of additional points up to 110 points being awarded for measurable performance above the participant's targeted performance level. Participants must achieve at least 70 points for their Individual Factor to be eligible for a bonus award under the Plan.
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Participation

- Eligible participants consist of officers, managers and certain key employees.
 - Participation in the Management Incentive Program will be determined each year. Each participant will be assigned a "Target Bonus Percentage" ranging from 5 to 70 percent depending on duties and responsibilities. The Executive Compensation and Employee Benefits Committee will approve the Target Bonus Percentage for the CEO and the senior executives designated by the Committee each year.
 - The Target Bonus Percentage for each participant will be applied to their base salary.
 - Actual bonuses may range from 0, if the company's financial results falls below the minimum threshold or the participant does not make sufficient progress toward achieving his or her objectives (i.e. performance measure points totaling less than 70 points), to 187.5 percent if performance — both Company and individual — is rated at the maximum.
 - New employees who are hired into a position that is eligible to participate in the Management Incentive Plan, will normally be eligible to receive a portion of the bonus calculated in accordance with this Plan that is pro-rated based on the number of full calendar months between the new employee's hire date and the end of the calendar year.
 - Employees who would otherwise be eligible to participate in this Management Incentive Plan, but who leave employment with the company, either voluntarily, involuntarily or as a result of retirement, prior to the end of the Company's fiscal year will not receive a bonus for the year in which their employment terminates. If an employee who would otherwise be eligible to participate in this Management Incentive Plan dies, the company will pay the deceased employee's estate a portion of the bonus the deceased employee would otherwise have been entitled to assuming a 100% Individual Factor, but pro-rated for the number of full calendar months the employee completed before his or her death.
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Company Factor

- Company performance will be measured on the following schedule:

	Percent of Target	Company Factor
Threshold	<90%	0%
	90	50
	92	65
	95	80
	96	85
	97	90
	98	94
	99	97
Plan	100	100
	105	110
	>110	125

- The actual Company Factor should be calculated by interpolation between the points shown in the table above.
- Regardless of the Company rating resulting from this Schedule, the Executive Compensation and Employee Benefits Committee retains the authority to determine the final Company Factor for purposes of this Plan.

Individual Factor

- Individual performance will be measured on the following scale:

Performance Measure Points	Individual Factor
0 - 69	0%
70	70%
80	80%
90	90%
100	100%
110	110%

- In addition, up to 40 additional points and additional percentage points may be awarded to a participant at the discretion of the Chief Executive Officer for exemplary performance. Individual performance points for the Chief Executive Officer are determined by the Executive Compensation and Employee Benefits Committee.
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Sample Calculations

• Example 1

Salary or	\$70,000
Target Bonus	10 percent (\$7,000)
Company Factor	100 percent
Individual Factor	90 percent

Calculation:

$$\begin{array}{rcccccc} \text{Target Bonus} & \times & \text{Individual} & \times & \text{Company} & = & \text{Individual} \\ & & \text{Factor} & & \text{Factor} & & \text{Bonus Earned} \\ \$7,000 & \times & 100\% & \times & 90\% & = & \underline{\underline{\$6,300}} \end{array}$$

• Example 2

- Using the same salary and target bonus, but assuming Company performance was less than 90 percent of Target EBITD, there would be no bonus earned.

Calculation:

$$\$7,000 \times 0 \times 90\% = 0$$

• Example 3

- Similarly, if the Individual Factor is rated below 70 points, no bonus would be earned regardless of the Company Factor.

Calculation:

$$\$7,000 \times 100\% \times 0 = 0$$

- Example 4

- If the Company Factor is allocated between two companies, the bonus will be calculated separately based on the allocation.

Calculation:

<u>Target Bonus</u>	x	<u>Company Factor</u>	x	<u>Company Allocation</u>	x	<u>Individual Factor</u>	=	Bonus Earned
\$7,000	x	100%	x	20%	x	90%	=	\$ 1,260
\$7,000	x	110%	x	80%	x	90%	=	<u>\$5,544</u>
Total Bonus							=	\$6,804

- Example 5

- It is also possible that one portion of the applicable Company Rating Factor is zero, for which there would be no bonus, regardless of the participant's Individual Rating Factor.

Calculation:

<u>Target Bonus</u>	x	<u>Company Factory</u>	x	<u>Company Allocation</u>	x	<u>Individual Factor</u>	=	Bonus Earned
\$7,000	x	0%	x	20%	x	90%	=	\$ 0
\$7,000	x	110%	x	80%	x	90%	=	<u>\$5,544</u>
Total Bonus							=	\$ 5,544

