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October 4, 2002

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Ms. Blanca Bayo  
Commission Clerk and Administrative Services Director  
Florida Public Service Commission  
2540 Shumard Oak Boulevard  
Tallahassee, FL 32399

021023-WS

RE: Philadelphia Suburban Corporation; Joint Application for Approval of the Acquisition by Philadelphia Suburban Corporation of the Stock of AquaSource Utility, Inc. and Resulting Transfer of a Controlling Interest in (1) Arredondo Utility Company, Inc., (2) Crystal River Utilities, Inc., (3) Jasmine Lakes Utilities, Corp., (4) Lake Suzy Utility, Inc., and (5) Ocala Oaks Utilities, Inc.  
Our File No.: 37053.01

Dear Ms. Bayo:

Enclosed are the original and five (5) copies of the above-referenced Application along with the filing fee of \$5,250. Also enclosed is an original and five (5) copies of the Emergency Petition for Variance or Waiver of Rules 25-30-.037 (3) (i), (j) and (k), and 25-30.030 (4) (c), Florida Administrative Code. Please advise me of the Board's schedule for consideration of the Application and Emergency Petition.

I have also enclosed an extra copy of this letter which I would appreciate you date stamping and returning to me in the enclosed self-addressed stamped envelope.

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FPSC-BUREAU OF RECORDS

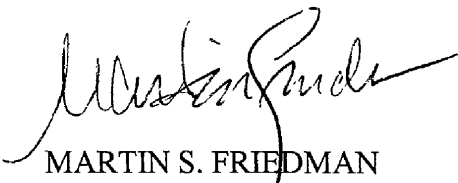
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Ms. Blanca Bayo  
October 4, 2002  
Page 2

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Should you have any questions concerning this matter, please do not hesitate to contact me.

Very truly yours,



MARTIN S. FRIEDMAN

For the Firm

MSF/dmp  
Enclosures

cc: Thomas P. Gadsden, Esquire  
Kathy Lee Pape, Esquire  
Richard S. Herskovitz, Esquire

**STATE OF FLORIDA  
BEFORE THE PUBLIC SERVICE COMMISSION**

**JOINT APPLICATION FOR APPROVAL OF :  
THE ACQUISITION BY PHILADELPHIA :  
SUBURBAN CORPORATION OF THE :  
STOCK OF AQUASOURCE UTILITY, INC. :  
AND THE RESULTING TRANSFER OF A :  
CONTROLLING INTEREST IN (1) :  
ARREDONDO UTILITY COMPANY, INC., :  
(2) CRYSTAL RIVER UTILITIES, INC., (3) :  
JASMINE LAKES UTILITIES CORP. , :  
(4) LAKE SUZY UTILITY, INC. AND (5) :  
OCALA OAKS UTILITIES, INC. :**

Docket No. 021023-WS

**TO THE FLORIDA PUBLIC SERVICE COMMISSION:**

**A. INTRODUCTION**

Philadelphia Suburban Corporation (“PSC”), AquaSource Utility, Inc. (“AquaSource Utility”), Arredondo Utility Company, Inc. (“Arredondo”), Crystal River Utilities, Inc. (“Crystal River”), Jasmine Lakes Utilities Corp. (“Jasmine Lakes”), Lake Suzy Utility, Inc. (“Lake Suzy”), and Ocala Oaks Utilities, Inc. (“Ocala Oaks”) (hereinafter collectively the “Joint Applicants”), pursuant to Florida Statutes Section 367.071, hereby request that the Public Service Commission (“Commission”) approve the acquisition by PSC of the stock of AquaSource Utility and the resulting transfer of a controlling interest in Arredondo, Crystal River, Jasmine Lakes, Lake Suzy and Ocala Oaks (hereinafter, together with AquaSource Utility, collectively the “Regulated Companies”).

1. The names and mailing addresses of the Joint Applicants are as follows:

**Philadelphia Suburban Corporation  
762 West Lancaster Avenue  
Bryn Mawr, PA 19010-3489**

**AquaSource Utility, Inc.**  
**411 Seventh Avenue, 14<sup>th</sup> Floor**  
**Pittsburgh, PA 15219**

**Arredondo Utility Company, Inc.**  
**Crystal River Utilities, Inc.**  
**Jasmine Lake Utilities Corp.**  
**Lake Suzy Utility, Inc.**  
**Ocala Oaks Utilities, Inc.**  
**6960 Professional Parkway East**  
**Suite 400**  
**Sarasota, FL 34240**

2. The names, mailing and e-mail addresses, and telephone and facsimile numbers of the Joint Applicants' attorneys are as follows:

**For PSC:**

Thomas P. Gadsden  
Morgan, Lewis & Bockius LLP  
1701 Market Street  
Philadelphia, PA 19103  
Tel: (215) 963-5234  
Fax: (215) 963-5001  
e-mail: tgadsden@morganlewis.com

Kathy Lee Pape  
Vice President, Treasurer & Rate Counsel  
Philadelphia Suburban Corporation  
762 W. Lancaster Avenue  
Bryn Mawr, PA 19010  
Tel: (610) 645-1142  
Fax: (610) 519-0989  
e-mail: papek@suburbanwater.com

**For The Regulated Companies:**

Martin S. Friedman  
Rose, Sundstrom & Bentley, LLP  
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Altamonte Springs, FL 32701  
Tel: (407) 830-6331  
Fax: (407) 830-8522  
e-mail: mfriedman@rsbattorneys.com

Richard S. Herskovitz  
Assistant General Counsel  
DQE, Inc.  
411 Seventh Avenue  
Mail Drop 9-1  
Pittsburgh, PA 15219  
Tel: (412) 393-3662  
Fax: (412) 393-5602  
e-mail: rherskovitz@dqe.com

**B. OVERVIEW**

3. The transaction proposed herein will have no immediate effect on the rates

charged or service provided by the Regulated Companies.<sup>1</sup> It is presently anticipated by PSC that local management will remain substantially in place and staffing levels will not be materially disturbed. Indeed, the Regulated Companies are expected to continue to operate in much the same manner as they currently do and will continue to be fully subject to all applicable laws, rules and policies governing the regulation of Florida public utilities.

4. What will change, if this Joint Application is approved, is that ultimate ownership and control of the Regulated Companies will rest with PSC, rather than DQE, Inc.<sup>2</sup> However, for the reasons set forth hereinafter, the proposed acquisition will produce a stronger water and wastewater utility system -- one that has the strategic focus, financial and human resources, size and scope to address the challenges facing the water and wastewater utility industry in a more cost-effective manner.

### **C. DESCRIPTION OF THE JOINT APPLICANTS**

5. PSC, duly organized and existing under the laws of the Commonwealth of Pennsylvania, is the second largest investor-owned water utility holding company in the United States, serving approximately two million residents in six states. PSC's largest subsidiary is Pennsylvania Suburban Water Company ("PSW"),<sup>3</sup> which is engaged in the business of furnishing water and wastewater service to the public throughout Pennsylvania. Substantial additional water and/or wastewater operations are conducted through other subsidiaries in Illinois, Maine, New Jersey, North Carolina and Ohio. A copy of PSC's most recent annual

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<sup>1</sup> Nothing herein is intended to limit the ability of the Regulated Companies to prosecute, or obtain a ruling with respect to, any rate proceeding(s) prior to the consummation of the transaction contemplated by this Agreement.

<sup>2</sup> DQE is the corporate parent of AquaSource, Inc., which owns all the outstanding common stock of AquaSource Utility, which, in turn, owns all the outstanding stock of Arredondo, Crystal River, Jasmine Lakes, Lake Suzy and Ocala Oaks.

<sup>3</sup> Prior to January 1, 2002, Pennsylvania Suburban Water Company was known as Philadelphia Suburban Water Company.

report to shareholders; a list of the names and addresses of the other utilities owned by PSC; and a roster of PSC's officers and directors are attached as Exhibits "A" – "C," respectively.

6. As noted previously, AquaSource Utility, duly organized and existing under the laws of the State of Texas, is a subsidiary of AquaSource, Inc., which, in turn, is a subsidiary of DQE, a Pennsylvania based energy service company.<sup>4</sup> AquaSource Utility, directly or indirectly through subsidiaries, owns and operates water and wastewater systems in twelve states. In Florida, AquaSource Utility furnishes regulated water service in portions of Highlands, Lake and Polk Counties and regulated wastewater service in portions of Lake, Lee and Polk Counties.

7. Arredondo is a corporation organized and existing under the laws of the State of Florida and is a wholly owned subsidiary of AquaSource Utility. Arredondo furnishes regulated water and wastewater service in portions of Alachua County.

8. Crystal River is a corporation organized and existing under the laws of the State of Florida and is a wholly owned subsidiary of AquaSource Utility. Crystal River furnishes regulated water service in portions of Lake, Palm Beach, Polk and Sumter Counties and regulated wastewater service in portions of Polk and Sumter Counties.

9. Jasmine Lakes is a corporation organized and existing under the laws of the State of Florida and is a wholly owned subsidiary of AquaSource Utility. Jasmine Lakes furnishes regulated water and wastewater service in portions of Pasco County.

10. Lake Suzy is a corporation organized and existing under the laws of the State of Florida and is a wholly owned subsidiary of AquaSource Utility. Lake Suzy furnishes regulated

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<sup>4</sup> DQE's largest subsidiary is Duquesne Light Company, which provides electric transmission and distribution service in the Pittsburgh area.

water service in portions of Charlotte and DeSoto Counties and regulated wastewater service in portions of DeSoto County.

11. Ocala Oaks is a corporation organized and existing under the laws of the State of Florida and is a wholly owned subsidiary of AquaSource Utility. Ocala Oaks furnishes regulated water service in portions of Marion County.

#### **D. SUMMARY OF THE PROPOSED TRANSACTION**

12. On July 29, 2002, PSC, Aqua Acquisition Corporation (“Acquisition”),<sup>5</sup> DQE, and AquaSource, Inc. entered into a Purchase Agreement, a copy of which is attached as Exhibit “D.” Pursuant to the Purchase Agreement, PSC will acquire all of the issued and outstanding shares of common stock and 90 of the 100 outstanding shares of preferred stock of AquaSource Utility; all of the issued and outstanding shares of common stock of AquaSource Development Company;<sup>6</sup> and all of the issued and outstanding shares of common stock of The Reynolds Group.<sup>7</sup> In addition, Acquisition will purchase certain non-regulated assets, consisting largely of contract operating agreements with various water and wastewater service providers. As such, Arredondo, Crystal River, Jasmine Lakes, Lake Suzy and Ocala Oaks will remain first tier subsidiaries of AquaSource Utility and will become second tier subsidiaries of PSC. A diagram depicting the pre and post-acquisition chain of ownership of the Regulated Companies is attached as Exhibit “E.”

13. The Purchase Agreement provides for a target cash purchase price of approximately \$205 million. The final purchase price may be increased by up to \$10 million or

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<sup>5</sup> Acquisition, a Pennsylvania corporation, is a wholly owned subsidiary of PSC that was formed to help effectuate the proposed transaction.

<sup>6</sup> AquaSource Development is a Texas corporation that does not conduct business in Florida.

<sup>7</sup> The Reynolds Group is an Indiana water utility holding company. Neither it nor any of its subsidiaries conduct business in Florida.

decreased by up to \$25 million as various purchase price adjustments are applied. Such adjustments relate to the achievement of certain operating performance metrics, involving revenue, rate base and projected customer connections, and are described in Article I of the Purchase Agreement.

14. PSC and Acquisition intend to fund the purchase with cash from a combination of short-term debt, long-term debt, common stock and/or securities convertible into common stock. The ultimate funding decision will be driven by financial market conditions existing at the time the acquisition is consummated.

15. Closing on the proposed transaction is scheduled to occur five business days after the satisfaction of the conditions precedent set forth in the Purchase Agreement, including the receipt of all required regulatory approvals.

#### **E. IMPACT ON SERVICE, RATES AND LOCAL COMMUNITIES**

16. PSC is committed to providing adequate, efficient, safe and reliable water and wastewater service and its performance bears this out.<sup>8</sup> PSC intends to rely substantially on incumbent local management to operate the Regulated Companies and, consequently, the acquisition by PSC should have no immediate effect on customer service. The Joint Applicants believe, however, that the combined entity, by virtue of its greater resources, will be better positioned to meet future demands and to ensure that the high quality of service presently being provided is maintained.

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<sup>8</sup> For example, PSW, PSC's largest subsidiary, has the lowest customer complaint ratio of any investor-owned water company in Pennsylvania. In addition, PSW has consistently complied with all Federal and State drinking water standards and, in fact, has **never** violated a primary maximum contaminant level (MCL) standard.



17. The proposed transaction will have no immediate impact on the rates charged customers of the Regulated Companies.<sup>9</sup> The rates, rules, regulations, and terms and conditions of service in effect on the date of closing will not change as a result of the acquisition. Going forward, the Joint Applicants believe that economies of scale and scope may help to partially offset the ongoing rise in the cost of providing water and wastewater service and thereby moderate somewhat the magnitude of future rate increase requests.

18. The proposed transaction is not expected to have any immediate impact on jobs in Florida -- no material changes in local staffing or compensation are anticipated at the present time. Rather, customers of the Regulated Companies will continue to receive the same level of service from essentially the same organization on which they have depended in the past. Moreover, employees of the Regulated Companies should benefit from the expanded training and growth opportunities offered by the combined entity.

#### **F. BENEFITS OF THE PROPOSED TRANSACTION**

19. Florida Statutes Section 367.071 provides, in pertinent part, that “[n]o utility shall sell assign, or transfer . . . majority organizational control without determination and approval of the commission that the proposed sale is in the public interest and that the buyer, assignee, or transferee will fulfill the commitments, obligations, and representations of the utility.” The Joint Applicants respectfully submit that the proposed transaction fully satisfies the foregoing standards for the following reasons.

20. **Focus On Water And Wastewater Service.** DQE, the Regulated Companies’ ultimate parent, is currently engaged in multiple lines of business, including, but not limited to,

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<sup>9</sup> Nothing herein is intended to limit the ability of the Regulated Companies to prosecute, or obtain a ruling with respect to, any rate proceeding(s) prior to the consummation of the transaction contemplated by this Agreement.

electric transmission and distribution service, communications, landfill gas collection and processing, and propane distribution. The proposed acquisition would place DQE's water and wastewater operations in the hands of an experienced company and industry leader whose sole focus is the provision of high quality utility service at reasonable prices.

21. **Size And Financing Capability.** The Regulated Companies' customers will be served by a large, fiscally sound company that has the capability to finance necessary capital additions. To illustrate, as of December 31, 2001, PSC's total permanent capitalization was approximately \$1.0 billion. As the Commission is well aware, the need to comply with increasingly stringent environmental standards, while also rehabilitating and replacing aging infrastructure, has created substantial demands for capital investment by water and wastewater utilities.<sup>10</sup> Given its size, access to capital and its recognized strengths in system planning, capital budgeting and construction management, PSC is uniquely well-positioned to provide high quality water and wastewater service. In addition, because of its outstanding credit quality, PSC believes that it will be able to access the capital markets on favorable terms.<sup>11</sup>

22. **Economies Of Scale And Scope.** As the second largest investor-owned water and wastewater utility system in the country, PSC enjoys substantial economies of scale and scope through the mass purchasing of certain goods (e.g., chemicals and equipment) and the provision of centralized services (e.g., the system-wide administration of employee pension and benefit plans). The proposed transaction presents an opportunity to further expand these

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<sup>10</sup> In the past several years, PSW has become a leader in the area of infrastructure rehabilitation, having tripled the miles of aging distribution main that are repaired or replaced on an annual basis. This undertaking is critically important, not only to assure high quality water service, but also to maintain adequate pressures for fire protection purposes.

<sup>11</sup> Although PSC itself is not rated, PSW has been assigned a corporate credit rating of "A+" by Standard & Poors.

economies and to extend their resulting benefits to customers of the Regulated Companies through consolidation and the elimination of duplicative functions in such areas as accounting and record keeping, financial and regulatory reporting, customer billing and accounting, and customer service.

23. **Commitment To Customer Service.** PSC is totally committed to providing its customers with the highest quality service at the lowest reasonable price. In addition, PSC has worked in partnership with State and local officials to address the problems faced by smaller systems that may lack the financial and/or technical resources needed to comply with evolving water quality and wastewater collection and disposal standards. As part of the PSC system, the Regulated Companies should be better equipped to pursue these opportunities.

24. **Opportunities For Employees.** The proposed acquisition offers expanded opportunities to the Regulated Companies' employees for career advancement and professional growth. These enhanced opportunities, in turn, will benefit customers by making it easier for the Regulated Companies to recruit, develop and maintain a skilled workforce.

#### **G. SUPPORTING DATA**

25. As previously noted, the Joint Applicants are providing as Exhibit "A" a copy of PSC's 2001 annual report to shareholders.

#### **H. CORPORATE APPROVALS**

26. The proposed transaction has been approved by the Boards of Directors of PSC, DQE and AquaSource, Inc. Approval by the shareholders of PSC and/or DQE is not required.

#### **I. OTHER REGULATORY APPROVALS**

27. The proposed transaction is subject to approval by this Commission, as well as by the Connecticut Department of Public Utility Control, the Kentucky Public Service Commission,

the Missouri Public Service Commission, the New Jersey Board of Public Utilities, the New York Public Service Commission, the North Carolina Utilities Commission, the South Carolina Public Service Commission, the Texas Commission On Environmental Quality, the Virginia State Corporation Commission, the Citrus County (Florida) Water and Sewer Authority, the Board of County Commissioners of Sarasota County (Florida) and the Federal Communications Commission.

28. The proposed acquisition is subject to expiration of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended.

#### **J. MISCELLANEOUS**

29. PSC hereby pledges that it will fulfill the commitments, obligations and representations of the Regulated Companies with regard to utility matters.

30. After reasonable investigation, the utility systems operated by the Regulated Companies appear to be in satisfactory condition and in material compliance with all applicable standards set by the Florida Department of Environmental Protection.

31. An affidavit that actual notice of the Joint Application was given to the entities on the list provided by the Commission in accordance with Section 367.045(1)(a), Florida Statutes, and Rule 25-30.030, Florida Administrative Code, will be submitted as Late Filed Exhibit "F."

32. An affidavit that actual notice of the Joint Application was given to each customer in accordance with Section 367.045(1)(a), Florida Statutes, and Rule 25-30.030, Florida Administrative Code, will be submitted as Late Filed Exhibit "G."

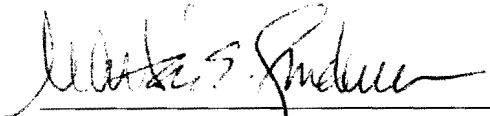
33. An affidavit that notice of the Joint Application was published once in a newspaper of general circulation in the applicable territories in accordance with Rule 25-30.030, Florida Administrative Code, will be submitted as Late Filed Exhibit "H."

34. Since this is a transfer of majority organizational control, there are no tariff sheet changes required at this time.

35. Since this is a transfer of majority organizational control whereby the ownership of the subsidiaries remains unchanged, there will be no change to the Regulated Companies' Certificates.

WHEREFORE, for the foregoing reasons, the Joint Applicants respectfully request that the Commission approve this Application and authorize the acquisition by PSC of the stock of AquaSource Utility and the resulting transfer of control of Arredondo, Crystal River, Jasmine Lakes, Lake Suzy and Ocala Oaks.

Respectfully submitted,

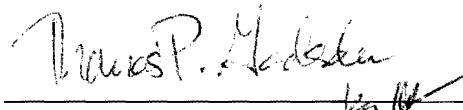


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Attorneys for the Regulated Companies

Dated: October 4, 2002



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Attorneys for Philadelphia Suburban Corporation

STATE OF FLORIDA  
BEFORE THE PUBLIC SERVICE COMMISSION

JOINT APPLICATION FOR  
APPROVAL OF THE ACQUISITION  
BY PHILADELPHIA SUBURBAN  
CORPORATION OF THE STOCK OF  
AQUASOURCE UTILITY, INC. AND  
THE RESULTING TRANSFER OF A  
CONTROLLING INTEREST IN (1)  
ARREDONDO UTILITY COMPANY,  
INC., (2) CRYSTAL RIVER  
UTILITIES, INC., (3) JASMINE  
LAKES UTILITIES CORPORATION,  
(4) LAKE SUZY UTILITIES, INC. AND  
(5) OCALA OAKS UTILITIES, INC.

Docket No. \_\_\_\_\_

AFFIDAVIT

I, Frank A. Hoffmann, as President of AquaSource, Inc., do solemnly swear or affirm that the facts stated in the foregoing application and all exhibits attached thereto are true and correct and that said statements of fact thereto constitute a complete statement of the matter to which it relates.

By: \_\_\_\_\_

*Frank Hoffmann*  
Frank A. Hoffmann  
President, AquaSource, Inc.

Subscribed and sworn to before me this 4<sup>th</sup> day of October, 2002, by Frank A. Hoffmann, as President of AquaSource, Inc., who is personally known to me.

*Renee J. Cypher*  
\_\_\_\_\_  
Notary Public

Print, Type or Stamp Name of Notary

Notarial Seal  
Renee J. Cypher, Notary Public  
City of Pittsburgh, Allegheny County  
My Commission Expires Sept. 22, 2005  
Member, Pennsylvania Association of Notaries

**AFFIDAVIT**

I, David P. Smeltzer, as Senior Vice President of Philadelphia Suburban Corporation, do solemnly swear or affirm that the facts stated in the foregoing application and all exhibits attached thereto are true and correct and that said statements of fact thereto constitutes a complete statement of the matter to which it relates.

BY: David P. Smeltzer  
Applicant's Signature

David P. Smeltzer

Applicant's Name (Typed)

Senior Vice President

Applicant's Title \*

Subscribed and sworn to before me this 3rd day of October, 2002, by

David P. Smeltzer, as Senior Vice President of

Philadelphia Suburban Corporation, who is personally known to me Catherine

Lezzi or produced the following identification

\_\_\_\_\_  
Type of Identification Produced

Catherine Lezzi  
Notary Public's Signature

Notarial Seal  
Catherine A. Lezzi, Notary Public  
Upper Merion Twp., Montgomery County  
My Commission Expires Dec 8, 2004  
Member, Pennsylvania Association of Notaries

\_\_\_\_\_  
Print, Type or Stamp Commissioned Name of Notary

**STATE OF FLORIDA  
BEFORE THE PUBLIC SERVICE COMMISSION**

**JOINT APPLICATION FOR APPROVAL OF :  
THE ACQUISITION BY PHILADELPHIA :  
SUBURBAN CORPORATION OF THE :  
STOCK OF AQUASOURCE UTILITY, INC. :  
AND THE RESULTING TRANSFER OF A :  
CONTROLLING INTEREST IN (1) : Docket No. \_\_\_\_\_  
ARREDONDO UTILITY COMPANY, INC., :  
(2) CRYSTAL RIVER UTILITIES, INC., (3) :  
JASMINE LAKES UTILITIES CORP., (4) :  
LAKE SUZY UTILITY, INC. AND (5) :  
OCALA OAKS UTILITIES, INC. :**

***EXHIBITS TO JOINT APPLICATION***

TAB

|   |   |
|---|---|
| Copy of PSC's 2001 annual report to shareholders .....              | A |
| Other utilities owned by PSC .....                                  | B |
| PSC officers and directors .....                                    | C |
| Purchase Agreement dated July 29, 2002 .....                        | D |
| Diagram depicting pre and post-acquisition chain of ownership ..... | E |





EXHIBIT "A"

# 2001 Annual Report

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## Company Profile

Philadelphia Suburban Corporation (NYSE:PSC) is one of the nation's largest, publicly-traded water utilities. Its two major operating subsidiaries, Pennsylvania Suburban Water Company and Consumers Water Company, serve approximately two million residents with water and wastewater utility operations in Pennsylvania, Ohio, Illinois, New Jersey, Maine and North Carolina.

## Financial Highlights

### Philadelphia Suburban Corporation Financial Highlights

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

|  | 2001      | 2000      | % Change |
|--|-----------|-----------|----------|
| Operating revenues   | \$307,280 | \$274,014 | 12.1     |
| Income from operations, exclusive of nonrecurring items (a)                              | 60,005    | 50,548    | 18.7     |
| Net income available to common stock (b)   | 60,005    | 52,784    | 13.7     |
| Diluted income per common share from operations, exclusive of nonrecurring items (a) (c) | 0.87      | 0.77      | 13.0     |
| Diluted net income per common share (b) (c)  | 0.87      | 0.81      | 7.4      |
| Annual dividend rate per common share (c)  | 0.53      | 0.50      | 6.0      |
| Dividends paid per common share (c)  | 0.50      | 0.47      | 6.4      |
| Common stockholders' equity per share (c)  | 6.90      | 6.38      | 8.2      |
| Stockholders' equity   | 473,833   | 432,347   | 9.6      |
| Total assets   | 1,560,339 | 1,413,723 | 10.4     |
| Capital additions (d)  | 124,088   | 129,740   | (4.4)    |
| Number of customers served   | 602,510   | 579,219   | 4.0      |

(a) Excludes 2000 net gain of \$2,236 (\$0.04 per share) for the partial recovery of the merger costs related to the Consumers Water Company merger.

(b) Includes nonrecurring items noted in (a) above.

(c) Restated for 2001 5-for-4 stock split.

(d) Excludes payments for acquired water systems: \$9,517 in 2001 and \$3,546 in 2000.

**March 13, 2002**  
**Dear Shareholder**



At the annual meeting last year, we outlined a growth plan for our company to improve on the solid financial position we've managed to achieve over the last several years. Over the year, while continuing to provide our customers with quality water and reliable service, the plan called for us to grow our customer base by four percent; revenues by seven percent; earnings by 10 percent; and dividends by five percent. As we look back on 2001, I am happy to report that with the support of our employees and investors, we have achieved—and in some areas surpassed—those targets.

A four percent increase in our customer base propelled the company past the 600,000-customer mark and as of the year-end, PSC served 602,510 customers. That growth coupled with rate relief in five of the six states in which we operate and favorable weather conditions contributed to a 12.1 percent increase in revenue for the year to \$307.3 million compared to \$274.0 million for the prior year.

Net income for the year ended December 31, 2001 increased 13.7 percent to \$60.0 million versus \$52.8 million in the prior year. Diluted net income per share for the year increased 7.4 percent to \$0.87, versus \$0.81 in 2000, on 5.1 percent more average shares outstanding. Diluted income per share from operations increased to \$0.87 per share, up 13.0 percent in comparison to \$0.77 in 2000 (excluding a \$.04 recovery of net merger expenses).

As a result of the company's solid financial performance, the Board of Directors rewarded shareholders with the eleventh cash dividend increase in the last 10 years and the fourth stock split in six years.

The majority of our customer growth was a result of our continuing growth-through-acquisition strategy, which after 10 years, has resulted in more than 90 acquisitions and growth ventures. In 2001, the 10th year of the program, we completed 20 acquisitions and other growth ventures in the six states we serve, including 11 in Pennsylvania where the bulk of our customers (approximately 395,000) are located. In 2002, customer growth is continuing with two acquisitions completed (Citizens Water Company of Wapwallopen and the White Haven Municipal Authority in north-eastern Pennsylvania), and several other transactions in the negotiation phase. The success of our growth program has helped to mitigate the amount of rate increases for our customers.

Operations and maintenance (O&M) expenses as a percent of revenue (efficiency ratio) continued to improve in 2001 to 36.4 percent, versus 37.1 percent in 2000, continuing a three-year trend of an average 100 basis point annual decrease in the efficiency ratio since the merger with Consumers Water in 1999. Controlling our operating expenses provides more cash flow to invest in the capital improvements needed to provide our customers with quality water and reliable service. In 2001, we invested \$124 million throughout our operating subsidiaries to replace aging pipes in our distribution systems and build new treatment facilities to continually improve water quality.

Effective January 1, 2002, for legal, financing and administrative efficiencies and benefits, all of our Pennsylvania operating subsidiaries were merged into a single company—Pennsylvania Suburban Water Company. For operational purposes, these entities will continue to do business under their former names. Standard & Poor's (S&P) has assigned the new company an A+ corporate credit rating and a AA- rating on its first mortgage bonds. From a practical perspective, the new legal entity—Pennsylvania Suburban Water Company—and its excellent credit rating will allow for more cost-effective capital formation at all of our operations in the Commonwealth of Pennsylvania.

A review of the last 10 years indicates that PSC's success is directly attributable to our ability to: increase our customer base as a result of our successful growth-through-acquisition strategy; keep a tight reign on operating expenses; and conduct an aggressive, but prudent, capital investment program. There are still more than 50,000 water systems in the U.S. and our management is experienced at acquiring water systems, and making needed capital investments to improve water quality and customer service.

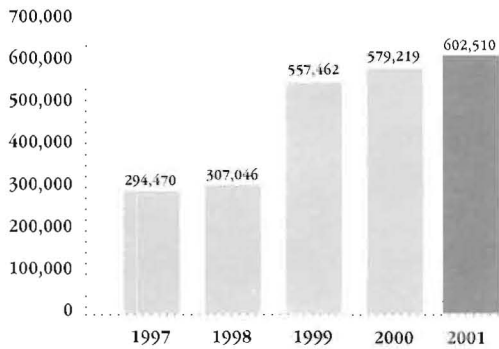
We are optimistic about our future and our ability to continue to navigate the same road that has brought the company and its shareholders the success we've all experienced over the past decade. Thank you for your continuing support.

Sincerely,



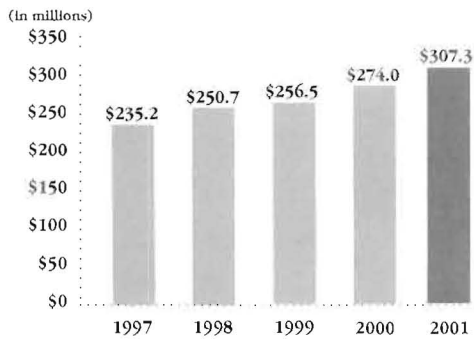
Nicholas DeBenedictis  
Chairman and President

## Customers\*



\*Amounts include operations and management contract customers and exclude Consumers Water Company customers of 232,170 in 1997 and 226,801 in 1998.

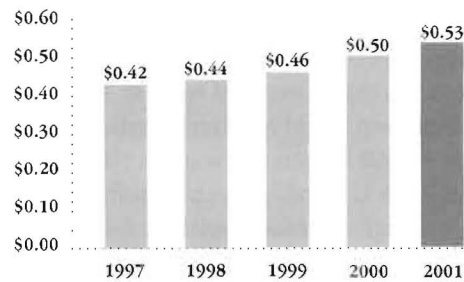
## Operating Revenues



## Dividend Highlights

- Dividends paid for 57 consecutive years
- A 5-for-4 common stock split effected in the form of a 25 percent stock distribution and a 6.9 percent cash dividend increase to shareholders of record, paid on December 1, 2001
- 11 cash dividend increases in the last 10 years
- Issued four stock splits in the form of a stock distribution in the last six years

## Dividend Rate\*



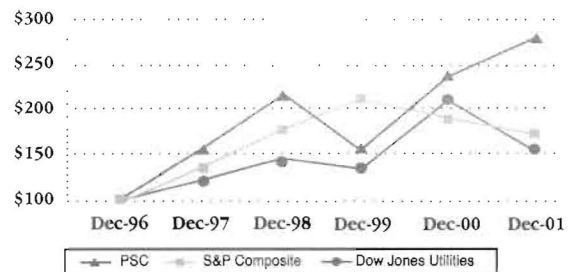
\* Restated for 2001 5-for-4 stock split

## Earnings Per Share\*



\*Income from continuing operations, exclusive of certain non-recurring items, on a diluted basis. Per share amounts restated for 2001 5-for-4 stock split.

## Five-Year Growth - Total Return



PHILADELPHIA SUBURBAN CORPORATION  
FINANCIAL STATEMENTS  
FOR THE YEAR ENDED DECEMBER 31, 2001

PHILADELPHIA SUBURBAN CORPORATION  
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# 2001 Financial Data

# PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(In thousands of dollars, except per share amounts)

### FORWARD-LOOKING STATEMENTS

This report by Philadelphia Suburban Corporation ("we" or "us") contains, in addition to historical information, forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements address, among other things: our use of cash; projected capital expenditures; liquidity; as well as information contained elsewhere in this report where statements are preceded by, followed by or include the words "believes," "expects," "anticipates," "plans" or similar expressions. These statements are based on a number of assumptions concerning future events, and are subject to a number of uncertainties and other factors, many of which are outside our control. Actual results may differ materially from such statements for a number of reasons, including the effects of regulation, abnormal weather, changes in capital requirements and funding, and the success of our growth strategy. We undertake no obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.

### GENERAL INFORMATION

Philadelphia Suburban Corporation is the holding company for regulated utilities providing water or wastewater services to approximately 2 million people in Pennsylvania, Ohio, Illinois, New Jersey, Maine and North Carolina. Our two primary subsidiaries are Pennsylvania Suburban Water Company ("PSW"), a regulated public utility that provides water or wastewater services to about 1.3 million residents in the suburban areas north and west of the City of Philadelphia and in ten other counties in Pennsylvania, and Consumers Water Company ("CWC"), a holding company for several regulated public utility companies that provide water or wastewater service to about 700,000 residents in various communities in the other states where we operate. We are among the largest investor-owned water utilities in the United States based on the number of customers. In addition, we provide water service to approximately 35,000 people through operating and maintenance contracts with municipal authorities and other parties close to our operating companies' service territories. Some of our subsidiaries provide wastewater services (primarily residential) to approximately 40,000 people in Pennsylvania, Illinois, New Jersey and North Carolina. During 2001 and each of the previous four years, the operating revenues associated with wastewater services have been less than 3% of our consolidated operating revenues.

In March 1999, we completed a merger with CWC. Shares of our common stock were exchanged for all of the outstanding shares of CWC and CWC became a wholly-owned subsidiary. The merger was accounted for under the pooling-of-interests method of accounting. Accordingly, this report includes the accounts and results of CWC as if the merger had been completed as of the beginning of the earliest period presented.

In January 2002, Philadelphia Suburban Water Company and various of our other Pennsylvania operating subsidiaries were merged together into Pennsylvania Suburban Water Company. The purpose of the merger was to achieve certain legal, financing and administrative efficiencies and benefits. For operational purposes, these entities will continue to do business under their former names. For discussion purposes, all references to PSW relate to Pennsylvania Suburban Water Company or its predecessor companies.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Following are our selected five-year financial statistics:

| Years ended December 31,  | 2001       | 2000       | 1999       | 1998       | 1997       |
|---|------------|------------|------------|------------|------------|
| Operating revenues ( a )  | \$ 307,280 | \$ 274,014 | \$ 256,546 | \$ 250,718 | \$ 235,162 |
| Income from continuing operations   | \$ 60,111  | \$ 52,890  | \$ 36,384  | \$ 45,015  | \$ 35,210  |
| Income from continuing operations<br>before income taxes and<br>non-recurring items ( b ) | \$ 99,087  | \$ 82,954  | \$ 73,036  | \$ 68,453  | \$ 57,642  |
| <b>Operating Statistics</b>   |            |            |            |            |            |
| Operating revenues  | 100.0%     | 100.0%     | 100.0%     | 100.0%     | 100.0%     |
| Costs and expenses:   |            |            |            |            |            |
| Operations and maintenance  | 36.4%      | 37.1%      | 38.5%      | 39.9%      | 41.1%      |
| Depreciation and amortization   | 13.1%      | 12.4%      | 12.4%      | 11.8%      | 11.9%      |
| Taxes other than income taxes   | 6.8%       | 8.2%       | 8.5%       | 8.7%       | 9.1%       |
| Interest expense and other ( c )  | 11.9%      | 12.9%      | 12.9%      | 12.8%      | 13.8%      |
| Allowance for funds used during<br>construction   | (0.4)%     | (0.9)%     | (0.8)%     | (0.5)%     | (0.4)%     |
| Total costs and expenses  | 67.8%      | 69.7%      | 71.5%      | 72.7%      | 75.5%      |
| Income from continuing operations<br>before income taxes and<br>non-recurring items ( b ) | 32.2%      | 30.3%      | 28.5%      | 27.3%      | 24.5%      |
| Effective tax rates ( a )   | 39.3%      | 39.2%      | 42.2%      | 40.1%      | 38.9%      |

( a ) Continuing operations only.

( b ) Non-recurring items include the 2000 gain of \$2,236 (\$4,041 pre-tax) for the partial recovery of the merger costs related to the 1999 merger with Consumers Water Company, 1999 charges of \$8,596 (\$10,121 pre-tax) for transaction costs and restructuring costs related to the merger with Consumers Water Company, and the 1998 gain of \$3,903 (\$6,680 pre-tax) on the sale of Consumer Water Company's New Hampshire system.

( c ) Includes dividends on preferred stock of subsidiary and minority interest.



PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Following are our selected five-year operating and sales statistics:

| Years ended December 31, |                     | 2001              | 2000              | 1999              | 1998              | 1997              |
|--------------------------|---------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Customers                | Residential water   | 526,776           | 512,442           | 497,937           | 478,160           | 473,309           |
|                          | Commercial water    | 29,745            | 29,317            | 29,241            | 27,612            | 26,369            |
|                          | Industrial water    | 1,454             | 1,446             | 1,430             | 1,327             | 1,386             |
|                          | Other water         | 9,947             | 9,500             | 9,067             | 8,277             | 7,574             |
|                          | Wastewater          | 19,615            | 12,441            | 11,262            | 10,583            | 10,522            |
|                          | Operating contracts | 14,973            | 14,073            | 8,525             | 7,888             | 7,480             |
|                          | <b>Total</b>        | <b>602,510</b>    | <b>579,219</b>    | <b>557,462</b>    | <b>533,847</b>    | <b>526,640</b>    |
| Operating Revenues       | Residential water   | \$ 188,303        | \$ 170,597        | \$ 154,881        | \$ 156,523        | \$ 148,323        |
|                          | Commercial water    | 53,103            | 47,109            | 45,192            | 44,894            | 40,439            |
|                          | Industrial water    | 16,140            | 14,943            | 13,944            | 13,970            | 12,818            |
|                          | Other water         | 35,682            | 29,582            | 31,999            | 25,672            | 25,132            |
|                          | Wastewater          | 6,960             | 5,414             | 5,235             | 4,755             | 4,378             |
|                          | Other               | 7,092             | 6,369             | 5,295             | 4,904             | 4,072             |
|                          | <b>Total</b>        | <b>\$ 307,280</b> | <b>\$ 274,014</b> | <b>\$ 256,546</b> | <b>\$ 250,718</b> | <b>\$ 235,162</b> |

RESULTS OF OPERATIONS

Our income from continuing operations has grown at an annual compound rate of approximately 15.5% during the five-year period ended December 31, 2001. During this same period, operating revenues grew at a compound rate of 7.3% and total expenses, exclusive of income taxes, grew at a compound rate of 4.5%.

Operating Revenues

The growth in revenues over the past five years is a result of increases in the customer base and in water rates. The number of customers increased at an annual compound rate of 3.6% in the past five years primarily as a result of acquisitions of local water systems. Acquisitions made during the five-year period ended December 31, 2001 have provided water and wastewater revenues of approximately \$17,427 in 2001, \$10,637 in 2000 and \$5,606 in 1999. Excluding the effect of acquisitions, our customer base increased at a five-year annual compound rate of 0.9%. Rate increases implemented during the past three years have provided additional operating revenues of approximately \$13,100 in 2001, \$15,400 in 2000 and \$1,700 in 1999. In addition to water and wastewater operating revenues, we had other non-regulated revenues that were primarily associated with operating and management contracts, and data processing service fees of \$7,092 in 2001, \$6,369 in 2000 and \$5,295 in 1999.