EMPLOYEE RECOGNITION ("CHAIRMAN'S AWARD") PROGRAM

1. In addition to the Management Incentive Program, the Company maintains an Employee Recognition Program known as the Chairman's Award program to reward non-union employees who are not eligible for the management bonus plan for superior performance that contains costs, improves efficiency and productivity of the workforce and better serves our customers. Awards may also be made for a special action or heroic deed, or for a project that positively impacts the performance or image of the Company.
2. Awards will be made from an annual pool designated by the Chairman of Aqua America with the approval of the Executive Compensation and Employee Benefits Committee. Unused funds will not be carried over to the next year. If financial performance warrants, management may request special awards under the program.
3. In general, Chairman's Awards will not be made to employees of a company that does not achieve at least 90% of its EBITD objective for the year.
4. Awards may be made throughout the year, however, no more than one-third of a company's Chairman's Award pool may be awarded until the company's final EBITD for the year is determined.
5. Nominations for employees to receive Chairman's Awards will be made to the applicable officer and should include documentation on the reasons for the recommendations. The applicable officer will review the nominations and forward their recommendations to the Chairman of Aqua America.
6. The Chairman will determine the individuals to actually receive a bonus and the amount. The maximum award to any one employee is \$5,000.
7. Employees who would otherwise be eligible to participate in the Chairman's Award program, but who leave employment with the company, either voluntarily, involuntarily or as a result of retirement, prior to the end of the Company's fiscal year will not receive a Chairman's Award for the year in which their employment terminates.

AQUA AMERICA, INC
2004 EQUITY COMPENSATION PLAN
(as amended February 22, 2007)

1. Purpose

The purpose of this plan (the "Plan") is to provide an incentive, in the form of a proprietary interest in Aqua America, Inc. (the "Corporation"), to officers, other key employees and Non-employee Directors, as defined below, of the Corporation and its subsidiaries and key consultants who are in a position to contribute materially to the successful operation of the business of the Corporation, to increase their interest in the Corporation's welfare, and to provide a means through which the Corporation can attract and retain officers, other key employees and Non-employee Directors and key consultants of significant abilities. The Plan is a successor plan to the Corporation's existing Amended and Restated 1994 Equity Compensation Plan (the "1994 Plan.")

2. Administration

This Plan shall be administered by a Committee (the "Committee") of the Board of Directors of the Corporation. Each of the members of the Committee may be an "outside director" as defined under section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), and related Treasury regulations and each of whom shall also be a "non-employee director" as defined under Rule 16b-3 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). However, the Board of Directors may ratify or approve any grants made by the Committee if the Committee deems it appropriate in a particular circumstance.

From time to time the Committee may make grants, subject to the terms of the Plan, with respect to such number of shares of Common Stock of the Corporation as the Committee, acting in its sole discretion, may determine. All references to the Committee hereunder shall also mean the Board of Directors to the extent that the Board of Directors is acting pursuant to its authority to ratify or approve grants under the Plan. Non-employee Directors, as defined below, may only receive stock grants pursuant to the provisions of Section 7(f).

Subject to the provisions of the Plan, the Committee shall be authorized to interpret the Plan and the grants made under the Plan, to establish, amend and rescind any rules and regulations relating to the Plan, to determine the terms and provisions of the agreement related to grants described in Section 9 hereof, and to make all other determinations, including factual determinations, necessary or advisable for the administration of the Plan. The Committee may correct any defect, supply any omission and reconcile any inconsistency in the Plan or in any option or grant in the manner and to the extent it shall be deemed desirable to carry it into effect. The determinations of the Committee in the administration of the Plan, as described herein, shall be final and conclusive. The Committee may adopt such rules and regulations as it deems necessary for governing its affairs. All powers of the Committee shall be executed in its sole discretion, in the best interest of the Corporation, not as a fiduciary, and in keeping with the objectives of the Plan and need not be uniform as to similarly situated individuals. An Agreement, as defined below, shall be executed by each grantee and shall constitute that grantee's acknowledgement and acceptance of the terms of the Plan and the Committee's authority and discretion.

3. Grants

Pursuant to the terms of the Plan, the Committee shall have the authority to grant stock options to officers and other key employees and key consultants and restricted stock and dividend equivalents to officers and other key employees; provided, however, that Non-employee Directors, as defined below, may receive stock grants in accordance with Section 7(f) (hereinafter collectively referred to as the "Grants"). All Grants shall be subject to the terms and conditions set forth herein and to those other terms and conditions consistent with this Plan as the Committee deems appropriate and as are specified in writing by the Corporation in the agreement described in Section 9 of the Plan (the "Agreement"). Grants under a particular Section of the Plan need not be uniform as among the grantees and Grants under two or more Sections of the Plan may be combined in one instrument.

4. Shares Subject to the Plan

Subject to adjustment as provided in Section 15, the maximum aggregate number of shares of the Common Stock of the Corporation that may be issued or transferred under the Plan shall be 3,675,000 shares; provided, however, that no more than 50% of these shares shall be available for issuance as restricted stock. The maximum number of shares of Common Stock that may be subject to Grants made under the Plan to any individual during any calendar year shall be 150,000 shares, subject to adjustment as provided in Section 15. Shares deliverable under the Plan may be authorized and unissued shares or treasury shares, as the Committee may from time to time determine. Shares of Common Stock related to the unexercised or undistributed portion of any terminated, expired or forfeited Grant also may be made available for distribution in connection with future Grants under the Plan. Additionally, if and to the extent options granted under the 1994 Plan terminate or expire without being exercised, or if any shares of restricted stock are forfeited, or shares of Common Stock otherwise issuable under the 1994 Plan are withheld by the Corporation in satisfaction of withholding taxes incurred in connection with the exercise of a stock option or vesting of a restricted stock award, the shares subject to such awards may be made available for distribution in connection with future Grants under the Plan.

5. Eligibility

Only officers, key employees, members of the Board of Directors who are not employed in any capacity by the Corporation (hereinafter referred to as "Non-employee Directors") and key consultants of the Corporation and its subsidiaries shall be eligible for Grants under the Plan; provided, however, that Grants to Non-employee Directors shall be made only in accordance with Section 7(f). The term "subsidiaries" shall mean any corporation in an unbroken chain of corporations beginning with the Corporation, if at the time of the Grant, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

6. Granting of Options

The Committee may, from time to time, grant stock options to eligible officers and other key employees and shall designate options at the time of grant as either "incentive stock options" intended to qualify as such under section 422 of the Internal Revenue Code of 1986, as from time to time amended or any successor statute of similar purpose (the "Code"), or "nonqualified stock options", which options are not intended to so qualify. The Committee may, from time to time, grant nonqualified stock options to key consultants. Except as hereinafter provided, options granted pursuant to the Plan shall be subject to the following terms and conditions:

- (a) *Price.* The purchase price per share of stock deliverable upon the issuance of shares pursuant to the exercise of each option shall be not less than 100% of the fair market value of the Corporation's Common Stock on the date the option is granted. The fair market value shall be the mean of the closing price of the Corporation's Common Stock on the New York Stock Exchange — Composite Transactions or other recognized market source, as determined by the Committee, on the date the option is granted, or if there is no sale on such date, then the closing price on the last previous day on which a sale is reported. In any event, in case of the grant of an incentive stock option, the fair market value shall be determined in a manner consistent with section 422 of the Code.

Shares may be purchased only by delivering a notice of exercise to the Corporation with payment of the purchase price therefore to be paid in full prior to the issuance of the shares. Such notice may instruct the Corporation to deliver shares of Common Stock due upon the exercise of the option to any registered broker or dealer in lieu of delivery to the grantee. Such instructions must designate the account into which the shares are to be deposited. The grantee may tender this notice of exercise, which has been properly executed by the grantee, and the aforementioned delivery instructions to any broker or dealer. With the consent of the Committee, payment of the purchase price may be made, in whole or in part, through the surrender of shares of the Common Stock of the Corporation (including without limitation shares of Common Stock acquired pursuant to the option then being exercised) at the fair market value of such shares determined as of the last trading day prior to the date on which the option is exercised, in the same manner set forth in the above paragraph.

- (b) *Terms of Options.* The term during which each incentive stock option may be exercised shall be determined by the Committee, but in no event shall an incentive stock option be exercisable in whole or in part more than 10 years from the date it is granted and in no event shall a nonqualified stock option be exercisable in whole or in part more than 10 years and one day from the date it is granted. All rights to purchase pursuant to an option shall, unless sooner terminated, expire at the date designated by the Committee.

The Committee shall determine the date on which each option shall become exercisable and may provide that an option shall become exercisable in installments. The shares comprising each installment may be purchased in whole or in part at any time after such installment becomes exercisable. The Committee may, in its sole discretion, accelerate the time at which any option may be exercised in whole or in part. Notwithstanding any determinations by the Committee regarding the exercise period of any option, all outstanding options shall become immediately exercisable upon a Change of Control of the Corporation (as defined herein).

- (c) *Termination of Employment.* Upon the termination of a grantee's regular full-time employment for any reason (except as a result of retirement, disability or death), the options held by such grantee shall terminate. Notwithstanding the fact that, in all cases, a grantee's employment shall be deemed to have terminated upon the sale of a "subsidiary" of the Corporation (an entity in which the Corporation has at least a 50% ownership of the entity's total voting power) that employs such grantee, the Committee, in its sole discretion, may extend the period during which any option held by such a grantee may be exercised after such sale to the earliest of (i) a date which is not more than three years from the date of the sale of the subsidiary, (ii) the date of the grantee's termination of employment as a regular full-time employee with the subsidiary (or successor employer) following such sale for reasons other than retirement, disability or death, (iii) the date which is one year from the date of the grantee's termination of employment with the subsidiary on account of the grantee's total disability (as defined in section 22(e)(3) of the Code), or three months from the date of such termination if on account of death, retirement or a disability other than a total disability, or (iv) the expiration of the original term of the option as established at the time of grant. The Committee, in its sole discretion, may similarly extend the period of exercise of any option held by a grantee employed by the Corporation or a subsidiary, whose employment with the Corporation or subsidiary is terminated in connection with the sale of a subsidiary of the Corporation. To the extent that any option is not otherwise exercisable as of the date on which the grantee ceases to be employed as a regular full-time employee by the subsidiary or the Corporation, as applicable, such unexercisable portion of the option shall terminate as of such date.

Upon termination of a grantee's employment as a result of retirement, disability or death, the period during which the options may be exercised shall not exceed: (i) one year from the date of such termination of employment in the case of death; (ii) two years from the date of such termination in the case of permanent and total disability (within the meaning of section 22(e)(3) of the Code) or retirement; and (iii) three months from the date of such termination of employment in the case of other disability; provided, however, that in no event shall the period extend beyond the expiration of the option term. To the extent that any option is not otherwise exercisable as of the date on which the grantee ceases to be employed by the Corporation or any subsidiary, as applicable, such unexercisable portion of the option shall terminate as of such date.