*Economic Regulation* - 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 profitability of our utility operations is influenced to a great extent by the timeliness and adequacy of rate allowances in the various states in which we operate. Accordingly, we

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

maintain a rate case management capability to ensure that the tariffs of the utility operations reflect, to the extent practicable, the timely recovery of increases in costs of operations, capital, taxes, energy, materials and compliance with environmental regulations. In assessing our rate case strategy, we consider the amount of utility plant additions and replacements made since the previous rate decision, the changes in the cost of capital, changes in the capital structure and changes in other costs. Based on these assessments, our utility operations periodically file rate increase requests with their respective state regulatory commissions. The rates for some divisions of CWC's Ohio subsidiary can be fixed by negotiated agreements with the municipalities that are served by those divisions in lieu of regulatory approval from the Public Utility Commission of Ohio. Currently, two of the six regulated divisions in Ohio are operating under such rate ordinances.

In November 2001, Pennsylvania Suburban Water Company filed an application with the Pennsylvania Public Utility Commission ("PAPUC") requesting a \$28,000 or 13.4% increase in annual revenues. The application is currently pending before the PAPUC and a final determination is anticipated by August 2002. In April 2000, the PAPUC approved a rate settlement reached between Pennsylvania Suburban Water Company and the parties actively litigating the joint rate application filed in October 1999. The settlement was designed to increase annual revenues by \$17,000 or 9.4% above the level in effect at the time of the filing. The rates in effect at the time of the filing included \$7,347 in Distribution System Improvement Charges ("DSIC") ranging from 0.33% to 5%. Consequently, the settlement resulted in a total base rate increase of \$24,347 or 13.5% above the rates in effect before the DSIC was applied. The settlement agreement also provided for the recovery of up to \$5,295 (the merger costs allocable to our Pennsylvania operations) of the \$10,121 (\$8,596 after-tax) in merger costs that were expensed in 1999 in connection with the CWC merger. During 2000, a regulatory asset was established to reflect the amount to be recovered as a result of the rate settlement. This resulted in a recovery of \$1,136 of restructuring costs and \$2,905 of merger transaction costs as reported on the Consolidated Statements of Income and Comprehensive Income.

The CWC operating subsidiaries were allowed annual rate increases of \$4,799 in 2001, \$698 in 2000 and \$390 in 1999 resulting from nine, four and two rate decisions, respectively. Revenues from these increases realized in the year of grant were approximately \$4,200 in 2001, \$450 in 2000 and \$308 in 1999. The CWC operating subsidiaries currently have four rate requests in process requesting a \$3,858 increase in annual revenues. The applications are currently under review by the respective state regulatory commission.

*Distribution System Improvement Charges* - The PAPUC permits Pennsylvania water utilities to add a surcharge to their water bills to offset the additional depreciation and capital costs associated with certain capital expenditures related to replacing and rehabilitating distribution systems. Prior to the DSIC mechanism being approved in 1996, water utilities absorbed all of the depreciation and capital costs of these projects between base rate increases without the benefit of additional revenues. The gap between the time that a capital project is completed and the recovery of its costs in base rates is known as regulatory lag. The DSIC mechanism is intended to substantially reduce regulatory lag that often acted as a disincentive to water utilities in rehabilitating their distribution systems.

The DSIC is adjusted quarterly based on additional qualified capital expenditures made in the previous quarter. The DSIC is capped at 5% of base rates. The DSIC 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 PAPUC benchmark that is determined quarterly. The DSIC in 2000 was set at 5% until new base rates became effective in April 2000, at which point the DSIC was reset to zero. The DSIC in 2001 ranged from the first quarter amount of 2.2% and increased each successive quarter to 5% in the fourth quarter. The DSIC has

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

been set at 5% in the first quarter of 2002. The DSIC provided revenues of \$6,672 in 2001, \$2,301 in 2000 and \$4,140 in 1999.

In 2001, the Illinois Commerce Commission issued regulations implementing an infrastructure surcharge mechanism known as a Qualifying Infrastructure Plant Surcharge ("QIPS") for use by Illinois water and wastewater utilities. QIPS is similar to DSIC, however, it is established annually and prospectively based on anticipated qualifying capital expenditures, and it includes a broader range of qualifying capital expenditures, including certain wastewater capital expenditures. Our operating subsidiary in Illinois received approval to add a QIPS to its bills in three of its operating divisions beginning January 1, 2002 at various rates ranging from 1.06% to 2.49%.

*Rate Surcharges* - In addition to its base rates and DSIC, our Pennsylvania subsidiary has utilized a surcharge or credit on its bills to reflect certain changes in Pennsylvania State taxes until such time as the tax changes are incorporated in base rates. Operating revenues were reduced by rate credits of \$639 in 2001 and increased by rate surcharges of \$74 in 2000 and \$1,306 in 1999. In the first quarter of 2002, the rate credit has been set at 0.35%.

*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 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.

Our exposure to regional weather conditions is lessened by our geographic diversity, as our customers are located in the following states: 65% in Pennsylvania, 14% in Ohio, 11% in Illinois, 6% in New Jersey, 3% in Maine and 1% in North Carolina. In 2001, our territories in Pennsylvania and New Jersey experienced hot, dry weather. As a result, water consumption in these portions of our service territory increased during this period. In 2000, our service territories in several states, in particular the southeastern Pennsylvania territory, experienced cool and wet weather conditions during the summer months. As a result, water consumption in these portions of our service territory declined during this period.

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. At times other than the summer months, warnings and restrictions generally have less of an effect on water consumption. In February 2002, a drought emergency was declared in 24 counties, including seven of the counties we serve in Pennsylvania. A drought emergency imposes a ban on nonessential water use. A drought warning and drought watch had previously been issued in November 2001 for portions of our service territory in Pennsylvania. Water use restrictions were also issued during the summer of 1999, in Pennsylvania and New Jersey, when we experienced abnormally dry weather in our service areas resulting in governmental authorities declaring drought warnings and water use restrictions in the affected areas. As a result of these actions, water consumption and water revenues in these areas declined to levels below those experienced in

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

1998. When the drought restrictions were lifted in the fall of 1999, water revenues returned to normal levels. Throughout the restriction periods, we generally had sufficient quantities of raw water and maintained adequate storage levels of treated water.

#### Operations and Maintenance Expenses

Operations and maintenance expenses totaled \$111,885 in 2001, \$101,741 in 2000 and \$98,758 in 1999. Most elements of operating costs are subject to the effects of inflation, as well as the effects of changes in the number of customers served, in water consumption 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, electricity, chemicals and maintenance expenses. Electricity and chemical expenses vary in relationship to water consumption, raw water quality, and to a lesser extent the 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 2001 as compared to 2000 by \$10,144 or 10.0% due to additional operating costs associated with acquisitions, increased water production expenses associated with the higher water consumption, and increased wage and benefit costs.

Operations and maintenance expenses increased in 2000 as compared to 1999 by \$2,983 or 3.0% due to additional operating costs associated with acquisitions, higher fuel and electric costs, and increased administrative costs, offset in part by a reduction in corporate costs as part of our cost containment initiatives. Administrative costs increased as a result of increases in insurance costs and an increased allowance for doubtful accounts. The reduction in corporate costs was related to the cost synergies resulting from the Consumers Water Company merger in March 1999.

#### Depreciation and Amortization Expenses

Depreciation expense was \$37,979 in 2001, \$32,271 in 2000 and \$30,612 in 1999, and has increased principally as a result of the significant capital expenditures made to expand and improve the utility facilities, and as a result of acquisitions of water systems, offset in part by the effect in 2000 of a change in depreciation rates.

Amortization expense was \$2,189 in 2001, \$1,829 in 2000 and \$1,291 in 1999. The increase in 2001 and 2000 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 decreased by \$1,633 or 7.3% in 2001 as compared to 2000 and increased by \$687 or 3.1% in 2000 as compared to the previous year. The decrease in 2001 is due to a reduction in state and local taxes and a decrease in the Pennsylvania Capital Stock Tax. The increase in 2000 is associated with increased property taxes and an increase in Pennsylvania Public Utility Realty tax due to a higher base on which the tax is calculated.

#### Restructuring costs (recovery)

During 2000, a recovery of restructuring costs of \$1,136 resulted from an April 2000 rate settlement. These costs were included in a 1999 charge of \$3,787 for restructuring costs that included severances of \$2,940 and exit costs associated with the closing of CWC's corporate office.

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

#### Interest Expense, net

Net interest expense was \$39,859 in 2001, \$40,360 in 2000 and \$33,698 in 1999. Interest expense decreased in 2001 primarily as a result of decreased interest rates on short-term borrowings, offset in part by increased borrowings to fund capital expenditures and the acquisition of other utility systems. Interest expense during 2001 was favorably impacted by a reduction in the weighted cost of long-term debt from 7.2% at December 31, 2000 to 7.0% at December 31, 2001. Interest expense increased in 2000 primarily as a result of higher levels of borrowing in order to finance capital expenditures and the acquisition of other water systems, offset partially by the effects of decreased interest rates on short-term borrowings.

#### Gains on Sale of Other Assets

Gains on sale of other assets totaled \$3,384 in 2001, \$5,076 in 2000 and \$780 in 1999. Gains on sale of land totaled \$3,018 in 2001, \$1,524 in 2000 and \$780 in 1999. Gains on sale of marketable securities totaled \$366 in 2001 and \$3,552 in 2000. There were no marketable securities sold in 1999.

#### Dividends on Preferred Stock of Subsidiary and Minority Interest

Dividends on preferred stock of subsidiary and minority interest were \$0 in 2001, \$103 in 2000 and \$93 in 1999. The change in 2001 is a result of substantially eliminating the minority ownership of three operating subsidiaries during 2001 and the redemption of the preferred stock of subsidiaries.

#### Allowance for Funds Used During Construction

The allowance for funds used during construction ("AFUDC") was \$1,222 in 2001, \$2,688 in 2000 and \$1,995 in 1999 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 decrease in 2001 is a result of a reduction in the average balance of CWIP, to which AFUDC is applied, due to the completion of a \$35,000 water treatment plant in the third quarter of 2000 and a decrease in the AFUDC rate. The increase in 2000 is a result of an increased average balance of CWIP, to which AFUDC is applied, due to the increased level of capital expenditures in 2000, particularly due to the construction of a \$35,000 water treatment plant. Construction commenced on this facility in 1997 and was completed in 2000.

#### Merger transaction costs (recovery)

During 2000, a recovery of merger transaction costs of \$2,905 was recognized resulting from the April 2000 rate settlement. These costs were included in a \$6,334 charge that was recorded in 1999 when the CWC merger was completed. The charge represents the fees for investment bankers, attorneys, accountants and other administrative charges.

#### Income Taxes

Our effective income tax rate was 39.3% in 2001, 39.2% in 2000 and 42.2% in 1999. The effective tax rate was higher in 1999 due to the estimated non-deductible portion of the \$6,334 of merger transaction costs recorded in 1999. Exclusive of the merger transaction costs and related tax benefits of \$200, the 1999 effective tax rate would have been 38.6%. The changes in the effective tax rates in 2001 and 2000 are due to differences between tax deductible expenses and book expenses.

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

#### Summary

Operating income was \$134,340 in 2001, \$116,789 in 2000 and \$100,265 in 1999 and net income was \$60,111 in 2001, \$52,890 in 2000 and \$36,384 in 1999. Our operating results have been affected by several non-operating items in 2000 and 1999. Operating income and net income for 2000 includes the gain for the partial recovery of restructuring costs related to the CWC merger of \$1,136 (\$665 after tax or \$0.01 per share) and for 1999 includes the charge for restructuring costs related to the CWC merger of \$3,787 (\$2,462 after tax or \$0.04 per share). Net income for 2000 includes the gain for the partial recovery of merger transaction costs related to the CWC merger of \$2,905 (\$1,571 after tax or \$0.02 per share) and for 1999 includes the charge for \$6,334 (\$6,134 after tax or \$0.09 per share) of merger transaction costs associated with the CWC merger. Diluted net income per share was \$0.87 in 2001, \$0.81 in 2000 and \$0.56 in 1999. Diluted income per share from operations, exclusive of the aforementioned non-recurring items, was \$0.87 in 2001, \$0.77 in 2000 and \$0.70 in 1999. The changes in the per share income in 2001 and 2000 over the previous years were due to the aforementioned changes in income and impacted by a 5.1% and 1.4% increase in the average number of common shares outstanding during 2001 and 2000, respectively.

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

#### Fourth Quarter Results

Net income available to common stock was \$12,209 in the fourth quarter of 2001 and \$12,434 in the same period of 2000. The change in net income is due to a \$5,932 increase in operating revenues, and a reduction in interest expense of \$401, offset by \$3,931 of increases in costs and expenses, and \$2,213 of lower gains realized from the sales of other assets in the fourth quarter of 2001 as compared to 2000. The increase in operating revenues was a result of an increase in water rates, additional revenues from acquisitions and non-regulated revenues associated with operating and management contracts and rental income. The decreased interest expense is a result of lower interest rates primarily on short-term borrowings. Operations and maintenance expenses increased primarily due to operating costs associated with acquisitions, higher water production expenses associated with higher water consumption, and increased wage and benefit costs. Depreciation expense increased \$1,303 due to utility plant additions and acquisitions made since the fourth quarter of 2000. The change in the gains realized from the sale of other assets is a result of a pre-tax gain on the sale of marketable securities of \$2,491 being realized in the fourth quarter of 2000 compared to \$211 realized in the fourth quarter of 2001.

#### Effects of Inflation

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

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Security

In light of recent concerns regarding security in the wake of the September 11, 2001 terrorist attacks, we have increased security measures at our facilities. These increased security measures were not made in response to any specific threat. We are in contact with federal, state and local authorities and industry trade associations regarding current information on possible threats and security measures for water utility operations. The cost of the increased security measures is expected to be fully recoverable in water rates and is not expected to have a material impact on our results from operations or financial condition.

FINANCIAL CONDITION

Cash Flow and Capital Expenditures

Net operating cash flow, dividends paid on common stock and capital expenditures, including allowances for funds used during construction, for the five years ended December 31, 2001 were as follows:

|      | Net Operating<br>Cash Flow | Common<br>Dividends | Capital<br>Expenditures |
|------|----------------------------|---------------------|-------------------------|
| 1997 | \$ 71,252                  | \$ 26,752           | \$ 67,378               |
| 1998 | 84,362                     | 29,349              | 87,973                  |
| 1999 | 74,103                     | 29,217              | 96,383                  |
| 2000 | 86,972                     | 30,406              | 129,740                 |
| 2001 | 102,165                    | 34,234              | 124,088                 |
|      | \$ 418,854                 | \$ 149,958          | \$ 505,562              |

Included in capital expenditures for the five-year period are: expenditures for the modernization and replacement of existing treatment plants; new water mains and customer service lines; rehabilitation of existing water mains, hydrants and customer service lines; water meters; and the construction of a divisional operations center. During this five-year period, we received \$29,052 of customer advances and contributions in aid of construction to finance new water mains and related facilities. In addition, during this period, we have made sinking fund contributions and retired debt in the amount of \$53,921, retired \$7,747 of preferred stock, and have refunded \$20,620 of customer advances for construction. Despite an annual increase in the common dividends declared and paid on our common stock over the past five years, the total common dividends paid in 1999 declined as compared to 1998 due to the exchange of the Consumers Water Company common stock for our common stock.

During the past five years, we have also expended \$92,063 related to the acquisitions of utility systems, primarily water utilities and some wastewater utilities, including the issuance of 976,148 shares of common stock. These acquisitions were accounted for as purchases. In March 1999, we completed a merger with Consumers Water Company. On the date of the merger, we issued 20,334,398 shares of Common Stock in exchange for all of the outstanding shares of CWC and CWC became our wholly-owned subsidiary. Our common shares issued in the CWC merger have been restated for the effect of the 2001 5-for-4 common stock split in the form of a 25% stock distribution.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

The CWC merger has been accounted for as a pooling-of-interests. In 1998, CWC's New Hampshire operations were sold under the New Hampshire condemnation statute for \$33,728, net of certain closing costs, which was used to pay down long-term debt.

Since net operating cash flow plus advances and contributions in aid of construction have not been sufficient to fully fund cash requirements, we issued approximately \$228,752 of First Mortgage Bonds and obtained other short-term borrowings during the past five years. In September 2000, we sold 2,066,406 shares of common stock in a public offering for net proceeds of \$29,689. The proceeds of this offering were used to make an equity contribution to PSW. In 1998, we sold 1,953,125 shares of common stock in a public offering for net proceeds of \$25,840. The proceeds of this offering were used to make a \$19,000 equity contribution to PSW and to repay short-term debt. At December 31, 2001, we had short-term lines of credit and other credit facilities of \$195,500, of which \$85,832 was available. Our short-term lines of credit and other credit facilities are either payable on demand or have a 364-day term.

We offer a Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") that provides a convenient and economical way to purchase shares of Philadelphia Suburban Corporation. Under the direct stock purchase portion of the Plan, shares are sold throughout the year and the shares are obtained by our transfer agent in the open market. The dividend reinvestment portion of the Plan offers a 5% discount on the purchase of original issue shares of common stock with reinvested dividends. As of the December 2001 dividend payment, holders of 17.5% of the common shares outstanding participated in the dividend reinvestment portion of the Plan. During the past five years, we have sold 2,246,563 original issue shares of common stock for net proceeds of \$28,028 through the dividend reinvestment portion of the Plan and the proceeds were used to invest in our operating subsidiaries, to relieve our operating subsidiaries of the need to pay a dividend to us, to repay short-term debt, and for general corporate purposes.

The Board of Directors has authorized us to purchase our common stock, from time to time, in the open market or through privately negotiated transactions. There were no shares repurchased in 2001 in the open market or through privately negotiated transactions. We purchased 288,750 shares in 2000 and 127,188 shares in 1999 at a net cost of \$3,500 in 2000 and \$1,771 in 1999. For comparative purposes the number of shares purchased is presented as if they were adjusted for the effect of the 2001 5-for-4 common stock split in the form of a 25% stock distribution. As of December 31, 2001, 328,967 shares remain available for repurchase. Funding for future stock purchases, if any, is not expected to have a material impact on our financial position.

As of December 31, 2001, our contractual cash obligations are as follows:

|                                    | Payments Due By Period |           |           |           |           |            | Total      |
|------------------------------------|------------------------|-----------|-----------|-----------|-----------|------------|------------|
|                                    | 2002                   | 2003      | 2004      | 2005      | 2006      | Thereafter |            |
| Long-term debt                     | \$ 14,935              | \$ 34,945 | \$ 39,972 | \$ 40,961 | \$ 17,130 | \$ 383,512 | \$ 531,455 |
| Operating leases                   | 1,901                  | 1,655     | 1,140     | 795       | 651       | 15,907     | 22,049     |
| Unconditional purchase obligations | 7,205                  | 8,098     | 8,098     | 6,919     | 6,811     | 36,947     | 74,078     |
| Total                              | \$ 24,041              | \$ 44,698 | \$ 49,210 | \$ 48,675 | \$ 24,592 | \$ 436,366 | \$ 627,582 |

The amounts reported as long-term debt in the above table represent sinking fund obligations and debt maturities that are due in the periods noted. We lease motor vehicles, buildings, land and other equipment under operating leases that are noncancelable. The unconditional purchase obligations represent our commitment to purchase minimum quantities of water as stipulated in agreements with



PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

municipal authorities. We use purchased water to supplement our water supply, particularly during periods of peak customer demand. In addition to these obligations, we make refunds on Customers' Advances for Construction over a specific period of time based on operating revenues related to developer-installed water mains or as new customers are connected to and take service from such mains. After all refunds are made, any remaining balance is transferred to Contributions in Aid of Construction. The refund amounts are not included in the above table because the refund amounts and timing cannot be accurately estimated since future refund payments depend on several variables, including new customer connections, customer consumption levels and future rate increases. Portions of these refund amounts are payable annually through 2017 and amounts not paid by the contract expiration dates become non-refundable.

Our planned 2002 capital program, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to be \$120,021 of which \$38,959 is for DSIC-qualified projects in Pennsylvania and QIPS-qualified projects in Illinois. We have increased our capital spending for infrastructure rehabilitation in response to the DSIC and QIPS and should these infrastructure surcharge mechanisms be discontinued for any reason, which is not anticipated, we would likely reduce our capital program significantly. Our 2002 capital program, along with \$14,935 of sinking fund obligations and debt maturities, and \$9,106 of other contractual cash obligations, is expected to be financed through internally-generated funds, our revolving credit facilities, our equity investments and the issuance of new long-term debt.

Future utility construction in the period 2003 through 2006, including recurring programs, such as the ongoing replacement of water meters, the rehabilitation of water mains and additional transmission mains to meet customer demands, exclusive of the costs of new mains financed by advances and contributions in aid of construction, is estimated to require aggregate expenditures of approximately \$500,000. We anticipate that less than one-half of these expenditures will require external financing including the additional issuance of Common Stock through our dividend reinvestment plan and possible future public equity offerings. We expect to refinance \$133,008 of sinking fund obligations and debt maturities during this period as they become due with new issues of long-term debt. The estimates discussed above do not include any amounts for possible future acquisitions of water systems or the financing necessary to support them.

We continue to hold acquisition discussions with several water systems. Acquisitions are expected to be financed through the issuance of equity or funded initially with short-term debt with subsequent repayment from the proceeds of long-term debt or proceeds from equity offerings.

Our primary source of liquidity is cash flows from operations, borrowings under various short-term lines of credit and other credit facilities, and advances and contributions in aid of construction. Our cash flow from operations, or internally-generated funds, is impacted by the timing of rate relief and water consumption. We fund our capital and acquisition programs through internally-generated funds, supplemented by short-term borrowings. Over time, we refinance our short-term borrowings with long-term debt and proceeds from the issuance of common stock. The ability to finance our future construction programs, as well as our acquisition activities, depends on our ability to attract the necessary external financing and maintain or increase internally-generated funds. Rate orders permitting compensatory rates of return on invested capital and timely rate adjustments will be required by our operating subsidiaries to achieve an adequate level of earnings to enable them to secure the capital they will need and to maintain satisfactory debt coverage ratios.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Market Risk

We are subject to market risks in the normal course of business, including changes in interest rates and equity prices. The exposure to changes in interest rates is a result of financings through the issuance of fixed-rate, long-term debt. Such exposure is typically related to financings between utility rate increases, since generally our rate increases provide a revenue level to allow recovery of our current cost of capital. Interest rate risk is managed through the use of a combination of long-term debt, which is at fixed interest rates and short-term debt, which is at floating interest rates. As of December 31, 2001, the debt maturities by period and the weighted average interest rate for fixed-rate, long-term debt are as follows:

|                             | 2002      | 2003      | 2004      | 2005      | 2006      | Thereafter | Total      | Fair Value |
|-----------------------------|-----------|-----------|-----------|-----------|-----------|------------|------------|------------|
| Long-term debt (fixed rate) | \$ 14,935 | \$ 34,945 | \$ 39,972 | \$ 40,961 | \$ 17,130 | \$ 383,512 | \$ 531,455 | \$ 562,740 |
| Average interest rate       | 6.54%     | 6.75%     | 6.36%     | 7.22%     | 7.20%     | 7.02%      | 6.96%      |            |

From time to time, we make investments in marketable equity securities. As a result, we are exposed to the risk of changes in equity prices for the "available for sale" marketable equity securities. As of December 31, 2001, our carrying value of marketable equity securities was \$6,425, which reflects the market value of such securities. The market risks that we are exposed to are consistent with the risks that we were exposed to in the prior year.

Capitalization

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

| December 31,                | 2001   | 2000   | 1999   | 1998   | 1997   |
|-----------------------------|--------|--------|--------|--------|--------|
| Long-term debt*             | 52.9%  | 52.4%  | 53.8%  | 51.9%  | 56.9%  |
| Preferred stock*            | 0.1%   | 0.2%   | 0.2%   | 0.4%   | 1.0%   |
| Common stockholders' equity | 47.0%  | 47.4%  | 46.0%  | 47.7%  | 42.1%  |
|                             | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

\*Includes current portion.

The changes in the capitalization ratios primarily result from the issuance of common stock over the past five years and the issuance of debt to finance our acquisitions and capital program. It is our goal to maintain an equity ratio adequate to support PSW's current Standard and Poors corporate credit rating of "A+" and its senior secured debt rating of "AA-".

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

Dividends on Common Stock

We have paid common dividends consecutively for 57 years. In 2001, our Board of Directors authorized an increase of 6.9% in the dividend rate over the amount we previously paid. As a result of this authorization, beginning with the dividend payment in December 2001, the annual dividend rate increased to \$0.53 per share. We presently intend to pay quarterly cash dividends in the future, on March 1, June 1, September 1 and December 1, subject to our earnings and financial condition, regulatory requirements and such other factors as our Board of Directors may deem relevant. During the past five years, after restatement for the 1999 CWC pooling, our common dividends paid have averaged 65.3% of income from continuing operations.

CRITICAL ACCOUNTING POLICIES

Our financial condition and results of operations are impacted by the methods, assumptions, and estimates used in the application of critical accounting policies. The following accounting policies are particularly important to our financial condition or results of operations, and require estimates or other judgements of matters of uncertainty. Changes in the estimates or other judgements included within these accounting policies could result in a significant change to the financial statements. We believe our most critical accounting policies include revenue recognition, the use of regulatory assets and liabilities as permitted by Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation", the review for impairment of our long-lived assets which consist primarily of Utility Plant in Service and regulatory assets, and our accounting for pensions and other postretirement benefits.

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

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

In accordance with the requirements of SFAS No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of", we review for impairment of our long-lived assets, including Utility Plant in Service. We also review regulatory assets for the continued application of SFAS No. 71. Our review determines whether there have been changes in circumstances or events that have occurred that require adjustments to the carrying value of these assets. In accordance with SFAS No. 71, adjustments to the carrying value of these assets would be made in instances where the inclusion in the rate-making process is unlikely.

# PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

We have defined benefit plans that cover our full-time employees and we offer certain postretirement benefits other than pensions to our employees retiring with a minimum level of service. Accounting for pensions and other postretirement benefits requires an extensive use of assumptions about the discount rate, expected return on plan assets, the rate of future compensation increases received by our employees, mortality, turnover and medical costs. While our actuarial consultants provide guidance in establishing the assumptions, the assumptions that we use may differ materially from actual results due to changes in actual circumstances, conditions or experience. These differences will impact the amount of pension and other postretirement benefit expense that we recognize. We expect future changes in the amount of expense recognized will be properly included in the rate-making process.

### IMPACT OF RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board ("FASB") issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and in June 1999 amended this standard by issuing SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133." In September 2000, the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," an amendment to SFAS No. 133. SFAS No. 138 establishes accounting and reporting standards for derivative instruments and for hedging activities and requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. SFAS No. 137 changed the timing of the implementation of SFAS No. 133. The adoption of these statements on January 1, 2001 did not have a material impact on our results of operations or financial condition. As of December 31, 2001, we had no derivative instruments or hedging activities.

In June 2001, the FASB approved SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. We adopted SFAS No. 142 on January 1, 2002 as required, and this statement applies to all goodwill and other intangible assets recorded on our balance sheet at that date, regardless of when those assets were originally recorded. We adopted SFAS No. 141 on July 1, 2001 and it did not have a material impact on our results of operations or financial position.

In July 2001, the FASB approved SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred. When the liability is initially recognized, the carrying amount of the related long-lived asset is increased by the same amount. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, we may settle the obligation for its recorded amount, or an alternative amount, thereby incurring a gain or loss upon settlement. We intend to adopt this statement as required in 2003. We are currently evaluating the provisions of this statement and have not yet determined the effect of adoption on our results of operations or financial position.

In August 2001, the FASB approved SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 replaces SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." We adopted SFAS No. 144 on January 1, 2002 as required and it did not have a material impact on our results of operations or financial position.

# PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

## Report of Management

The consolidated financial statements and related information for the years ended December 31, 2001, 2000 and 1999 were prepared by management in accordance with accounting principles generally accepted in the United States of America and include management's best estimates and judgments, as required. Financial information included in other sections of this annual report is consistent with that in the consolidated financial statements.

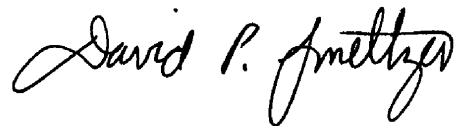
The Company has an internal accounting control structure designed to provide reasonable assurance that assets are safeguarded and that transactions are properly authorized and recorded in accordance with established policies and procedures. The internal control structure is supported by the selection and training of qualified personnel, the delegation of management authority and responsibility and dissemination of policies and procedures.

The Company's independent accountants, PricewaterhouseCoopers LLP, provide an independent review of management's reporting of results of operations and financial condition. PricewaterhouseCoopers has audited the financial statements by conducting tests as they deemed appropriate and their report follows.

The Board of Directors through the Audit Committee selects the Company's independent auditors and reviews the scope and results of their audits. The Audit Committee also reviews the adequacy of the Company's internal control structure and other significant matters. The Audit Committee is comprised of three outside Directors who meet periodically with management, our internal audit director and the independent auditors. The Audit Committee held two meetings in 2001.



Nicholas DeBenedictis  
Chairman &  
President



David P. Smeltzer  
Senior Vice President - Finance

## Report of Independent Accountants

To the Board of Directors and Stockholders of  
Philadelphia Suburban Corporation:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income and comprehensive income, of capitalization and of cash flow present fairly, in all material respects, the financial position of Philadelphia Suburban Corporation and its subsidiaries at December 31, 2001 and 2000, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. The financial statements of the Company as of December 31, 1999 and for the year then ended were audited by other independent accountants whose report dated January 31, 2000 expressed an unqualified opinion on those statements.



PricewaterhouseCoopers LLP  
Philadelphia, PA  
February 1, 2002

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(In thousands, except per share amounts)

Years ended December 31, 2001, 2000 and 1999

|   | 2001       | 2000       | 1999       |
|---|------------|------------|------------|
| Operating revenues  | \$ 307,280 | \$ 274,014 | \$ 256,546 |
| Costs and expenses:   |            |            |            |
| Operations and maintenance  | 111,885    | 101,741    | 98,758     |
| Depreciation  | 37,979     | 32,271     | 30,612     |
| Amortization  | 2,189      | 1,829      | 1,291      |
| Taxes other than income taxes                                       | 20,887     | 22,520     | 21,833     |
| Restructuring costs (recovery)                                      | -          | (1,136)    | 3,787      |
|   | 172,940    | 157,225    | 156,281    |
| Operating income  | 134,340    | 116,789    | 100,265    |
| Other expense (income):   |            |            |            |
| Interest expense, net   | 39,859     | 40,360     | 33,698     |
| Allowance for funds used during construction                        | (1,222)    | (2,688)    | (1,995)    |
| Gain on sale of other assets  | (3,384)    | (5,076)    | (780)      |
| Merger transaction costs (recovery)                                 | -          | (2,905)    | 6,334      |
| Dividends on preferred stock of subsidiary<br>and minority interest | -          | 103        | 93         |
| Income before income taxes  | 99,087     | 86,995     | 62,915     |
| Provision for income taxes  | 38,976     | 34,105     | 26,531     |
| Net income  | 60,111     | 52,890     | 36,384     |
| Dividends on preferred stock  | 106        | 106        | 109        |
| Net income available to common stock                                | \$ 60,005  | \$ 52,784  | \$ 36,275  |
| Net income  | \$ 60,111  | \$ 52,890  | \$ 36,384  |
| Other comprehensive income (loss), net of tax:                      |            |            |            |
| Unrealized gains on securities                                      | 39         | 908        | 2,020      |
| Reclassification adjustment for gains reported in net income        | (239)      | (2,002)    | -          |
|   | (200)      | (1,094)    | 2,020      |
| Comprehensive income  | \$ 59,911  | \$ 51,796  | \$ 38,404  |
| Net income per common share:  |            |            |            |
| Basic   | \$ 0.88    | \$ 0.82    | \$ 0.57    |
| Diluted   | \$ 0.87    | \$ 0.81    | \$ 0.56    |
| Average common shares outstanding during the period:                |            |            |            |
| Basic   | 67,873     | 64,759     | 63,850     |
| Diluted   | 68,755     | 65,414     | 64,539     |

See accompanying notes to consolidated financial statements.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(In thousands of dollars, except per share amounts)  
December 31, 2001 and 2000

|  | 2001         | 2000         |
|--|--------------|--------------|
| Assets   |              |              |
| Property, plant and equipment, at cost   | \$ 1,677,061 | \$ 1,536,162 |
| Less accumulated depreciation  | 308,946      | 284,735      |
| Net property, plant and equipment  | 1,368,115    | 1,251,427    |
| Current assets:  |              |              |
| Cash and cash equivalents  | 1,010        | 4,087        |
| Accounts receivable and unbilled revenues, net   | 56,331       | 50,242       |
| Inventory, materials and supplies  | 4,446        | 4,352        |
| Prepayments and other current assets   | 8,085        | 7,054        |
| Total current assets   | 69,872       | 65,735       |
| Regulatory assets  | 79,669       | 67,470       |
| Deferred charges and other assets, net   | 22,915       | 25,129       |
| Funds restricted for construction activity   | 19,768       | 3,962        |
|  | \$ 1,560,339 | \$ 1,413,723 |
| Liabilities and Stockholders' Equity   |              |              |
| Stockholders' equity:  |              |              |
| 6.05% Series B cumulative preferred stock  | \$ 1,116     | \$ 1,760     |
| Common stock at \$.50 par value, authorized 100,000,000 shares,<br>issued 69,300,346 and 67,939,281 in 2001 and 2000 | 34,650       | 27,260       |
| Capital in excess of par value   | 304,039      | 291,013      |
| Retained earnings  | 149,682      | 123,911      |
| Minority interest  | 787          | 2,823        |
| Treasury stock, at cost, 913,877 and 844,376 shares in 2001 and 2000   | (17,167)     | (15,346)     |
| Accumulated other comprehensive income   | 726          | 926          |
| Total stockholders' equity   | 473,833      | 432,347      |
| Long-term debt, excluding current portion  | 516,520      | 468,769      |
| Commitments  | -            | -            |
| Current liabilities:   |              |              |
| Current portion of long-term debt  | 14,935       | 3,943        |
| Loans payable  | 109,668      | 100,994      |
| Accounts payable   | 27,667       | 20,635       |
| Accrued interest   | 10,199       | 10,199       |
| Accrued taxes  | 22,865       | 15,815       |
| Other accrued liabilities  | 17,301       | 21,310       |
| Total current liabilities  | 202,635      | 172,896      |
| Deferred credits and other liabilities:  |              |              |
| Deferred income taxes and investment tax credits   | 167,577      | 151,718      |
| Customers' advances for construction   | 59,886       | 58,718       |
| Other  | 9,204        | 9,109        |
| Total deferred credits and other liabilities   | 236,667      | 219,545      |
| Contributions in aid of construction   | 130,684      | 120,166      |
|  | \$ 1,560,339 | \$ 1,413,723 |

See accompanying notes to consolidated financial statements.



PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CAPITALIZATION  
(In thousands of dollars, except per share amounts)  
December 31, 2001 and 2000

|   | 2001       | 2000       |
|---|------------|------------|
| Stockholders' equity:   |            |            |
| 6.05% Series B cumulative preferred stock                               | \$ 1,116   | \$ 1,760   |
| Common stock, \$.50 par value   | 34,650     | 27,260     |
| Capital in excess of par value  | 304,039    | 291,013    |
| Retained earnings   | 149,682    | 123,911    |
| Minority interest   | 787        | 2,823      |
| Treasury stock, at cost   | (17,167)   | (15,346)   |
| Accumulated other comprehensive income                                  | 726        | 926        |
| Total stockholders' equity  | 473,833    | 432,347    |
| Long-term debt:   |            |            |
| First Mortgage Bonds secured by utility plant:                          |            |            |
| Interest Rate Range   |            |            |
| 0.00% to 2.49%  | 8,325      | 4,368      |
| 2.50% to 4.99%  | 9,023      | 6,712      |
| 5.00% to 5.49%  | 50,545     | 6,667      |
| 5.50% to 5.99%  | 30,660     | 31,060     |
| 6.00% to 6.49%  | 160,525    | 145,570    |
| 6.50% to 6.99%  | 55,200     | 55,200     |
| 7.00% to 7.49%  | 60,000     | 62,007     |
| 7.50% to 7.99%  | 23,000     | 23,000     |
| 8.00% to 8.49%  | 17,595     | 16,621     |
| 8.50% to 8.99%  | 9,000      | 10,460     |
| 9.00% to 9.49%  | 53,535     | 53,615     |
| 9.50% to 9.99%  | 46,031     | 49,831     |
| 10.00% to 10.50%  | 6,000      | 6,167      |
| Total First Mortgage Bonds  | 529,439    | 471,278    |
| Note payable, 6.05%, due 2006   | 644        | -          |
| Installment note payable, 9%, due in equal annual payments through 2013 | 1,372      | 1,434      |
|   | 531,455    | 472,712    |
| Current portion of long-term debt                                       | 14,935     | 3,943      |
| Long-term debt, excluding current portion                               | 516,520    | 468,769    |
| Total capitalization  | \$ 990,353 | \$ 901,116 |

See accompanying notes to consolidated financial statements.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES  
CONSOLIDATED CASH FLOW STATEMENTS

(In thousands of dollars)

Years ended December 31, 2001, 2000 and 1999

|   | 2001             | 2000             | 1999             |
|---|------------------|------------------|------------------|
| Cash flows from operating activities:   |                  |                  |                  |
| Net income  | \$ 60,111        | \$ 52,890        | \$ 36,384        |
| Adjustments to reconcile net income to net cash flows from operating activities:  |                  |                  |                  |
| Depreciation and amortization   | 40,168           | 34,100           | 31,903           |
| Deferred income taxes   | 14,935           | 10,885           | 6,342            |
| Gain on sale of other assets  | (3,384)          | (5,076)          | (780)            |
| Net increase in receivables, inventory and prepayments  | (5,295)          | (5,531)          | (3,073)          |
| Net increase in payables, accrued interest, accrued taxes and other accrued liabilities   | 7,045            | 4,247            | 444              |
| Payment of Competitive Transition Charge  | (11,465)         | -                | -                |
| Other   | 50               | (4,543)          | 2,380            |
| Net cash flows from discontinued operations   | -                | -                | 503              |
| Net cash flows from operating activities  | <u>102,165</u>   | <u>86,972</u>    | <u>74,103</u>    |
| Cash flows from investing activities:   |                  |                  |                  |
| Property, plant and equipment additions, including allowance for funds used during construction of \$1,222, \$2,688 and \$1,995 | (124,088)        | (129,740)        | (96,383)         |
| Acquisitions of water and wastewater systems  | (9,517)          | (3,546)          | (39,164)         |
| Net increase in funds restricted for construction activity  | (15,806)         | (3,962)          | -                |
| Net proceeds from the sale (purchases) of other assets  | 5,211            | 5,896            | (4,789)          |
| Other   | (173)            | (1,711)          | (280)            |
| Net cash flows used in investing activities   | <u>(144,373)</u> | <u>(133,063)</u> | <u>(140,616)</u> |
| Cash flows from financing activities:   |                  |                  |                  |
| Customers' advances and contributions in aid of construction  | 5,175            | 7,603            | 5,345            |
| Repayments of customers' advances   | (4,652)          | (4,642)          | (4,077)          |
| Net proceeds (repayments) of short-term debt  | 8,385            | (14,075)         | 39,519           |
| Proceeds from long-term debt  | 64,024           | 67,791           | 54,412           |
| Repayments of long-term debt  | (8,498)          | (13,289)         | (6,733)          |
| Redemption of preferred stock of subsidiary   | (1,349)          | -                | -                |
| Redemption of preferred stock   | (644)            | -                | (1,460)          |
| Proceeds from issuing common stock  | 13,522           | 37,190           | 7,061            |
| Repurchase of common stock  | (2,493)          | (4,383)          | (1,773)          |
| Dividends paid on preferred stock   | (106)            | (106)            | (117)            |
| Dividends paid on common stock  | (34,234)         | (30,406)         | (29,217)         |
| Other   | 1                | (163)            | (36)             |
| Net cash flows from financing activities  | <u>39,131</u>    | <u>45,520</u>    | <u>62,924</u>    |
| Net decrease in cash and cash equivalents   | (3,077)          | (571)            | (3,589)          |
| Cash and cash equivalents at beginning of year  | 4,087            | 4,658            | 8,247            |
| Cash and cash equivalents at end of year  | <u>\$ 1,010</u>  | <u>\$ 4,087</u>  | <u>\$ 4,658</u>  |
| Cash paid during the year for:  |                  |                  |                  |
| Interest, net of amounts capitalized  | \$ 38,637        | \$ 36,507        | \$ 31,036        |
| Income taxes  | <u>\$ 19,388</u> | <u>\$ 23,008</u> | <u>\$ 20,313</u> |

See Summary of Significant Accounting Policies-Customers' Advances for Construction, Merger with Consumers Water Company, Acquisitions and Water Sale Agreements and Employee Stock and Incentive Plans footnotes for description of non-cash activities.