Subject to the foregoing, in the event of a grantee's death, such options may be exercised by a grantee's legal representative or beneficiary, but only to the extent that an option has become exercisable as of the date of death. Notwithstanding the foregoing, the Committee, in its sole discretion, may determine that any portion of an option that has not become exercisable as of the date of the grantee's death, termination of employment on account of permanent and total disability (within the meaning of section 22(e)(3) of the Code) or other termination of employment may also be exercised by a grantee, or in the case of death, a grantee's legal representative or beneficiary. Transfer from the Corporation to a subsidiary, from a subsidiary to the Corporation, or from one subsidiary to another, shall not be deemed to be a termination of employment. All references in this Section 6(c) to the termination of a grantee's employment shall include the termination of a consultant's relationship with the Corporation or any subsidiary.

- (d) *Limits on Incentive Stock Options.* Each Grant of an incentive stock option shall provide that it (i) is not transferable by the grantee otherwise than by will or the laws of descent and distribution and (ii) is exercisable, during the grantee's lifetime, only by the grantee and that the aggregate fair market value of the Common Stock on the date of the Grant with respect to which incentive stock options are exercisable for the first time by a grantee during any calendar year under the Plan and under any other stock option plan of the Corporation shall not exceed the limitation set forth in section 422(d) of the Code.

An incentive stock option shall not be granted to any grantee who, at the time of grant, owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the Corporation or subsidiary of the Corporation, unless the exercise price of the incentive stock option is no less than 110% of the fair market value per share on the date of grant and the term of the incentive stock option is not more than five years. Unless a grantee could otherwise transfer Common Stock issued pursuant to an incentive stock option granted hereunder without incurring liability under section 16(b) of the Exchange Act, at least six months must elapse from the date of acquisition of an incentive stock option to the date of disposition of the Common Stock issued upon exercise of such option.

7. Restricted Stock Grants

The Committee may issue or transfer shares of Common Stock of the Corporation to an eligible officer or other key employee. The following provisions are applicable to restricted stock grants:

- (a) *General Requirements.* Shares of Common Stock of the Corporation issued pursuant to restricted stock grants may be issued for consideration or for no consideration. Subject to any other restrictions by the Committee as provided pursuant to Section 7(e) and 7(g), restrictions on the transfer of shares of Common Stock set forth in Section 7(c) shall lapse on such date or dates as the Committee may approve until the restrictions have lapsed on 100% of the shares; provided, however, that upon a Change of Control of the Corporation, all restrictions on the transfer of the shares which have not, prior to such date, been forfeited shall immediately lapse. The period of years during which the restricted stock grant will remain subject to restrictions will be designated by the Committee (the "Restriction Period"). Prior to the lapse of the Restriction Period the shares of Common Stock granted to any grantee shall be held by the Corporation, subject to the provisions of Section 15 with respect to voting and dividends.
- (b) *Number of Shares.* The Committee may grant to each grantee a number of shares of Common Stock of the Corporation determined in its sole discretion.
- (c) *Requirement of Employment.* If the grantee's regular full-time employment terminates during the Restriction Period, the restricted stock grant terminates as to all shares covered by the Grant as to which restrictions on transfer have not lapsed, and those shares of Common Stock must be immediately returned to the Corporation. The Committee may, however, provide for complete or partial exceptions to this requirement as it deems equitable.
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- (d) *Restrictions on Transfer and Legend on Stock Certificate* . During the Restriction Period, a grantee may not sell, assign, transfer, pledge, or otherwise dispose of the shares of Common Stock to which such Restriction Period applies except to a Successor Grantee (as defined in Section 10 of the Plan). Each certificate for a share issued or transferred under a restricted stock grant shall contain a legend giving appropriate notice of the restrictions in the Grant. The grantee shall be entitled to have the legend removed from the stock certificate or certificates covering any of the shares subject to restrictions when all restrictions on such shares have lapsed.
- (e) *Lapse of Restrictions* . All restrictions imposed under the restricted stock grant shall lapse upon the expiration of the applicable Restriction Period; provided, however, that upon the death of the grantee or a Change of Control of the Corporation, all restrictions on the transfer of shares which have not, prior to such date, been forfeited shall immediately lapse. In addition, the Committee may determine as to any or all restricted stock grants, that all the restrictions shall lapse, without regard to any Restriction Period, under such circumstances as it deems equitable.
- (f) *Stock grants to Non-employee Directors* . As of the first day of the month following the Corporation's annual meeting of shareholders, each Non-employee Director shall receive a grant of 1,500 shares of Common Stock. Such shares shall not be sold for 6 months following the date of grant. No other restrictions shall apply to such shares. Notwithstanding any other provision of the Plan, this Section 7(f) may not be amended more than once every 12 months, except for amendments necessary to conform the Plan to changes of the provisions of, or the regulations relating to, the Code.
- (g) (1) *Restricted Stock Awards Subject to Performance Goals*. From time to time the Committee may issues shares of Common Stock of the Corporation pursuant to restricted stock grants, which, in addition to the terms and restrictions of Sections 7(a)-(f) above, will be subject to certain pre-established performance goals. In setting the performance goals for grants designated as "qualified performance-based compensation" pursuant to this Section 7, the Committee may establish that the Restriction Period of such restricted stock grants will lapse only upon the achievement of certain pre-established corporate performance goals that
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shall be objectively determinable. The performance goals may be based on one or more of the following criteria: (1) total return to shareholders; (2) dividends; (3) earnings per share; (4) customer growth; (5) cost reduction goals; (6) the achievement of specified operational goals, including water quality and the reliability of water supply; (7) measures of customer satisfaction; (8) net income (before or after taxes) or operating income; (9) earnings before interest, taxes, depreciation and amortization or operating income before depreciation and amortization; (10) revenue targets; (11) return on assets, capital or investment; (12) cash flow; (13) budget comparisons; (14) implementation or completion of projects or processes strategic or critical to the Company's business operations; and (15) any combination of, or a specified increase in, any of the foregoing. In addition, such performance goals may be based upon the attainment of specified levels of the Corporation's performance under one or more of the measures described above relative to the performance of other entities and may also be based on the performance of any of the Corporation's business units or divisions or any parent or subsidiary. Performance goals may be based upon the attainment of specified levels of the Company's performance under one or more of the measures described above during a specified time period, which may differ from the Restriction Period. Performance goals may include a minimum threshold level of performance below which no award will be earned, levels of performance at which specified portions of an award will be earned and a maximum level of performance at which an award will be fully earned. These performance goals shall satisfy the requirements for "qualified performance-based compensation," including the requirement that the achievement of the goals be substantially uncertain at the time they are established and that the performance goals be established in such a way that a third party with knowledge of the relevant facts could determine whether and to what extent the performance goals have been met. The Committee shall not have discretion to increase the amount of compensation that is payable upon achievement of the designated performance goals, but the Committee may reduce the amount of compensation that is payable upon achievement of the designated performance goals.

(2) *Timing of Establishment of Goals* . The Committee shall establish the performance goals in writing either before the beginning of the commencement of the period during which the specified performance goals are to be measured or during a period ending no later than the earlier of (i) 90 days after the beginning of the period during which the specified performance goals are to be measured or (ii) the date on which 25% of the period during which the specified performance goals are to be measured has been completed, or such other date as may be required or permitted under applicable regulations under Code section 162(m).

(3) *Announcement of Results* . The Committee shall certify and announce the results for the Restriction Period to all grantees after the Company announces the Company's financial results for the Restriction Period. If and to the extent that the Committee does not certify that the performance goals have been met, the applicable grants for the Restriction Period shall be forfeited or shall not be paid, as applicable.

(4) *Death, Disability or Other Circumstances* . The Committee may provide that grants shall be payable or restrictions shall lapse, in whole or in part, in the event of the grantee's death or disability during the Restriction Period, a Change of Control or under other circumstances consistent with the Treasury regulations and rulings under Code section 162(m).

8. Dividend Equivalents

The Committee may grant dividend equivalents to eligible officers and other key employees either alone or in conjunction with all or part of any option granted under the Plan. A dividend equivalent shall be equal to the dividend payable on a share of Common Stock of the Corporation. The amount of dividend equivalents for any grantee (the "Dividend Equivalent Amount") is determined by multiplying the number of dividend equivalents subject to the Grant by the per-share cash dividend, or the per-share fair market value (as determined by the Committee) of any dividend in other than cash, paid by the Corporation with respect to each record date for the payment of a dividend during the period described in Section 8(a).