See accompanying notes to consolidated financial statements.

# PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

### Summary of Significant Accounting Policies

*Basis of Presentation* – On March 10, 1999, Philadelphia Suburban Corporation (the “Company” or “PSC”) completed a merger (the “Merger”) with Consumers Water Company (“CWC”). On the date of the Merger, the Company issued 20,334,398 shares of Common Stock in exchange for all of the outstanding shares of CWC and CWC became a wholly-owned subsidiary of the Company. The Company’s common shares issued and exchanged for CWC shares have been restated for the effect of the 2001 5-for-4 common stock split effected in the form of a stock distribution. The Merger has been accounted for as a pooling-of-interests under Accounting Principles Board Opinion No. 16. Accordingly, the Company’s consolidated financial statements and footnotes presented in this report include the accounts and results of CWC as if the Merger had been completed as of the beginning of the earliest period presented.

*Nature of Operations* - The business of Philadelphia Suburban Corporation is conducted primarily through its wholly-owned subsidiary Pennsylvania Suburban Water Company (“PSW”) and the four operating companies of CWC (collectively referred to as “operating companies”). The operating companies of PSC are regulated public utilities which supply water and provide wastewater service to 602,510 customers in Pennsylvania, Ohio, Illinois, New Jersey, Maine and North Carolina. The customers of our operating companies are residential, commercial and industrial in nature. PSW, our largest subsidiary, is a regulated public utility which supplies water to approximately 336,700 customers, principally in the suburban areas north and west of the City of Philadelphia and in ten other counties in western, north central and northeastern Pennsylvania. In January 2002, Philadelphia Suburban Water Company and various other wholly-owned Pennsylvania operating subsidiaries were merged together into Pennsylvania Suburban Water Company. For operational purposes, these entities will continue to do business under their former names. For discussion purposes, all references to PSW relate to Pennsylvania Suburban Water Company or its predecessor companies. CWC owns 100% of the voting stock of three water companies and at least 99% of the voting stock of one water company. In addition, the Company provides water and wastewater service to approximately 15,000 customers through operating and maintenance contracts in Pennsylvania, Illinois, New Jersey and Maine.

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

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

*Recognition of Revenues* - Revenues include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the latest billing to the end of the accounting period. Non-utility revenues are recognized when services are performed.

*Property, Plant and Equipment and Depreciation* - Property, plant and equipment consist primarily of utility plant. The cost of additions includes contracted cost, direct labor and fringe benefits, materials, overheads and, for certain utility plant, allowance for funds used during construction. Water systems acquired are recorded at estimated original cost of utility plant when first devoted to utility service and the applicable depreciation is

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

recorded to accumulated depreciation. The difference between the estimated original cost, less applicable accumulated depreciation, and the purchase price is recorded as an acquisition adjustment within utility plant. At December 31, 2001, utility plant includes a net credit acquisition adjustment of \$9,043, which is being amortized over 20 to 40 years. Consistent with the Company's rate settlements, \$545 was amortized during 2001, \$541 was amortized during 2000 and \$558 was amortized during 1999.

Utility expenditures for maintenance and repairs, including minor renewals and betterments, are charged to operating expenses in accordance with the system of accounts prescribed by the public utility commissions of the states in which the company operates. The cost of new units of property and betterments are capitalized. When units of utility property are replaced, retired or abandoned, the recorded value thereof is credited to the asset account and such value, together with the net cost of removal, is charged to accumulated depreciation.

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

In accordance with the requirements of Statement of Financial Accounting Standards ("SFAS") No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of", the long-lived assets of the Company, which consist primarily of Utility Plant in Service and regulatory assets, have been reviewed for impairment. There has been no change in circumstances or events that have occurred that require adjustments to the carrying values of these assets.

*Allowance for Funds Used During Construction* - The allowance for funds used during construction ("AFUDC") is a non-cash credit which represents the estimated cost of funds used to finance the construction of utility plant. In general, AFUDC is applied to construction projects requiring more than one month to complete. No AFUDC is applied to projects funded by customer advances for construction or contributions in aid of construction. AFUDC includes the net cost of borrowed funds and a rate of return on other funds when used, and is recovered through water rates as the utility plant is depreciated. The amount of AFUDC related to equity funds was \$334 in 2000 and \$57 in 1999. There was no AFUDC related to equity funds in 2001.

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

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

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

*Income Taxes* - The Company accounts for certain income and expense items in different time periods for financial reporting than for tax reporting purposes. Deferred income taxes are provided on the temporary differences between the tax basis of the assets and liabilities and the amounts at which they are carried in the

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

consolidated financial statements. The income tax effect of temporary differences not allowed currently in rates is recorded as deferred taxes with an offsetting regulatory asset or liability. These deferred income taxes are based on the enacted tax rates expected to be in effect when such temporary differences are projected to reverse. Investment tax credits are deferred and amortized over the estimated useful lives of the related properties.

*Customers' Advances for Construction* - Water mains or, in some instances, cash advances to reimburse the Company for its costs to construct water mains, are contributed to the Company by customers, real estate developers and builders in order to extend water service to their properties. The value of these contributions is recorded as Customers' Advances for Construction. The Company makes refunds on these advances over a specific period of time based on operating revenues related to the main or as new customers are connected to and take service from the main. After all refunds are made, any remaining balance is transferred to Contributions in Aid of Construction. Non-cash property, in the form of water mains, has been received, generally from developers, as advances or contributions of \$10,196, \$6,060 and \$10,069 in 2001, 2000 and 1999.

*Contributions in Aid of Construction* - Contributions in aid of construction include direct non-refundable contributions and the portion of customers' advances for construction that become non-refundable.

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

*Stock-Based Compensation* - The Company adopted SFAS No. 123, "Accounting for Stock-Based Compensation", electing the provision of the statement allowing it to continue its practice of not recognizing compensation expense related to granting of stock options to the extent that the option price of the underlying stock was equal to, or greater than, the market price on the date of option grant. Disclosure of the impact on the results of operations, had the Company elected to recognize compensation expense, is provided in the Employee Stock and Incentive Plans footnote as required by the Statement.

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

*Reclassifications* - Certain prior year amounts have been reclassified to conform with current year's presentation.

*Recent Accounting Pronouncements* - In June 1998, the Financial Accounting Standards Board ("FASB") issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and in June 1999 amended this standard by issuing SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133." In September 2000, the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," an amendment to SFAS No. 133. SFAS No. 138 establishes accounting and reporting standards for derivative instruments and for hedging activities and requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. SFAS No. 137 changed the timing of the implementation of SFAS No. 133. The adoption of these statements on January 1, 2001 did not have a material impact on the Company's results of operations or financial condition. As of December 31, 2001, the Company had no derivative instruments or hedging activities.

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

In June 2001, the FASB approved SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. The Company adopted SFAS No. 142 on January 1, 2002 as required, and this statement applies to all goodwill and other intangible assets recorded on our balance sheet at that date, regardless of when those assets were originally recorded. The adoption of SFAS No. 141 on July 1, 2001 did not have a material impact on the Company's results of operations or financial position.

In July 2001, the FASB approved SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred. When the liability is initially recognized, the carrying amount of the related long-lived asset is increased by the same amount. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, the Company may settle the obligation for its recorded amount, or an alternative amount, thereby incurring a gain or loss upon settlement. The Company intends to adopt this statement as required in 2003. The Company is currently evaluating the provisions of this statement and has not yet determined the effect of adoption on its results of operations or financial position.

In August 2001, the FASB approved SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 replaces SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." The adoption of SFAS No. 144 on January 1, 2002 did not have a material impact on the Company's results of operations or financial position.

#### Merger with Consumers Water Company

On March 10, 1999, the Company completed a merger ("the Merger") with CWC. Pursuant to the merger agreement, the Company issued 20,334,398 shares of Common Stock in exchange for all of the outstanding stock of CWC. CWC common shareholders received 2.2 shares of the Company's Common Stock for each CWC common share and CWC preferred shareholders received 8.8 shares of the Company's Common Stock for each CWC preferred share. The Company's common shares issued and exchanged for CWC shares have been restated for the effect of the 2001 5-for-4 common stock split effected in the form of a 25% stock distribution. As a result of the Merger, CWC became a wholly-owned subsidiary of the Company. CWC's water companies serve approximately 245,000 customers in service territories covering parts of five states in which we operate.

During 1999, the Company recorded a charge of \$6,334 (\$6,134, after tax benefits of \$200) for merger transaction costs consisting primarily of fees for investment bankers, attorneys, accountants and other administrative charges. In addition, the Company recorded a restructuring reserve of \$3,787 (\$2,462, after tax benefits of \$1,325) in 1999 that includes severances of \$2,940 and exit costs associated with the closing of CWC's corporate office. Since the restructuring reserve was established, cash payments have substantially eliminated this reserve balance during the first half of 2000. In connection with a rate settlement received in 2000, recovery of a portion of the merger costs has been granted and a regulatory asset was established to reflect this recovery. As a result, a gain on recovery of merger costs of \$2,236 (\$4,041 pre-tax) was recognized in 2000. The merger transaction costs and related recovery have been reported in Other expenses and the restructuring costs and related recovery have been reported as Costs and expenses in the Consolidated Statements of Income and Comprehensive Income.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Acquisitions and Water Sale Agreements

During 2001, the Company completed 20 acquisitions or other growth ventures in the various states in which the Company operates. The total purchase price of \$14,878 for the systems acquired in 2001 consisted of \$9,517 in cash and the issuance of 331,710 shares of the Company's common stock. The increase in annual revenues resulting from the acquired systems approximate \$4,699 (unaudited) and operating revenues included in the consolidated financial statements during the period owned by the Company was \$3,432.

During 2000, the Company completed 18 acquisitions or other growth ventures, including the Company's entry into a sixth state, North Carolina. The total purchase price of \$11,840 for the systems acquired in 2000 consisted of \$3,546 in cash and the issuance of 578,813 shares of the Company's common stock. Operating revenues included in the consolidated financial statements related to the systems acquired in 2000 were \$2,623 in 2001 and \$394 in 2000.

During 1999, exclusive of the Merger, the Company completed 16 acquisitions or other growth ventures in the various states where the Company operates. The total purchase price for the systems acquired in 1999 was \$39,164 in cash. Operating revenues included in the consolidated financial statements related to the systems acquired in 1999 were \$5,101 in 2001, \$4,808 in 2000 and \$559 in 1999.

Property, Plant and Equipment

|                                       | December 31,        |                     |
|---------------------------------------|---------------------|---------------------|
|                                       | 2001                | 2000                |
| Utility plant and equipment           | \$ 1,622,788        | \$ 1,513,480        |
| Utility construction work in progress | 51,531              | 19,820              |
| Non-utility plant and equipment       | 2,742               | 2,862               |
| Total property, plant and equipment   | <u>\$ 1,677,061</u> | <u>\$ 1,536,162</u> |

Depreciation is computed based on estimated useful lives of 2 to 110 years for utility plant and 3 to 10 years for both utility transportation and mechanical equipment and all non-utility plant, office equipment and laboratory equipment.

Accounts Receivable

|                                      | December 31,     |                  |
|--------------------------------------|------------------|------------------|
|                                      | 2001             | 2000             |
| Billed utility revenue               | \$ 33,476        | \$ 30,846        |
| Unbilled utility revenue             | 23,493           | 20,645           |
| Other                                | 1,844            | 658              |
|                                      | <u>58,813</u>    | <u>52,149</u>    |
| Less allowance for doubtful accounts | 2,482            | 1,907            |
| Net accounts receivable              | <u>\$ 56,331</u> | <u>\$ 50,242</u> |

The Company's customers are located in the following states: 65% in Pennsylvania, 14% in Ohio, 11% in Illinois, 6% in New Jersey, 3% in Maine and 1% in North Carolina. No single customer accounted for more than one percent of the Company's operating revenues during the years ended December 31, 2001, 2000 or 1999.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Regulatory Assets

The regulatory assets represent costs that are excluded from the Company's rate base but are expected to be fully recovered in future rates. The components of this asset are as follows:

|                                       | December 31,     |                  |
|---------------------------------------|------------------|------------------|
|                                       | 2001             | 2000             |
| Income taxes                          | \$ 61,080        | \$ 58,650        |
| Competitive Transition Charge payment | 10,319           | -                |
| Postretirement benefits               | 1,374            | 1,685            |
| Merger costs                          | 3,759            | 4,308            |
| Water tank painting                   | 2,088            | 1,657            |
| Rate case filing expenses and other   | 1,049            | 1,170            |
|                                       | <u>\$ 79,669</u> | <u>\$ 67,470</u> |

Items giving rise to deferred state income taxes, as well as a portion of deferred Federal income taxes related to certain differences between tax and book depreciation expense, are recognized in the rate setting process on a cash or flow-through basis and will be recovered as they reverse. The regulatory asset associated with the Competitive Transition Charge payment represents the full pay off in 2001, net of amortization, of the allocable share of a Competitive Transition Charge ("CTC") as negotiated by PSW from its electric distribution company, PECO Energy Company. The Pennsylvania Electricity Generation Customer Choice and Competition Act permitted electric distribution utilities to recover their stranded costs from its customers in the form of a CTC. The \$11,465 CTC payment is expected to be recovered in future water rates over 10 years. Postretirement benefits include pension and other postretirement benefits. The pension costs are deferred net pension expense in excess of amounts funded which the Company believes will be recoverable in future years as pension funding is required. The regulatory asset related to postretirement benefits other than pensions represents costs that were deferred between the time that the accrual method of accounting for these benefits was adopted in 1993 and the recognition of the accrual method in the Company's rates as prescribed in subsequent rate filings. Amortization of the amount deferred for postretirement benefits other than pensions began in 1994 and is currently being recovered in rates. The regulatory asset related to the recovery of merger costs represents the portion of the CWC merger costs that will be recovered in rates as a result of a rate settlement in 2000 and is being amortized over the recovery period. Expenses associated with water tank painting are deferred and amortized over a period of time as approved in the regulatory process. The regulatory asset related to rate case filing expenses represents the costs associated with filing for rate increases that are deferred and amortized over periods that generally range from one to three years.



PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Income Taxes

The provision for income taxes consists of:

|                   | Years Ended December 31, |                  |                  |
|-------------------|--------------------------|------------------|------------------|
|                   | 2001                     | 2000             | 1999             |
| Current:          |                          |                  |                  |
| Federal           | \$ 18,935                | \$ 19,888        | \$ 15,233        |
| State             | 5,106                    | 4,900            | 3,695            |
|                   | <u>24,041</u>            | <u>24,788</u>    | <u>18,928</u>    |
| Deferred:         |                          |                  |                  |
| Federal           | 13,048                   | 8,371            | 6,862            |
| State             | 1,887                    | 946              | 741              |
|                   | <u>14,935</u>            | <u>9,317</u>     | <u>7,603</u>     |
| Total tax expense | <u>\$ 38,976</u>         | <u>\$ 34,105</u> | <u>\$ 26,531</u> |

The statutory Federal tax rate is 35% and the state corporate net income tax rates range from 7.18% to 9.99% for all years presented. The Company's Federal income tax returns for all years through 1997 have been closed.

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

|  | Years Ended December 31, |                  |                  |
|--|--------------------------|------------------|------------------|
|  | 2001                     | 2000             | 1999             |
| Computed Federal tax expense at statutory rate                                   | \$ 34,680                | \$ 30,448        | \$ 22,020        |
| Increase in tax expense for depreciation expense to be recovered in future rates | 452                      | 353              | 387              |
| Merger transaction costs   | -                        | 120              | 2,017            |
| Charitable contribution  | -                        | (83)             | (479)            |
| Gain on sale of land   | -                        | -                | 83               |
| Amortization of deferred investment tax credits                                  | (276)                    | (287)            | (279)            |
| Prior year rate reductions   | (322)                    | (311)            | (313)            |
| State income taxes, net of federal tax benefit                                   | 4,545                    | 3,799            | 2,883            |
| Other, net   | (103)                    | 66               | 212              |
| Actual income tax expense  | <u>\$ 38,976</u>         | <u>\$ 34,105</u> | <u>\$ 26,531</u> |

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

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

|   | December 31,      |                   |
|---|-------------------|-------------------|
|   | 2001              | 2000              |
| Deferred tax assets:  |                   |                   |
| Customers' advances for construction  | \$ 18,060         | \$ 19,120         |
| Costs expensed for book not deducted for tax, principally accrued expenses and bad debt reserves  | 1,689             | 5,064             |
| Other   | 290               | -                 |
| Total gross deferred tax assets   | <u>20,039</u>     | <u>24,184</u>     |
| Deferred tax liabilities:   |                   |                   |
| Utility plant, principally due to depreciation and differences in the basis of fixed assets due to variation in tax and book accounting | 156,332           | 143,615           |
| Deferred taxes associated with the gross-up of revenues necessary to recover, in rates, the effect of temporary differences             | 23,626            | 23,344            |
| Deferred investment tax credit  | 7,219             | 7,498             |
| Unrealized gain on marketable securities  | 439               | 547               |
| Other   | -                 | 898               |
| Total gross deferred tax liabilities  | <u>187,616</u>    | <u>175,902</u>    |
| Net deferred tax liability  | <u>\$ 167,577</u> | <u>\$ 151,718</u> |

Commitments

The Company maintains agreements with municipal authorities for the purchase of water to supplement its water supply, particularly during periods of peak demand. The agreements stipulate purchases of minimum quantities of water to the year 2026. The estimated annual commitments related to such purchases are expected to approximate \$7,426 through 2006. The Company purchased approximately \$5,807, \$5,592 and \$3,172 of water under these agreements during the years ended December 31, 2001, 2000 and 1999, respectively.

The Company leases motor vehicles, buildings and other equipment under operating leases that are noncancelable. During the next five years, \$4,271 of future minimum lease payments are due: \$1,526 in 2002, \$1,281 in 2003, \$766 in 2004, \$421 in 2005 and \$277 in 2006. PSW leases parcels of land on which its Media treatment plant and other facilities are situated and adjacent parcels that are used for watershed protection. The two operating leases are noncancelable, expire in 2045 and 2052 and contain certain renewal provisions. The leases are subject to an adjustment every five years based on changes in the Consumer Price Index. During each of the next five years, \$374 of lease payments for land, subject to the aforesaid adjustment, are due.

Rent expense was \$2,281, \$1,815 and \$1,894 for the years ended December 31, 2001, 2000 and 1999, respectively.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Long-term Debt and Loans Payable

The Consolidated Statements of Capitalization provides a summary of long-term debt and loans outstanding as of December 31, 2001 and 2000. The supplemental indentures with respect to certain issues of the First Mortgage Bonds restrict the ability of PSW and CWC to declare dividends, in cash or property, or repurchase or otherwise acquire PSW's and CWC's stock. As of December 31, 2001, approximately \$203,000 of PSW's and \$49,000 of CWC's retained earnings were free of these restrictions. Certain supplemental indentures also prohibit PSW and CWC from making loans to, or purchasing the stock of, the Company.

Annual sinking fund payments are required for certain issues of First Mortgage Bonds by the supplemental indentures. The future sinking fund payments and debt maturities of the Company's long-term debt are as follows:

| Interest Rate Range | 2002             | 2003             | 2004             | 2005             | 2006             | Thereafter        |
|---------------------|------------------|------------------|------------------|------------------|------------------|-------------------|
| 0.00% to 2.49%      | \$ 395           | \$ 387           | \$ 394           | \$ 396           | \$ 381           | \$ 6,372          |
| 2.50% to 4.99%      | 347              | 357              | 362              | 372              | 381              | 7,204             |
| 5.00% to 5.49%      | 60               | 60               | 70               | 70               | 75               | 50,210            |
| 5.50% to 5.99%      | 400              | 10,000           | 10,000           | -                | -                | 10,260            |
| 6.00% to 6.49%      | 10,000           | -                | 15,000           | -                | 644              | 135,525           |
| 6.50% to 6.99%      | -                | 10,400           | 400              | 10,400           | 10,400           | 23,600            |
| 7.00% to 7.49%      | 2,000            | 12,000           | 12,000           | 28,000           | 2,000            | 4,000             |
| 7.50% to 7.99%      | -                | -                | -                | -                | -                | 23,000            |
| 8.00% to 8.49%      | 31               | 33               | 31               | -                | -                | 17,500            |
| 8.50% to 8.99%      | -                | -                | -                | -                | -                | 9,000             |
| 9.00% to 9.49%      | 548              | 554              | 561              | 568              | 576              | 52,100            |
| 9.50% to 9.99%      | 1,154            | 1,154            | 1,154            | 1,155            | 2,673            | 38,741            |
| 10.00% to 10.50%    | -                | -                | -                | -                | -                | 6,000             |
| Total               | <u>\$ 14,935</u> | <u>\$ 34,945</u> | <u>\$ 39,972</u> | <u>\$ 40,961</u> | <u>\$ 17,130</u> | <u>\$ 383,512</u> |

PSW has a five-year \$300,000 medium-term note program through December 2004 that provides for the issuance of long-term debt with maturities ranging between one and 35 years at fixed rates of interest, as determined at the time of issuance. The notes issued under this program are secured by the Thirty-Third Supplement to the trust indenture relating to PSW's First Mortgage Bonds. In October 2001, PSW issued First Mortgage Bonds through the program of \$15,000 6.21% Series due 2011. In January 2000, PSW issued First Mortgage Bonds through the program of \$15,000 7.40% Series due 2005, and in April 2000, \$11,000 7.40% Series due 2005. The proceeds from these issuances were used to fund acquisitions, to reduce the balance of PSW's short-term debt and for PSW's ongoing capital program.

In September 2001, one of CWC's operating subsidiaries issued \$12,000 of tax-exempt bonds due in 2031 at a rate of 5.00%. In November 2001, PSW issued \$30,000 in First Mortgage Bonds 5.35% Series due 2031 as security for an equal amount of Bonds issued by the Delaware County Industrial Development Authority. The proceeds from these bonds are restricted to funding the costs of certain capital projects. At various times during 2001, PSW and other operating subsidiaries issued notes payable in aggregate of \$6,725 at a weighted average interest rate of 2.8% due at various times in 2006, 2021, 2022 and 2031. The proceeds from the notes payable issued in 2001 were used to reduce a portion of the balance of short-term debt at each of the respective operating subsidiaries, to redeem \$2,400 of 9.6% First Mortgage Bonds of one

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

of CWC's operating subsidiaries through an early redemption, and redeem PSC preferred stock of \$644. As of December 31, 2001, the Trustees for seven issues held \$19,768 pending completion of the projects financed with the issues and are reported in the consolidated balance sheet as funds restricted for construction activity.

In June 2000, PSW issued \$18,360 of tax-exempt bonds due in 2030 at a rate of 6.00%. At various times during 2000, PSW and other operating subsidiaries issued notes payable in aggregate of \$12,583 at various rates of interest ranging from 0% to 5.4% due at various times in 2019, 2020, and 2030. The proceeds from the other issues were used to reduce a portion of the balance of short-term debt at each of the respective operating subsidiaries. In connection with various acquisitions completed during 2000, the Company acquired \$3,102 of long-term debt at various rates of interest ranging from 1% to 10.5% due in various years. During 2001, a substantial portion of this debt has been refinanced with lower-cost debt. The pro forma weighted cost of long-term debt at December 31, 2001 and 2000 was 7.0% and 7.2%, respectively.

PSW has a \$70,000 364-day revolving credit facility with four banks and CWC has a \$20,000 364-day bank revolving credit facility. Funds borrowed under these agreements are classified as loans payable and are used to provide working capital. The PSW facility replaced an expiring facility of \$50,000 and has been increased in order to consolidate borrowings of the Pennsylvania operating subsidiaries and reduce the short-term lines of credit. As of December 31, 2001 and 2000, funds borrowed under the PSW revolving credit agreements were \$64,882 and \$46,270, respectively, and \$13,500 and \$12,000 were borrowed under the CWC revolving credit agreement, respectively. Interest under these facilities is based, at the borrower's option, on the prime rate, an adjusted federal funds rate, an adjusted London Interbank Offered Rate corresponding to the interest period selected, an adjusted Euro-Rate corresponding to the interest period selected or at rates offered by the banks. These agreements restrict the total amount of short-term borrowings of PSW and CWC. A commitment fee ranging from 1/4 to 1/10 of 1% is charged on the unused portion of the revolving credit agreements. The average cost of borrowing under these facilities was 4.5% and 6.8%, and the average borrowing was \$60,417 and \$56,541, during 2001 and 2000, respectively. The maximum amount outstanding at the end of any one month was \$78,382 in 2001 and \$64,000 in 2000.

At December 31, 2001 and 2000, the Company had combined short-term lines of credit of \$105,500 and \$120,000, respectively. Funds borrowed under these lines are classified as loans payable and are used to provide working capital. The average borrowing under the lines was \$61,232 and \$49,901 during 2001 and 2000, respectively. The maximum amount outstanding at the end of any one month was \$76,858 in 2001 and \$58,878 in 2000. Interest under the lines is based at the Company's option, depending on the line, on the prime rate, an adjusted Euro-Rate, an adjusted federal funds rate or at rates offered by the banks. The average cost of borrowings under all lines during 2001 and 2000 was 5.2% and 7.3%, respectively.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Preferred Stock of Subsidiaries

The Company's subsidiaries have preferred stock (\$100 par value) authorized as of December 31, 2001:

|                                  | Cumulative<br>Dividend<br>Rate | Current<br>Call Price<br>Per Share | Shares<br>Authorized | Shares<br>Outstanding |
|----------------------------------|--------------------------------|------------------------------------|----------------------|-----------------------|
| Consumers Illinois Water Company | 5.50%                          | 107                                | 5,000                | 3,575                 |
| Consumers Maine Water Company    | -                              | None                               | 4,000                | -                     |

During 2001, Consumers Maine Water Company called and retired 2,739 shares of its preferred stock for an aggregate amount of \$288 and Consumers Pennsylvania – Shenango Valley Division called and substantially retired 9,646 shares of preferred stock for an aggregate amount of \$1,061.

Fair Value of Financial Instruments

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

|                      | December 31, |            |
|----------------------|--------------|------------|
|                      | 2001         | 2000       |
| Carrying amount      | \$ 531,455   | \$ 472,712 |
| Estimated fair value | 562,740      | 475,330    |

The fair value of long-term debt has been determined by discounting the future cash flows using current market interest rates for similar financial instruments of the same duration. The Company's customers' advances for construction and related tax deposits have a carrying value of \$59,886 and \$58,718 at December 31, 2001 and 2000, respectively. Their relative fair values cannot be accurately estimated since future refund payments depend on several variables, including new customer connections, customer consumption levels and future rate increases. Portions of these non-interest bearing instruments are payable annually through 2017 and amounts not paid by the contract expiration dates become non-refundable. The fair value of these amounts would, however, be less than their carrying value due to the non-interest bearing feature.

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

### Stockholders' Equity

At December 31, 2001, the Company had 1,770,819 shares of Series Preferred Stock with a \$1.00 par value authorized, of which 100,000 shares are designated as Series A Preferred Stock. During 1996, the Company designated 32,200 shares as Series B Preferred Stock, \$1.00 par value. The Series A Preferred Stock, as well as the undesignated shares of Series Preferred Stock, remains unissued. In 1996, the Company issued all of the 6.05% Series B Preferred Stock in connection with an acquisition. The Series B Preferred Stock is recorded on the balance sheet at its liquidation value of \$100 per share. Dividends on the Series B Preferred Stock are cumulative and payable quarterly. PSC may not pay dividends on common stock unless provision has been made for payment of the preferred dividends. Under the provisions of this issue, the holders may redeem the shares, in whole or in part, at the liquidation value beginning December 1, 1998 and the Company may redeem up to 20% of this issue each year beginning December 1, 2001 and, at the holders' option, this redemption may be made in cash or through the issuance of debt with a five year maturity at an interest rate of 6.05%. As of December 31, 2001, all dividends have been provided for. In January 1999, 14,600 shares of Series B Preferred Stock were redeemed in cash at the liquidation value of \$100 per share. In December 2001, 6,440 shares of Series B Preferred Stock were redeemed at the liquidation value of \$100 per share and the holder chose to receive a five year note for the redemption proceeds of \$644 at an interest rate of 6.05%. In January 2002, an additional 3,000 shares were redeemed at the holders' option in cash at the liquidation value of \$100 per share.

In August 2001, the Company's Board of Director's declared a 5-for-4 common stock split effected in the form of a 25% stock distribution for all common shares outstanding, to shareholders of record on November 16, 2001. Common shares outstanding do not include shares held by the Company in treasury. The new shares were distributed on December 1, 2001. The Company's par value of \$0.50 per share remained unchanged and \$6,829 was transferred from Capital in Excess of Par Value to Common Stock to record the split. All share and per share data for all periods presented have been restated to give effect to the stock split.

At December 31, 2001, the Company had 100,000,000 shares of common stock authorized; par value \$0.50. Shares outstanding at December 31, 2001, 2000 and 1999 were 68,386,469, 67,094,905 and 64,082,197 respectively. Treasury shares held at December 31, 2001, 2000 and 1999 were 913,877, 844,376, and 615,038, respectively.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

The following table summarizes the activity of common stockholders' equity:

|  | Common<br>stock | Treasury<br>stock | Capital in<br>excess of<br>par value | Retained<br>earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|--|-----------------|-------------------|--------------------------------------|----------------------|---|------------|
| Balance at December 31, 1998   | \$ 20,617       | \$ (9,478)        | \$ 244,457                           | \$ 91,683            | \$ -  | \$ 347,279 |
| Net income   | -               | -                 | -                                    | 36,275               | -   | 36,275     |
| Other comprehensive income,<br>net of income tax of \$1,433                                      | -               | -                 | -                                    | -                    | 2,020   | 2,020      |
| Dividends  | -               | -                 | -                                    | (26,425)             | -   | (26,425)   |
| Sale of stock  | 114             | 354               | 4,807                                | -                    | -   | 5,275      |
| Repurchase of stock  | -               | (2,146)           | -                                    | -                    | -   | (2,146)    |
| Equity Compensation Plan   | 2               | -                 | 98                                   | -                    | -   | 100        |
| Exercise of stock options  | 81              | -                 | 1,873                                | -                    | -   | 1,954      |
| Tax benefit from exercise of<br>employee stock options   | -               | -                 | 205                                  | -                    | -   | 205        |
| Balance at December 31, 1999   | 20,814          | (11,270)          | 251,440                              | 101,533              | 2,020   | 364,537    |
| Net income   | -               | -                 | -                                    | 52,784               | -   | 52,784     |
| Other comprehensive income,<br>net of income tax of \$489  | -               | -                 | -                                    | -                    | 908   | 908        |
| Reclassification adjustment for<br>gains reported in net income,<br>net of income tax of \$1,375 | -               | -                 | -                                    | -                    | (2,002)   | (2,002)    |
| Dividends  | -               | -                 | -                                    | (30,406)             | -   | (30,406)   |
| Stock split  | 5,319           | -                 | (5,319)                              | -                    | -   | -          |
| Stock issued for acquisitions  | 228             | -                 | 8,067                                | -                    | -   | 8,295      |
| Sale of stock  | 803             | 307               | 34,318                               | -                    | -   | 35,428     |
| Repurchase of stock  | -               | (4,383)           | -                                    | -                    | -   | (4,383)    |
| Equity Compensation Plan   | 12              | -                 | 545                                  | -                    | -   | 557        |
| Exercise of stock options  | 84              | -                 | 1,677                                | -                    | -   | 1,761      |
| Tax benefit from exercise of<br>employee stock options   | -               | -                 | 285                                  | -                    | -   | 285        |
| Balance at December 31, 2000   | 27,260          | (15,346)          | 291,013                              | 123,911              | 926   | 427,764    |
| Net income   | -               | -                 | -                                    | 60,005               | -   | 60,005     |
| Other comprehensive income,<br>net of income tax of \$19   | -               | -                 | -                                    | -                    | 39  | 39         |
| Reclassification adjustment for<br>gains reported in net income,<br>net of income tax of \$127   | -               | -                 | -                                    | -                    | (239)   | (239)      |
| Dividends  | -               | -                 | -                                    | (34,234)             | -   | (34,234)   |
| Stock split  | 6,829           | -                 | (6,829)                              | -                    | -   | -          |
| Stock issued for acquisitions  | 133             | -                 | 5,228                                | -                    | -   | 5,361      |
| Sale of stock  | 128             | 672               | 5,783                                | -                    | -   | 6,583      |
| Repurchase of stock  | -               | (2,493)           | -                                    | -                    | -   | (2,493)    |
| Equity Compensation Plan   | 3               | -                 | 141                                  | -                    | -   | 144        |
| Exercise of stock options  | 297             | -                 | 6,642                                | -                    | -   | 6,939      |
| Tax benefit from exercise of<br>employee stock options   | -               | -                 | 2,061                                | -                    | -   | 2,061      |
| Balance at December 31, 2001   | \$ 34,650       | \$ (17,167)       | \$ 304,039                           | \$ 149,682           | \$ 726  | \$ 471,930 |

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

In September 2000, the Company issued 2,066,406 shares of common stock through a public offering, providing net proceeds of \$29,689 which were used to make an equity contribution to PSW. PSW used the contribution from the Company to reduce the balance of its revolving credit loan.

In December 1999, the Company filed a shelf registration statement with the Securities and Exchange Commission for the offering and sale of up to 2,000,000 shares of common stock and 500,000 shares of preferred stock. During 2001 and 2000, 331,710 and 578,813 shares of common stock totaling \$5,361 and \$8,295, respectively, were issued to acquire water and wastewater systems. The Company expects to offer from time to time, the remainder of these shares for acquisitions. The precise amount and timing of the application of such proceeds will depend upon our funding requirements and the availability and cost of other funds.

The Company reports comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income." Accordingly, the Company's accumulated other comprehensive income for unrealized gains on securities is reported in the Stockholders' Equity section of the Consolidated Balance Sheets and the related other comprehensive income is reported in the Consolidated Statements of Income and Comprehensive Income.

The Company has a Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") that allows reinvested dividends to be used to purchase original issue shares of common stock at a five percent discount from the current market value. Under the direct stock purchase program, shares are purchased by investors at market price and the shares are purchased by the Company's transfer agent in the open-market at least weekly. During 2001, 2000 and 1999, under the dividend reinvestment portion of the Plan, 303,906, 419,766 and 358,556 original issue shares of common stock were sold providing the Company with proceeds of \$5,980, \$5,482 and \$5,044, respectively.

The Board of Directors has authorized the Company to purchase its common stock, from time to time, in the open market or through privately negotiated transactions. During 2000 and 1999, 288,750 and 127,188 shares have been purchased at a net cost of \$3,500 and \$1,771, respectively. There were no shares repurchased in 2001 in the open market or through privately negotiated transactions. For comparative purposes the number of shares purchased is presented as if they were adjusted for the effect of the 2001 5-for-4 common stock split in the form of a 25% stock distribution. As of December 31, 2001, 328,967 shares remain available for purchase by the Company.



# PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

## Net Income per Common Share and Equity per Common Share

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

|   | Years ended December 31, |        |        |
|---|--------------------------|--------|--------|
|   | 2001                     | 2000   | 1999   |
| Average common shares outstanding during the period for Basic computation   | 67,873                   | 64,759 | 63,850 |
| Dilutive effect of employee stock options                                   | 882                      | 655    | 689    |
| Average common shares outstanding during the period for Diluted computation | 68,755                   | 65,414 | 64,539 |

Equity per common share was \$6.90 and \$6.38 at December 31, 2001 and 2000, respectively. These amounts were computed by dividing common stockholders' equity by the number of shares of common stock outstanding at the end of each year.

## Shareholder Rights Plan

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

## Employee Stock and Incentive Plans

Under the 1994 Equity Compensation Plan ("1994 Plan"), as amended and restated effective March 3, 1998, the Company may grant qualified and non-qualified stock options to officers, key employees and consultants. Officers and key employees may also be granted dividend equivalents and restricted stock. Restricted stock may also be granted to non-employee members of the Board of Directors ("Board"). In November 1998, the Shareholders authorized an increase to the number of shares from 1,900,000 shares to 2,900,000 shares of common stock for issuance under the 1994 Plan. The maximum number of shares that may be subject to grants under the 1994 Plan to any one individual in any one year is 100,000. Awards under this plan are made by the Board of Directors or a committee of the Board.

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

Options under the 1994 plan, as well as the earlier 1988 Stock Option Plan were issued at the market price of the stock on the day of the grant. Options are exercisable in installments of 33% annually, starting one year from the date of the grant and expire 10 years from the date of the grant.