- (a) *Amount of Dividend Equivalent Credited* . The Corporation shall credit to an account for each grantee maintained by the Corporation in its books and records on each record date, from the date of grant until the earlier of the date of (i) the end of the applicable Accumulation Period designated by the Committee at the time of grant, (ii) the date of the termination of regular full-time employment for any reason (including retirement), other than total disability (as defined in section 22(e)(3) of the Code) or death of the grantee, or as otherwise determined by the Committee, in its sole discretion, at the time of a grantee's termination of employment or (iii) the end of a period of four years from the date of grant, that portion of the Dividend Equivalent Amount for each such grantee attributable to each record date. The Corporation shall maintain in its books and records separate accounts which identify each Grantee's Dividend Equivalent Amount. Except as set forth in Section 8(e) below, no interest shall be credited to any such account.
 - (b) *Payment of Credited Dividend Equivalents* . The Committee, at the time of grant, shall designate the percentage of each grantee's Dividend Equivalent Amount that shall be paid to the grantee at the end of an applicable performance period (the "Performance Period"), generally being four years from the date of grant (the Committee, in its sole discretion, shall retain the right to designate a longer or shorter Performance Period at the time of grant); provided, however, that such Performance Period shall be:
 - (i) Reduced by one year for each calendar year during the applicable Performance Period ending after the date of grant in which the measurable performance criteria established by the Committee for the applicable Performance Period exceeds the targets for such criteria established by the Committee .
 - (ii) Increased by one year for each calendar year during the applicable Performance Period ending after the date of grant in which the measurable performance criteria established by the Committee for the applicable Performance Period is less than the targets for such criteria established by the Committee.
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- (iii) In no event shall the Performance Period be reduced to less than two years or increased to more than eight years from the date of grant.
 - (iv) In the event that the Performance Period is shorter than the period described in Section 8(a), a grantee shall receive the payment of the amount credited to his account at the end of the applicable Performance Period and any portion of the Dividend Equivalent Amount not yet so credited to his account shall be paid on the Corporation's normal dividend payment dates until the grantee's Dividend Equivalent Amount for the period described in Section 8(a) is fully paid to the grantee.
 - (c) *Timing of Payment of Dividend Equivalents.* Except as otherwise determined by the Committee in the event of a grantee's termination from regular full-time employment prior to the end of the applicable Performance Period, no payments of the Dividend Equivalent Amount shall be made until the end of the applicable Performance Period and no payments shall be made to any grantee whose regular full-time employment by the Corporation or a subsidiary terminates prior to the end of the applicable Performance Period for any reason other than retirement under the Corporation's or a subsidiary's retirement plan, death or total disability (as defined in section 22(e)(3) of the Code). Subject to Section 8(b)(iv), as soon as practicable after the end of such Performance Period, unless a grantee shall have made an election under Section 8(f) to defer receipt of any portion of such amount, a grantee shall receive 100% of the Dividend Equivalent Amount payable to him. Notwithstanding the foregoing, upon a Change of Control of the Corporation, any Dividend Equivalent Amount or portion thereof, which has not, prior to such date, been paid to the grantee or forfeited shall immediately become payable to the grantee without regard to whether the applicable Performance Period has ended.
 - (d) *Form of Payment.* The Committee shall have the sole discretion to determine whether the Corporation's obligation in respect of the payment of a Dividend Equivalent Amount shall be paid solely in credits to be applied toward payment of the option price under then exercisable options, solely in cash or partly in such credits and partly in cash.
 - (e) *Interest on Dividend Equivalents.* From a date which is 45 days after the end of the applicable Performance Period until the date that the Dividend Equivalent Amount payable to the grantee is paid to such grantee, the account maintained by the Corporation in its books and records with respect to such dividend equivalents shall be credited with interest at a market rate determined by the Committee.
 - (f) *Deferral of Dividend Equivalents.* A grantee shall have the right to defer receipt of any Dividend Equivalent Amount payments if he shall elect to do so on or prior to December 31 of the year preceding the beginning of the last full year of the applicable Performance Period (or such other time as the Committee shall determine is appropriate to make such deferral effective under the applicable requirements of federal tax laws). The terms and conditions of any such deferral (including the period of time thereof and any earnings on the deferral) shall be subject to approval by the Committee and all deferrals shall be made on a form provided a grantee for this purpose.
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9. Agreement with Grantees

Each grantee who receives a Grant under the Plan shall enter into an agreement with the Corporation which shall contain such provisions, consistent with the provisions of the Plan, as may be established from time to time by the Committee and shall constitute that grantee's acknowledgement and acceptance of the terms of the Plan and the Committee's authority and discretion.

10. Transferability of Grants

- (a) *Nontransferability of Grants* . Only a grantee or his or her authorized legal representative may exercise rights under a Grant. Such persons may not transfer those rights except by will or by the laws of descent and distribution or, with respect to Grants other than incentive stock options, if permitted in any specific case by the Committee in their sole discretion, pursuant to a domestic relations order as defined under the Code or Title I of ERISA or the rules thereunder. When a grantee dies, the personal representative or other person entitled to succeed to the rights of the grantee ("Successor Grantee") may exercise such rights. A Successor Grantee must furnish proof satisfactory to the Corporation of his or her right to receive the Grant under the grantee's will or under the applicable laws of descent and distribution.
- (b) *Transfer of Nonqualified Stock Options* . Notwithstanding the foregoing, the Committee may provide, in the Agreement, that a grantee may transfer nonqualified stock options to family members, one or more trusts for the benefit of family members, or one or more partnerships of which family members are the only partners, according to such terms as the Committee may determine; provided that the grantee receives no consideration for the transfer of an option and the transferred option shall continue to be subject to the same terms and conditions as were applicable to the option immediately before the transfer.

11. Funding of the Plan

This Plan shall be unfunded. The Corporation shall not be required to establish any special or separate fund or to make any other segregation of assets to assure the payment of any Grants under this Plan. Subject to Section 8(e), in no event shall interest be paid or accrued on any Grant, including unpaid installments of Grants.

12. Rights of Grantees

Nothing in this Plan shall entitle any grantee or other person to any claim or right to receive a Grant under this Plan or to any of the rights and privileges of, a shareholder of the Corporation in respect of any shares related to any Grant or purchasable upon the exercise of any option, in whole or in part, unless and until certificates for such shares have been issued. Notwithstanding the foregoing, a grantee who receives a grant of restricted stock shall have all rights of a shareholder, except as set forth in Section 7(d), during the Restriction Period, including the right to vote and receive dividends. Neither this Plan nor any action taken hereunder shall be construed as giving any grantee any rights to be retained in the employ of the Corporation, to be retained as a consultant by the Corporation or to be retained as a Non-employee Director by the Corporation.

13. Withholding of Taxes

The Corporation shall have the right to deduct from all Grants paid in cash any federal, state or local taxes required by law to be withheld with respect to such cash awards. The grantee or other person receiving such shares shall be required to pay to the Corporation the amount of any such taxes which the Corporation is required to withhold with respect to such Grants. With respect to Grants of restricted stock or nonqualified stock options, the Corporation shall have the right to require that the grantee make such provision, or furnish the Corporation such authorization as may be necessary or desirable so that the Corporation may satisfy its obligation, under applicable income tax laws, to withhold for income or other taxes due upon or incident to such restricted stock or the exercise of such nonqualified stock options.