The following table summarizes stock option transactions for the two plans:

|                                | As of or For the Years Ended December 31, |  |                  |  |                  |  |
|--------------------------------|---|--|------------------|--|------------------|--|
|                                | 2001                                      |  | 2000             |  | 1999             |  |
|                                | Shares                                    | Weighted<br>Average<br>Exercise<br>Price | Shares           | Weighted<br>Average<br>Exercise<br>Price | Shares           | Weighted<br>Average<br>Exercise<br>Price |
| Options:                       |   |  |                  |  |                  |  |
| Outstanding, beginning of year | 2,263,803                                 | \$ 10.69                                 | 2,005,194        | \$ 10.12                                 | 1,771,730        | \$ 8.80                                  |
| Granted                        | 535,679                                   | 19.10                                    | 560,609          | 11.75                                    | 472,656          | 13.71                                    |
| Terminated                     | (18,183)                                  | 12.13                                    | (70,911)         | 13.17                                    | (11,807)         | 13.12                                    |
| Exercised                      | (733,489)                                 | 9.39                                     | (231,089)        | 7.58                                     | (227,385)        | 7.15                                     |
| Outstanding, end of year       | <u>2,047,810</u>                          | <u>\$ 13.32</u>                          | <u>2,263,803</u> | <u>\$ 10.69</u>                          | <u>2,005,194</u> | <u>\$ 10.12</u>                          |
| Exercisable, end of year       | <u>1,015,708</u>                          | <u>\$ 10.79</u>                          | <u>1,295,561</u> | <u>\$ 9.21</u>                           | <u>1,132,550</u> | <u>\$ 7.71</u>                           |

Options exercised during 2001 ranged in price from \$4.60 per share to \$15.28 per share. At December 31, 2001, 991,937 options under the 1994 Plan were still available for grant. The following table summarizes the price ranges of the options outstanding and options exercisable as of December 31, 2001:

|                  | Options Outstanding |  |  | Options Exercisable |  |
|------------------|---------------------|--|--|---------------------|--|
|                  | Shares              | Weighted<br>Average<br>Remaining<br>Life (years) | Weighted<br>Average<br>Exercise<br>Price | Shares              | Weighted<br>Average<br>Exercise<br>Price |
| Range of prices: |                     |  |  |                     |  |
| \$ 5.78 - 8.99   | 281,185             | 3.6  | \$ 6.47                                  | 281,185             | \$ 6.47                                  |
| \$ 9.00 - 11.99  | 670,089             | 7.3  | 11.13                                    | 313,472             | 10.44                                    |
| \$12.00 - 14.99  | 562,083             | 6.8  | 13.88                                    | 421,051             | 13.94                                    |
| \$15.00 - 19.10  | 534,453             | 9.2  | 19.09                                    | -                   | -  |
|                  | <u>2,047,810</u>    | <u>7.1</u>                                       | <u>\$ 13.32</u>                          | <u>1,015,708</u>    | <u>\$ 10.79</u>                          |

Under SFAS No. 123, "Accounting for Stock-Based Compensation", the Company elects to continue to apply the provisions of APB Opinion No. 25 and to provide the pro forma disclosure provisions of this statement. Accordingly, no compensation cost has been recognized in the financial statements for stock options that have been granted. Had the Company determined compensation cost based on the fair value at

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

the grant date for its stock options under SFAS No. 123, the Company's net income available to common stock and Basic and Diluted net income per share would have been reduced to the pro forma amounts indicated below:

|                                       | Years Ended December 31, |           |           |
|---------------------------------------|--------------------------|-----------|-----------|
|                                       | 2001                     | 2000      | 1999      |
| Net income available to common stock: |                          |           |           |
| As reported                           | \$ 60,005                | \$ 52,784 | \$ 36,275 |
| Proforma                              | 57,013                   | 51,206    | 35,398    |
| Basic net income per share:           |                          |           |           |
| As reported                           | \$ 0.88                  | \$ 0.82   | \$ 0.57   |
| Proforma                              | 0.84                     | 0.79      | 0.55      |
| Diluted net income per share:         |                          |           |           |
| As reported                           | \$ 0.87                  | \$ 0.81   | \$ 0.56   |
| Proforma                              | 0.83                     | 0.78      | 0.55      |

The per share weighted-average fair value at the date of grant for stock options granted during 2001, 2000 and 1999 was \$5.58, \$2.82, and \$3.42 per option, respectively. The fair value of options at the date of grant was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

|                       | 2001  | 2000  | 1999  |
|-----------------------|-------|-------|-------|
| Expected life (years) | 5.2   | 10    | 10    |
| Interest rate         | 5.0%  | 6.4%  | 5.4%  |
| Volatility            | 32.7% | 21.1% | 20.9% |
| Dividend yield        | 2.6%  | 3.9%  | 3.2%  |

Restricted stock awards provide the grantee with the rights of a shareholder, including the right to receive dividends and to vote such shares, but not the right to sell or otherwise transfer the shares during the restriction period. During 2001, 2000 and 1999, 7,875, 36,875 and 6,875 shares of restricted stock were granted with a restriction period ranging from six to 36 months. The value of restricted stock awards, which are "compensatory", is equal to the fair market value of the stock on the date of the grant less payments made by the grantee and is amortized ratably over the restriction period.

Pension Plans and Other Postretirement Benefits

The Company has defined benefit pension plans that cover its full-time employees. Retirement benefits under the plans are generally based on the employee's total years of service and compensation during the last five years of employment. The Company's policy is to fund these plans annually at a level which is deductible for income tax purposes and which provides assets sufficient to meet its pension obligations. To offset certain limitations imposed by the Internal Revenue Code with respect to payments under qualified plans, the Company has a non-qualified Excess Benefit Plan for Salaried Employees in order to prevent certain employees from being penalized by these limitations. The Company also has non-qualified Supplemental Executive Retirement Plans for current and retired employees. The net pension costs and obligations of the qualified and non-qualified plans are included in the tables which follow.

In addition to providing pension benefits, the Company offers certain Postretirement Benefits other than Pensions ("PBOPs") to employees retiring with a minimum level of service. These PBOPs

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

include continuation of medical and prescription drug benefits for all eligible retirees and life insurance benefits for certain eligible retirees. The Company funds its gross PBOP cost through various trust accounts.

The Company's pension expense (credit) includes the following components:

|   | Years Ended December 31, |            |          |
|---|--------------------------|------------|----------|
|   | 2001                     | 2000       | 1999     |
| Benefits earned during the year               | \$ 2,986                 | \$ 2,553   | \$ 3,232 |
| Interest cost on projected benefit obligation | 8,261                    | 7,612      | 7,214    |
| Expected return on plan assets                | (10,891)                 | (11,281)   | (10,304) |
| Net amortization and deferral                 | (206)                    | (1,283)    | (105)    |
| Capitalized costs                             | (49)                     | (56)       | (47)     |
| Rate-regulated adjustment                     | (553)                    | 1,403      | 430      |
| Special termination benefits                  | -                        | 43         | 716      |
| Net pension cost (credit)                     | \$ (452)                 | \$ (1,009) | \$ 1,136 |

The rate-regulated adjustment set forth above is required in order to reflect pension expense (credit) for the Company in accordance with the method used in establishing water rates. During 2000 and 1999, the Company instituted early retirement and restructuring programs. These actions resulted in additional termination benefits of \$43 in 2000 and \$716 in 1999.

The Company's costs for postretirement benefits other than pensions includes the following components:

|                                  | Years Ended December 31, |          |          |
|----------------------------------|--------------------------|----------|----------|
|                                  | 2001                     | 2000     | 1999     |
| Benefits earned during the year  | \$ 705                   | \$ 555   | \$ 645   |
| Interest cost                    | 1,427                    | 1,267    | 1,249    |
| Expected return on plan assets   | (947)                    | (920)    | (699)    |
| Net amortization and deferral    | 567                      | 417      | 628      |
| Special termination benefits     | -                        | -        | 209      |
| Amortization of regulatory asset | 136                      | 208      | 208      |
| Gross PBOP cost                  | 1,888                    | 1,527    | 2,240    |
| Capitalized costs                | (475)                    | (512)    | (464)    |
| Net PBOP cost                    | \$ 1,413                 | \$ 1,015 | \$ 1,776 |

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

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

|  | Pension Benefits |                 | Other Postretirement Benefits |                 |
|--|------------------|-----------------|-------------------------------|-----------------|
|  | 2001             | 2000            | 2001                          | 2000            |
| <b>Change in benefit obligation:</b>                   |                  |                 |                               |                 |
| Benefit obligation at January 1,                       | \$ 110,214       | \$ 98,228       | \$ 18,581                     | \$ 17,292       |
| Service cost   | 2,986            | 2,553           | 705                           | 555             |
| Interest cost  | 8,261            | 7,612           | 1,428                         | 1,267           |
| Special termination benefits                           | -                | 43              | -                             | 282             |
| Plan amendments  | -                | -               | (1,205)                       | -               |
| Actuarial loss   | 3,645            | 6,963           | 3,680                         | -               |
| Benefits paid  | (5,439)          | (5,185)         | (872)                         | (815)           |
| Benefit obligation at December 31,                     | <u>119,667</u>   | <u>110,214</u>  | <u>22,317</u>                 | <u>18,581</u>   |
| <b>Change in plan assets:</b>                          |                  |                 |                               |                 |
| Fair value of plan assets at January 1,                | 123,715          | 128,367         | 11,896                        | 11,097          |
| Actual return on plan assets                           | (5,001)          | 479             | (688)                         | (323)           |
| Employer contributions                                 | 55               | 54              | 1,880                         | 1,937           |
| Benefits paid  | (5,439)          | (5,185)         | (872)                         | (815)           |
| Fair value of plan assets at December 31,              | <u>113,330</u>   | <u>123,715</u>  | <u>12,216</u>                 | <u>11,896</u>   |
| <b>Funded status of plan:</b>                          |                  |                 |                               |                 |
| Funded status at December 31,                          | 6,337            | (13,501)        | 10,101                        | 6,685           |
| Unrecognized actuarial gain (loss)                     | (2,051)          | 18,014          | 854                           | 6,345           |
| Unrecognized prior service cost                        | (2,581)          | (3,012)         | 704                           | 761             |
| Rate-regulated adjustment                              | (516)            | 37              | -                             | -               |
| Unrecognized net transition obligation                 | 1,645            | 1,755           | (8,838)                       | (10,846)        |
| Accrued benefit costs                                  | <u>\$ 2,834</u>  | <u>\$ 3,293</u> | <u>\$ 2,821</u>               | <u>\$ 2,945</u> |
| <b>Weighted-average assumptions as of December 31,</b> |                  |                 |                               |                 |
| Discount rate  | 7.25%            | 7.50%           | 7.25%                         | 7.50%           |
| Expected return on plan assets                         | 9.00%            | 9.00%           | 6.00-9.00%                    | 6.00-9.00%      |
| Rate of compensation increase                          | 4.50-5.50%       | 4.50-5.50%      | 4.50%                         | 4.50%           |

The accumulated benefit obligation is in excess of plan assets for certain non-qualified plans. The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for these plans were \$3,551, \$2,341 and \$0, and \$3,490, \$2,078 and \$0, respectively as of December 31, 2001 and 2000.

The assumed medical inflation rates under the PSC and CWC plans are 12.0%, reducing to 5.0% by 2006. The effect of a 1% increase in the assumed medical inflation rates would be to increase the accumulated postretirement benefit obligation as of December 31, 2001 and the 2001 PBOP costs by \$664 and \$71, respectively. The effect of a 1% decrease in the assumed medical inflation rates would be to decrease the accumulated postretirement benefit obligation as of December 31, 2001 and the 2001 PBOP costs by \$866 and \$154, respectively. The benefits of retired officers and certain other retirees are paid by the Company and not from plan assets due to limitations imposed by the Internal Revenue Code.

## PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES

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

The Company has 401(k) savings plans that cover substantially all employees. The Company makes matching contributions that are invested in PSC common stock based on a percentage of an employee's contribution, subject to certain limitations. The Company's matching contribution, recorded as compensation expense, was \$798, \$786 and \$741 for the years ended December 31, 2001, 2000 and 1999, respectively.

### Water Rates

In November 2001, PSW filed an application with the Pennsylvania Public Utility Commission ("PAPUC") for our Pennsylvania subsidiaries requesting a \$28,000 or 13.4% increase in annual revenues. The application is currently pending before the PAPUC and a final determination is anticipated by August 2002.

On April 27, 2000, the PAPUC approved a rate settlement reached between PSC's Pennsylvania utility subsidiaries, and the parties actively litigating the joint rate application filed in October 1999. The settlement was designed to increase annual revenue by \$17,000 or 9.4% above the level in effect at the time of the filing. The rates in effect at the time of the filing included \$7,347 in Distribution System Improvement Charges ("DSIC") ranging from 0.33% to 5%. Consequently, the settlement resulted in a total base rate increase of \$24,347 or 13.5% above the rates in effect before the DSIC was applied. As a part of the rate settlement, the DSIC was reset to zero. The settlement agreement also provided for the recovery of up to \$5,295 (the merger costs allocable to our Pennsylvania operations) of the \$10,121 (\$8,596 after-tax) in merger costs that were expensed in the first quarter of 1999 in connection with the Merger. As a result, a regulatory asset was established to reflect the amount to be recovered as a result of the rate settlement.

The CWC operating subsidiaries were allowed annual rate increases of \$4,799 in 2001, \$698 in 2000 and \$390 in 1999, represented by nine, four and two rate decisions, respectively. Revenues from these increases realized in the year of grant were approximately \$4,200, \$450 and \$308 in 2001, 2000 and 1999, respectively.

The DSIC enables water utilities in Pennsylvania to add a surcharge to customer bills reflecting the capital costs and depreciation related to certain distribution system improvement projects completed and placed into service between base rate filings. PSW is permitted to request adjustments to the DSIC quarterly to reflect subsequent capital expenditures and it is reset to zero when new base rates that reflect the costs of those additions become effective or when PSW's pro forma earnings exceed a PUC benchmark. The maximum DSIC that can be in effect at any time is 5%. The DSIC in 2001 ranged from 2.21% in the first quarter to 5% in the fourth quarter, and has been set at 5% in the first quarter of 2002. The DSIC provided revenues in 2001, 2000 and 1999 of \$6,672, \$2,301 and \$4,140, respectively.

In 2001, the Illinois Commerce Commission issued regulations implementing an infrastructure surcharge known as a Qualifying Infrastructure Plant Surcharge ("QIPS") for use by Illinois water and wastewater utilities. QIPS is similar to DSIC, however, it is established annually and prospectively based on anticipated qualifying capital expenditures, and it includes a broader range of qualifying capital expenditures, including certain wastewater capital expenditures. Our operating subsidiary in Illinois received approval to add a QIPS to its bills in three of its operating divisions beginning January 1, 2002 at various rates ranging from 1.06% to 2.49%.

In addition to its base rates and DSIC, PSW has utilized a surcharge or credit on its bills to reflect certain changes in Pennsylvania State taxes until such time as the tax changes are incorporated in base rates. A rate credit reduced operating revenues in 2001 by \$639, and various surcharge rates provided operating revenues of \$74 in 2000 and \$1,306 in 1999.

Selected Quarterly Financial Data (Unaudited)  
(in thousands of dollars, except per share amounts)

Philadelphia Suburban Corporation and Subsidiaries

|                                      | First     | Second    | Third     | Fourth    | Year       |
|--------------------------------------|-----------|-----------|-----------|-----------|------------|
| <b>2001</b>                          |           |           |           |           |            |
| Operating revenues                   | \$ 70,193 | \$ 77,240 | \$ 84,726 | \$ 75,121 | \$ 307,280 |
| Operations and maintenance expense   | 26,186    | 26,462    | 28,994    | 30,243    | 111,885    |
| Net income available to common stock | 13,085    | 15,432    | 19,279    | 12,209    | 60,005     |
| Basic net income per common share    | 0.19      | 0.23      | 0.28      | 0.18      | 0.88       |
| Diluted net income per common share  | 0.19      | 0.22      | 0.28      | 0.18      | 0.87       |
| Dividend paid per common share       | 0.124     | 0.124     | 0.124     | 0.13248   | 0.504      |
| Dividend declared per common share   | 0.124     | 0.124     | 0.25648   | -         | 0.504      |
| Price range of common stock          |           |           |           |           |            |
| - high                               | 19.39     | 20.40     | 23.28     | 24.64     | 24.64      |
| - low                                | 15.65     | 16.60     | 18.66     | 20.80     | 15.65      |
| <b>2000</b>                          |           |           |           |           |            |
| Operating revenues                   | \$ 64,208 | \$ 68,494 | \$ 72,123 | \$ 69,189 | \$ 274,014 |
| Operations and maintenance expense   | 24,928    | 24,350    | 25,037    | 27,426    | 101,741    |
| Net income available to common stock | 10,246    | 13,565    | 16,539    | 12,434    | 52,784     |
| Basic net income per common share    | 0.16      | 0.21      | 0.26      | 0.19      | 0.82       |
| Diluted net income per common share  | 0.16      | 0.21      | 0.25      | 0.18      | 0.81       |
| Dividend paid per common share       | 0.1152    | 0.1152    | 0.1152    | 0.124     | 0.4696     |
| Dividend declared per common share   | 0.1152    | 0.1152    | 0.2392    | -         | 0.4696     |
| Price range of common stock          |           |           |           |           |            |
| - high                               | 14.08     | 15.96     | 15.56     | 19.95     | 19.95      |
| - low                                | 10.56     | 11.60     | 12.80     | 13.56     | 10.56      |

All per share data as presented has been adjusted for the 2001 5-for-4 common stock split effected in the form of a 25% stock distribution. High and low prices of the Company's common stock are as reported on the New York Stock Exchange Composite Tape. The cash dividends paid in December 2001 of \$0.13248 and December 2000 of \$0.124 were declared in August 2001 and August 2000, respectively.

Net income available to common stock and net income per common share for 2000 includes the partial recovery of the merger costs related to the Merger as follows: \$972 (\$1,059 pre-tax) or \$0.02 per share in the second quarter and \$1,264 (\$2,982 pre-tax) or \$0.02 per share in the third quarter.

**Summary of Selected Financial Data**  
(in thousands of dollars, except per share amounts)

Philadelphia Suburban Corporation and Subsidiaries

| Years ended December 31,                       | 2001        | 2000*       | 1999*       | 1998*       | 1997*       |
|--|-------------|-------------|-------------|-------------|-------------|
| <b>PER COMMON SHARE:</b>                       |             |             |             |             |             |
| Income from continuing operations (a)          |             |             |             |             |             |
| Basic  | \$0.88      | \$0.82      | \$0.57      | \$0.71      | \$0.58      |
| Diluted  | 0.87        | 0.81        | 0.56        | 0.70        | 0.58        |
| Net income (a)                                 |             |             |             |             |             |
| Basic  | 0.88        | 0.82        | 0.57        | 0.71        | 0.54        |
| Diluted  | 0.87        | 0.81        | 0.56        | 0.70        | 0.53        |
| Cash dividends paid (b)                        | 0.50        | 0.47        | 0.45        | 0.43        | 0.40        |
| Cash dividends declared (b) (c)                | 0.50        | 0.47        | 0.45        | 0.32        | 0.50        |
| Return on average stockholders' equity (a) (d) | 13.3%       | 13.2%       | 10.1%       | 13.6%       | 11.8%       |
| Book value at year end                         | \$6.90      | \$6.38      | \$5.69      | \$5.46      | \$4.93      |
| Market value at year end                       | 22.55       | 19.60       | 13.24       | 18.92       | 14.13       |
| <b>INCOME STATEMENT HIGHLIGHTS:</b>            |             |             |             |             |             |
| Operating revenues (d)                         | \$307,280   | \$274,014   | \$256,546   | \$250,718   | \$235,162   |
| Depreciation and amortization (d)              | 40,168      | 34,100      | 31,903      | 29,464      | 27,977      |
| Interest expense (d) (e)                       | 38,637      | 37,775      | 31,796      | 30,785      | 32,317      |
| Income before income taxes (d)                 | 99,087      | 86,995      | 62,915      | 75,133      | 57,642      |
| Provision for income taxes (d)                 | 38,976      | 34,105      | 26,531      | 30,118      | 22,432      |
| Income from continuing operations (a)          | 60,111      | 52,890      | 36,384      | 45,015      | 35,210      |
| Net income available to common stock (a)       | 60,005      | 52,784      | 36,275      | 44,820      | 32,278      |
| <b>BALANCE SHEET HIGHLIGHTS:</b>               |             |             |             |             |             |
| Total assets                                   | \$1,560,339 | \$1,413,723 | \$1,280,805 | \$1,156,733 | \$1,083,162 |
| Property, plant and equipment, net             | 1,368,115   | 1,251,427   | 1,135,364   | 1,016,194   | 952,626     |
| Stockholders' equity                           | 473,833     | 432,347     | 368,901     | 353,088     | 306,816     |
| Preferred stock with mandatory redemption (f)  | -           | -           | -           | -           | 4,214       |
| Long-term debt (f)                             | 531,455     | 472,712     | 425,946     | 377,355     | 407,526     |
| Total debt                                     | 641,123     | 573,706     | 529,015     | 440,905     | 436,756     |
| <b>ADDITIONAL INFORMATION:</b>                 |             |             |             |             |             |
| Net cash flows from operating activities       | \$102,165   | \$86,972    | \$74,103    | \$84,362    | \$71,252    |
| Capital additions (d) (g)                      | 124,088     | 129,740     | 96,383      | 87,973      | 67,378      |
| Dividends on common stock                      | 34,234      | 30,406      | 29,217      | 29,349      | 26,752      |
| Number of customers served                     | 602,510     | 579,219     | 557,462     | 533,847     | 526,640     |
| Number of shareholders of common stock         | 20,920      | 20,978      | 21,187      | 20,553      | 19,902      |
| Common shares outstanding (000)                | 68,386      | 67,095      | 64,082      | 63,597      | 61,112      |
| Employees (full-time)                          | 951         | 943         | 945         | 973         | 979         |

\*Share and per share data has been restated for the 2001 5-for-4 stock split.

(a) The 2000 amounts include a net gain of \$2,236 (\$4,041 pre-tax) or \$0.04 per share for the partial recovery of the merger costs related to the Merger. The 1999 amounts include a net charge of \$8,596 (\$10,121 pre-tax) or \$0.13 per share for the Merger transaction costs and related restructuring costs. The 1998 amounts include a net gain of \$3,903 (\$6,680 pre-tax) or \$0.06 per share on the sale of Consumers Water Company's New Hampshire system pursuant to the State's condemnation statute.

(b) Amount represents PSC's historical dividends per common share.

(c) The cash dividend of \$0.10, paid in March 1998, was declared in December 1997.

(d) Continuing operations only.

(e) Includes dividends on preferred stock of subsidiary and minority interest; net of allowance for funds used during construction.

(f) Includes current portion.

(g) Excludes payments for acquired water systems of \$9,517 in 2001, \$3,546 in 2000, \$39,164 in 1999, \$24,498 in 1998, and \$1,226 in 1997.



PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES  
INVESTOR AND SHAREHOLDER INFORMATION

Financial Reports and Investor Relations

Shareholders may request, without charge, copies of the company's financial reports including Annual Reports and Forms 10-K and 10-Q. Such requests, as well as other inquiries of an investor relations nature, should be addressed to:

Investor Relations Department  
Philadelphia Suburban Corporation  
762 W. Lancaster Avenue  
Bryn Mawr, PA 19010-3489  
www.suburbanwater.com

Annual Meeting

10:00 a.m. Eastern Daylight Time  
Thursday, May 16, 2002  
Springfield Country Club  
400 West Sproul Road  
Springfield, PA

Transfer Agent and Registrar

EquiServe Trust Company, N.A.  
P.O. Box 43010  
Providence, RI 02940-3010  
800-205-8314 or 781-575-3100  
www.equiserve.com

Independent Certified Public Accountants

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

Stock Exchanges

The Common Stock of the company is listed on the New York Stock Exchange and the Philadelphia Stock Exchange under the ticker symbol "PSC". The daily closing price is printed in *The Wall Street Journal* and other major newspapers, typically as PhilSuburbn.

Dividend Reinvestment and Direct Stock Purchase Plan

The company's Dividend Reinvestment and Direct Stock Purchase Plan ("Plan") enables shareholders to reinvest all, or a designated portion of, dividends paid on up to 100,000 shares of Common Stock in additional shares of Common Stock at a five percent discount from a price based on the market value of the stock with no commissions or service charges. In addition, shareholders may purchase additional shares of PSC Common Stock at any time with a minimum investment of \$50, up to a maximum of \$250,000 annually. PSC pays the commissions and fees on purchases. Individuals who are not shareholders may become shareholders by making an initial investment of at least \$500 either through automatic withdrawal from your bank or by check or money order. A Plan prospectus may be obtained by calling 800-205-8314. **Please read the prospectus carefully before you invest.** Shares for the direct stock purchase portion of the Plan are purchased in the open market at prevailing market prices, with no commissions or other fees.

IRA, Roth IRA, Education IRA

An IRA, Roth IRA or Education IRA may be opened through the Plan to hold shares of Common Stock of the company and to make contributions to the IRA to purchase shares of Common Stock. Participants in the Plan may roll over an existing IRA or other qualified plan distribution in cash into an IRA under the Plan to purchase the company's common stock. Participants may also transfer the company's Common Stock from an existing IRA into an IRA under the Plan. Purchases of shares through the IRA are made without any fees,

PHILADELPHIA SUBURBAN CORPORATION AND SUBSIDIARIES  
INVESTOR AND SHAREHOLDER INFORMATION

commissions, or service charges. A prospectus, IRA forms and a disclosure statement may be obtained by calling EquiServe Trust Company at 800-472-7428. **Please read the prospectus carefully before you invest.**

Direct Deposit

With direct deposit, PSC cash dividends are deposited automatically on the dividend payment date of each quarter. Shareholders receive confirmation of the deposit in the mail. Shareholders interested in direct deposit should call the transfer agent at 800-205-8314.

Multiple Accounts

Some shareholders have multiple accounts. The transfer agent cannot change or merge accounts without your written request. If you would like to help us avoid the expense of multiple mailings, call the transfer agent at 800-205-8314 to get details on how to have your accounts consolidated.

Dividends

PSC has paid dividends consecutively for 57 years. The normal Common Stock dividend dates through June 2003 are:

| <u>Declaration Date</u> | <u>Ex-Dividend Date</u> | <u>Record Date</u> | <u>Payment Date</u> |
|-------------------------|-------------------------|--------------------|---------------------|
| February 5, 2002        | February 7, 2002        | February 12, 2002  | March 1, 2002       |
| April 30, 2002          | May 9, 2002             | May 14, 2002       | June 1, 2002        |
| August 6, 2002          | August 13, 2002         | August 16, 2002    | September 1, 2002   |
| November 5, 2002        | November 12, 2002       | November 15, 2002  | December 1, 2002    |
| February 4, 2003        | February 11, 2003       | February 14, 2003  | March 1, 2003       |
| April 29, 2003          | May 8, 2003             | May 13, 2003       | June 1, 2003        |

In order to be the owner of record and be eligible to receive the quarterly dividend, shares must have been purchased and the transaction settled before the ex-dividend date. Owners of any share(s) bought after this date will not receive the dividend for that quarter. The previous owner—the owner of record—will receive the dividend.

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

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

Lost Dividend Checks and Stock Certificates

Dividend checks lost by shareholders, or those that might be lost in the mail, will be replaced upon notification of the lost or missing check. All inquiries concerning lost or missing dividend checks should be made to the transfer agent by calling 800-205-8314.

Shareholders should call or write the transfer agent to report a lost certificate. Appropriate documents will be prepared and sent to the shareholder together with instructions.

Safekeeping of Stock Certificates

Shareholders may have their stock certificate deposited with the transfer agent for safekeeping free of charge. Stock certificates and written instructions should be forwarded to:

EquiServe Trust Company, N.A.  
P.O. Box 43010  
Providence, RI 02940-3010

## Board of Directors

Nicholas DeBenedictis, 56  
Chairman, President & CEO  
PSC  
Director since 1992

John F. McCaughan, 66  
Chairman (Retired)  
Betz Laboratories, Inc.  
Director since 1984

Mary C. Carroll, 61  
Consultant and  
Community Volunteer  
Director since 1981

John E. Menario, 66  
Assistant to the President  
Banknorth Group, Inc.  
Director since 1999

G. Fred DiBona, Jr., 51  
President and CEO  
Independence Blue Cross  
Director since 1993

Andrew D. Seidel, 39  
President and CEO  
United States Filter Corporation  
Director since 2000

Richard H. Glanton, 55  
Partner  
Reed Smith LLP  
Director since 1995

Richard L. Smoot, 61  
Regional Chairman, Advisory Board  
PNC Financial Services Group  
Philadelphia and Southern New Jersey  
Director since 1997

Alan Hirsig, 62  
President and CEO (Retired)  
ARCO Chemical Company  
Director since 1997

## Officers

Nicholas DeBenedictis, 56  
Chairman, President and CEO

Richard R. Riegler, 55  
Senior Vice President,  
Engineering and  
Environmental Affairs

Morrison Coulter, 65  
President  
Pennsylvania Suburban  
Water Company  
Philadelphia Suburban Division

David P. Smeltzer, 43  
Senior Vice President-  
Finance and CFO

Robert G. Liptak, 54  
President  
Consumers Water Company

Roy H. Stahl, Esq., 49  
Executive Vice President,  
General Counsel,  
and Corporate Secretary



## Notes



**762 W. Lancaster Avenue  
Bryn Mawr, Pennsylvania 19010-3489  
Tel: 610-525-1400  
Fax: 610-645-1061  
[www.suburbanwater.com](http://www.suburbanwater.com)**

**EXHIBIT B**

**Other Utilities Owned By PSC**

Consumers Applegrove Water Company  
6650 South Avenue  
Boardman, OH 44512

Consumers Illinois Water Company  
P.O. Box 152  
1000 S. Schuyler Avenue  
Kankakee, IL 60901

Consumers Maine Water Company  
855 Rockland Street  
Rockport, ME 04856

Consumers Masury Water Company  
6650 South Avenue  
Boardman, OH 44512

Consumers New Jersey Water Company  
10 Black Forest Road  
Hamilton, NJ 08691

Consumers Ohio Water Company  
6650 South Avenue  
Boardman, OH 44512

Hydraulics, Ltd.  
706 N. Regional Road  
Greensboro, NC 27509

Pennsylvania Suburban Water Company  
762 W. Lancaster Avenue  
Bryn Mawr, PA 19010-3489

PSC Officers And Directors<sup>1</sup>

## I. Officers

|                         |  |
|-------------------------|--|
| Nicholas DeBenedictis   | Chairman, President & CEO                                |
| Roy H. Stahl            | Executive Vice President, General Counsel, Secretary     |
| David P. Smeltzer       | Sr. Vice President - Finance, Chief Financial Officer    |
| Richard R. Riegler      | Sr. Vice President – Engineering & Environmental Affairs |
| Christopher H. Franklin | Vice President – Corp. & Public Affairs                  |
| Kathy Pape              | Vice President , Treasurer & Rate Counsel                |
| Robert A. Rubin         | Controller   |
| Suzanne Falcone         | Ass't. Secretary   |

## II. Directors

|  |  |
|--|--|
| Nicholas DeBenedictis<br>Chairman, President & CEO<br>PSC<br>Director since 1992           | Alan Hirsig<br>President and CEO (Retired)<br>ARCO Chemical Company<br>Director since 1997   |
| Mary C. Carroll<br>Consultant & Community Volunteer<br>Director since 1981                 | John F. McCaughan<br>Chairman (Retired)<br>Betz Laboratories, Inc.<br>Director since 1984  |
| G. Fred DiBona, Jr.<br>President and CEO<br>Independence Blue Cross<br>Director since 1993 | John E. Menario<br>Assistant to the President<br>Banknorth Group, Inc.<br>Director since 1999  |
| Richard H. Glanton<br>Partner<br>Reed Smith LLP<br>Director since 1995                     | Richard D. Smoot<br>Regional Chairman, Advisory Board<br>PNC Financial Services Group<br>Philadelphia and Southern New Jersey<br>Director since 1997 |

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<sup>1</sup> PSC has no 10% owners.



PURCHASE AGREEMENT

by and among

AQUASOURCE, INC.

and

DQE, INC.,

on the one hand,

and

PHILADELPHIA SUBURBAN CORPORATION

and

AQUA ACQUISITION CORPORATION,

on the other hand

Dated as of July 29, 2002

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## PURCHASE AGREEMENT

This Purchase Agreement, dated as of July 29, 2002 (this "Agreement"), is entered into by and among AquaSource, Inc., a Delaware corporation (the "Seller"), and DQE, Inc., a Pennsylvania corporation ("DQE"), on the one hand, and Philadelphia Suburban Corporation, a Pennsylvania corporation ("PSC"), and Aqua Acquisition Corporation, a Pennsylvania corporation ("Acquisition" and, together with PSC, the "Buyer"), on the other hand (each of the Seller, DQE, PSC and Acquisition, a "Party", and collectively, the "Parties").

WHEREAS, the Seller owns all of the issued and outstanding shares of common stock (the "Utility Shares") of AquaSource Utility, Inc., a Texas corporation ("Utility") and 90 of the 100 outstanding shares of preferred stock of Utility (the "Utility Preferred Shares"); and

WHEREAS, the Seller owns all of the issued and outstanding shares of common stock (the "Development Shares") of AquaSource Development Company, a Texas corporation ("Development"); and

WHEREAS, the Seller owns all of the issued and outstanding shares of common stock (the "Reynolds Shares") of The Reynolds Group, Inc., an Indiana corporation ("Reynolds"); and

WHEREAS, the Seller owns, directly or indirectly, all of the Integrated Assets (as defined in Section 1.1) which are not held by Utility, Development or Reynolds but are integrated with the business and/or operations of Utility, Development or Reynolds; and

WHEREAS, each of the Boards of Directors of PSC, Acquisition, DQE and the Seller has approved, and deems it advisable and in the best interests of its respective shareholders to consummate, the acquisition by PSC of Utility, Development, Reynolds and by Acquisition of the Integrated Assets, which acquisition is to be effected by the purchase of (i) the Utility Shares, the Utility Preferred Shares, the Development Shares and the Reynolds Shares (collectively, the "Shares") by PSC and (ii) all of the Integrated Assets by Acquisition upon the terms and subject to the conditions set forth herein;

NOW, THEREFORE, in consideration of the premises and the representations, warranties, covenants and agreements contained herein, the Parties hereto, intending to be legally bound hereby, agree as follows:

**ARTICLE I**  
**PURCHASE AND SALE OF SHARES AND INTEGRATED ASSETS**

Section 1.1 Sale and Transfer of Shares and Integrated Assets.

(a) Subject to the terms and conditions of this Agreement, on the Closing Date (as defined in Section 2.1), (i) the Seller agrees to sell, convey, assign, transfer and deliver to PSC (or to such Buyer Subsidiary (as defined in Section 5.1) as PSC may designate in writing within forty-five (45) calendar days of the date hereof), and PSC agrees to purchase and accept (or cause such Buyer Subsidiary to purchase and accept) from the Seller, all of the Seller's rights, title and interest in and to the Shares, (ii) the Seller agrees to sell, convey, assign, transfer and deliver, or cause to be sold, conveyed, assigned, transferred and delivered, to Acquisition (or to such other Buyer Subsidiary as PSC may designate in writing within forty-five (45) calendar days of the date hereof), and Acquisition agrees to purchase and accept (or PSC agrees to cause such other Buyer Subsidiary to purchase and accept) from the Seller, or one or more Subsidiaries (as defined in Section 3.2) of the Seller, all of the Seller's, and any Subsidiary of the Seller's, rights, title and interest in and to the Integrated Assets, and (iii) except as otherwise provided in this Agreement, Acquisition agrees to assume and discharge (or PSC agrees to cause any other Buyer Subsidiary that purchases the Integrated Assets to assume and discharge) when due, without recourse to the Seller or any Subsidiary of the Seller, in accordance with the respective terms and subject to the respective conditions thereof, all of the Integrated Liabilities (as defined below).

(b) The "Integrated Assets" shall mean all of those assets set forth in Section 1.1 of the Seller Disclosure Schedule (as defined in Section 3.1).

(c) The "Integrated Liabilities" shall mean (i) all of the performance obligations of the Seller and any Subsidiary of the Seller which relate to the Contracts included among the Integrated Assets, and (ii) all of the liabilities of the Seller and any Subsidiary of the Seller, direct or indirect, known or unknown, absolute or contingent, which relate to the Contracts included among the Integrated Assets and which arise on or after the Closing Date (as defined in Section 2.1).

Section 1.2 The Purchase Price.

(a) Subject to the terms and conditions of this Agreement, on the Closing Date, in consideration of (i) the aforesaid sale, conveyance, assignment, transfer and delivery to PSC (or such Buyer Subsidiary as PSC may designate pursuant to Section 1.1) of the Shares, and (ii) the aforesaid sale, conveyance, assignment, transfer and delivery to Acquisition (or such other Buyer Subsidiary as PSC may designate pursuant to Section 1.1) of the Integrated Assets and Integrated



Liabilities, PSC shall pay to the Seller an amount of cash equal to Two Hundred Five Million Dollars (\$205,000,000) (subject to any adjustments to the Purchase Price contemplated by this Article I, the "Purchase Price").

(b) Subject to the terms and conditions of this Agreement, the Purchase Price shall be determined as of Closing Date in accordance with the following steps, subject to additional adjustment, post-Closing, pursuant to the post-Closing procedures that are specifically contained in this Article I:

(i) start with the Base Purchase Price, derived as follows: the "Base Purchase Price" shall mean the amount of \$205,000,000, subject to reduction to the extent that any of the Excludable Operations (as defined in Section 1.3) are excluded from the transaction in accordance with the provisions of Section 1.3;

(ii) adjust the Base Purchase Price in the manner contemplated by Section 1.4 and Exhibit 1.4, subject to all limitations on any such adjustments contained in Section 1.4 and Exhibit 1.4, and subject to any adjustments to the Target Amounts (as defined in Section 1.3) contemplated by Section 1.3, to determine the Adjusted Purchase Price (the "Adjusted Purchase Price"); and

(iii) further adjust the resulting Adjusted Purchase Price by the Working Capital Adjustment (as defined in Section 1.5), as contemplated by Section 1.5, subject to all limitations on any such adjustments contained in that Section 1.5 to determine the Final Purchase Price (the "Final Purchase Price").

**Section 1.3 Excludable Operations.** In accordance with the following procedure, the Base Purchase Price shall be reduced, as applicable.

(a) The parties agree that the Seller may elect, by delivering a written notice to the Buyer, no later than forty-five (45) calendar days from the date hereof, to treat any of the following assets of the Company as Excluded Assets (as defined in Section 6.3): (i) those assets of the Seller, Utility, Development, Reynolds or any Company Subsidiary associated with or related to the Company's operations in Hawaii (the "Hawaii Operations"), (ii) those assets of the Seller, Utility, Development, Reynolds or any Company Subsidiary associated with or related to the Company's operations in Connecticut and New York (the "Northeast Operations"), (iii) those assets of the Seller, Utility, Development, Reynolds or any Company Subsidiary associated with or related to the Company's operations in New Jersey (the "New Jersey Operations"), or (iv) those assets of the Seller, Utility, Development, Reynolds or any Company Subsidiary associated with or related to the

Company's operations in Kentucky (the "Kentucky Operations"). Following any such election, the Hawaii Operations and/or the Northeast Operations and/or the New Jersey Operations and/or the Kentucky Operations, as the case may be, shall be listed on Section 6.3 of the Seller Disclosure Schedule and shall be treated, for all purposes under this Agreement, as Excluded Assets.

(b) As used in this Agreement, the term "Excludable Operations" means the Hawaii Operations, the Northeast Operations, the New Jersey Operations and the Kentucky Operations. The Seller's election to treat any one or more of the above referenced Excludable Operations as Excluded Assets will result in a reduction to the Base Purchase Price equal to such amounts for such Excludable Operations as PSC and the Seller may mutually agree.

(c) In the event that the Seller elects to treat one or more of the above-referenced Excludable Operations as Excluded Assets, then each of the target amounts that are taken into consideration in determining the Adjusted Purchase Price as contemplated by Section 1.4 (collectively, the "Target Amounts"), including those in respect of Customer Connections (as defined in Exhibit 1.4), Rate Base (as defined in Exhibit 1.4), ConOps Revenue (as defined in Exhibit 1.4), and Rate Initiatives (as defined in Exhibit 1.4), shall be reduced to the extent of and so as to reflect the effects of any election made by the Seller to treat any of the Excluded Operations as Excluded Assets pursuant to Section 1.3, as contemplated by Schedules 1.4(a), (b), (c) and (d) of Exhibit 1.4. For example, the total target Rate Base is \$240,000,000 and the target Customer Connection number at October 31, 2003 is 145,615, as shown on Schedule 1.4(b) and 1.4(a) of Exhibit 1.4, respectively. In the event that the Hawaii Operations are elected by Seller to be treated as an Excluded Asset, then the targets would need to be adjusted accordingly. Specifically, based on this example, the total Rate Base target would be reduced by \$6,925,000 consistent with the amount attributable to the Hawaii Operations resulting in a revised target Rate Base of \$233,075,000 instead of \$240,000,000. Similarly, assuming a Closing on October 31, 2003, the total Customer Connection target would be reduced by the 513 connections projected to be attributable to the Hawaii Operations as of that date resulting in a revised Customer Connection target of 145,102 instead of the total 145,615. The new target numbers (reflecting the exclusion of the Hawaii Operations) would then be used to determine the Adjusted Purchase Price as contemplated by Section 1.4.

(d) In the event that a Condemnation Proceeding results in a governmental taking or settlement in lieu thereof of all or part of one or more of the Company's Investor Owned Utility (IOU) systems, then the Target Amounts shall be reduced to reflect the effects of any such governmental taking or settlement in such manner as the parties may mutually agree or such amount as is determined pursuant to this Section 1.3(d). No later than thirty (30) calendar days following any such

governmental taking or settlement, the Seller shall deliver to PSC the Seller's proposed adjustments to the Target Amounts as a result of such government taking or settlement. Following the delivery of such notice, if the Seller and PSC are unable to agree within thirty (30) calendar days following PSC's receipt of the Seller's proposed adjustment in respect thereof, the Seller and the Buyer shall appoint a nationally recognized accounting firm mutually acceptable to each of the Seller and the Buyer, which shall, at the Seller's and the Buyer's joint expense, review the governmental taking or settlement and all adjustments to the Target Amounts proposed in respect thereof and make a final determination with respect to such adjustment within thirty (30) calendar days of such appointment. The Seller and the Buyer agree to cooperate with such accounting firm and provide it with such information as it reasonably requests to enable it to make such determination. The finding of such accounting firm shall be binding on the parties hereto.

Section 1.4 Purchase Price Adjustment. The Base Purchase Price (as adjusted by Section 1.3) shall be adjusted using the individual Target Amounts as described in Exhibit 1.4 to establish the Adjusted Purchase Price, provided, however, that in no event shall the sum of these Target Amounts in determining the Adjusted Purchase Price pursuant to this Section 1.4 cause the Base Purchase Price to be reduced by an amount greater than \$25,000,000 or to be increased by an amount greater than \$10,000,000. For the avoidance of doubt, if the cumulative adjustments resulting from this Section 1.4 would result in reducing the Base Purchase Price by an amount that is greater than \$25 million, the Adjusted Purchase Price shall equal the Base Purchase Price less \$25 million; and if the cumulative adjustments contemplated by this Section 1.4 would result in increasing the Base Purchase Price by an amount that is greater than \$10 million, then the Adjusted Purchase Price shall equal the Base Purchase Price plus \$10 million. In addition, the Parties recognize and agree that the Working Capital Adjustment contemplated by Section 1.5 is separate and apart from the adjustments contemplated by this Section 1.4 and, as such, is neither increased nor decreased or affected in any way by the limitations on adjustments contained in this Section 1.4

(a) At least ten (10) calendar days prior to the Closing Date, the Seller shall prepare and deliver to the Buyer in good faith its estimate of the Adjusted Purchase Price, if any (the "Estimated Adjusted Purchase Price") showing the individual and cumulative effect of all adjustments contemplated by this Section 1.4 for Buyer's review and comment. At the Closing, the Purchase Price shall be adjusted to reflect the Estimated Adjusted Purchase Price, subject to further adjustment post-Closing as contemplated by Section 1.4(b).

(b) Within thirty (30) calendar days following the Closing Date (or if on the Closing Date the Company shall not yet have received a Final Order approving the Planned Rate Initiative (as defined in Exhibit 1.4) that is not yet

filed on the date of this Agreement and that is budgeted to exceed 10% of the Target Amount for Rate Initiatives, then within thirty (30) calendar days following the date that such Final Order is received but in no event later than April 10, 2004), the Seller shall prepare and deliver to the Buyer in good faith a Final Closing Statement setting forth the Adjusted Purchase Price as finally determined by the Seller in accordance with this Section 1.4 (the "Final Closing Statement"). For purposes of the Final Closing Statement, the Planned Rate Initiative that is not yet filed on the date of this Agreement and that is budgeted to exceed 10% of the Target Amount for Rate Initiatives that has received a Final Order after the Closing Date but prior to March 30, 2004 (a "Post-Closing Rate Initiative") shall be treated for purposes of determining "Adjustment #4 regarding Rate Initiatives" as contemplated on Exhibit 1.4 as if such Planned Rate Initiative had occurred prior to Closing. Within fifteen (15) calendar days following the Buyer's receipt of the Final Closing Statement, the Buyer may object in good faith to the Adjusted Purchase Price in writing. In the event of any such objection, the Buyer and the Seller shall attempt to resolve their differences by negotiation. If such parties are unable to do so within thirty (30) calendar days following Seller's receipt of the Buyer's objection, the Seller and the Buyer shall appoint a nationally recognized accounting firm mutually acceptable to each of the Seller and the Buyer, which shall, at the Seller's and the Buyer's joint expense, review the Final Closing Statement and determine the Adjusted Purchase Price within thirty (30) calendar days of such appointment. The Seller and the Buyer agree to cooperate with such accounting firm and provide it with such information as it reasonably requests to enable it to make such determination. The finding of such accounting firm shall be binding on the parties hereto. Upon determination by agreement of the Seller and the Buyer or by binding determination of said accounting firm of the Adjusted Purchase Price, (i) if the Adjusted Purchase Price exceeds the Estimated Adjusted Purchase Price (such excess amount, the "Deficiency"), the Buyer shall pay to the Seller the Deficiency, or (ii) if the Estimated Adjusted Purchase Price exceeds the Adjusted Purchase Price (such excess amount, the "Excess"), the Seller shall pay to the Buyer the Excess. Any portion of any Deficiency or Excess owed hereunder shall be paid to the Party or Parties owed the same by the Party or Parties owing the same by wire transfer in immediately available funds to an account designated by the Party or Parties owed the same no later than five (5) business days following the determination by agreement of the Seller and the Buyer or by binding determination of said accounting firm of the Adjusted Purchase Price, and such excess or deficiency payment shall be accompanied by an additional payment of interest, calculated with a 4% annual interest rate from the date of Closing to the date of payment under this provision (except that any amount payable resulting from the Post-Closing Rate Initiative shall be disregarded for purposes of calculating such interest payment).

Section 1.5 Working Capital Adjustment. The Adjusted Purchase Price shall be adjusted to determine the Final Purchase Price, as contemplated by this

Section 1.5, provided, however, that in no event, shall the increase in the Adjusted Purchase Price resulting from any adjustment contemplated by this Section 1.5 exceed the amount of \$10,000,000, and provided, further, that for the purposes of calculating current assets as contemplated by Section 1.5(a), the Company's unbilled revenues entitled to be considered in any such calculation shall not exceed the amount of \$3,000,000. Notwithstanding the foregoing, the Buyer shall waive the foregoing cap on unbilled revenues if, and to the extent that, the Seller has been impacted by documented billing delays that have prohibited certain unbilled revenues from being billed to customers in a timely fashion consistent with past practice.

(a) The Adjusted Purchase Price shall be adjusted by an amount of dollars, positive or negative, as the case may be, equal to the net amount of (i) the aggregate amount of the current liabilities of the Company (incurred in the ordinary course of business consistent with past practice), including, but not limited to, accounts payable owed by the Company to any unaffiliated third party as of the Closing Date, excluding any accrued Taxes that are to be paid by the Seller pursuant to this Agreement, and (ii) the aggregate amount of current assets of the Company (incurred in the ordinary course of business consistent with past practice), including, but not limited to, accounts receivable owed by any unaffiliated third party as of the Closing Date, but excluding any monies held in escrow pursuant to Section 7.16 (such net amount, the "Working Capital Adjustment"). At least ten (10) calendar days prior to the Closing Date, the Seller shall prepare and deliver to the Buyer in good faith its estimate of the Working Capital Adjustment, if any (the "Estimated Working Capital Adjustment") showing the individual and cumulative effect of all adjustments contemplated by this Section 1.5 for Buyer's review and comment. At the Closing, the Adjusted Purchase Price shall be adjusted to reflect the Estimated Working Capital Adjustment, subject to further adjustment post-Closing as contemplated by Section 1.5(b).

(b) Within thirty (30) calendar days following the Closing Date, the Seller shall prepare and deliver to the Buyer in good faith a final closing statement setting forth the Working Capital Adjustment in accordance with this Section (the "Final Working Capital Closing Statement"). Within thirty (30) calendar days following the Buyer's receipt of the Final Working Capital Closing Statement, the Buyer may object in good faith to the Working Capital Adjustment in writing. In the event of any such objection, the Buyer and the Seller shall attempt to resolve their differences by negotiation. If such parties are unable to do so within thirty (30) calendar days following Seller's receipt of the Buyer's objection, the Seller and the Buyer shall appoint a nationally recognized accounting firm mutually acceptable to each of the Seller and the Buyer, which shall, at the Seller's and the Buyer's joint expense, review the Final Working Capital Closing Statement and determine the Working Capital Adjustment, if any, within thirty (30) calendar days

of such appointment. The Seller and the Buyer agree to cooperate with such accounting firm and provide it with such information as it reasonably requests to enable it to make such determination. The finding of such accounting firm shall be binding on the parties hereto. Upon determination by agreement of the Seller and the Buyer or by binding determination of said accounting firm of the Working Capital Adjustment, (i) if the Working Capital Adjustment exceeds the Estimated Working Capital Adjustment (such excess amount, the "Working Capital Deficiency"), the Buyer shall pay to the Seller the Working Capital Deficiency, or (ii) if the Estimated Working Capital Adjustment exceeds the Working Capital Adjustment (such excess amount, the "Working Capital Excess"), the Seller shall pay to the Buyer the Working Capital Excess. Any portion of any Working Capital Deficiency or Working Capital Excess owed hereunder shall be paid to the Party or Parties owed the same by the Party or Parties owing the same by wire transfer in immediately available funds to an account designated by the Party or Parties owed the same no later than five (5) business days following the determination by agreement of the Seller and the Buyer or by binding determination of said accounting firm of the Working Capital Adjustment, and such payment shall be accompanied by an additional payment of interest, calculated with a 4% annual interest rate from the date of Closing to the date of payment under this provision.

## **ARTICLE II THE CLOSING**

Section 2.1 Closing. The consummation of the sale and transfer of the Shares and the Integrated Assets as contemplated by Section 1.1 (the "Closing") shall take place at the Washington, D.C. office of Skadden, Arps, Slate, Meagher & Flom LLP at 10:00 a.m., local time, on the fifth (5<sup>th</sup>) business day immediately following the date on which the last of the conditions set forth in Article VIII hereof is fulfilled or waived, or at such other time, date and place as the Seller and the Buyer shall mutually agree (the "Closing Date").

Section 2.2 Closing Transactions. At the Closing:

(a) (i) The Seller shall deliver to PSC (or such Buyer Subsidiary as PSC may designate pursuant to Section 1.1) free and clear of any liens, claims, security interests and other encumbrances of any nature whatsoever (collectively, "Encumbrances"), except for those Encumbrances arising under the Securities Act of 1933, as amended (the "Securities Act") or any applicable state securities laws and those Encumbrances created by this Agreement or PSC (or such Buyer Subsidiary as PSC may designate pursuant to Section 1.1) (collectively, "Permitted Encumbrances"), certificates representing the Shares, each such certificate to be duly and validly endorsed in favor of PSC (or such Buyer Subsidiary as PSC may designate pursuant to

Section 1.1) or accompanied by a separate stock power duly and validly executed by the Seller and otherwise sufficient to vest in PSC (or such Buyer Subsidiary as PSC may designate pursuant to Section 1.1) good title to the Shares;

(ii) The Seller shall deliver to Acquisition (or such other Buyer Subsidiary as PSC may designate pursuant to Section 1.1): (i) one or more bills of sale duly executed by the Seller or a Subsidiary of the Seller, in the form attached hereto as Exhibit 2.2(a)(ii)(i) (each, a “Bill of Sale”) selling, assigning, conveying, transferring and delivering to Acquisition (or such other Buyer Subsidiary as PSC may designate pursuant to Section 1.1), free and clear of any Encumbrances (except for Permitted Encumbrances), the Integrated Assets, and (ii) an assignment and assumption agreement, in the form attached hereto as Exhibit 2.2(a)(ii)(ii) (the “Assignment and Assumption Agreement”), duly executed by the Seller; and

(iii) The Seller shall deliver to PSC (or such Buyer Subsidiary as PSC may designate pursuant to Section 1.1) or to Acquisition (or such other Buyer Subsidiary as PSC may designate pursuant to Section 1.1), as the case may be, such other documents as are required to be delivered by the Seller to PSC, Acquisition or such other Buyer Subsidiary, as the case may be, pursuant hereto.

(b) PSC shall deliver, or cause to be delivered, to the Seller (i) the Purchase Price, by wire transfer in immediately available funds to an account designated by the Seller prior to Closing, (ii) the Assignment and Assumption Agreement, duly executed by Acquisition (or such other Buyer Subsidiary as PSC may designate pursuant to Section 1.1), assuming and agreeing to discharge when due, without recourse to the Seller, or any Subsidiary of the Seller, in accordance with the respective terms and subject to the respective conditions thereof, all of the Integrated Liabilities, and (iii) such other documents as are required to be delivered by PSC, Acquisition or such other Buyer Subsidiary, as the case may be, to the Seller pursuant hereto.

### **ARTICLE III REPRESENTATIONS AND WARRANTIES OF THE SELLER**

The Seller represents and warrants to the Buyer as follows:

#### **Section 3.1 Organization and Qualification.**

(a) Except as set forth in Section 3.1(a) of the schedule

delivered by the Seller to the Buyer on the date hereof and attached to this Agreement (the "Seller Disclosure Schedule"): (i) the Seller is a corporation duly organized, validly existing and in good standing under the laws of Delaware, (ii) Utility, Development and Reynolds and each Company Subsidiary (as defined in Section 3.1(c)) is a corporation or other entity duly organized, validly existing and in good standing under the laws of its jurisdiction of incorporation or organization, has all requisite power and authority to own, lease and operate its assets and properties to the extent owned, leased and operated and to carry on its business as it is now being conducted and is duly qualified to do business in each jurisdiction in which the nature of its business or the ownership or leasing of its assets and properties makes such qualification necessary other than in such jurisdictions where the failure to be in good standing or be so qualified is not reasonably likely to have a Company Material Adverse Effect (as defined below), and (iii) each Company Subsidiary has received from its respective state or county regulatory authority the requisite authorization to own utility assets or stock and to provide water or wastewater utility service in the area in which such Company Subsidiary is currently providing water or wastewater utility service, except for such failures to have such authorizations as are not reasonably likely, individually or in the aggregate, to have a Company Material Adverse Effect.

(b) As used in this Agreement, the term "Company Material Adverse Effect" shall mean any material adverse effect on the business, assets, financial condition or results of operations of the Company (as defined below), taken as a whole, totaling in each instance \$1,000,000 for all purposes hereunder except for Sections 3.11 and 3.19, and \$500,000 for purposes of Sections 3.11 and 3.19; provided, however, that for all purposes hereunder the term "Company Material Adverse Effect" shall not include (i) any such effect resulting from any change in law, rule, or regulation of any Governmental Authority (as defined in Section 3.4(c)) that applies generally to similarly situated Persons (as defined below), (ii) effects relating to or resulting from general changes in the industries in which the Company operates its assets or conducts its businesses or (iii) the direct financial impact on the Company of any change in the Rate Base, Customer Connections, Rate Initiatives or ConOps Revenue, or the composition of the Excluded Assets, that is taken into account under Article I, as applicable, as an adjustment to the Purchase Price to the extent that any such change would result in a permissible adjustment to the Purchase Price, given all applicable limitations on any such adjustments, under Article I, as applicable (a "Permitted Financial Impact").

(c) As used in this Agreement, (i) the term "Company" shall mean, collectively, Utility, Development and Reynolds, the Company Subsidiaries (as defined below) and the Integrated Assets, but shall at all times exclude the Excluded Assets, (ii) the term "knowledge" when referring to the knowledge of the Seller shall mean the knowledge of an officer of the Seller, Utility, Development,



Reynolds or a Company Subsidiary, (iii) the term "Person" shall mean any natural person, corporation, general or limited partnership, limited liability company, joint venture, trust, association or entity of any kind, (iv) the term "Company Subsidiaries" shall mean, collectively, the Subsidiaries of Utility, Development and Reynolds and (v) for the purposes of this Article III, the term "Seller" shall include, with respect to the Integrated Assets and Integrated Liabilities, the Seller and its Subsidiaries and all references to the Seller shall be read as if qualified by the phrase "(in respect of the Company)."

Section 3.2 Subsidiaries. Section 3.2 of the Seller Disclosure Schedule sets forth a complete list of all of the Company Subsidiaries and their respective jurisdictions of incorporation or organization. Except as set forth in Section 3.2 of the Seller Disclosure Schedule, all of the issued and outstanding shares of capital stock of each Company Subsidiary are validly issued, fully paid and nonassessable, and are owned, directly or indirectly, by Utility, Development or Reynolds, as the case may be, free and clear of any Encumbrances, except for Permitted Encumbrances. As used in this Agreement, the term "Subsidiary" of a Person shall mean any corporation or other entity (including partnerships and other business associations) of which at least a majority of the voting power represented by the outstanding capital stock or other voting securities or interests having voting power under ordinary circumstances to elect directors or similar members of the governing body of such corporation or entity (or, if there are no such voting interests, 50% or more of the equity interests in such corporation or entity) shall at the time be held, directly or indirectly, by such Person.

Section 3.3 Ownership and Possession of Shares; Capitalization; Ownership and Possession of Integrated Assets.

(a) As of the date hereof, (i) the authorized capital stock of Utility consists of 100 shares of common stock and 100 shares of preferred stock, (ii) 100 shares of such common stock are issued and outstanding and 100 shares of preferred stock are issued and outstanding, (iii) the Utility Shares represent all such issued and outstanding shares of such common stock and the Utility Preferred Shares represent 90% of all such issued and outstanding share of such preferred stock, and (iv) all Utility Shares and all Utility Preferred Shares are validly issued, fully paid and nonassessable.

(b) As of the date hereof, (i) the authorized capital stock of Development consists of 1000 shares of common stock, (ii) 1000 shares of such common stock are issued and outstanding, (iii) the Development Shares represent all such issued and outstanding shares of such common stock, and (iv) all Development Shares are validly issued, fully paid and nonassessable.

(c) As of the date hereof, (i) the authorized capital stock of Reynolds consists of 1000 shares of common stock, (ii) 1000 shares of such common stock are issued and outstanding, (iii) the Reynolds Shares represent all such issued and outstanding shares of such common stock, and (iv) all Reynolds Shares are validly issued, fully paid and nonassessable.

(d) All of the Shares are owned, directly or indirectly, by the Seller free and clear of any Encumbrances, except for Permitted Encumbrances. Except as set forth in Section 3.3(d) of the Seller Disclosure Schedule, there are no options, warrants, calls, rights, commitments or agreements of any character to which the Seller, Utility, Development or Reynolds, or any Company Subsidiary, is a party or by which it is bound obligating the Seller, Utility, Development or Reynolds, or any Company Subsidiary, to issue, deliver or sell, or cause to be issued, delivered or sold, additional shares of capital stock of Utility, Development or Reynolds, or any Company Subsidiary, or obligating the Seller, Utility, Development or Reynolds, or any Company Subsidiary, to grant, extend or enter into any such option, warrant, call, right, commitment or agreement. All of the Integrated Assets are owned, directly or indirectly, by the Seller free and clear of any Encumbrances, except for Permitted Encumbrances.

(e) As of the date hereof, the authorized capital stock and the number of issued and outstanding shares of capital stock for each Company Subsidiary are listed on Section 3.3(e) of the Seller Disclosure Schedule.

Section 3.4 Authority; Non-Contravention; Statutory Approvals; Compliance.

(a) Authority. The Seller has all requisite corporate power and authority to (i) enter into this Agreement and (ii) subject to the receipt of the applicable Seller Required Statutory Approvals (as defined in Section 3.4(c)) and the applicable Seller Required Consents (as defined in Section 3.4(b)), to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation by the Seller of the transactions contemplated hereby have been duly authorized by all necessary corporate action on the part of the Seller. No vote of, or consent by, the holders of any class or series of stock issued by the Seller or any Subsidiary of the Seller that has not already been obtained is necessary to authorize the execution and delivery by the Seller of this Agreement or the consummation by it of the transactions contemplated hereby. This Agreement has been duly executed and delivered by the Seller and, assuming the due authorization, execution and delivery hereof by the Buyer, constitutes the valid and binding obligation of the Seller enforceable against it in accordance with its terms, subject to bankruptcy, insolvency, fraudulent transfer, reorganization, moratorium and similar laws of general applicability relating to or affecting creditors' rights and to general

equity principles.

(b) **Non-Contravention.** Except as set forth in Section 3.4(b)(i) of the Seller Disclosure Schedule, the execution and delivery of this Agreement by the Seller does not, and the consummation of the transactions contemplated hereby will not, violate or result in a material breach of any provision of, constitute a material default (with or without notice or lapse of time or both) under, result in the termination or modification of, accelerate the performance required by, result in a right of termination, cancellation or acceleration of any obligation or the loss of a material benefit under, or result in the creation of any material Encumbrance, except for Permitted Encumbrances, upon any of the properties or assets of the Company or the Seller (in respect of the Company) (any such violation, breach, default, right of termination, modification, cancellation or acceleration, loss or creation, is referred to herein as a "Violation" with respect to the Seller and the Company and such term when used in Article V has a correlative meaning with respect to the Buyer) pursuant to any provisions of (i) the articles of incorporation, by-laws or similar governing documents of the Seller, Utility, Development or Reynolds, or any Company Subsidiary, (ii) subject to obtaining the Seller Required Statutory Approvals (as defined in Section 3.4(c)), any statute, law, ordinance, rule, regulation, judgment, decree, order, injunction, writ, permit or license of any Governmental Authority applicable to the Seller, the Company or any of their respective properties or assets, or (iii) subject to obtaining the third-party consents set forth in Section 3.4(b)(iii) of the Seller Disclosure Schedule (the "Seller Required Consents"), any note, bond, mortgage, indenture, deed of trust, license, franchise, permit, concession, contract, lease or other instrument, obligation or agreement of any kind to which the Seller, Utility, Development or Reynolds, or any Company Subsidiary, is a party or by which they or any of their respective properties or assets may be bound or affected, except in the case of clause (ii) or (iii) for any such Violation which is not reasonably likely to have a Company Material Adverse Effect.

(c) **Statutory Approvals.** Except as described in Section 3.4(c) of the Seller Disclosure Schedule (the "Seller Required Statutory Approvals"), no declaration, filing or registration with, or notice to or authorization, consent or approval of, any court, federal, state, local or foreign governmental or regulatory body (including a national securities exchange or other self-regulatory body) or authority (each, a "Governmental Authority") is necessary for the execution and delivery of this Agreement by the Seller or the consummation by the Seller of the transactions contemplated hereby, except those which the failure to obtain is not reasonably likely to result in a Company Material Adverse Effect (it being understood that references in this Agreement to "obtaining" such Seller Required Statutory Approvals shall mean (i) making such declarations, filings or registrations; (ii) giving such notices; (iii) obtaining such authorizations, consents or approvals;

(iv) having such waiting periods expire as are necessary to avoid a violation of law); and (v) having any applicable appeals period expire without any appeal being filed, or if such an appeal is filed, such appeal is fully and finally dismissed without the opportunity for further appeal.

(d) **Compliance.** Except as set forth in Section 3.4(d)(i), Section 3.7, Section 3.10 or Section 3.11 of the Seller Disclosure Schedule, neither the Seller, Utility, Development nor Reynolds, nor any Company Subsidiary, is in violation of, is currently being charged with any violation of, or to the knowledge of Seller, is under investigation with respect to any violation of, any law, statute, order, rule, regulation, ordinance, tariff, rate or judgment of any Governmental Authority, except for possible violations which are not reasonably likely to have a Company Material Adverse Effect or to prevent, materially delay or materially impair the ability of the Seller to consummate the transactions contemplated by this Agreement. Except as set forth in Section 3.4(d)(ii) or Section 3.12 of the Seller Disclosure Schedule or as disclosed in the Seller SEC Reports (as defined below) filed prior to the date hereof, the Seller, Utility, Development and Reynolds, and each Company Subsidiary, have all permits, licenses, franchises and other governmental authorizations, consents and approvals necessary to conduct their businesses as presently conducted except those that the absence of which are not reasonably likely to have a Company Material Adverse Effect or to prevent, materially delay or materially impair the ability of the Seller to consummate the transactions contemplated by this Agreement. Except as set forth in Section 3.4(d)(iii) of the Seller Disclosure Schedule, neither the Seller, Utility, Development nor Reynolds, nor any Company Subsidiary, is in breach or violation of any term or provision of their respective articles of incorporation or by-laws. As used in this Agreement, the term "Seller SEC Reports" shall mean each report, schedule, registration statement and definitive proxy statement filed with the Securities and Exchange Commission (the "SEC") by DQE since December 31, 1999, pursuant to the requirements of the Securities Act, or the Securities Exchange Act of 1934, as amended (the "Exchange Act").

**Section 3.5 Financial Statements.** True and complete copies of the Company Financial Statements (as defined below) are set forth in Section 3.5 of the Seller Disclosure Schedule. The Company Financial Statements have been prepared from, are in accordance with, and accurately reflect the books and records of the Company, comply in all material respects with applicable accounting requirements, have been prepared in accordance with United States generally accepted accounting principles ("GAAP") applied on a consistent basis during the period involved (except as may be stated in the notes thereto) and are true and correct in all material respects and fairly present the consolidated financial position and the consolidated results of operations and cash flows (and changes in financial position, if any) of the Company as of the time and for the period referred to therein. As of the dates of the statements

of assets, liabilities and stockholders' equity included in the Company Financial Statements, the Company has no liabilities or obligations of any nature whatsoever (whether known, unknown, absolute, accrued, contingent or otherwise) which are not fully reflected or reserved against in such Company Financial Statements or which were not incurred in the ordinary course consistent with past practice and this Agreement and are, therefore, not required by GAAP to be so reflected or reserved against in such Company Financial Statements. As used in this Agreement, the term "Company Financial Statements" shall mean the consolidated balance sheet of the Company as at December 31, 2001 (the "December 31, 2001 Balance Sheet") and as at June 30, 2002 (the "June 30, 2002 Balance Sheet"), in each case together with the consolidated statements of income, shareholders' equity and cash flows for the periods then ended. The Company Financial Statements are not audited and reflect only the Company, including the related assets and liabilities, contemplated to be transferred to the Buyer pursuant to this Agreement.

Section 3.6 Absence of Certain Changes or Events. Except as set forth in Section 3.6 of the Seller Disclosure Schedule, since December 31, 2001, the Seller, Utility, Development and Reynolds, and each Company Subsidiary, has conducted its business only in the ordinary course of business consistent with past practice and there has not been any development or combination of developments affecting the Seller, Utility, Development or Reynolds, or any Company Subsidiary, of which the Seller has knowledge, that is reasonably likely to have a Company Material Adverse Effect.

Section 3.7 Litigation. Except as set forth in Section 3.7, Section 3.8(a), Section 3.8(b), Section 3.9(i), Section 3.10 or Section 3.11 of the Seller Disclosure Schedule, (a) there are no claims, suits, actions or proceedings before any court, governmental department, commission, agency, instrumentality or authority or any arbitrator pending or, to the knowledge of the Seller, threatened, nor are there, to the knowledge of the Seller, any investigations or reviews by any court, governmental department, commission, agency, instrumentality or authority or any arbitrator pending or threatened against, relating to or affecting the Seller, Utility, Development or Reynolds, or any Company Subsidiary, and (b) there are no judgments, decrees, injunctions, rules or orders of any court, governmental department, commission, agency, instrumentality or authority or any arbitrator applicable to the Seller, Utility, Development or Reynolds, or any Company Subsidiary, except, in the case of both clause (a) and clause (b), for such that are not reasonably likely to have a Company Material Adverse Effect or reasonably likely to prevent, materially delay or materially impair the Seller's ability to consummate the transactions contemplated by this Agreement.

Section 3.8 Tax Matters.

(a) Except as set forth in Section 3.8(a) of the Seller Disclosure Schedule: (i) Utility, Development and Reynolds, and each Company Subsidiary, has timely filed (or has had filed on its behalf) with appropriate taxing authorities all Tax Returns (as defined in Section 3.8(c)) required to be filed by it on or prior to the date hereof, and such Tax Returns are correct, complete and accurate in all material respects; (ii) all Taxes (as defined in Section 3.8(c)) of Utility, Development and Reynolds, and each Company Subsidiary, have been timely paid; (iii) all Tax withholding and deposit requirements imposed on or with respect to Utility, Development and Reynolds, and each Company Subsidiary (including any withholding with respect to wages or other amounts paid to employees) have been satisfied in full in all material respects; (iv) there are no liens for Taxes upon any property or assets of Utility, Development or Reynolds, or any Company Subsidiary, except for liens for Taxes not yet due and payable; and for which adequate reserves to pay such Taxes have been set aside by Utility, Development or Reynolds, or any Company Subsidiary, as the case may be; (v) there are no outstanding requests, agreements, consents or waivers to extend the statutory period of limitations applicable to the assessment or collection of any Taxes or deficiencies against Utility, Development or Reynolds, or any Company Subsidiary, (vi) neither Utility, Development nor Reynolds, nor any Company Subsidiary, has made the election under Section 341(f) of the Internal Revenue Code of 1986, as amended (the "Code"); and (vii) neither Utility, Development nor Reynolds, nor any Company Subsidiary, is currently subject to an adjustment described in Section 481 of the Code.

(b) Except as set forth in Section 3.8(b) of the Seller Disclosure Schedule: (i) the Seller has timely filed (or has had filed on its behalf) with appropriate taxing authorities all Tax Returns with respect to the Integrated Assets required to be filed by it on or prior to the date hereof, and such Tax Returns are correct, complete and accurate in all material respects, (ii) all Taxes on or in respect to the Integrated Assets have been timely paid; (iii) all Tax withholding and deposit requirements imposed on or with respect to the Integrated Assets (including any withholding with respect to wages or other amounts paid to employees) have been satisfied in full in all material respects; (iv) there are no liens for Taxes upon any of the Integrated Assets, except for liens for Taxes not yet due and payable and for which adequate reserves to pay such Taxes have been set aside by the Seller; and (v) there are no outstanding requests, agreements, consents or waivers to extend the statutory period of limitations applicable to the assessment or collection of any Taxes or deficiencies attributable to the Integrated Assets.

(c) As used in this Agreement: (i) the term "Tax" includes all federal, state, local and foreign income, profits, franchise, gross receipts,

environmental, customs duty, capital stock, severance, stamp, payroll, sales, employment, unemployment, disability, use, property, withholding, excise, production, value added, occupancy and other taxes, duties or assessments of any nature whatsoever, together with all interest, penalties and additions imposed with respect thereto; and (ii) the term "Tax Return" includes all returns and reports (including elections, declarations, disclosures, schedules, estimates and information returns) required to be supplied to a Tax authority relating to Taxes.

(d) The Net Inside Tax Basis of the Company equals or exceeds the Rate Base of the Company. For purposes of this Agreement, the term "Net Inside Tax Basis" means the difference between (i) the adjusted tax basis (as defined under Section 1011 of the Code) of all assets of the Company for federal income tax purposes, less (ii) the adjusted tax basis (as defined under Section 1011 of the Code) of all liabilities of the Company for federal income tax purposes.

### Section 3.9 Employee Benefits; ERISA.

(a) Company Plans. Section 3.9(a) of the Seller Disclosure Schedule contains a list of each employee benefit plan, program, agreement or arrangement (including without limitation any employee benefit plan within the meaning of Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA")), in each case, that is sponsored, maintained or contributed to or required to be contributed to by the Company, the Seller, DQE or by any trade or business, whether or not incorporated (an "ERISA Affiliate"), that together with the Company, the Seller or DQE would be deemed a "single employer" within the meaning of Section 4001(a)(14) or Section 4001(b) of ERISA or Section 414 of the Code or to which the Company, the Seller, DQE or an ERISA Affiliate is a party, for the benefit of any employee or former employee of the Seller or any affiliate of the Seller whose employment is (in the case of current employees) or was (in the case of former employees) principally attributable to the businesses carried on by or in respect of the Company (such individuals, the "Business Employees," and such plans, programs, agreements or arrangements, collectively, the "Company Plans").

(b) Deliveries. With respect to each Company Plan, the Seller has heretofore delivered or made available to the Buyer true and complete copies of (i) such Company Plan and any amendments thereto; (ii) if such Company Plan is funded through a trust or any third party funding vehicle, a copy of the trust or other funding agreement; and (iii) the most recent determination letter received from the Internal Revenue Service with respect to each such Company Plan intended to qualify under Section 401 of the Code.

(c) Absence of Liability. Except as set forth in Section 3.9(c) of the Seller Disclosure Schedule, no liability under Title IV of ERISA has

been incurred by the Seller, DQE, the Company or any ERISA Affiliate with respect to a Company Plan or with respect to any defined benefit plan currently or previously maintained or contributed to or required to be contributed to by DQE, the Seller, the Company or any ERISA Affiliate that has not been satisfied in full, and, to the knowledge of the Seller, no condition exists that presents a material risk to the Company of incurring any such liability, other than liability for premiums due the Pension Benefit Guaranty Corporation (which premiums have been paid when due) and no Company Plan or plan of the Seller, DQE or any ERISA Affiliate which is subject to the minimum funding requirements of Part III of Subtitle B of Title I of ERISA or of Section 412 of the Code, has incurred any "accumulated funding deficiency" within the meaning of Section 302 of ERISA or Section 412 of the Code.

(d) Multiemployer Plan. No Company Plan is a "multiemployer plan," as defined in Section 4001(a)(3) of ERISA or is a plan described in Section 4063(a) of ERISA. The Seller, DQE, the Company and the ERISA Affiliates have never withdrawn from any plan which is a multiemployer plan or which is a plan described in Section 4063(a) of ERISA with respect to which there is any outstanding withdrawal liability.

(e) No Violations. Except as set forth in Section 3.9(e) of the Seller Disclosure Schedule, each Company Plan has been operated and administered in all material respects in accordance with its terms and applicable law, including without limitation ERISA and the Code.

(f) Section 401(a) Qualification. Each Company Plan intended to be "qualified" within the meaning of Section 401(a) of the Code has received or timely applied for a determination letter from the Internal Revenue Service to the effect that it is so qualified.

(g) Post-Employment Benefits. Except as set forth in Section 3.9(g) of the Seller Disclosure Schedule, no Company Plan provides medical, surgical, hospitalization, death or similar benefits (whether or not insured) for Business Employees for periods extending beyond their respective dates of retirement or other termination of service, other than (i) coverage mandated by applicable law, (ii) death benefits under any "pension plan," or (iii) benefits the full cost of which is borne by the Business Employee (or his beneficiary).

(h) Effect of Change of Control. Except as set forth in Section 3.9(h) of the Seller Disclosure Schedule, the consummation of the transactions contemplated by this Agreement will not, alone or together with any other event, (i) entitle any Business Employee to severance pay, unemployment compensation or any other payment, except as expressly provided in this Agreement,



or (ii) accelerate the time of payment or vesting, or increase the amount of compensation due any such Business Employee.

(i) Claims. Except as set forth in Section 3.9(i) of the Seller Disclosure Schedule, there are no pending, or to the knowledge of the Seller threatened, material claims by or on behalf of any Company Plan, by any employee, former employee or beneficiary covered under any such Company Plan, or otherwise involving any such Company Plan (other than routine claims for benefits).

Section 3.10 Labor and Employee Relations. As of the date hereof, except as disclosed in Section 3.10 of the Seller Disclosure Schedule, neither Utility, Development nor Reynolds, nor any Company Subsidiary, is a party to any collective bargaining agreement or other labor agreement with any union or labor organization. Except as disclosed in Section 3.10 of the Seller Disclosure Schedule or except to the extent not reasonably likely to have a Company Material Adverse Effect, (i) there is no strike, lockout, slowdown or work stoppage pending or, to the knowledge of the Seller, threatened against or involving the Company, and (ii) there is no proceeding, claim, suit, action or governmental investigation pending or, to the knowledge of the Seller, threatened in respect of which any director, officer, employee or agent of the Company is or may be entitled to claim indemnification from Utility, Development or Reynolds pursuant to their respective articles of incorporation, by-laws or any indemnification agreement.

Section 3.11 Environmental Matters.

(a) Except as set forth in Section 3.11 of the Seller Disclosure Schedule and except for those matters disclosed in that certain environmental disclosure documentation which was delivered by the Seller to the Buyer under cover of the Seller's letter dated July 29, 2002 (such documentation, collectively, the "Environmental Whitepaper"):

(i) The Seller (in respect of the Company), Utility, Development and Reynolds, and each Company Subsidiary, are and have been in compliance with all applicable Environmental Laws (as defined in Section 3.11(b)(i)), including, but not limited to, possessing all permits and other governmental authorizations required for their operations under applicable Environmental Laws, except for such noncompliance that is not having as of the date hereof, and would not be reasonably likely to have, a Company Material Adverse Effect. To the extent that the Seller, Utility, Development and Reynolds, and any Company Subsidiary, had or has any outstanding violations of any applicable Environmental Law that is having as of the date hereof, or is reasonably likely to have a Company Material

Adverse Effect, each such violation has been set forth either in the Environmental Whitepaper or in Section 3.11 of the Seller Disclosure Schedule, and the Seller (in respect of the Company), Utility, Development and Reynolds, and each Company Subsidiary, as the case may be, having such violation has completed or is, as of the date hereof, in the process of addressing in accordance with any applicable deadline, all actions required by any applicable Environmental Law or appropriate Governmental Authority to correct or otherwise respond to such violation, or is otherwise implementing such actions as are appropriate and consistent with the policies and programs identified in the Environmental Whitepaper.

(ii) (A) There is no pending or threatened written claim, lawsuit, or administrative proceeding against the Seller (in respect of the Company), Utility, Development or Reynolds, or any Company Subsidiary, under or pursuant to any Environmental Law, and there is no claim, lawsuit, or administrative proceeding threatened in writing against Utility, Development or Reynolds, or any Company Subsidiary, under or pursuant to any Environmental Law, in either case that is reasonably likely to have a Company Material Adverse Effect; (B) neither the Seller, Utility, Development nor Reynolds, nor any Company Subsidiary, is subject to, or is proposed by any Governmental Authority to be subject to, any administrative or judicial consent order, decree or unilateral administrative or judicial order in connection with any Environmental Laws or the Release (as defined in Section 3.11(b)(iii)) or threatened Release of Hazardous Substances (as defined in Section 3.11(b)(ii)) that is having as of the date hereof, or is reasonably likely to have, a Company Material Adverse Effect; and (C) neither the Seller, Utility, Development nor Reynolds, nor any Company Subsidiary, has received written notice from any Person, including but not limited to any Governmental Authority, alleging that the Seller, Utility, Development or Reynolds, or any Company Subsidiary, is in violation or potentially in violation of any applicable Environmental Law or otherwise may be liable under any applicable Environmental Law, which violation or liability is unresolved or unlikely to be resolved in the ordinary course of business and the failure to resolve such violation in the ordinary course of business is having as of the date hereof, or is reasonably likely to have, a Company Material Adverse Effect.

(iii) With respect to the real property that was formerly or is currently owned, occupied or leased by the Seller (in

respect of the Company), Utility, Development or Reynolds, or any Company Subsidiary, there have been no Releases of Hazardous Substances on or underneath any of such real property during the ownership, occupation or lease of such property by the Seller, Utility, Development, Reynolds, or any Company Subsidiary, as the case may be, (and to the Seller's knowledge, during any other period of time) in violation of any applicable Environmental Law and that is having as of the date hereof, or is reasonably likely to have, a Company Material Adverse Effect.