The Committee may adopt such rules, forms and procedures as it considers necessary or desirable to implement such withholding procedures, which rules, forms and procedures shall be binding upon all grantees, and which shall be applied uniformly to all grantees similarly situated.

14. Listing and Registration

Each Grant shall be subject to the requirement that, if at any time the Committee shall determine in its discretion that the listing, registration or qualification of the Grant or the shares subject to the Grant upon any securities exchange or under any state or federal law, or the consent or approval of any governmental regulatory body, is necessary or desirable as a condition of, or in connection with, such Grant or the issue or purchase of shares thereunder, no such Grant may be exercised in whole or in part unless such listing, registration, qualification, consent or approval shall have been effected or obtained free of any conditions not acceptable to the Committee.

15. Adjustment of and Changes in Common Stock of the Corporation.

In the event of a reorganization, recapitalization, change of shares, stock split, spin-off, stock dividend, reclassification, subdivision or combination of shares, merger, consolidation, rights offering, or any other change in the corporate structure or shares of the Corporation, the Committee will make such adjustment as it deems appropriate in the number and kind of shares authorized by the Plan, in the number and kind of shares covered by Grants made under the Plan, in the purchase prices of outstanding options or the terms and conditions applicable to dividend equivalents. Any adjustment determined by the Committee shall be final, binding and conclusive.

16. Change of Control of the Corporation

As used herein, the following defined terms shall have the meanings described in this Section:

- (a) "Affiliate" and "Associate" shall have the respective meanings ascribed to such terms in Rule 12b-2 of the General Rules and Regulations under the Securities Exchange Act of 1934, as amended (the "Exchange Act").
 - (b) A Person shall be deemed the "Beneficial Owner" of any securities: (i) that such Person or any of such Person's Affiliates or Associates, directly or indirectly, has the right to acquire (whether such right is exercisable immediately or only after the passage of time) pursuant to any agreement, arrangement or understanding (whether or not in writing) or upon the exercise of conversion rights, exchange rights, rights, warrants or options, or otherwise; provided, however, that a Person shall not be deemed the "Beneficial Owner" of securities tendered pursuant to a tender or exchange offer made by such Person or any of such Person's Affiliates or Associates until such tendered securities are accepted for payment, purchase or exchange; (ii) that such Person or any of such Person's Affiliates or Associates, directly or indirectly, has the right to vote or dispose of or has "beneficial ownership" of (as determined pursuant to Rule 13d-3 of the General Rules and Regulations under the Exchange Act), including without limitation pursuant to any agreement, arrangement or understanding, whether or not in writing; provided, however, that a Person shall not be deemed the "Beneficial Owner" of any security under this clause (ii) as a result of an oral or written agreement, arrangement or understanding to vote such security if such agreement, arrangement or understanding (A) arises solely from a revocable proxy given in response to a public proxy or consent solicitation made pursuant to, and in accordance with, the applicable provisions of the General Rules and Regulations under the Exchange Act, and (B) is not then reportable by such Person on Schedule 13D under the Exchange Act (or any comparable or successor report); or (iii) that are beneficially owned, directly or indirectly, by any other Person (or any Affiliate or Associate thereof) with which such Person (or any of such Person's Affiliates or Associates) has any agreement, arrangement or understanding (whether or not in writing) for the purpose of acquiring, holding, voting (except pursuant to a revocable proxy as described in the proviso to clause (ii) above) or disposing of any voting securities of the Corporation; provided, however, that nothing in this subsection (b) shall cause a Person engaged in business as an underwriter of securities to be the "Beneficial Owner" of any securities acquired through such Person's participation in good faith in a firm commitment underwriting until the expiration of forty days after the date of such acquisition.
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(c) "Change of Control" shall mean:

- (i) any Person (including any individual, firm, corporation, partnership or other entity except the Corporation, any subsidiary of the Corporation, any employee benefit plan of the Corporation or of any subsidiary, or any Person or entity organized, appointed or established by the Corporation for or pursuant to the terms of any such employee benefit plan), together with all Affiliates and Associates of such Person, shall become the Beneficial Owner in the aggregate of 20% or more of the Common Stock of the Corporation then outstanding;
- (ii) during any twenty-four month period, individuals who at the beginning of such period constitute the Board cease for any reason to constitute a majority thereof, unless the election, or the nomination for election by the Corporation's shareholders, of at least seventy-five percent of the directors who were not directors at the beginning of such period was approved by a vote of at least seventy-five percent of the directors in office at the time of such election or nomination who were directors at the beginning of such period; or
- (iii) there occurs a sale of 50% or more of the aggregate assets or earning power of the Corporation and its subsidiaries, or its liquidation is approved by a majority of its shareholders or the Corporation is merged into or is merged with an unrelated entity such that following the merger the shareholders of the Corporation no longer own more than 50% of the resultant entity.

Notwithstanding anything in this subsection (c) to the contrary, a Change of Control shall not be deemed to have taken place under clause (c)(i) above if (i) such Person becomes the beneficial owner in the aggregate of 20% or more of the Common Stock of the Corporation then outstanding as a result, in the determination of a majority of those members of the Board of Directors of the Corporation in office prior to the acquisition, of an inadvertent acquisition by such Person if such Person, as soon as practicable, divests itself of a sufficient amount of its Common Stock so that it no longer owns 20% or more of the Common Stock then outstanding, or (ii) such Person becomes the beneficial owner in the aggregate of 20% or more of the common stock of Corporation outstanding as a result of an acquisition of common stock by the Corporation which, by reducing the number of common stock outstanding, increases the proportionate number of shares of common stock beneficially owned by such Person to 20% or more of the shares of common stock then outstanding; provided, however that if a Person shall become the beneficial owner of 20% or more of the shares of common stock then outstanding by reason of common stock purchased by the Corporation and shall, after such share purchases by the Corporation become the beneficial owner of any additional shares of common stock, then the exemption set forth in this clause shall be inapplicable.

17. Amendment and Termination

- (a) The Plan may be amended by the Board of Directors of the Corporation as it shall deem advisable to ensure such qualification and conform to any change in the law or regulations applicable thereto, including such new regulations as may be enacted pertaining to the tax treatment of incentive stock options to be granted under this Plan, or in any other respect that the Board may deem to be in the best interest of the Corporation; provided, however, that the Board may not amend the Plan, without the authorization and approval of the shareholders of this Corporation, if such approval is required by section 422 of the Code or section 162(m) of the Code.

The Board of Directors shall not amend the Plan if the amendment would cause the Plan or the Grant or exercise of an incentive stock option under the Plan to fail to comply with the requirements of section 422 of the Code including, without limitation, a reduction of the option price set forth in Section 6(a) or an extension of the period during which an incentive stock option may be exercised as set forth in Section 6(b).

- (b) The Board of Directors of the Corporation may, in its discretion, terminate, or fix a date for the termination of, the Plan. Unless previously terminated, the Plan shall terminate on March 17, 2014 and no Grants shall be made under the Plan after such date.
- (c) A termination or amendment of the Plan that occurs after a Grant is made shall not result in the termination or amendment of the Grant unless the grantee consents or unless the Committee acts under Section 18. The termination of the Plan shall not impair the power and authority of the Committee with respect to an outstanding Grant. Whether or not the Plan has terminated, an outstanding Grant may be terminated or amended under this Section 17 or may be amended by agreement of the Corporation and the grantee consistent with the Plan.

18. Compliance with Law

The Plan, the exercise of Grants and the obligations of the Corporation to issue or transfer shares of Common Stock under Grants shall be subject to all applicable laws, including any applicable federal or Pennsylvania state law, and to approvals by a governmental or regulatory agency as may be required. With respect to persons subject to Section 16 of the Exchange Act, it is the intent of the Corporation that the Plan and all transactions under the Plan comply with all applicable conditions of Rule 16b-3 or its successors under the Exchange Act. In addition, it is the intent of the Corporation that the Plan and applicable Grants of stock options under the Plan comply with the applicable provisions of sections 162(m) and 422 of the Code. The Committee may revoke any Grant if it is contrary to law or modify a Grant to bring it into compliance with any valid and mandatory government regulation. The Committee may also adopt rules regarding the withholding of taxes on payments to grantees. The Committee may, in its sole discretion, agree to limit its authority under this Section.

19. Effective Date of the Plan

The Plan shall be effective on March 18, 2004, but subject to the approval of the Corporation's stockholders at the May 20, 2004 meeting of the Corporation's stockholders or any resumption thereof.

Non-Employee Directors' Compensation for 2007

At its regularly scheduled meeting on December 6, 2006, the Board of Directors of Aqua America, Inc., upon the recommendation of its Executive Compensation and Employee Benefits Committee, approved the following directors' compensation for 2007 for the non-employee directors of Aqua America, Inc.: (1) an annual cash retainer of \$17,500; (2) an annual cash retainer for the Chair of the Executive Compensation and Employee Benefits Committee and Corporate Governance Committee of \$5,000; (3) an annual cash retainer for the Chair of the Audit Committee of \$7,500; (4) a meeting fee of \$1,500 for each meeting of the Board of Directors; (5) a meeting fee of \$1,250 per meeting for meetings of the Audit Committee and a meeting fee of \$1,000 per meeting for meetings of the other Committees; and (6) an annual stock grant to directors of 1,500 shares payable on the first of the month following the Annual Meeting of Shareholders. All directors are reimbursed for reasonable expenses incurred in connection with attendance at Board or Committee meetings. Directors are eligible to defer part or all of their fees under the Company's Director Deferral Plan. Amounts deferred accrue interest at the prime interest rate plus 1.0%.

SELECTED PORTIONS OF ANNUAL REPORT TO SHAREHOLDERS
FOR THE YEAR ENDED DECEMBER 31, 2006

- civil disturbance or terroristic threats or acts.

AQUA AMERICA, INC. AND SUBSIDIARIES
Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)
(In thousands of dollars, except per share amounts)

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.

AQUA AMERICA, INC. AND SUBSIDIARIES
Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)
(In thousands of dollars, except per share amounts)

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.

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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.

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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.

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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.

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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.

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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.

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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.

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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
	<u>81,370</u>	<u>76,856</u>
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	<u>\$ 25,723</u>	<u>\$ 22,150</u>

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.