(iv) Where applicable, the Seller (in respect of the Company), Utility, Development or Reynolds, or any Company Subsidiary, holding any permit or authorization required under any applicable Environmental Laws has timely filed any renewal application or request necessary to continue performing, in accordance with such applicable Environmental Laws, the permitted or otherwise authorized activity, and no such renewal application or request is expected by the Company to be denied, except for such failures to so file or request or for such denials which are not having as of the date hereof, and are not reasonably likely to have, a Company Material Adverse Effect.

(v) None of the real property currently owned, occupied, or leased by the Seller (in respect of the Company), Utility, Development, Reynolds, or any Company Subsidiary, and, to the Seller's knowledge, none of the real property formerly owned, occupied or leased by the Seller (in respect of the Company), Utility, Development, Reynolds, or any Company Subsidiary, is listed or is proposed for listing on the National Priorities List ("NPL") established by the federal Comprehensive Environmental Response, Compensation and Liability Act, as amended ("CERCLA"), 42 U.S.C. § 9601 et seq., or any state analog to the NPL maintained or created under the Environmental Laws of any state. In addition, to the Seller's knowledge, none of the real property currently or formerly owned, occupied or leased by the Seller (in respect of the Company), Utility, Development, Reynolds, or any Company Subsidiary is listed or is proposed for listing on the Comprehensive Environmental Response, Compensation and Liability Information System ("CERCLIS") established by CERCLA or any state analog to CERCLIS maintained or created under the Environmental Laws of any state.

(vi) To the Seller's knowledge, there are no

asbestos-containing materials in, on, or under any of the real property currently owned, occupied or leased by the Seller (in respect of the Company), Utility, Development, Reynolds, or any Company Subsidiary, except for those materials which are appropriate to be used in, and are used in, the ordinary course of business in substantial compliance with applicable Environmental Laws, including roofing material, flooring material, transite pipe and other insulating materials.

(b) For purposes of this Agreement:

(i) "Environmental Laws" shall mean all federal, state and local laws, regulations, rules and ordinances relating to pollution or the protection of human health and safety or the environment, including, without limitation, laws relating to releases or threatened releases of Hazardous Substances into the environment (including, without limitation, ambient air, surface water, groundwater, land, surface and subsurface strata), in effect and applicable to the Company's operations as of the Closing Date, unless a less stringent requirement goes into effect thereafter. Such laws include the common law to the extent relating to injuries caused by the release or presence of Hazardous Substances.

(ii) "Hazardous Substances" shall mean any chemicals, materials or substances defined as or included in the definition of "hazardous substances", "hazardous wastes", "hazardous materials", "hazardous constituents", "restricted hazardous materials", "extremely hazardous substances", "toxic substances", "contaminants", "pollutants", "toxic pollutants", or words of similar meaning and regulatory effect under any applicable Environmental Law including, without limitation, petroleum and asbestos.

(iii) "Release" shall mean any spill, leaking, pumping, pouring, emitting, emptying, dumping, injection, deposit, disposal, discharge, dispersal, leaching, or allowing the escape of any Hazardous Substances into the environment at or from any property.

(c) The amount of capital expenditures contained in the Business Plan (as defined in Section 6.1) is adequate and sufficient to resolve completely any obligations in respect of any non-compliance with Environmental Laws that is addressed in any of those consent agreements with Governmental Authorities disclosed in the Environmental Whitepaper.

(d) None of the real property currently owned, occupied or leased by the Seller (in respect of the Company), Utility, Development, Reynolds, or any Company Subsidiary, and, to the Seller's knowledge, none of the real property formerly owned, occupied or leased by the Seller (in respect of the Company), Utility, Development, Reynolds, or any Company Subsidiary, is subject to any investigation, sampling, remediation, or other response action under CERCLA or any state statute analogous thereto.

(e) The policies and programs described in the Environmental Whitepaper result from the exercise of the skill, diligence, prudence and foresight which would reasonably and ordinarily be expected from a Person experienced in owning or operating the sort of business the Seller (in respect of the Company), Utility, Development, Reynolds, and each Company Subsidiary own or operate and do not, to the Seller's knowledge, violate any Environmental Laws.

(f) The representations and warranties set forth in this Section 3.11 are the sole and exclusive representations and warranties relating to environmental matters made by the Seller in this Agreement.

Section 3.12 No Breaches or Defaults. Except as disclosed on Section 3.7 or Section 3.12 of the Seller Disclosure Schedule, neither the Seller, Utility, Development nor Reynolds, nor any Company Subsidiary, is in breach or violation of or in default in the performance or observance of any term or provision of, and no event has occurred which, with the lapse of time or action by a third party, could result in a default by the Seller, Utility, Development or Reynolds, or any Company Subsidiary, under, nor, to the knowledge of the Seller, is any third party in breach or default in any material respect under, any Contract, except (i) in any such case, for such breaches and defaults as to which requisite waivers or consents have been or will be obtained prior to the Closing Date and (ii) for such breaches and defaults that are not reasonably likely to have a Company Material Adverse Effect. The term "Contracts" means all written notes, bonds, mortgages, indentures, deeds of trust, licenses, franchises, permits, contracts, leases or other instruments, obligations or agreements of any kind which are included among the Integrated Assets or to which Utility, Development or Reynolds, or any Company Subsidiary, is a party or by which any of the Company's properties or assets may be bound, provided, however, that for purposes of this Section 3.12, Contracts shall not include Company Plans or any agreement with any Governmental Authority regarding compliance with Environmental Laws.

Section 3.13 Insurance. Section 3.13 of the Seller Disclosure Schedule describes the material fire and casualty, general liability, business interruption, product liability, pollution and sprinkler and water damage insurance policies maintained by the Seller or DQE on behalf of the Company as well as a

description of any self-insurance arrangement by or affecting the Company, including any reserves thereunder. All of such policies are in full force and effect, all premiums with respect thereto are currently paid and neither the Seller nor DQE has received any notice of nonrenewal, cancellation or termination with respect to any such insurance policy or denial of coverage or reservation of rights with respect to any claim arising from occurrences prior to the Closing Date involving contamination of drinking water provided by the Company or involving environmental impairment, subject to the deductible and loss limits under such policies.

Section 3.14 Brokers or Finders. The Seller has not entered into any agreement or arrangement entitling any agent, broker, investment banker, financial advisor or other firm or Person to any broker's or finder's fee or any other commission or similar fee in connection with any of the transactions contemplated by this Agreement, except Lehman Brothers, whose fees and expenses will be paid by the Seller in accordance with the Seller's agreements with such firms.

Section 3.15 Intellectual Property. Except as set forth in Section 3.15 of the Seller Disclosure Schedule, the Seller or Utility, Development or Reynolds (a) owns, leases or licenses all Intellectual Property Rights (as defined below) necessary to conduct the business of the Company, except when the failure to own, lease or license would not have a Company Material Adverse Effect and (b) has the right to transfer all such Intellectual Property Rights to PSC or Acquisition. Except as set forth in Section 3.15 of the Seller Disclosure Schedule, (i) there has been no claim made against the Seller (in respect of the Company), Utility, Development, Reynolds or any Company Subsidiary asserting the invalidity, misuse or unenforceability of any of its Intellectual Property Rights, (ii) to the knowledge of the Seller, there is no infringement or misappropriation of any of the Company's Intellectual Property Rights, (iii) to the knowledge of the Seller, neither the Seller (in respect of the Company), Utility, Development, Reynolds nor any Company Subsidiary has infringed or misappropriated any Intellectual Property Rights of any other entity, and (iv) the Seller (in respect of the Company), Utility, Development, Reynolds or any Company Subsidiary owns all the Intellectual Property Rights free and clear of any and all liens, claims or encumbrances, except in the case of clause (i), (ii), (iii) or (iv) for such claims, infringements, misappropriations, violations, failures to own, liens or encumbrances as are not reasonably likely to have a Company Material Adverse Effect. As used herein, "Intellectual Property Rights" means any trademark, servicemark, registration therefor or application for registration therefor, trade name, invention, patent, patent application, trade secret, know-how, copyright, copyright registration, application for copy registration, or any other similar type of proprietary rights, in each case owned, leased or licensed and used or held for use by the Company.

Section 3.16 Change in Business Relationships. Except as set forth in Section 3.16 of the Seller Disclosure Schedule, neither the Seller, Utility, Development nor Reynolds, nor any Company Subsidiary, has knowledge of any event or circumstance that indicates that, whether on account of the transactions contemplated by this Agreement or otherwise, any customer, agent, representative or supplier of the Seller (in respect of the Company), Utility, Development or Reynolds, or any Company Subsidiary, intends to discontinue, diminish or change its relationship with the Seller, Utility, Development or Reynolds, or any Company Subsidiary, in any way that would be reasonably likely to have a Company Material Adverse Effect.

Section 3.17 Title to Property. The Seller, Utility, Development and Reynolds, and the Company Subsidiaries, have good and marketable title to all of their properties and assets, free and clear of all liens, except liens for taxes not yet due and payable and such liens or other imperfections of title, if any, as do not materially detract from the value of or interfere with the present use of the property affected thereby or which would not have a Company Material Adverse Effect; and, to the knowledge of the Seller, all leases pursuant to which the Seller, Utility, Development or Reynolds, or any Company Subsidiary, lease from others material amounts of real or personal property are in good standing, valid and effective in accordance with their respective terms and there is not, to the knowledge of the Seller, under any of such leases, any existing default or event of default (or event which with notice or lapse of time, or both, would constitute a default), except when the lack of such good standing, validity and effectiveness or the existence of such default would not have a Company Material Adverse Effect.

Section 3.18 Other Obligations.

(a) Except as set forth in Section 3.18(a) of the Seller Disclosure Schedule, to the Seller's knowledge, neither the Seller (in respect of the Company), Utility, Development, Reynolds nor any Company Subsidiary has indemnified or agreed to indemnify any third party in connection with any transaction involving any disposition or purchase of the present or former assets of Utility, Development, Reynolds or any Company Subsidiary or any of the Integrated Assets, except for those indemnities or agreements to indemnify which have been fully performed or satisfied, have expired or are otherwise no longer in effect and binding and except for those that are not likely to have a Company Material Adverse Effect.

(b) Except as set forth in Section 3.18(b) of the Seller Disclosure Schedule, to the Seller's knowledge, neither the Seller (in respect of the Company), Utility, Development, Reynolds nor any Company Subsidiary has agreed to or has become contractually bound to pay any earn-out, profit-sharing or similar

payments, which have not been satisfied as of the date hereof, to any third party in connection with any transaction involving any disposition or purchase of the present or former assets of the Seller (in respect of the Company), Utility, Development, Reynolds or any of the Company Subsidiaries or the any of the Integrated Assets.

Section 3.19 Water Quality. The drinking water supplied by the Seller (in respect of the Company), Utility, Development, Reynolds, or any Company Subsidiary to their customers is and has been in compliance with all applicable federal and state drinking water standards except for such failures which are not having as of the date hereof, and are not reasonably likely to have, a Company Material Adverse Effect.

Section 3.20 Limitation on Representations and Warranties. Except for the representations and warranties contained in this Article III, neither the Seller nor any other Person or entity acting on behalf of the Seller makes any representation or warranty, express or implied, concerning the Shares, the Integrated Assets or the business, assets, or liabilities of the Company or any other matter.

#### ARTICLE IV INDEMNIFICATION

##### Section 4.1 Indemnification Obligations.

(a) Subject to the limitations set forth in Sections 4.3 and 4.4 hereof, the Seller and DQE shall, jointly and severally, indemnify, defend and hold harmless PSC, the Buyer Subsidiaries, its and their officers, directors, employees, shareholders, affiliates and agents (each, a “Buyer Indemnitee”) from and against any and all Indemnifiable Losses (as defined below) asserted against or suffered by any Buyer Indemnitee (each, a “Buyer Indemnifiable Loss”) during the Indemnity Period (as defined below) in any way relating to, resulting from or arising out of (i) any breach by the Seller of the representations and warranties contained in Article III hereof, and (ii) the Indemnified Liabilities (as defined below).

(b) Subject to the limitations set forth in Sections 4.3 and 4.4 hereof, PSC and Acquisition shall, jointly and severally, indemnify, defend and hold harmless the Seller, DQE, its and their Subsidiaries, officers, directors, employees, shareholders, affiliates and agents (each, a “Seller Indemnitee”) from and against any and all Indemnifiable Losses asserted against or suffered by any Seller Indemnitee (each, a “Seller Indemnifiable Loss”) during the Indemnity Period in any way relating to, resulting from or arising out of (i) any breach by PSC or Acquisition of the representations and warranties contained in Article V hereof, and (ii) the Indemnified Liabilities.



Section 4.2 Certain Definitions. As used in this Agreement:

(a) the term “Indemnity Period” shall mean the period of time commencing with the Closing Date and continuing until the second (2<sup>nd</sup>) anniversary of the Closing Date; provided, however, that if, prior to the first (1<sup>st</sup>) anniversary of the Closing Date, PSC, Acquisition and/or any Buyer Subsidiary designated by PSC pursuant to Section 1.1 identifies additional liabilities and obligations of the Company that arose prior to the Closing Date but were not disclosed on the Seller Disclosure Schedule on the Closing Date and that have an aggregate value of \$5,000,000 or more (excluding additional liabilities and obligations that should have been disclosed on Section 3.11 or 3.19 of the Seller Disclosure Schedule), then the Indemnity Period shall continue until the third (3<sup>rd</sup>) anniversary of the Closing Date, and provided further, that, in any event, (i) the Indemnity Period shall not limit the indemnity obligations of the Parties in respect of Taxes, as set forth in Section 4.5, (ii) the Indemnity Period shall not limit the indemnity obligations of the Seller and DQE in respect of certain litigation, as set forth in Section 4.6, and (iii) the Indemnity Period in respect of the indemnity obligations of DQE and the Seller as set forth in Section 4.7 (other than in respect of breaches of any representation or warranty made in Section 3.11 or Section 3.19) shall continue until the tenth (10<sup>th</sup>) anniversary of the Closing Date;

(b) the term “Indemnifiable Loss” shall mean any claim, demand, suit, loss, liability, damage, obligation, payment, fine, penalty, cost or expense (including, without limitation, the cost and expense of any action, suit, proceeding, assessment, judgment, settlement or compromise relating thereto and reasonable attorneys’ fees and reasonable disbursements in connection therewith);

(c) the term “Indemnified Liabilities” shall mean, in determining the Buyer Indemnifiable Losses: (i) all litigation, existing or threatened, that is set forth in Section 3.7 of the Seller Disclosure Schedule, (ii) any liabilities or obligations that relate to the Excluded Assets, and (iii) any liabilities or obligations of Utility, Development, Reynolds and the Company Subsidiaries except for Excepted Liabilities (as defined in Section 4.2(d)), and any liabilities or obligations that relate to or arise by virtue of the Seller’s or any Subsidiary of the Seller’s ownership of the Integrated Assets except for Excepted Liabilities, in any case whether direct or indirect, known or unknown, absolute or contingent, that relate to, resulted from, arose during or are attributable to the period of time prior to the Closing Date; provided, however, that Indemnified Liabilities shall exclude any liabilities or obligations that are disclosed in any Section of the Seller Disclosure Schedule and are expressly designated, by agreement of the Parties, as Excepted Liabilities on such Seller Disclosure Schedule; and shall mean in determining the Seller Indemnifiable Losses: (i) any liabilities or obligations of Utility, Development or Reynolds and any liabilities that relate to or arise by virtue of the Buyer’s or any

Buyer Subsidiary's ownership of the Company, the Integrated Assets or Integrated Liabilities, in any case whether direct or indirect, known or unknown, absolute or contingent, that relate to, resulted from, arose during, or are attributable to the period of time on or after the Closing Date and (ii) any liabilities or obligations that relate to the Excepted Liabilities;

(d) the term "Excepted Liabilities" shall mean (i) any liabilities or obligations of Utility, Development or Reynolds, or the Company Subsidiaries, that arise out of any of the following liabilities or obligations incurred by Utility, Development or Reynolds, or the Company Subsidiaries, as the case may be, prior to the Closing Date: (1) any liability or obligation of Utility, Development or Reynolds, or the Company Subsidiaries, that is allocable to the right of Utility, Development or Reynolds, or the Company Subsidiaries, as the case may be, to receive property, services or other benefits on or after the Closing Date (excluding any obligation of Kaanapali Water Corporation to indemnify Maui Pineapple Limited in connection with that certain letter of understanding dated May 18, 1999), (2) any liability or obligation of Utility, Development or Reynolds, or the Company Subsidiaries, to repay the \$11,500,000 owed to third parties as reflected on the June 30, 2002 Balance Sheet as well as any indebtedness incurred as permitted by Section 6.1, and (3) any liability or obligation of Utility, Development or Reynolds, or the Company Subsidiaries, to make any expenditure under any Contract, settlement agreement or consent order, including, without limitation, those disclosed in the Environmental Whitepaper, to which Utility, Development or Reynolds, or the Company Subsidiaries, is a party, pursuant to any order, rule or regulation of any Governmental Authority by which Utility, Development or Reynolds, or the Company Subsidiaries, or any of their assets, is bound, as listed in the Seller Disclosure Schedule, or if not required to be listed in the Seller Disclosure Schedule, or if entered into in compliance with Section 6.1 or otherwise in the ordinary course of business, (ii) with respect to the Integrated Assets, any liabilities or obligations of the Seller that arise out of any of the following liabilities or obligations incurred by the Seller prior to the Closing Date: (1) any liability or obligation that is allocable to the right of the owner of the Integrated Assets to receive property, services or other benefits in respect of the Integrated Assets on or after the Closing Date, (2) any liability or obligation to repay the \$11,500,000 owed to third parties as reflected on the June 30, 2002 Balance Sheet as well as any indebtedness incurred as permitted by Section 6.1, and (3) any liability or obligation to make any expenditure in respect of any Integrated Asset under any Contract, settlement agreement or consent order relating to the Integrated Assets, pursuant to any order, rule or regulation of any Governmental Authority relating to or by which any of the Integrated Assets is bound, as listed in the Seller Disclosure Schedule, or if not required to be listed in the Seller Disclosure Schedule, or if entered into in compliance with Section 6.1 or otherwise in the ordinary course of business, and (iii) those liabilities or obligations that are disclosed on any Section of the Seller Disclosure Schedule and expressly

designated on such Section of the Seller Disclosure Schedule, by agreement of the Parties, as Excepted Liabilities.

#### Section 4.3 Limitations on Indemnification.

(a) Notwithstanding any other provision of this Agreement to the contrary, the Parties' obligations pursuant to this Article IV are, and at all times shall be, subject to the limitations set forth in this Section 4.3. The Parties shall not be required to indemnify, defend or hold harmless any Buyer Indemnitee or Seller Indemnitee, as the case may be, until the aggregate amount of the Buyer Indemnifiable Losses or Seller Indemnifiable Losses, as the case may be, exceeds the Indemnity Basket (as defined in Section 4.3(b)), following which the indemnifying Party shall indemnify, defend and hold harmless the Buyer Indemnitees or the Seller Indemnitees, as the case may be, only to the extent that the Buyer Indemnifiable Losses or the Seller Indemnifiable Losses, as the case may be, exceed the Indemnity Basket. In addition, the Seller's and DQE's liability, taken together, for Buyer Indemnifiable Losses and the Buyer's liability for Seller Indemnifiable Losses, in either case, as contemplated by this Article IV shall in no event exceed an aggregate amount of dollars equal to the Indemnity Cap (as defined in Section 4.3(b)); provided, however, that in determining whether the Seller's and DQE's liability for a particular Buyer Indemnifiable Loss or the Buyer's liability for a particular Seller Indemnifiable Loss, in either case, pursuant to this Article IV is limited by the Indemnity Cap, the Parties shall refer to the Indemnity Cap that is or was in effect on the date that the Buyer Indemnitee or Seller Indemnitee, as the case may be, delivered a written notice of such Buyer Indemnifiable Loss or Seller Indemnifiable Loss, as the case may be, to the Seller as contemplated by Section 4.4 hereof.

(b) As used in this Agreement, (i) the term "Indemnity Basket" shall mean \$250,000, and (ii) the term "Indemnity Cap" shall mean \$15,000,000; provided, however, that on the first (1<sup>st</sup>) anniversary of the Closing Date, the Indemnity Cap shall be reduced to, and shall thereafter mean, \$7,500,000; and provided further, that on the second (2<sup>nd</sup>) anniversary of the Closing Date, the Indemnity Cap shall be reduced to, and shall thereafter mean, zero, unless the Indemnity Period has been extended until the third (3<sup>rd</sup>) anniversary of the Closing Date, pursuant to Section 4.2(a), in which case the Indemnity Cap shall continue to mean \$7,500,000 until the third (3<sup>rd</sup>) anniversary of the Closing Date, upon which it shall be reduced to, and shall thereafter mean, zero. Notwithstanding any other provision of this Agreement to the contrary, the Seller's and DQE's liability for the following Buyer Indemnifiable Losses shall not be limited by the Indemnity Cap: Buyer Indemnifiable Losses relating to (i) any litigation, existing or threatened, that is required to be set forth in Sections 3.7, 3.8(a), 3.8(b), 3.9(i) or 3.10 of the Seller Disclosure Schedule, (ii) Excluded Assets, (iii) any and all liabilities and obligations of the Seller or the Subsidiaries of the Seller (other than any liabilities or obligations

of the Seller (in respect of the Company), Utility, Development, Reynolds or any Company Subsidiary or any of the Integrated Assets or Integrated Liabilities), (iv) indemnity obligations of the Parties in respect of Taxes, as set forth in Section 4.5, (v) indemnity obligations of the Seller and DQE in respect of certain litigation as set forth in Section 4.6, (vi) indemnity obligations of the Seller and DQE in respect of Environmental Law, as set forth in Section 4.7, and (vii) any fraud committed by DQE, the Seller, the Company or any Company Subsidiary (provided that the foregoing reference to the Company or any Company Subsidiary refers to fraud committed prior to the Closing Date); in addition, the Buyer's liability for the following Seller Indemnifiable Losses shall not be limited by the Indemnity Cap: Seller Indemnifiable Losses relating to (i) indemnity obligations of the Parties in respect of Taxes, as set forth in Section 4.5, (ii) any breach or violation of any Environmental Law by PSC, Acquisition, any Buyer Subsidiary designated by PSC pursuant to Section 1.1, the Company or any Company Subsidiary on or after the Closing Date, and (iii) any fraud committed by PSC, Acquisition, any Buyer Subsidiary designated by PSC pursuant to Section 1.1, the Company or any Company Subsidiary (provided that the foregoing reference to the Company or any Company Subsidiary refers to fraud committed on or after the Closing Date).

(c) For the avoidance of doubt, if at any time during the Indemnity Period, the amount of the Seller's and DQE's aggregate liability for Buyer Indemnifiable Losses, taking into account all liability for Buyer Indemnifiable Losses incurred by the Seller and DQE since the Closing Date (other than those Buyer Indemnifiable Losses that are not limited by the Indemnity Cap as contemplated by Section 4.3(b)), equals the applicable Indemnity Cap, then the Seller shall have no further obligation whatsoever to indemnify, defend or hold harmless any Buyer Indemnitee in respect of any Buyer Indemnifiable Losses that are subject to the Indemnity Cap; similarly, if at any time during the Indemnity Period, the amount of PSC's aggregate liability for Seller Indemnifiable Losses, taking into account all liability for Seller Indemnifiable Losses incurred by PSC since the Closing Date (other than those Seller Indemnifiable Losses that are not limited by the Indemnity Cap as contemplated by Section 4.3(b)), equals the applicable Indemnity Cap, then PSC shall have no further obligation whatsoever to indemnify, defend or hold harmless any Seller Indemnitee in respect of any Seller Indemnifiable Losses that are subject to the Indemnity Cap.

(d) Notwithstanding any other provision of this Agreement to the contrary, any Buyer Indemnitee or Seller Indemnitee shall use commercially reasonable efforts to mitigate all losses, damages and the like relating to a claim under these indemnification provisions, including availing itself of any defenses, limitations, rights of contribution, claims against third Persons and other rights at law or equity. The Buyer Indemnitee's or Seller Indemnitee's, as the case may be, commercially reasonable efforts shall include the reasonable expenditure of money

to mitigate or otherwise reduce or eliminate any loss or expenses for which indemnification would otherwise be due, and the indemnifying Party shall, to the extent that Buyer Indemnifiable Losses or Seller Indemnifiable Losses, as the case may be, exceed the Indemnity Basket, reimburse the Buyer Indemnitee or Seller Indemnitee, as the case may be, for its reasonable expenditures (except for any portion of the wages, salary, benefits, overhead or other costs attributable to Buyer Indemnitee or Seller Indemnitee, as the case may be, and its officers, directors, employees and agents) in undertaking the mitigation and shall, to such extent, take such expenses into account in calculating the aggregate amount of the Seller's and DQE's liability for the Buyer Indemnifiable Losses or the Buyer liability for the Seller Indemnifiable Losses, as the case may be. Notwithstanding any other provision of this Agreement to the contrary, any Buyer Indemnifiable Loss or Seller Indemnifiable Loss shall be net of (i) the dollar amount of any insurance or other proceeds actually received by the Buyer Indemnitee or any of its affiliates with respect to the Buyer Indemnifiable Loss or by the Seller or DQE or any of their affiliates with respect to the Seller Indemnifiable Loss, and (ii) income tax benefits to the Buyer Indemnitee, to the extent realized by the Buyer Indemnitee, or to the Seller Indemnitee, to the extent recognized by the Seller Indemnitee. Any Person seeking indemnity hereunder shall use commercially reasonable efforts to seek coverage (including both costs of defense and indemnity) under applicable insurance policies with respect to any such Buyer Indemnifiable Loss or Seller Indemnifiable Loss, as the case may be.

(e) Notwithstanding any other provision of this Agreement to the contrary, (i) except to the extent otherwise provided in Article IX, the rights and remedies of the Parties under this Article IV are exclusive and in lieu of any and all other rights and remedies which the Parties may have under this Agreement for monetary relief with respect to (A) any breach by the Parties of their respective representations and warranties and (B) the Indemnified Liabilities, and (ii) no Party (nor any Buyer Indemnitee or Seller Indemnitee) shall be entitled to recover from any other Party for any liabilities, damages, obligations, payments, losses, costs, or expenses under this Agreement any amount in excess of the actual compensatory damages, court costs and reasonable attorneys' and other advisor fees suffered by such Party (or Buyer Indemnitee or Seller Indemnitee, as the case may be). Each Party waives any right to recover incidental, special, exemplary and consequential damages arising in connection with or with respect to this Agreement.

#### Section 4.4 Defense of Claims.

(a) (i) If any Buyer Indemnitee receives notice of the assertion or commencement of any claim, action or proceeding made or brought by any Person who is not a Party or an affiliate of a Party (a "Third Party Claim") with respect to which indemnification is to be sought from the

Seller and DQE, the Buyer Indemnitee shall give the Seller and DQE reasonably prompt written notice thereof, but in any event such notice shall not be given later than twenty (20) calendar days after the Buyer Indemnitee's receipt of written notice of such Third Party Claim. Such written notice shall describe the nature of the Third Party Claim in reasonable detail and shall indicate the estimated amount, if practicable, of the Buyer Indemnifiable Loss that has been or may be sustained by the Buyer Indemnitee. The Seller and DQE will have the right to participate in or, by giving written notice to the Buyer Indemnitee, to elect to assume the defense of any Third Party Claim by the Seller's own counsel, the cost for which shall be borne by the Seller and DQE to the extent that Buyer Indemnifiable Losses exceed the Indemnity Basket and shall, to such extent, be taken into account in calculating the aggregate amount of the Seller's and DQE's liability for Buyer Indemnifiable Losses under the Indemnity Cap. The Buyer Indemnitee shall cooperate in good faith in such defense at such Buyer Indemnitee's own expense. If the Seller and DQE elect not to assume the defense of any Third Party Claim, the Buyer Indemnitee may compromise or settle such Third Party Claim over the objection of the Seller and DQE, which settlement or compromise shall conclusively establish the Seller's and DQE's liability pursuant to this Agreement.

(ii) If any Seller Indemnitee receives notice of the assertion or commencement of a Third Party Claim with respect to which indemnification is to be sought from the Buyer, the Seller Indemnitee shall give the Buyer reasonably prompt written notice thereof, but in any event such notice shall not be given later than twenty (20) calendar days after the Seller Indemnitee's receipt of written notice of such Third Party Claim. Such written notice shall describe the nature of the Third Party Claim in reasonable detail and shall indicate the estimated amount, if practicable, of the Seller Indemnifiable Loss that has been or may be sustained by the Seller Indemnitee. The Buyer will have the right to participate in or, by giving written notice to the Seller Indemnitee, to elect to assume the defense of any Third Party Claim by the Buyer's own counsel, the cost for which shall be borne by the Buyer to the extent that Seller Indemnifiable Losses exceed the Indemnity Basket and shall, to such extent, be taken into account in calculating the aggregate amount of the Buyer's liability for Seller Indemnifiable Losses under the Indemnity Cap. The Seller Indemnitee shall cooperate in good faith in such defense at such Seller Indemnitee's own expense. If the Buyer elects not to assume the defense of any Third Party Claim, the Seller Indemnitee may compromise or settle such Third Party Claim over the objection of the Buyer, which settlement or compromise shall

conclusively establish the Buyer's liability pursuant to this Agreement.

(b) (i) If, after a Buyer Indemnitee provides written notice to the Seller and DQE of any Third Party Claims, the Buyer Indemnitee receives written notice from the Seller or DQE that the Seller or DQE has elected to assume the defense of such Third Party Claim, the Seller and DQE will not be liable for any legal expenses subsequently incurred by the Buyer Indemnitee in connection with the defense thereof. Without the prior written consent of the Buyer Indemnitee, the Seller and DQE shall not enter into any settlement of any Third Party Claim that would lead to liability or create any financial or other obligation on the part of the Buyer Indemnitee for which the Buyer Indemnitee is not entitled to indemnification hereunder. If a firm offer is made to settle a Third Party Claim without leading to liability or the creation of a financial or other obligation on the part of the Buyer Indemnitee for which the Buyer Indemnitee is not entitled to indemnification hereunder and the Seller and DQE desire to accept and agree to such offer, the Seller and DQE shall give written notice to the Buyer Indemnitee to that effect. If the Buyer Indemnitee fails to consent to such firm offer within ten (10) calendar days after its receipt of such notice, the Seller and DQE shall be relieved of their obligations to defend such Third Party Claim and the Buyer Indemnitee may contest or defend such Third Party Claim. In such event, the maximum liability of the Seller and DQE as to such Third Party Claim will be the amount of such settlement offer plus reasonable costs and expenses paid or incurred by the Buyer Indemnitee up to the date of said notice, at all time subject to the additional limitations on the Seller's and DQE's liability contained in this Article IV.

(ii) If, after a Seller Indemnitee provides written notice to the Buyer of any Third Party Claims, the Seller Indemnitee receives written notice from the Buyer that the Buyer has elected to assume the defense of such Third Party Claim, the Buyer will not be liable for any legal expenses subsequently incurred by the Seller Indemnitee in connection with the defense thereof. Without the prior written consent of the Seller Indemnitee, the Buyer shall not enter into any settlement of any Third Party Claim that would lead to liability or create any financial or other obligation on the part of the Seller Indemnitee for which the Seller Indemnitee is not entitled to indemnification hereunder. If a firm offer is made to settle a Third Party Claim without leading to liability or the creation of a financial or other obligation on the part of the Seller Indemnitee for which the Seller Indemnitee is not entitled to indemnification hereunder and the Buyer desires to accept and agree to such offer, the Buyer shall give written notice to the Seller Indemnitee to that effect. If the Seller Indemnitee fails to consent to

such firm offer within ten (10) calendar days after its receipt of such notice, the Buyer shall be relieved of its obligation to defend such Third Party Claim and the Seller Indemnitee may contest or defend such Third Party Claim. In such event, the maximum liability of the Buyer as to such Third Party Claim will be the amount of such settlement offer plus reasonable costs and expenses paid or incurred by the Seller Indemnitee up to the date of said notice, at all time subject to the additional limitations on the Buyer's liability contained in this Article IV.

(c) (i) Any claim that does not result from a Third Party Claim (a "Direct Claim") by a Buyer Indemnitee on account of a Buyer Indemnifiable Loss shall be asserted by giving the Seller and DQE reasonably prompt written notice thereof, stating the nature of such claim in reasonable detail and indicating the estimated amount, if practicable, but in any event such notice shall not be given later than twenty (20) calendar days after the Buyer Indemnitee becomes aware of such Direct Claim, and the Seller and DQE shall have a period of thirty (30) calendar days from receipt of such notice within which to respond to such Direct Claim. If the Seller or DQE does not respond within such thirty (30) calendar day period, the Seller and DQE shall be deemed to have accepted such claim. If the Seller and DQE reject such claim, the Buyer Indemnitee will be free to seek enforcement of its right to indemnification under this Agreement.

(ii) Any Direct Claim by a Seller Indemnitee on account of a Seller Indemnifiable Loss shall be asserted by giving the Buyer reasonably prompt written notice thereof, stating the nature of such claim in reasonable detail and indicating the estimated amount, if practicable, but in any event such notice shall not be given later than twenty (20) calendar days after the Seller Indemnitee becomes aware of such Direct Claim, and the Buyer shall have a period of thirty (30) calendar days from receipt of such notice within which to respond to such Direct Claim. If the Buyer does not respond within such thirty (30) calendar day period, the Buyer shall be deemed to have accepted such claim. If the Buyer rejects such claim, the Seller Indemnitee will be free to seek enforcement of its right to indemnification under this Agreement.

(d) If the amount of any Buyer Indemnifiable Loss or Seller Indemnifiable Loss, as the case may be, at any time subsequent to the making of an indemnity payment in respect thereof, is reduced by recovery, settlement or otherwise under or pursuant to any insurance coverage, or pursuant to any claim, recovery, settlement or payment by, from or against any other entity, the amount of such reduction, less any costs, expenses or premiums incurred in connection therewith (together with interest thereon from the date of payment thereof at the



publicly announced prime rate then in effect of The Chase Manhattan Bank) shall promptly be repaid by the Buyer Indemnitee to the Seller and DQE or by the Seller Indemnitee to the Buyer, as the case may be.

(e) With respect to those pending litigation matters set forth in Schedule 3.7 of the Seller Disclosure Schedule (each a "Pending Litigation Matter"), the Parties agree as follows: no later than the Closing Date, DQE and/or the Seller shall identify those Pending Litigation Matters for which DQE and/or the Seller will defend, continue to defend or assume the defense of on and after the Closing Date (each such defense, an "Assumed Defense"). PSC and Acquisition agree to cooperate, and to cause their Subsidiaries, officers, directors and employees to cooperate, fully in connection therewith, including, but not limited to, providing access to personnel and records. The Seller or DQE shall reimburse PSC, Acquisition and their Subsidiaries for any out of pocket expenses (e.g. travel, lodging, meals and related expenses) incurred by them in cooperation with the Seller or DQE as contemplated by this Section 4.4(e); provided, however, that the Seller and DQE shall not reimburse PSC, Acquisition or their Subsidiaries, and PSC, Acquisition and their Subsidiaries shall not be entitled to reimbursement, for any portion of the wages, salary, benefits, overhead or other costs, attributable to the officers, directors and employees of PSC, Acquisition or their Subsidiaries whose cooperation may be required by this Section 4.4(e). For the avoidance of doubt, (i) the defense of any Pending Litigation Matter, the defense of which is not assumed by the Seller or DQE as an Assumed Defense, shall be the responsibility of PSC or Acquisition on and after the Closing Date, subject at all times to the procedures, limitations and other obligations in respect thereof set forth in Article IV, and (ii) the obligations set forth in this Section 4.4(e) in no way limit or reduce the Seller's and DQE's indemnity obligation, in respect of any Pending Litigation Matters, whether or not any such Pending Litigation Matter has been assumed by the Seller or DQE as an Assumed Defense.

**Section 4.5 Tax Indemnity.** Notwithstanding any other provision of this Agreement to the contrary, the Seller and DQE shall, jointly and severally, indemnify, defend and hold harmless each Buyer Indemnitee, and PSC and Acquisition shall, jointly and severally, indemnify, defend and hold harmless each Seller Indemnitee from and against any and all of the liabilities of the Seller and DQE, and PSC and Acquisition, respectively, as set forth below:

(a) The Seller and DQE shall be liable for, shall pay to the appropriate Tax authorities (or shall pay to Utility, Development or Reynolds, as the case may be, as a reimbursement of Taxes paid to the appropriate Tax authorities for a Straddle Period (as defined below) Tax Return), and shall indemnify and hold the Buyer and the Company harmless against, all Taxes of the Company that relate to (i) the taxable periods ending before or on the Closing Date (other than Taxes

attributable to transactions not in the ordinary course of business occurring after the Closing which are effectuated or initiated by the Buyer), (ii) any taxable period that includes but does not end on the Closing Date (a "Straddle Period"), but only to the extent that such Taxes relate to the portion of such Straddle Period up to and including the Closing Date, and (iii) any liability for Taxes of the consolidated group of which DQE is the common parent arising under Treasury Regulation section 1.1502-6 (or similar provision of state, local or foreign law). The Seller shall be entitled to all Tax refunds (including interest) attributable to the taxable periods for which it is liable; provided, that the Buyer shall elect under Treasury Regulation section 1.1502-21(b)(3)(ii) (or similar provision of state, local or foreign law) to relinquish, with respect to any net operating losses attributable to Utility, Development or Reynolds, or any Company Subsidiary, the portion of the carryback period for which any such corporation was a member of the consolidated group of which DQE is the common parent.

(b) The Buyer shall be liable for, shall pay to the appropriate Tax authorities, and shall indemnify and hold the Seller and DQE harmless against all Taxes of the Company that relate to (i) the taxable periods that begin after the Closing Date (including, for this purpose, any Taxes attributable to transactions not in the ordinary course of business occurring after the Closing which are effectuated or initiated by the Buyer) and (ii) the portion of any Straddle Period commencing with the first (1<sup>st</sup>) day after the Closing Date. The Buyer shall be entitled to all Tax refunds (including interest) attributable to the taxable periods for which it is liable.

(c) The obligations of the Parties to indemnify each other pursuant to this Section 4.5 shall continue until the statutory period of limitations (taking into account any extensions or waivers thereof) for the assessment of Taxes, covered by this Section 4.5, has expired. Any payment due to an indemnified Party pursuant to this Section 4.5 shall be paid promptly by the indemnifying Party upon receipt of written notice.

(d) Neither Party shall take any action the purpose and intent of which is to prejudice the defense of any claim subject to indemnification hereunder or to induce a third party to assert a claim subject to indemnification hereunder.

(e) After the Closing, each of the Seller and the Buyer shall notify the chief tax officer of the other Party in writing (including by telecopier) within ten (10) calendar days of the receipt of any written notice of any pending or threatened Audit (as defined below) which, if determined adversely, could be grounds for indemnification under this Section 4.5 (a "Tax Claim"); provided, however, that any failure to give such notice shall not affect the rights of the Parties hereunder unless and to the extent such failure materially and adversely affects the

indemnifying Party's right to participate in and defend such Tax Claim. The Seller shall have the right at its expense to participate in and control the conduct of any Tax Claim of or attributable to the Company relating to taxable periods ending on or before the Closing Date and to employ counsel of its own choice at its expense; provided, however, that the Seller shall not settle any such Tax Claim or make or agree to any adjustment in any manner without the consent of the Buyer, which consent shall not be unreasonably withheld, conditioned or delayed; and provided, further, that the Buyer shall have the right to participate in (but not to control) such Tax Claim. If the Seller fails to participate in any Tax Claim of the Company relating to taxable periods ending on or before the Closing Date for which notice was provided pursuant to this Section 4.5(e), the Buyer may defend and settle such Tax Claim in such manner as it may deem appropriate in its sole discretion. Except as set forth above in the first sentence of this Section 4.5(e), the Buyer shall control the conduct of any Tax Claim of the Company relating to any taxable period ending after the Closing Date and may defend and settle such Tax Claim in such manner as it may deem appropriate in its sole discretion. The term "Audit" means any audit, assessment of Taxes, reassessment of Taxes, or other examination by any Governmental Authority or any judicial or administrative proceedings or appeal of such proceedings.

(f) All indemnity payments made by the Seller to the Buyer, or by the Buyer to the Seller, pursuant to this Agreement shall, to the maximum extent permitted under the Code (or other applicable Tax law), be treated for all Tax purposes as adjustments to the consideration paid with respect to the Shares and the Integrated Assets.

#### Section 4.6 Certain Litigation Indemnification and Related Matters.

(a) Notwithstanding any other provision of this Agreement to the contrary, the Seller and DQE shall, jointly and severally, indemnify, defend and hold harmless each Buyer Indemnitee from and against any claims that were brought or could have been brought in (i) the litigation captioned Edward Wallace, et al. v. AquaSource, Inc., et al. (Cause No. 2001-05987), filed in the 270<sup>th</sup> Judicial District Court of Harris County, Texas (the "Class B Stock Litigation"), or any settlement or compromise relating thereto, (ii) the litigation captioned AquaSource, Inc. v. JPT Financial, Inc. and Acquisition Partners, Inc., (Cause No. 2001-31233), filed in the 270<sup>th</sup> Judicial District Court of Harris County, Texas (the "JPT Litigation"), or any settlement or compromise relating thereto, and (iii) any other claims involving the Seller's Class B Common Stock, or any settlement or compromise relating thereto. In addition, notwithstanding any other provision of this Agreement to the contrary, any right, title or interest that Utility, Development or Reynolds, or any Company Subsidiary, may have in or to any benefit resulting from or arising out of the Class B Stock Litigation or the JPT Litigation, including any

benefits in the nature of claims or counterclaims, payments, insurance proceeds, settlements, awards, judgments and the like, shall be deemed to be Excluded Assets and, as such, shall be assigned to the Seller as contemplated by Section 6.3 of this Agreement.

(b) PSC and Acquisition acknowledge and agree that the Seller shall be entitled exclusively to control, defend, prosecute and settle the Class B Stock Litigation and the JPT Litigation and PSC and Acquisition agree that each of them will, and will cause their respective Subsidiaries (including, after the Closing Date, Utility, Development and Reynolds, and the Company Subsidiaries) and each of their Subsidiaries' officers, directors and employees, to cooperate fully in connection therewith, including, but not limited to, providing access to personnel and records. The Seller shall reimburse PSC, Acquisition and their Subsidiaries for any out-of-pocket expenses (i.e., travel, lodging, meals and related expenses) incurred by the them in cooperating with the Seller as contemplated by this Section 4.6(b), provided, however, that the Seller shall not reimburse PSC, Acquisition or their Subsidiaries, and PSC, Acquisition and their Subsidiaries shall not be entitled to reimbursement, for any portion of the wages, salary, benefits, overhead or other costs attributable to the officers, directors, employees and agents of PSC, Acquisition or their Subsidiaries whose cooperation may be required by this Section 4.6(b).

Section 4.7 Certain Indemnification in Respect of Environmental Law.

(a) Notwithstanding any other provision of this Agreement, the Seller and DQE shall, jointly and severally, indemnify, defend, reimburse, and hold harmless each Buyer Indemnitee from and against any and all Indemnifiable Losses arising out of or resulting from any of the following: (i) any breach of any representation or warranty made by the Seller in Section 3.11 or Section 3.19 hereof that is discovered within the Indemnity Period; (ii) any Third Party Claim (as defined in Section 4.4) asserted prior to the tenth (10<sup>th</sup>) anniversary of the Closing Date for any Pre-Closing Environmental Liability (as defined in Section 4.7(b)(ii)); and (iii) any First Party Environmental Claim (as defined in Section 4.7(b)(iv)) asserted prior to the tenth (10<sup>th</sup>) anniversary of the Closing Date for any Pre-Closing Violation or Contamination (as defined in Section 4.7(b)(i)). Any and all Indemnifiable Losses arising out of or resulting from clauses (i), (ii), or (iii) above shall not be limited by the Indemnity Cap (as defined in Section 4.3(b)), but shall be subject to the Indemnity Basket (as defined in Section 4.3(b)).

(b) As used in this Agreement:

(i) the term "Pre-Closing Violation or Contamination" means any and all cost and liability (other than

Excepted Liabilities) arising out of or related to: (A) any violation of any Environmental Laws by the Seller, Utility, Development, Reynolds, or any of the Company Subsidiaries, or any presence in the environment, Release, threat of Release or any exposure of either an individual or the environment, of or to any Hazardous Substances at or under any of the Properties (as defined in Section 4.7(b)(iii)), which, for any of the foregoing, occurred on or before or existed as of the Closing Date, and (B) any post-Closing Date liabilities arising from any such pre-Closing Date violation, presence, Release, threat of Release or exposure.

(ii) the term "Pre-Closing Environmental Liability" means any and all cost and liability (other than Excepted Liabilities) arising out of or related to: (A) any presence in the environment, Release, threat of Release, or any exposure of either an individual or the environment, of or to any Hazardous Substances from, at, or under any of the Properties or otherwise arising in connection with the Company's current or former operations before the Closing Date; (B) the off-site transportation, storage, treatment, recycling, or Release of any Hazardous Substances generated or Released, before the Closing Date, by the Seller, Utility, Development, Reynolds, or any of the Company Subsidiaries, or any predecessor of such Persons; (C) any violation of any Environmental Laws by the Seller, Utility, Development, Reynolds, or any of the Company Subsidiaries at or under any of the Properties which, occurred on or before or existed as of the Closing Date; and (D) any post-Closing Date liabilities arising from any such pre-Closing Date violation or presence, Release, threat of Release or exposure.

(iii) the term "Properties" means any property currently or formerly owned, occupied, or leased by the Seller, Utility, Development, Reynolds or any Company Subsidiary.

(iv) the term "First Party Environmental Claim" means any claim, action, or proceeding, made or brought by any Buyer Indemnitee asserting either liability or the potential for liability under any Environmental Laws.

(c) If, after the Closing Date, PSC, Acquisition or any Buyer Subsidiary: (i) exacerbates any Release or threatened Release of Hazardous Substances specifically disclosed by the Seller to PSC or Acquisition existing on or before the Closing Date (a "Pre-Existing Release") or (ii) exacerbates any violation by the Seller, Utility, Development, Reynolds, or any of the Company Subsidiaries

of any Environmental Laws that existed as of the Closing Date (a “Pre-Existing Violation”), then the obligation of the Seller and DQE for any Buyer Indemnifiable Losses in respect of any such Pre-Existing Release or Pre-Existing Violation shall be reduced to the extent that PSC, Acquisition or any Buyer Subsidiary exacerbated such Pre-Existing Release or Pre-Existing Violation. PSC, Acquisition and the Buyer Subsidiaries shall not be considered to have exacerbated a Pre-Existing Release or Pre-Existing Violation by having their employees act, in the ordinary course of business, in the same manner that any employees of the Seller, Utility, Development, Reynolds, or any of the Company Subsidiaries acted in the ordinary course of business before the Closing Date (the “Pre-Existing Actions”); provided, however, that PSC, Acquisition and the Buyer Subsidiaries shall be considered to have exacerbated a Pre-Existing Release or Pre-Existing Violation by their inaction or failure to modify any Pre-Existing Actions to the extent required to comply with any applicable Environmental Laws.

(d) Notwithstanding any other provision of this Agreement to the contrary, nothing in this Agreement is intended to restrict PSC, Acquisition or any Buyer Subsidiary from fulfilling its or their obligations to take appropriate actions as may be required by applicable Environmental Laws.

(e) The right of any Buyer Indemnitee to indemnification under this Section 4.7 shall be in addition to, and not in lieu of, any statutory rights which such Buyer Indemnitee has or may obtain under Environmental Laws.

(f) For the avoidance of doubt, the Parties agree that the provisions of Section 4.3(d), Section 4.3(e), and all of Section 4.4 shall apply to the indemnity obligations set forth in this Section 4.7, provided, however, that for purposes of applying such provisions to this Section 4.7, (i) all references to the Indemnity Cap contained in such provisions shall be disregarded, and (ii) all references to Direct Claims shall be read to include First Party Environmental Claims.

## **ARTICLE V REPRESENTATIONS AND WARRANTIES OF THE BUYER**

The Buyer represents and warrants to the Seller as follows:

### Section 5.1 Organization and Qualification.

(a) Except as set forth in Section 5.1 of the schedule delivered by PSC to the Seller on the date hereof and attached to this Agreement (the “Buyer Disclosure Schedule”) PSC, Acquisition and each of the Buyer Subsidiaries (as defined below) is a corporation duly organized, validly existing and in good

standing under the laws of its respective jurisdiction of incorporation or organization, has all requisite power and authority to own, lease and operate its assets and properties to the extent owned, leased and operated and to carry on its business as it is now being conducted and is duly qualified to do business in each jurisdiction in which the nature of its business or the ownership or leasing of its assets and properties makes such qualification necessary other than in such jurisdictions where the failure to be in good standing or be so qualified is not reasonably likely to have a Buyer Material Adverse Effect (as defined in Section 5.1(b)).

(b) As used in this Agreement, the term “Buyer Material Adverse Effect” shall mean any material adverse effect on the business, assets, financial condition or results of operations of the Buyer, taken as a whole, totaling in each instance \$1,000,000; provided, however, that the term “Buyer Material Adverse Effect” shall not include (i) any such effect resulting from any change in law, rule, or regulation of any Governmental Authority that applies generally to similarly situated Persons, (ii) effects relating to or resulting from general changes in the industries in which the Buyer operates its assets or conducts its business, or (iii) any Permitted Financial Impact. The term “Buyer Subsidiary” shall mean a Subsidiary of the Buyer.

Section 5.2 Authority; Non-Contravention; Statutory Approvals; Compliance.

(a) Authority. Each of PSC and Acquisition has all requisite corporate power and authority (i) to enter into this Agreement and (ii) subject to the receipt of the applicable Buyer Required Statutory Approvals (as defined in Section 5.2(c)) and applicable Buyer Required Consents (as defined in Section 5.2(b)), to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation by PSC, Acquisition and any Buyer Subsidiary as PSC may designate pursuant to Section 1.1 of the transactions contemplated hereby have been duly authorized by all necessary corporate action on the part of PSC and Acquisition. No vote of, or consent by, the holders of any class or series of stock issued by PSC, Acquisition or any Buyer Subsidiary is necessary to authorize the execution and delivery by PSC and Acquisition of this Agreement or the consummation by PSC, Acquisition and any Buyer Subsidiary as PSC may designate pursuant to Section 1.1 of the transactions contemplated hereby. This Agreement has been duly executed and delivered by PSC and Acquisition and, assuming the due authorization, execution and delivery hereof by the Seller and DQE, constitutes the valid and binding obligation of PSC and Acquisition enforceable against them in accordance with its terms, subject to bankruptcy, insolvency, fraudulent transfer, reorganization, moratorium and similar laws of general applicability relating to or affecting creditors’ rights and to general equity principles.

(b) Non-Contravention. Except as set forth in Section 5.2(b)(i) of the Buyer Disclosure Schedule, the execution and delivery of this Agreement by PSC and Acquisition does not, and the consummation of the transactions contemplated hereby will not, result in a Violation pursuant to any provisions of (i) the articles of incorporation, by-laws or similar governing documents of PSC, Acquisition or any of the Buyer Subsidiaries, (ii) subject to obtaining the Buyer Required Statutory Approvals, any statute, law, ordinance, rule, regulation, judgment, decree, order, injunction, writ, permit or license of any Governmental Authority applicable to PSC, Acquisition or any of the Buyer Subsidiaries or any of their respective properties or assets, or (iii) subject to obtaining the third-party consents set forth in Section 5.2(b)(iii) of the Buyer Disclosure Schedule (the “Buyer Required Consents”), any note, bond, mortgage, indenture, deed of trust, license, franchise, permit, concession, contract, lease or other instrument, obligation or agreement of any kind to which PSC, Acquisition or any of the Buyer Subsidiaries is a party or by which they or any of their respective properties or assets may be bound or affected, except in the case of clause (ii) or (iii) for any such Violation which is not reasonably likely to have a Buyer Material Adverse Effect.

(c) Statutory Approvals. Except as described in Section 5.2(c) of the Buyer Disclosure Schedule (the “Buyer Required Statutory Approvals”), no declaration, filing or registration with, or notice to or authorization, consent or approval of, any Governmental Authority is necessary for the execution and delivery of this Agreement by PSC or Acquisition or the consummation by PSC, Acquisition or any of the Buyer Subsidiaries of the transactions contemplated hereby, except those which the failure to obtain is not reasonably likely to result in a Buyer Material Adverse Effect (it being understood that references in this Agreement to “obtaining” such Buyer Required Statutory Approvals shall mean (i) making such declarations, filings or registrations; (ii) giving such notices; (iii) obtaining such authorizations, consents or approvals; (iv) having such waiting periods expire as are necessary to avoid a violation of law) and (v) having any applicable appeals period expire without any appeal being filed, or if such an appeal is filed, such appeal is fully and finally dismissed without the opportunity for further appeal.

(d) Compliance. Except as set forth in Section 5.2(d)(i) or Section 5.3 of the Buyer Disclosure Schedule, or as disclosed in the Buyer SEC Reports (as defined below) filed prior to the date hereof, neither PSC, Acquisition nor any of the Buyer Subsidiaries is in violation of, or has been given notice of or been charged with any violation of, or to the knowledge of PSC or Acquisition is under investigation with respect to any violation of any law, statute, order, rule, regulation, ordinance, tariff, rate or judgment of any Governmental Authority, except for possible violations which are not reasonably likely to have a Buyer Material Adverse Effect or to prevent, materially delay or materially impair PSC’s,



Acquisition's or any Buyer Subsidiary's ability to consummate the transactions contemplated by this Agreement. Except as set forth in Section 5.2(d)(ii) of the Buyer Disclosure Schedule or as disclosed in the Buyer SEC Reports filed prior to the date hereof, PSC, Acquisition and the Buyer Subsidiaries have all permits, licenses, franchises and other governmental authorizations, consents and approvals necessary to conduct their businesses as presently conducted except those that the absence of which are not reasonably likely to have a Buyer Material Adverse Effect or to prevent, materially delay or materially impair the ability of PSC, Acquisition or any Buyer Subsidiary to consummate the transactions contemplated by this Agreement. Except as set forth in Section 5.2(d)(iii) of the Buyer Disclosure Schedule, neither PSC, Acquisition nor any Buyer Subsidiary is in breach or violation of or in default in the performance or observance of any term or provision of, and no event has occurred which, with lapse of time or action by a third party, could result in a default by PSC, Acquisition or any Buyer Subsidiary under (i) their respective articles of incorporation or by-laws or (ii) any contract, commitment, agreement, indenture, mortgage, loan agreement, note, lease, bond, license, approval or other instrument to which they are a party or by which the PSC, Acquisition or any Buyer Subsidiary is bound or to which any of their property is subject, except for possible violations, breaches or defaults which are not reasonably likely to have a Buyer Material Adverse Effect or to prevent, materially delay or materially impair PSC's, Acquisition's or any Buyer Subsidiary's ability to consummate the transactions contemplated by this Agreement. As used in this Agreement, the term "Buyer SEC Reports" shall mean each report, schedule, registration statement and definitive proxy statement filed with the SEC by the Buyer, since December 31, 1999, pursuant to the requirements of the Securities Act or the Exchange Act.

Section 5.3 Litigation. Except as set forth in Section 5.3 of the Buyer Disclosure Schedule, (a) there are no claims, suits, actions or proceedings before any court, governmental department, commission, agency, instrumentality or authority or any arbitrator, pending or, to the knowledge of the PSC or Acquisition, threatened, nor are there, to the knowledge of PSC or Acquisition, any investigations or reviews by any court, governmental department, commission, agency, instrumentality or authority or any arbitrator pending or threatened against, relating to or affecting the PSC, Acquisition or any Buyer Subsidiary, and (b) there are no judgments, decrees, injunctions, rules or orders of any court, governmental department, commission, agency, instrumentality or authority or any arbitrator applicable to PSC, Acquisition or any Buyer Subsidiary except, in the case of both clause (a) and clause (b), for such that are not reasonably likely to have a Buyer Material Adverse Effect or reasonably likely to prevent, materially delay or materially impair PSC's, Acquisition's or any Buyer Subsidiary's ability to consummate the transactions contemplated by this Agreement.

Section 5.4 Investigation by the Buyer; the Seller's Liability. Each of PSC and Acquisition has conducted its own independent investigation, review and analysis of the business, operations, assets, liabilities, results of operations, financial condition, software, technology and prospects of the Company, which investigation, review and analysis was done by PSC, Acquisition and their affiliates and, to the extent PSC or Acquisition deemed appropriate, by the officers, directors, employees, accountants, counsel, investment bankers, financial advisors and other representatives (collectively, "Representatives") of PSC. In entering into this Agreement, each of PSC and Acquisition acknowledges that it has relied solely upon the aforementioned investigation, review and analysis and not on any factual representations of the Seller or the Seller's Representatives (except the specific representations and warranties of the Seller set forth in Article III of this Agreement), and each of PSC and Acquisition:

(a) acknowledges that none of the Seller, Utility, Development, Reynolds, any Company Subsidiary or any of their respective directors, officers, shareholders, employees, affiliates, controlling Persons, agents, advisors or Representatives makes or has made any representation or warranty, either express or implied, as to the accuracy or completeness of any of the information (including in materials furnished in the Seller's data room, in presentations by the Seller's management, on site visits or otherwise) provided or made available to PSC, Acquisition or their directors, officers, employees, affiliates, controlling Persons, advisors, agents or Representatives, and

(b) agrees, to the fullest extent permitted by law, that none of the Seller, Utility, Development, Reynolds, any Company Subsidiary or any of their respective directors, officers, employees, shareholders, affiliates, controlling Persons, agents, advisors or Representatives shall have any liability or responsibility whatsoever to PSC, Acquisition or their directors, officers, employees, affiliates, controlling Persons, agents or Representatives on any basis (including in contract or tort, under federal or state securities laws or otherwise) based upon any information provided or made available, or statements made (including in materials furnished in the Seller's data room, in presentations by the Seller's management, on site visits or otherwise) to PSC, Acquisition or their directors, officers, employees, affiliates, controlling Persons, advisors, agents or Representatives (or any omissions therefrom), including in respect of the specific representations and warranties of the Seller set forth in this Agreement, except that the foregoing limitations shall not apply to (i) fraud or willful breach of this Agreement by the Seller or DQE, or (ii) the Seller insofar as the Seller makes the specific representations and warranties set forth in Article III of this Agreement, but always subject to the limitations and restrictions contained in Articles IV and X.

Section 5.5 Acquisition of Shares; Ability to Evaluate and Bear Risk.

(a) PSC is acquiring the Shares for investment and not with a view toward, or for sale in connection with, any distribution thereof, nor with any present intention of distributing or selling the Shares. PSC acknowledges that the Shares have not been registered under the Securities Act and agrees that the Shares may not be sold, transferred, offered for sale, pledged, hypothecated or otherwise disposed of without registration under the Securities Act and any applicable state securities laws, except pursuant to an exemption from such registration under the Securities Act and any applicable state securities laws.

(b) PSC is able to bear the economic risk of holding the Shares for an indefinite period, and has knowledge and experience in financial and business matters such that it is capable of evaluating the risks of the investment in the Shares.

Section 5.6 Financing. PSC has or will have available, prior to the Closing, sufficient cash in immediately available funds to pay the Purchase Price pursuant to Article I hereof and to consummate the transactions contemplated hereby.

Section 5.7 Brokers or Finders. The Buyer has not entered into any agreement or arrangement entitling any agent, broker, investment banker, financial advisor or other firm or Person to any broker's or finder's fee or any other commission or similar fee in connection with any of the transactions contemplated by this Agreement.

**ARTICLE VI  
CONDUCT OF BUSINESS PENDING THE CLOSING**

Section 6.1 Covenants of the Seller. After the date hereof and prior to the Closing Date or earlier termination of this Agreement, the Seller agrees that, except as set forth in Section 6.1 of the Seller Disclosure Schedule and except as expressly contemplated in or permitted by (i) this Agreement, (ii) the business plan for the Company in the form delivered to the Buyer by the Seller on July 29, 2002 (as the same may be amended from time to time, but only to the extent that any such amendments do not result, or are not reasonably likely to result, in a Company Material Adverse Effect, the "Business Plan"), or (iii) or to the extent the Buyer shall otherwise consent in writing, which decision regarding consent shall be made as soon as reasonably practical, and which consent shall not be unreasonably withheld, conditioned or delayed:

(a) the business of the Company shall be conducted in the ordinary and usual course in substantially the same manner as heretofore conducted, in material compliance with all applicable laws, statutes, ordinances and regulations, and, to the extent consistent therewith, each of the Seller (in respect of the Company), Utility, Development and Reynolds, and each Company Subsidiary, shall use its respective commercially reasonable efforts to preserve its business organization intact and maintain its existing Contracts, relations and goodwill with customers, suppliers, creditors, regulators, lessors, employees and business associates;

(b) each of Utility, Development and Reynolds shall not (i) amend its articles of incorporation or by-laws; (ii) split, combine or reclassify its outstanding shares of capital stock; or (iii) declare, set aside or pay any dividend payable in cash, stock or property in respect of any of its capital stock except for dividends paid or payable by Utility in respect of Utility Preferred Shares, and except for dividends of Excluded Assets to the Seller as contemplated by Section 6.3;

(c) neither Utility, Development nor Reynolds, nor any Company Subsidiary, shall (i) issue, sell, pledge, dispose of or encumber any shares of, or securities convertible into or exchangeable or exercisable for, or options, warrants, calls, commitments or rights of any kind to acquire, any shares of its capital stock of any class or any other property or assets; (ii) except for intercompany indebtedness incurred by the Seller that will not be reflected on the balance sheet of the Company at the Closing, indebtedness incurred in connection with the refinancing of the existing indebtedness to third parties of \$11,500,000 as reflected on the June 30, 2002 Balance Sheet at a commercially reasonable cost of funds, transfer, lease, license, guarantee, sell, mortgage, pledge, dispose of or encumber any other property or assets (including capital stock of any Company Subsidiary) or incur or modify any indebtedness or other liability; or (iii) make any commitments for, make or authorize any capital expenditures (other than (A) those contemplated by the Business Plan, (B) capital expenditures not in excess of \$7,500,000 in the aggregate incurred in connection with the repair or replacement of facilities destroyed or damaged due to casualty or accident (to the extent not covered by insurance), (C) as required by law or by any consent agreement with a Governmental Authority by which the Seller, Utility, Development or Reynolds, or any Company Subsidiary, or its or their assets, is bound, or (D) in amounts less than \$500,000 individually and \$1,000,000 in the aggregate in any calendar year); or (iv) other than the ordinary and usual course of business, make any acquisition of, or investment in, assets or stock of any other Person or entity in excess of \$500,000 in the aggregate in any calendar year;

(d) neither the Seller, Utility, Development or Reynolds, nor any Company Subsidiary, shall terminate, establish, adopt, enter into, make any new

grants or awards of stock-based compensation or other benefits under, amend or otherwise modify any Company Plan or increase the salary, wage, bonus or other compensation of any directors, officers or employees except (i) for grants or awards to directors, officers and employees under existing Company Plans in such amounts and on such terms as are consistent with past practice, (ii) in the normal and usual course of business (which shall include normal periodic performance reviews and related plans and the provision of individual Company Plans consistent with past practice for newly hired or appointed officers and employees), or (iii) for actions necessary to satisfy existing contractual obligations under Company Plans existing as of the date hereof; provided, however, that the Seller shall have satisfied its obligations with respect to the Company Plans under this provision if the Seller or DQE maintains the Company Plans in such a manner as to comply with this provision;

(e) the Seller, on behalf of the Company, shall maintain insurance in such amounts and against such risks and losses as are consistent with the insurance heretofore maintained by DQE, on behalf of the Company; provided, however, that the Seller shall have satisfied its obligations under this provision if DQE maintains such insurance on behalf of the Seller;

(f) the Seller shall promptly provide PSC with copies of all filings made by the Seller, Utility, Development or Reynolds, or any Company Subsidiary, with, and inform PSC of any communications received from, any state or federal court, administrative agency, commission or other Governmental Authority in connection with this Agreement and the transactions contemplated hereby;

(g) the Seller shall, and shall cause Utility, Development and Reynolds, and each Company Subsidiary, to, use all commercially reasonable efforts to promptly obtain all of the Seller Required Consents and the Seller Required Statutory Approvals. The Seller shall promptly notify PSC of any failure or prospective failure to obtain any such consents or approvals and shall provide to PSC copies of all of the Seller Required Consents and the Seller Required Statutory Approvals obtained by the Seller, Utility, Development and Reynolds, and each Company Subsidiary;

(h) the Seller shall promptly provide PSC with copies of all notices of violation or proposed investigations involving the violation of any Environmental Laws by the Seller or the Company, and inform PSC of any communications received from, any state or federal court, administrative agency, commission or other Governmental Authority in connection with any such notice of violation or investigation;

(i) the Seller shall promptly provide PSC with copies of all pleadings in any lawsuit, equity action or other legal proceeding involving the Seller (in respect of the Company) or the Company with an amount in controversy in excess of \$50,000;

(j) the Seller shall cause the Company to not enter into any contract or obligation extending beyond December 31, 2003 except for (i) the renewal or replacement of the Contracts included in the Integrated Assets on substantially similar or other commercially reasonable terms and conditions and (ii) other contract or obligations with an annualized value or liability not in excess of \$25,000 unless PSC shall have first been provided a copy of such contract or obligation and a reasonable opportunity to comment on such contract or obligation prior to it becoming binding on the Company;

(k) the Seller shall not, and the Seller shall not permit any of its Subsidiaries to, willfully take any action that would or is reasonably likely to result in a material breach of any provision of this Agreement, or in any of its representations and warranties set forth in this Agreement being untrue on and as of the Closing Date, or to unduly delay the Closing;

(l) the Seller shall cause Utility, Development or Reynolds to accrue on their books any accrued and unpaid salary, bonus, vacation or other amounts due Affected Employee (as defined in Section 7.6(a)) for service prior to the Closing except for such salary, bonus, vacation or other amounts that are, or will be, paid by the Seller no later than thirty (30) calendar days following the Closing Date;

(m) the Seller shall use all commercially reasonable efforts to remedy the failures to be duly qualified, validly existing and in good standing disclosed in Section 3.1(a) of the Seller Disclosure Schedule; and

(n) the Seller shall from the date hereof until the Closing Date make capital expenditures in respect of the Company in such amounts for each calendar month from the date hereof until the Closing Date such that the cumulative amount of such capital expenditures are no less than the cumulative amount of capital expenditures for such months as set forth on Exhibit 6.1(n).

**Section 6.2 Covenants of the Buyer.** After the date hereof and prior to the Closing Date or earlier termination of this Agreement, each of PSC and Acquisition agrees, as to itself and to each of the Buyer Subsidiaries, as follows except as expressly contemplated or permitted in this Agreement or to the extent the Seller shall otherwise consent in writing, which decision regarding consent shall be made as soon as reasonably practical, and which consent shall not be unreasonably

withheld, conditioned or delayed:

(a) PSC and Acquisition shall promptly provide the Seller with copies of all filings made by PSC or Acquisition or any of the Buyer Subsidiaries with, and inform the Seller of any communications received from, any state or federal court, administrative agency, commission or other Governmental Authority in connection with this Agreement and the transactions contemplated hereby;

(b) PSC and Acquisition shall, and PSC shall cause the Buyer Subsidiaries to, use all commercially reasonable efforts to promptly obtain all of the Buyer Required Consents and the Buyer Required Statutory Approvals. PSC and Acquisition shall promptly notify the Seller of any failure or prospective failure to obtain any such consents or approvals and shall provide to the Seller copies of all of the Buyer Required Consents and the Buyer Required Statutory Approvals obtained by PSC, Acquisition or any Buyer Subsidiary to the Seller; and

(c) PSC and Acquisition shall not, and PSC shall not permit any of the Buyer Subsidiaries to, willfully take any action that would or is reasonably likely to result in a material breach of any provision of this Agreement or in any of its representations and warranties set forth in this Agreement being untrue on and as of the Closing Date or to unduly delay the Closing.

**Section 6.3 Mutual Covenants of the Seller and the Buyer.**

Notwithstanding any other provision of this Agreement to the contrary, the Seller, PSC and Acquisition expressly agree that prior to the Closing, the Seller shall cause any and all of Utility's, Development's and Reynolds', and the Company Subsidiaries', right, title and interest in and to all of those assets set forth on Section 6.3 of the Seller Disclosure Schedule (collectively, the "Excluded Assets") to be assigned, and all such Excluded Assets to be delivered, by Utility, Development, Reynolds and the Company Subsidiaries, as applicable, to the Seller, DQE or such third party as the Seller may designate, and all of the obligations and liabilities of Utility, Development, Reynolds or any Company Subsidiary in respect of any such Excluded Assets shall be assumed by the Seller, DQE or such third party, as the case may be.

**ARTICLE VII  
ADDITIONAL AGREEMENTS**

**Section 7.1 Access to Company Information and Cooperation.**

(a) Upon reasonable notice, the Seller shall, and shall cause Utility, Development and Reynolds, and each Company Subsidiary, to, afford to the

Representatives of the Buyer reasonable access, during normal business hours throughout the period prior to the Closing Date, to all of the Seller's (in respect of the Company), Utility's, Development's and Reynolds', and the Company Subsidiaries', properties, books, contracts, commitments and records (including, but not limited to, Tax Returns) and, during such period, the Seller shall, and shall cause Utility, Development and Reynolds, and each Company Subsidiary, to, furnish promptly to the Buyer and its Representatives, (i) access to each report, schedule and other document filed or received by the Seller (in respect of the Company), Utility, Development or Reynolds, or any Company Subsidiary, pursuant to the requirements of federal or state securities laws or filed with or sent to any federal or state regulatory agency or commission and (ii) access to all information concerning the Seller (in respect of the Company), the Integrated Assets, Utility, Development or Reynolds, or any Company Subsidiary, and its or their respective directors and officers and such other matters as may be reasonably requested by the Buyer or its Representatives in connection with any filings, applications or approvals required or contemplated by this Agreement or for any other reason related to the transactions contemplated by this Agreement; provided, however, that (i) any such access shall be granted only in such a manner as not to interfere unreasonably with the Seller's business operations in respect of the Company or otherwise, (ii) upon being granted such access, the Buyer shall not interfere with the Seller's business operations in respect of the Company or otherwise, (iii) in granting any such access the Seller, Utility, Development and Reynolds, and the Company Subsidiaries, shall not be required to take any action that would constitute a waiver of any legal privilege, including the attorney-client privilege, the work product privilege and the self critical investigation privilege, and (iv) in granting any such access, the Seller, Utility, Development and Reynolds, and the Company Subsidiaries, shall not be required to provide the Buyer with access to any information which the Seller, Utility, Development or Reynolds, or any Company Subsidiary, is under a legal or contractual obligation to withhold from disclosure. The Buyer shall, and shall cause its Subsidiaries and Representatives to, hold in strict confidence all documents and information concerning the Seller or the Company furnished or made available to it in connection with the transactions contemplated by this Agreement in accordance with the Confidentiality Agreement, dated January 23, 2001, entered into by and among the Seller, DQE and the Buyer (as amended on March 19, 2002, the "Confidentiality Agreement").

(b) Between the date hereof and the Closing Date, the Parties shall reasonably cooperate with one another so as to inform one another of the condition of the Company and the status of the transactions contemplated by this Agreement. Toward that end, the Parties shall each appoint an officer-level employee to serve as the head of their transition team and shall use commercially reasonable efforts to hold regular meetings and/or conference calls so that the members of the Seller's and the Buyer's management and transition teams may



discuss the Company and the transactions contemplated by this Agreement.

**Section 7.2 Regulatory Matters.**

(a) **HSR Filings.** The Seller and the Buyer shall, as soon as practicable after the date hereof, file or cause to be filed with the Federal Trade Commission and the Department of Justice any notifications required to be filed under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the “HSR Act”), and the rules and regulations promulgated thereunder with respect to the transactions contemplated hereby. The Seller and the Buyer will use all commercially reasonable efforts to respond on a timely basis to any requests for additional information made by either of such agencies.

(b) **Other Regulatory Approvals.** The Seller and the Buyer shall cooperate and use all commercially reasonable efforts to promptly prepare and file all necessary documentation, to effect all necessary applications, notices, petitions, filings and other documents, and to use all commercially reasonable efforts to obtain all necessary permits, consents, approvals and authorizations of all Governmental Authorities necessary or advisable to obtain the Seller Required Statutory Approvals and the Buyer Required Statutory Approvals; provided, however, that the Seller and the Buyer shall cooperate and use all commercially reasonable efforts to prepare and file any such applications, notices, petitions, filings and other documents within sixty (60) calendar days after the date hereof and shall thereafter cooperate to diligently prosecute all such applications, notices, petitions, filings and other documents. To the extent any such applications, notices, petitions, filings or other documents require an allocation of the Purchase Price among the assets of the Company, the Seller and the Buyer shall make any such allocation in a manner that is consistent with any allocations made pursuant to Section 7.9 hereof. The Buyer shall be precluded from including in any application for regulatory approval contingencies relating to rate treatment of acquisition premiums.

**Section 7.3 Consents.** The Seller and the Buyer agree to use all commercially reasonable efforts to obtain the Seller Required Consents and the Buyer Required Consents, respectively, and to cooperate with each other in connection with the foregoing.

**Section 7.4 Directors’ and Officers’ Indemnification.**

(a) **Indemnification.** To the fullest extent permitted by law, from and after the Closing Date, all rights to indemnification existing immediately prior to the Closing in favor of the current and former employees, agents, directors or officers of the Seller, Utility, Development and Reynolds, and each Company Subsidiary, (each, a “Company Indemnified Party” and, collectively, the “Company

Indemnified Parties") with respect to their activities as such prior to or on the Closing Date, as provided in the Seller's, Utility's, Development's and Reynolds', and each Company Subsidiary's, respective articles of incorporation, by-laws, other organizational documents or indemnification agreements in effect on the date of such activities or otherwise in effect on the date hereof, shall survive the Closing and shall continue in full force and effect for a period of not less than six (6) years from the Closing Date, provided that, in the event any claim or claims are asserted or made within such six (6) year period, all such rights to indemnification in respect of any claim or claims shall continue until final disposition of such claim or claims and provided further that, the Buyer's or any Buyer Subsidiary's indemnity obligation for a particular claim hereunder shall be reduced in respect of any Company Indemnified Party asserting such claim to the extent of any insurance proceeds actually received by such Company Indemnified Party in respect of such claim.

(b) Successors. In the event that after the Closing Date, Utility, Development or Reynolds, or any of their successors or assigns (i) consolidates with or merges into any other Person or entity and shall not be the continuing or surviving corporation or entity of such consolidation or merger or (ii) transfers all or substantially all of its properties and assets to any Person or entity, then and in either such case, proper provisions shall be made so that the successors and assigns of Utility, Development or Reynolds, as the case may be, shall assume the respective obligations of Utility, Development or Reynolds, as the case may be, set forth in this Section 7.4.

(c) Insurance for Pre-Closing Period. For a period of six (6) years after the Closing Date, DQE or the Seller shall maintain policies of directors' and officers' liability insurance for those Persons covered by such policies maintained by the Seller (in respect of the Company), Utility, Development or Reynolds immediately prior to the Closing in respect of pre-Closing acts or omissions on terms no less favorable than the terms of any such current insurance coverage.

(d) Benefit. The provisions of this Section 7.4 are intended to be for the benefit of, and shall be enforceable by, each Company Indemnified Party, his or her heirs and his or her representatives.

**Section 7.5 Public Announcements**. The Buyer and the Seller shall consult with each other before issuing any press release with respect to this Agreement and the transactions contemplated hereby and shall not issue any such press release or make any such written public statement without the prior written consent of the other Party, which shall not be unreasonably withheld, delayed or conditioned, provided, however, that a Party may, without the prior written consent of the other Party, issue such press release or make such written public statement as

the Party may determine, in good faith after consultation with counsel, is required by law or by obligations pursuant to any listing agreement with or rules of any national securities exchange, if it has used all commercially reasonable efforts to consult with the other Party.

Section 7.6 Workforce Matters.

(a) Neither Utility, Development, Reynolds nor any Company Subsidiary has any employees. The Buyer will make offers of employment, effective as of the Closing, to those employees of the Seller identified by mutual written agreement of the Seller and PSC as Affected Employees (such individuals, the "Affected Employees") such that such Affected Employees do not suffer an "employment loss" under the WARN Act (as defined below) as a result of such offers. The Buyer and the Seller acknowledge that if the Buyer makes appropriate offers to all Affected Employees, none of such Affected Employees will suffer an "employment loss" as defined under the WARN Act. As used in this Agreement, the term "WARN Act" shall mean the Worker Adjustment and Retraining Notification Act. In connection with the hiring process for Affected Employees, the Buyer shall comply with applicable laws pertaining to labor and employment, including, without limitation, Title VII of the Civil Rights Act of 1964, as amended, the Age Discrimination in Employment Act, the Americans With Disabilities Act, the Rehabilitation Act and comparable state and local laws. If any Affected Employee is not hired by the Buyer as of the Closing or if the Buyer or any Affected Employee terminates such Affected Employee's employment as of or after the Closing, then the Buyer shall be responsible for any and all severance costs for all such Affected Employees, including payments owing under those agreements, plans or arrangements listed in Section 3.9(a) of the Seller Disclosure Schedule. As between the Seller and the Buyer, neither the Seller nor DQE shall be obligated to provide any severance or separation pay benefits to any Affected Employee on account of any termination of such Affected Employee's employment on or after the Closing Date. Neither Buyer nor its affiliates shall be responsible for providing severance benefits to any employee of Seller or its affiliates other than benefits payable in respect of Affected Employees in accordance with this Section 7.6(a). The Buyer shall be responsible for providing any continuation coverage required under the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended ("COBRA"), in respect of Affected Employees who experience a qualifying event (within the meaning of COBRA) before, on or after the Closing Date. The Seller shall be responsible for any notices required to be given under, or otherwise comply with, the WARN Act or similar statutes or regulations of any jurisdiction relating to any "plant closing" or "mass layoff" or similar triggering event ordered by the Seller with respect to the Affected Employees prior to the Closing Date. The Buyer shall be responsible for any notices required to be given under, or otherwise comply with, the WARN Act or similar statutes or regulations of any jurisdiction relating to any

"plant closing" or "mass layoff" or similar triggering event ordered by the Buyer or any Buyer Subsidiary with respect to the Affected Employees on and after the Closing Date. For the avoidance of doubt, for purposes here, the Parties intend for the "effective date" within the meaning of the WARN Act to refer to and mean the Closing Date. To the extent possible, the Buyer and the Seller agree to treat the Buyer as a "successor employer" and the Seller or one or more of its affiliates as a "predecessor employer" within the meaning of Sections 3121(a)(1) and 3306(b)(1) of the Code, with respect to Affected Employees, for purposes of Taxes imposed under the United States Federal Unemployment Tax or the United States Federal Insurance Contributions Act.

(b) The Buyer expressly agrees that without the Seller's consent, (i) from the date hereof until the first (1<sup>st</sup>) anniversary of the Closing Date, it will not directly solicit for employment or employ any employees of the Seller who are not Affected Employees, and (ii) from the Closing Date until the first (1<sup>st</sup>) anniversary of the Closing Date, it will cause the Company and the Company Subsidiaries and any Buyer Subsidiaries not to directly solicit for employment or employ any employees of the Seller who are not Affected Employees; provided that nothing herein shall prohibit the Buyer or any of its affiliates from placing advertisements for employment. The Seller expressly agrees that without PSC's consent, (i) from the date hereof until the first (1<sup>st</sup>) anniversary of the Closing Date, it will not directly solicit for employment any of the Affected Employees or employ after the Closing Date any of the Affected Employees actually hired by the Buyer, and (ii) from the Closing Date until the first anniversary of the Closing Date, it will cause its affiliates to not, and require in any agreement entered into for the sale of any of its operations that any purchaser of such operations will not, directly solicit for employment any of the Affected Employees or employ after the Closing Date any of the Affected Employees actually hired by the Buyer; provided that nothing herein shall prohibit the Seller or any of its affiliates or any purchaser of the Seller's operations from placing advertisements for employment.

#### Section 7.7 Employee Benefit Plans.

(a) Continued Employment; Service Credit. Except as otherwise provided herein, the Buyer shall not assume any Company Plan, nor shall there be any transfer of assets or liabilities of any Company Plan to any plan, program or arrangement maintained by the Buyer or any of its affiliates. If any Affected Employee becomes a participant in any employee benefit plan, practice or policy of the Buyer or any of its affiliates, such Affected Employee shall be given credit under such plan for all service prior to the Closing Date with the Company, any of its affiliates, any ERISA Affiliate or any predecessor employer to the extent such credit was given by the Company, any of its affiliates, any ERISA Affiliate or any predecessor employer under a Company Plan, and all service with the Buyer or

any of its affiliates on and after the Closing Date but prior to the time such employee becomes such a participant, for purposes of determining eligibility and vesting and for purposes of severance and vacation. As of the Closing, the Company and its affiliates shall cease to provide coverage and benefits for Affected Employees and their dependents and beneficiaries under any benefit plan maintained by the Seller or DQE or any of their respective affiliates, except as required by applicable law.

(b) Continuation of Agreements. Section 7.7(b) of the Seller Disclosure Schedule lists all contracts, agreements and commitments of the Seller, Utility, Development or Reynolds, or any Company Subsidiary in effect as of the date hereof that apply to any Affected Employee (each, a "Section 7.7(b) Agreement"). The Buyer shall, and shall cause Utility, Development and Reynolds, and each Company Subsidiary, to assume and honor each Section 7.7(b) Agreement in accordance with its terms; provided, however, that this undertaking is not intended to prevent the Seller, Utility, Development or Reynolds, or any Company Subsidiary, from enforcing a Section 7.7(b) Agreement in accordance with its terms, including, without limitation, any reserved right to amend, modify, suspend, revoke or terminate the Section 7.7(b) Agreement or portion thereof.

#### Section 7.8 Tax Treatment.

(a) Neither the Seller nor the Buyer shall make or file any election under Section 338 of the Code or any corresponding provision of state or local Tax law with respect to the purchase of the Shares and for the stock of each Company Subsidiary pursuant to this Agreement.

(b) Utility, Development and Reynolds will each elect under Section 168(k)(2)(C)(iii) of the Code not to deduct additional first (1<sup>st</sup>) year depreciation for any water utility property placed in service during taxable years that include any period from September 11, 2001 through the Closing Date.

#### Section 7.9 Allocation of Consideration.

(a) The consideration attributable to the purchase of the Shares and the Integrated Assets shall be allocated among the Shares and the Integrated Assets as set forth in Exhibit 7.9 hereto, in compliance with Section 1060 of the Code and the regulations promulgated thereunder. Within thirty (30) calendar days after the determination of the adjustments pursuant to Article I, the Seller shall deliver to the Buyer a schedule (the "Adjustment Schedule") allocating said adjustments among the Shares and the Integrated Assets.

(b) The Buyer may dispute any allocation set forth on the Adjustment Schedule; provided, however, that (i) the Buyer shall not dispute any of

the original allocations set forth in Exhibit 7.9 and (ii) the Buyer shall notify the Seller in writing (the "Allocation Dispute Notice") of each disputed item, specifying the allocation in dispute and setting forth, in reasonable detail, the basis for such dispute within thirty (30) calendar days of the Buyer's receipt of the Adjustment Schedule. The Buyer shall submit only one Allocation Dispute Notice containing all disputed allocations. In the event of such a dispute, the Buyer and the Seller shall attempt to reconcile their differences and any resolution by them as to any disputed allocations shall be final, binding and conclusive. If the Buyer and the Seller are unable to reach a resolution with such effect within thirty (30) calendar days of the receipt by the Seller of the Allocation Dispute Notice, the Buyer and the Seller shall submit the items remaining in dispute for resolution to a nationally recognized accounting firm, mutually acceptable to both the Seller and PSC, which shall, within thirty (30) calendar days after submission, determine and report to the Parties upon such remaining disputed allocations, and such report shall be final, binding and conclusive on the Parties hereto. All costs and expenses of the nationally recognized accounting firm relating to the disputed allocations shall be borne equally by the Buyer and the Seller.

(c) Upon agreement of the Parties with respect to the Adjustment Schedule, or the completion of a report prepared by a nationally recognized accounting firm pursuant to Section 7.9(b), a schedule (the "Final Allocation Schedule") setting forth the allocation among the Shares and the Integrated Assets as specified in Section 7.9(a) and modified pursuant to Section 7.9(b) shall be prepared by the Parties. Each of the Buyer and the Seller shall (i) timely file with each relevant Tax authority all forms and Tax Returns required to be filed in connection with the allocation set forth in the Final Allocation Schedule (including Internal Revenue Service Form 8594), (ii) be bound by such allocation for purposes of determining Taxes, (iii) prepare and file, and cause their respective affiliates to prepare and file, their Tax Returns on a basis consistent with such allocation, and (iv) not take any position, or cause their respective affiliates to take any position, inconsistent with such allocation on any Tax Return, in any audit or proceeding before any Tax authority or in any report made for Tax purposes; provided, however, that, notwithstanding anything in this Section 7.9 to the contrary, the Parties shall be permitted to take a position inconsistent with that set forth in this Section 7.9 if required to do so by a final and unappealable decision, judgment, decree or other order by any court of competent jurisdiction. In the event that any of such allocations are disputed by any Tax authority, the Seller or the Buyer, as the case may be, receiving notice of the dispute shall promptly notify the Seller or the Buyer, as the case may be, not receiving notice of the dispute.

Section 7.10 Tax Returns. The Seller shall prepare and file, or cause to be prepared and filed, when due all Tax Returns that are required to be filed by or with respect to all or any portion of the Company for taxable years or periods

ending on or before the Closing Date. PSC shall prepare and file, or cause to be prepared and filed, when due all Tax Returns that are required to be filed by or with respect to all or any portion of the Company for taxable years or periods ending after the Closing Date. Any Tax Return required to be filed by PSC, Acquisition or any Buyer Subsidiary relating to any Straddle Period shall be prepared based on past practice and submitted (with copies of any relevant schedules, work papers and other documentation then available) to the Seller for the Seller's approval not less than thirty (30) calendar days prior to the due date for the filing of such Tax Return, which approval shall not be unreasonably withheld. The Seller and PSC shall make available all books and records and cooperate with each other as reasonably necessary for the preparation and filing of any Tax Returns relating to all or any portion of the Company.

Section 7.11 Transfer Taxes. Notwithstanding any other provision of this Agreement to the contrary, the Buyer and the Seller shall bear equally (a) all transfer (including real property transfer and documentary transfer) Taxes and fees imposed with respect to the transactions contemplated hereby and (b) all sales, use, gains (including state and local transfer gains), excise and other transfer or similar Taxes imposed with respect to the transactions contemplated hereby. The Seller shall execute and deliver to PSC, and PSC shall execute and deliver to the Seller at the Closing any certificates or other documents as the requesting Party may reasonably request in order to perfect any exemption from any such transfer, documentary, sales, use, gains, excise or other Taxes, or to otherwise comply with any applicable reporting requirements with respect to any such Taxes.

Section 7.12 Financial Information.

(a) After the Closing, upon reasonable written notice, the Buyer and the Seller shall furnish or cause to be furnished to each other and their respective accountants, counsel and other Representatives, during normal business hours, such information (including records pertinent to the Company) as is reasonably necessary for financial reporting and accounting matters.

The Buyer shall retain all of the books and records of the Integrated Assets, Utility, Development and Reynolds, and the Company Subsidiaries, for a period of ten (10) years after the Closing Date or such longer time as may be required by law. After the end of such period, before disposing of such books or records, the Buyer shall give notice to such effect to the Seller and give the Seller an opportunity to remove and retain all or any part of such books or records as the Seller may select.

Section 7.13 Transition Services. Within one hundred eighty (180) calendar days of the date hereof, the Parties shall use all commercially reasonable

effects to enter into one or more definitive agreements pursuant to which DQE or the Seller shall provide to the Buyer, for a period of six months following the Closing Date, any or all services previously provided by DQE or the Seller, respectively, to the Company prior to the Closing Date including, but not limited to: (i) accounting services (specifically the Lawson System), (ii) information technology services, (iii) data processing services, and (iv) such other services and products as shall be mutually agreed to by the Parties, in each case to the extent that DQE or the Seller is able to provide such services without any undue hardship on DQE or the Seller and in all cases at a price for any such services that is equal to DQE's or the Seller's actual cost for such services, as the case may be, to be paid on a monthly basis by the Buyer to DQE or the Seller.

**Section 7.14 Update of the Seller Disclosure Schedule.** The Seller may from time to time prior to or on the Closing Date by notice in accordance with this Agreement supplement or amend the Seller Disclosure Schedule, including one or more supplements or amendments to correct any matter that would otherwise constitute a breach of any representation, warranty or covenant contained herein. If the Seller Disclosure Schedule is updated pursuant to this provision so as to disclose additional liabilities or obligations of the Company that, in the aggregate, exceed \$15,000,000 (except for those liabilities or obligations resulting from (i) any change in law, rule or regulation of any Governmental Authority that applies generally to similarly situated Persons, (ii) general changes in the industries in which the Company operates its assets or conducts its business, and (iii) a Permitted Financial Impact), then the Buyer shall have the right to terminate this Agreement pursuant to Section 9.1(f). Notwithstanding any other provision hereof to the contrary, the Seller Disclosure Schedule and the representations and warranties made by the Seller shall be deemed for all purposes to include and reflect such supplements and amendments as of the date hereof and at all times thereafter, including the Closing Date.

**Section 7.15 Surety Bonds.**

(a) After the Closing, PSC shall, and shall cause Utility, Development and Reynolds to, use all commercially reasonable efforts to recover and replace those surety bonds listed in Exhibit 7.15(a) and to have such surety bonds returned to Seller within ninety (90) calendar days of the Closing Date.

(b) Each of PSC and Acquisition expressly acknowledges that, after the Closing, the Seller and/or DQE may cancel those surety bonds listed in Exhibit 7.15(b) without notice PSC or Acquisition, subject to the terms of the bond documents.



Section 7.16 Governmental Taking.

(a) Between the date hereof and the Closing Date, the Seller shall immediately notify PSC if a Governmental Authority commences condemnation, expropriation, eminent domain or similar proceedings affecting all or any portion of any real property, franchise, service territory or operations of the Company (a "Condemnation Proceeding"). Except for any Condemnation Proceeding in respect of Utility Center, Inc.'s "North System" (a "North System Condemnation") between the date hereof and the Closing Date, the Seller shall not enter into any Condemnation Proceeding settlement with the Governmental Authority that commences such Condemnation Proceeding without the prior written consent of PSC unless (i) the settlement pays the Seller at least Rate Base as compensation from the Governmental Authority in connection with the subject Condemnation Proceeding, (ii) the Seller shall deposit any monies resulting from any such settlement into a separate escrow account and (iii) the Seller shall cause such monies to be transferred from the Seller to the Company immediately prior to the Closing Date.

(b) Except for a North System Condemnation, between the date hereof and the Closing Date, with respect to any Condemnation Proceeding that is not resolved pursuant to a settlement and results in a governmental taking, (i) the Seller shall deposit any monies resulting from any such governmental taking into a separate escrow account and (ii) the Seller shall cause such monies to be transferred from the Seller to the Company immediately prior to the Closing Date.

(c) Between the date hereof and the Closing Date, with respect to any North System Condemnation, the Seller shall not enter into any settlement without the prior written consent of PSC unless (i) the settlement pays the Seller at least Rate Base of the North System as compensation from the Governmental Authority in connection with the North System Condemnation, (ii) the Seller shall deposit any monies resulting from any such settlement that do not exceed said Rate Base into a separate escrow account, together with fifty percent (50%) of the monies resulting from any such settlement that do exceed said Rate Base and (iii) the Seller shall cause such monies to be transferred from the Seller to the Company immediately prior to the Closing Date; provided, however, that the Seller shall be entitled to retain as an Excluded Asset or otherwise fifty percent (50%) of any monies resulting from any such settlement that exceeds said Rate Base.

(d) Between the date hereof and the Closing Date, with respect to any North System Condemnation that is not resolved pursuant to a settlement and results in a governmental taking, (i) the Seller shall deposit any monies resulting from any such taking that do not exceed the Rate Base of the North System into a separate escrow account, together with fifty percent (50%) of any

monies resulting from any such governmental taking that do exceed said Rate Base; provided, however, that the Seller shall be entitled to retain as an Excluded Asset or otherwise fifty percent (50%) of any monies resulting from any such governmental taking that exceeds said Rate Base.

(e) As used in this Section 7.16, the term "Rate Base" shall mean Rate Base with respect to a particular portion of real property, franchise, service territory or operations.

**Section 7.17 AquaSource Name.** The Seller and the Buyer acknowledge that as a result of the consummation of the transactions contemplated by this Agreement, on and after the Closing Date neither the Buyer nor the Company shall have any right, title or interest in and to the name and mark "AquaSource" or any derivations thereof. Notwithstanding the foregoing, the Seller agrees that on the Closing Date, and continuing until the first (1<sup>st</sup>) anniversary of Closing Date, it shall grant the Buyer, in respect of Utility, Development and Reynolds, and the Company Subsidiaries, a non-exclusive, fully-paid license to use the name "AquaSource" or any derivations thereof that may have been used by the Company on the date hereof anywhere in the United States of America and that upon the expiration of such one year period, the Buyer shall, for a period not to exceed ninety (90) calendar days, have the right to purchase Seller's right, title and interest in and to the name "AquaSource", as well as any and all federal or state applications and/or registrations thereof, for a purchase price of \$100,000. Within ninety (90) calendar days of the execution of this Agreement, the Seller and PSC shall use all commercially reasonable efforts to enter into an appropriate written agreement for the license and option to purchase the name and mark "AquaSource" as contemplated by this Section 7.17.

**Section 7.18 General and Automobile Liability Insurance.** The Seller agrees to use commercially reasonable efforts to have its general and automobile liability insurance policies for the twenty-four (24) months immediately following the Closing Date endorsed to make PSC and Acquisition an additional insured under such policies with respect to occurrences involving the Company and the Integrated Assets occurring prior to the Closing Date; provided, however, that the Seller shall have satisfied its obligations under this provision if DQE uses commercially reasonable efforts to have its general and automobile liability insurance so endorsed. PSC and Acquisition agree to use commercially reasonable efforts to have their general and automobile liability insurance policies for the twenty-four (24) months immediately following the Closing Date endorsed to make the Seller an additional insured under such policies with respect to occurrences involving the Company and the Integrated Assets occurring after the Closing Date.

Section 7.19 Further Assurances. Each Party will, and will cause its Subsidiaries to, execute such further documents or instruments and take such further actions as may reasonably be requested by any other Party in order to consummate the transaction contemplated hereby in accordance with the terms hereof or otherwise perform those obligations required hereunder. In the event that any Integrated Asset to be conveyed, assigned, transferred and delivered hereunder to the Buyer shall not have been so conveyed, assigned, transferred and delivered to the Buyer at the Closing, the Parties shall use all commercially reasonable efforts to so convey, assign, transfer and deliver such Integrated Asset to the Buyer and to cause the Buyer to assume all Integrated Liabilities associated therewith as promptly as is practicable following the Closing Date.

## ARTICLE VIII CONDITIONS

Section 8.1 Conditions to Each Party's Obligation to Effect the Closing. The respective obligations of each Party to effect the Closing shall be subject to the satisfaction on or prior to the Closing Date of the following conditions, except, to the extent permitted by applicable law, that such conditions may be waived in writing pursuant to Section 10.3 by the joint action of the Parties hereto:

(a) No Injunction. No application for a temporary restraining order or preliminary or permanent injunction or other order by any federal or state court preventing consummation of the transactions contemplated hereby shall have been applied or petitioned for and not dismissed with prejudice, and the transactions contemplated hereby shall not have been prohibited under any applicable federal or state law or regulation.

(b) Statutory Approvals. The Seller Required Statutory Approvals and the Buyer Required Statutory Approvals shall have been obtained at or prior to the Closing Date, such approvals shall have become Final Orders (as defined below) and such Final Orders shall not, individually or in the aggregate, impose terms or conditions (other than the preclusion of recovery of an acquisition premium) which would have a material adverse effect on the business, operations, properties, assets, financial condition, or results of operations of the Company and the Buyer and their respective Subsidiaries taken as a whole. A "Final Order" means action by the relevant regulatory authority which has not been reversed, stayed, enjoined, set aside, annulled or suspended, with respect to which any waiting period prescribed by law before the transactions contemplated hereby may be consummated has expired, as to which all conditions to the consummation of such transactions prescribed by law, regulation or order have been satisfied and having any applicable appeals period expire without any appeal being filed, or if such an appeal is filed, such appeal is fully and finally dismissed without the opportunity for further appeal.

(c) Assignment and Delivery of Excluded Assets and Assumption of Related Liabilities. All of Utility's, Development's, Reynolds, and the Company Subsidiaries' right, title and interest in and to the Excluded Assets shall have been assigned, and all such Excluded Assets shall have been delivered, to the Seller or such third party as the Seller may designate, and the Seller or such third party, as the case may be, shall have assumed all of the obligations and liabilities of Utility, Development, Reynolds and the Company Subsidiaries in respect of such Excluded Assets, as contemplated by Section 6.3 of this Agreement.

Section 8.2 Conditions to Obligation of the Buyer to Effect the Closing. The obligation of the Buyer to effect the Closing shall be further subject to the satisfaction, on or prior to the Closing Date, of the following conditions, except as may be waived by the Buyer in writing pursuant to Section 10.3:

(a) Performance of Obligations of the Seller. The Seller and/or the Company will have performed in all material respects its agreements and covenants contained in or contemplated by this Agreement which are required to be performed by it at or prior to the Closing.

(b) Representations and Warranties of the Seller. The representations and warranties of the Seller set forth in this Agreement shall be true and correct (i) on and as of the date hereof and (ii) on and as of the Closing Date with the same effect as though such representations and warranties had been made on and as of the Closing Date (except for representations and warranties that expressly speak only as of a specific date or time which need only be true and correct as of such date or time) except in each of cases (i) and (ii) for such failures of representations or warranties to be true and correct (without giving effect to any materiality qualification or standard contained in any such representations and warranties) which would not result in a Company Material Adverse Effect.

(c) Closing Certificate of the Seller. The Buyer shall have received a certificate signed by a duly authorized officer of the Seller, dated as of the Closing Date, to the effect that, to the best of such officer's knowledge, the conditions set forth in Section 8.2(a) and Section 8.2(b) have been satisfied.

(d) Material Adverse Effect on the Company. There shall exist no facts or circumstances that would result in a material adverse effect on the business, assets, financial condition or results of operations of the Company totaling, in the aggregate, \$15,000,000 or more other than those facts or circumstances which result from (i) any change in law, rule, or regulation of any Governmental Authority that applies generally to similarly situated Persons, (ii) general changes in the industries in which the Company operates its assets or conducts its businesses or (iii) any Permitted Financial Impact.

(e) The Seller Required Consents. The Seller Required Consents, the failure of which to obtain would have a Company Material Adverse Effect, shall have been obtained.

(f) Intercompany Debt. There shall be no intercompany indebtedness on the balance sheet of the Company.

Section 8.3 Conditions to Obligation of the Seller to Effect the Closing. The obligation of the Seller to effect the Closing shall be further subject to the satisfaction, on or prior to the Closing Date, of the following conditions, except as may be waived by the Seller in writing pursuant to Section 10.3:

(a) Performance of Obligations of the Buyer. The Buyer (and/or its appropriate Subsidiaries) will have performed in all material respects its agreements and covenants contained in or contemplated by this Agreement which are required to be performed by it at or prior to the Closing Date.

(b) Representations and Warranties of the Buyer. The representations and warranties of PSC and Acquisition set forth in this Agreement shall be true and correct (i) on and as of the date hereof and (ii) on and as of the Closing Date with the same effect as though such representations and warranties had been made on and as of the Closing Date (except for representations and warranties that expressly speak only as of a specific date or time which need only be true and correct as of such date or time) except in each of cases (i) and (ii) for such failures of representations or warranties to be true and correct (without giving effect to any materiality qualification or standard contained in any such representations and warranties) which would not result in a Buyer Material Adverse Effect.

(c) Closing Certificates of the Buyer. The Seller shall have received certificates signed by a duly authorized officer of PSC and Acquisition, dated as of the Closing Date, to the effect that, to the best of such officer's knowledge, the conditions set forth in Section 8.3(a) and Section 8.3(b) have been satisfied.

(d) Buyer Material Adverse Effect. No Buyer Material Adverse Effect shall have occurred and there shall exist no fact or circumstance that would result in a material adverse effect material adverse effect on the business, assets, financial condition or results of operations of the Buyer totaling, in the aggregate, \$15,000,000 or more other than those facts or circumstances which result from (i) any change in law, rule, or regulation of any Governmental Authority that applies generally to similarly situated Persons, (ii) general changes in the industries in which the Buyer operates its assets or conducts its business, or (iii) any Permitted Financial Impact.

(e) Buyer Required Consents. The Buyer Required Consents, the failure of which to obtain would have a Buyer Material Adverse Effect, shall have been obtained.

## ARTICLE IX TERMINATION

Section 9.1 Termination. This Agreement may be terminated at any time prior to the Closing Date:

- (a) by mutual written consent of the Seller and PSC;
- (b) by PSC or the Seller, if any state or federal law, order, rule or regulation is adopted or issued, which has the effect, as supported by the written opinion of outside counsel for such Party, of prohibiting the Closing, or by PSC or the Seller, if any court of competent jurisdiction in the United States or any state shall have issued an order, judgment or decree permanently restraining, enjoining or otherwise prohibiting the Closing, and, in either case, if such order, rule, regulation, judgment or decree shall have become final and nonappealable;
- (c) by PSC or the Seller, by written notice to the other Party, if the Closing Date shall not have occurred on or before December 31, 2003 (the "Termination Date"); provided, however, that the right to terminate the Agreement under this Section 9.1 shall not be available to any Party whose failure (or whose affiliate's failure) to fulfill any obligation under this Agreement shall have proximately caused the failure of the Closing Date to occur on or before such date;
- (d) by PSC, by written notice to the Seller, if there shall have been any breach or breaches of any representations or warranties, or any breach or breaches of any covenants or agreements of the Seller or DQE hereunder, which breach or breaches would, taken together, result in a material adverse effect on the business, assets, financial condition or results of operations of the Company totaling, in the aggregate, \$15,000,000 or more except for those breaches resulting from (i) any change in law, rule, or regulation of any Governmental Authority that applies generally to similarly situated Persons, (ii) general changes in the industries in which the Company operates its assets or conducts its businesses or (iii) any Permitted Financial Impact, and such breach or breaches shall not have been remedied within thirty (30) calendar days after receipt by the Seller of notice in writing from PSC, specifying the nature of such breach or breaches and requesting that it or they be remedied, or PSC shall not have received adequate assurance of a cure of such breach or breaches within such thirty (30) calendar day period;

(e) by the Seller, by written notice to PSC, if there shall have been any breach or breaches of any representations or warranties, or any breach or breaches of any covenants or agreements of PSC or Acquisition hereunder, which breach or breaches would, taken together, result in a material adverse effect on the business, assets, financial condition or results of operations of the Company totaling, in the aggregate, \$15,000,000 or more except for those breaches resulting from (i) any change in law, rule, or regulation of any Governmental Authority that applies generally to similarly situated Persons, (ii) general changes in the industries in which the Company operates its assets or conducts its businesses or (iii) any events or circumstances that are taken into consideration in adjusting the Purchase Price, and such breach or breaches shall not have been remedied within thirty (30) calendar days after receipt by PSC of notice in writing from the Seller, specifying the nature of such breach or breaches and requesting that it or they be remedied, or the Seller shall not have received adequate assurance of a cure of such breach or breaches within such thirty (30) calendar day period; or

(f) by PSC if the Seller Disclosure Schedule is updated so as to disclose additional liabilities or obligations of the Company that, in the aggregate, exceed \$15,000,000 (except for those liabilities or obligations resulting from (i) any change in law, rule, or regulation of any Governmental Authority that applies generally to similarly situated Persons, (ii) general changes in the industries in which the Company operates its assets or conducts its businesses or (iii) any events or circumstances that are taken into consideration in adjusting the Purchase Price).

Section 9.2 Effect of Termination. In the event of termination of this Agreement by either the Seller or the Buyer pursuant to Section 9.1 there shall be no liability on the part of either the Seller or the Buyer or their respective officers or directors hereunder, except (a) for fraud or for willful breach of this Agreement prior to such termination or abandonment of the transactions and (b) that Sections 10.2, 10.4, 10.8, 10.9, 10.10, 10.13, and the agreement contained in the last sentence of Section 7.1(a) shall survive the termination.

## **ARTICLE X GENERAL PROVISIONS**

Section 10.1 Survival of Obligations. The representations and warranties of the Parties contained in this Agreement shall survive the Closing until the second (2<sup>nd</sup>) anniversary of the Closing Date. None of the covenants, obligations or agreements of the Parties contained in this Agreement or in any instrument, certificate, opinion or other writing provided for herein, shall survive the Closing; provided, however, that, notwithstanding the foregoing, the covenants of the Seller and the Buyer contained in Sections 1.3(b), 1.4(b), 7.4, 7.5, 7.6, 7.7, 7.8, 7.9, 7.10,

7.11, 7.12, 7.13, 7.15, 7.16, 7.17, 7.18 and 7.19, the last sentence of Section 7.1(a) and all of Articles IV and X shall survive the Closing.

Section 10.2 Amendment and Modification. This Agreement may be amended, modified and supplemented in any and all respects, but only by a written instrument signed by each of the Parties hereto expressly stating that such instrument is intended to amend, modify or supplement this Agreement.

Section 10.3 Extension; Waiver. Any failure of any of the Parties to comply with any obligation, covenant, agreement or condition herein, and any inaccuracies in the representations and warranties contained herein or in any document delivered pursuant hereto, and any time for the performance of any of the obligations or other acts of a Party hereto, may be waived or extended, as the case may be, but only pursuant to a written instrument signed by all Parties entitled to the benefits thereof; provided, however, that any such waiver or extension of such obligation, covenant, agreement or condition, or inaccuracy, shall not operate as a waiver of, or estoppel with respect to, any subsequent failure to comply therewith. The failure of any Party to this Agreement to assert any of its rights under this Agreement or otherwise shall not constitute a waiver of such rights.

Section 10.4 Expenses. All costs and expenses incurred in connection with this Agreement and the transactions contemplated hereby shall be paid by the Party incurring such expenses except that the Seller and the Buyer shall each bear 50% of the fee payable in connection with the filing required by the HSR Act.

Section 10.5 Notices. All notices and other communications hereunder shall be in writing and shall be deemed given (a) when delivered personally, (b) when sent by reputable overnight courier service, or (c) when telecopied (which is confirmed by copy sent within one (1) business day by a reputable overnight courier service) to the Parties at the following addresses (or at such other address for a Party as shall be specified by like notice):

(i) If to the Seller, to

AquaSource, Inc.  
c/o DQE, Inc.  
411 Seventh Avenue  
Pittsburgh, Pennsylvania 15219

Telecopier No.: 412-393-1071  
Telephone No.: 412-393-1143  
Attention: David R. High, Esq.



with a copy to

Skadden, Arps, Slate, Meagher & Flom LLP  
1440 New York Avenue, N.W.  
Washington, D.C. 20005

Telecopier No.: (202) 393-5760  
Telephone No.: (202) 371-7000  
Attention: Erica Ward, Esq.

(ii) if to DQE, to

DQE, Inc.  
411 Seventh Avenue  
Pittsburgh, Pennsylvania 15219

Telecopier No.: 412-393-1071  
Telephone No.: 412-393-1143  
Attention: David R. High, Esq.

with a copy to

Skadden, Arps, Slate, Meagher & Flom LLP  
1440 New York Avenue, N.W.  
Washington, D.C. 20005

Telecopier No.: (202) 393-5760  
Telephone No.: (202) 371-7000  
Attention: Erica Ward, Esq.

(iii) if to PSC, to

Philadelphia Suburban Corporation  
762 West Lancaster Avenue  
Bryn Mawr, Pennsylvania 19010-3489

Telecopier No.: (610) 645-1061  
Telephone No.: (610) 525-1400  
Attention: Nicholas DeBenedictis  
Chairman, President and Chief Executive Officer

with a copy to

Reed Smith LLP  
2500 One Liberty Place  
1650 Market Street  
Philadelphia, Pennsylvania 19103-7301

Telecopier No.: (215) 851-1420  
Telephone No.: (215) 851-8130  
Attention: Peter J. Tucci, Esq.

And

(iv) if to Acquisition, to

Aqua Acquisition Corporation  
762 West Lancaster Avenue  
Bryn Mawr, Pennsylvania 19010-3489

Telecopier No.: (610) 645-1061  
Telephone No.: (610) 525-1400  
Attention: Nicholas DeBenedictis  
Chairman, President and Chief Executive Officer

with a copy to

Reed Smith LLP  
2500 One Liberty Place  
1650 Market Street  
Philadelphia, Pennsylvania 19103-7301

Telecopier No.: (215) 851-1420  
Telephone No.: (215) 851-8130  
Attention: Peter J. Tucci, Esq.

**Section 10.6 Entire Agreement; No Third Party Beneficiaries. This Agreement, including the Schedules attached hereto, and the Confidentiality Agreement (a) constitute the entire agreement and supersede all prior agreements and understandings, both written and oral, among the Seller and the Buyer with respect to the subject matter hereof and thereof and (b) are not intended to confer any rights or remedies hereunder upon any Person other than the Parties hereto and thereto, Company Indemnified Parties to the extent set forth in Section 7.4 and Buyer Indemnitees to the extent set forth in Article IV.**

Section 10.7 Severability. Any term or provision of this Agreement that is held by a court of competent jurisdiction or other authority to be invalid, void or unenforceable in any situation in any jurisdiction shall not affect the validity or enforceability of the remaining terms and provisions hereof or the validity or enforceability of the offending term or provision in any other situation or in any other jurisdiction. If the final judgment of a court of competent jurisdiction or other authority declares that any term or provision hereof is invalid, void or unenforceable, the Parties agree that the court making such determination shall have the power to reduce the scope, duration, area or applicability of the term or provision, to delete specific words or phrases, or to replace any invalid, void or unenforceable term or provision with a term or provision that is valid and enforceable and that comes closest to expressing the intention of the invalid or unenforceable term or provision.

Section 10.8 Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the Commonwealth of Pennsylvania without giving effect to the principles of conflicts of law thereof.

Section 10.9 Venue. EACH OF THE PARTIES HERETO (A) CONSENTS TO SUBMIT ITSELF TO THE EXCLUSIVE PERSONAL JURISDICTION OF ANY FEDERAL OR STATE COURT LOCATED IN AND FOR PITTSBURGH, PENNSYLVANIA OR PHILADELPHIA, PENNSYLVANIA IN THE EVENT ANY DISPUTE ARISES OUT OF THIS AGREEMENT, (B) AGREES THAT IT SHALL NOT ATTEMPT TO DENY OR DEFEAT SUCH PERSONAL JURISDICTION BY MOTION OR OTHER REQUEST FOR LEAVE FROM ANY SUCH COURT, AND (C) AGREES THAT IT SHALL NOT BRING ANY ACTION RELATING TO THIS AGREEMENT IN ANY COURT OTHER THAN A STATE OR FEDERAL COURT SITTING IN AND FOR PITTSBURGH, PENNSYLVANIA OR PHILADELPHIA, PENNSYLVANIA.

Section 10.10 Waiver of Jury Trial and Certain Damages. EACH PARTY TO THIS AGREEMENT WAIVES, TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, (A) ANY RIGHT IT MAY HAVE TO A TRIAL BY JURY IN RESPECT OF ANY ACTION, SUIT OR PROCEEDING ARISING OUT OF OR RELATING TO THIS AGREEMENT AND (B) ANY RIGHT IT MAY HAVE TO RECEIVE DAMAGES FROM THE OTHER PARTY BASED ON ANY THEORY OF LIABILITY FOR ANY SPECIAL, INDIRECT, OR CONSEQUENTIAL (INCLUDING LOST PROFITS) DAMAGES. The Parties agree that the aggregate liability of the Seller arising out of or relating to this Agreement or the transactions contemplated herein shall in no event exceed the Purchase Price.

Section 10.11 Assignment. Neither this Agreement nor any of the rights, interests or obligations hereunder shall be assigned by any Party hereto

(whether by operation of law or otherwise) without the prior written consent of the other Party; provided, however, that any Party may assign this Agreement, without the consent of the assigning Parties, to the assigning Party's successor as a result of a change in control of the assigning Party, a consolidation of the assigning Party with or into another entity, a sale of all or substantially all of the assets of the assigning Party, or a merger of the assigning Party with or into another entity, in any case whether or not the assigning Party is the surviving entity.

Section 10.12 Interpretation. When a reference is made in this Agreement to Articles or Sections, such reference shall be to an Article or Section of this Agreement, respectively, unless otherwise indicated. The table of contents and headings contained in this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement. Whenever the words "include," "includes" or "including" are used in this Agreement, they shall be deemed to be followed by the words "without limitation."

Section 10.13 No Specific Enforcement. Except with respect to the obligations set forth in the last sentence of Section 7.1(a) and all of Sections 1.3(b), 1.4(b), 7.4, 7.5, 7.6, 7.7, 7.8, 7.9, 7.10, 7.11, 7.12, 7.15, 7.16, 7.17, 7.18, 7.19, 9.2, 10.1, 10.4, 10.7, 10.8, 10.9, 10.10, 10.11, and Article IV, the Parties agree that in the event of a breach of this Agreement, the Parties shall not be entitled to specific performance of the terms hereof.

Section 10.14 Counterparts; Effect. This Agreement may be executed in one or more counterparts, each of which shall be deemed to be an original, but all of which shall constitute one and the same agreement.

[SIGNATURES FOLLOW ON NEXT PAGE]

IN WITNESS WHEREOF, each of the Seller, DQE, PSC and Acquisition has caused this Agreement to be signed by a duly authorized officer as of the date first written above.

AQUASOURCE, INC.

By: 

Name: Frank A. Hoffmann

Title: President

DQE, INC.

By: 

Name: Frank A. Hoffmann

Title: Executive Vice President

PHILADELPHIA SUBURBAN CORPORATION

By: 

Name: Nicholas DeBenedictis

Title: Chairman, President and  
Chief Executive Officer

AQUA ACQUISITION CORPORATION

By: 

Name: Nicholas DeBenedictis

Title: Chairman, President and  
Chief Executive Officer

**Purchase Price Adjustment**

Beginning with the Base Purchase Price, the following adjustments shall be made using the following Target Amounts:

a. Adjustment #1 regarding Customer Connections:

For purposes of this adjustment, the term "Customer Connections" shall mean the sum of the total number of active water connections and the total number of active sewer connections, excluding contract operation customers. The Target Amounts for Customer Connections, and the necessary reductions if the Seller elects to treat any of the Excludable Operations as an Excluded Asset, as contemplated by Section 1.3(a) of the Agreement, are set forth on Schedule 1.4(a) attached to this Exhibit. The Target Amounts for Customer Connections, and the necessary reductions if a Condemnation Proceeding results in a governmental taking or settlement in lieu thereof, shall be determined in such manner as the parties may mutually agree.

At Closing, the parties shall compare the actual number of Customer Connections with the applicable Target Amount for Customer Connections, as set forth on Schedule 1.4(a) attached to this Exhibit, and prorated to the day before the Closing Date (rounding any partial customer to the nearest whole customer). If the actual number of Customer Connections is greater than the applicable Target Amount for Customer

Connections, as set forth on Schedule 1.4(a) attached to this Exhibit, then this positive difference shall be considered to result in extra Customer Connections. If the actual number of Customer Connections is less than the Target Amount for Customer Connections, as set forth on Schedule 1.4(a) attached to this Exhibit, then this negative difference shall be considered to result in missing Customer Connections.

For each extra Customer Connection realized pursuant to this Adjustment #1, the Base Purchase Price shall be increased by \$4,000 per customer, but in no event shall any increase resulting from this adjustment exceed \$10 million.

For each missing Customer Connection, the Base Purchase Price shall be reduced by \$4,000 per each missing Customer Connection, but in no event shall any downward adjustment resulting from this adjustment be greater than \$25 million.

b. Adjustment #2 regarding Rate Base.

For purposes of this adjustment, the term "Rate Base" shall mean gross utility plant in service plus, other property plant and equipment, plus construction work in progress, minus accumulated depreciation, minus contributions in aid of construction and minus customer advances for construction. The Target Amounts for Rate Base, and the necessary reductions if Seller elects to treat any of the Excludable Operations as an Excluded Asset, as contemplated by Section 1.3(a) of the Agreement, are set forth on Schedule 1.4(b) attached to this Exhibit. The Target Amounts for Rate Base, and the

necessary reductions if a Condemnation Proceeding results in a governmental taking or settlement in lieu thereof, shall be determined in such manner as the parties may mutually agree.

At Closing, the parties shall compare the actual Rate Base with the applicable Target Amount for Rate Base, as set forth on Schedule 1.4(b) attached to this Exhibit. If the actual Rate Base is greater than the applicable Target Amount for Rate Base, as set forth on Schedule 1.4(b) attached to this Exhibit, then this positive difference shall be considered to result in extra Rate Base. If the actual Rate Base is less than the applicable Target Amount for Rate Base, as set forth on Schedule 1.4(b) attached to this Exhibit, then this negative difference shall be considered to result in missing Rate Base.

For each \$1.00 of extra Rate Base, the Base Purchase Price will be increased by \$1.00, but in no event shall any increase resulting from this adjustment exceed \$10 million.

There shall be no reduction in the Base Purchase Price until the amount of any missing Rate Base is greater than \$5 million. If the missing Rate Base is greater than \$5 million, the purchase price shall be reduced as follows: i) by \$2 for each \$1 of missing Rate Base that falls in the range of \$5 million to \$10 million; and ii) by \$1 for each \$1 of missing Rate Base that exceeds \$10 million, but in no event will the reduction resulting from this adjustment be greater than \$25 million.



c. Adjustment #3 regarding ConOps Revenue.

For purposes of this adjustment, the term ConOps Revenue shall mean the aggregate revenue from contract operations contracts included in the Integrated Assets (excluding revenues derived from Capital Engineering and Reynolds Group Service and Maintenance) and any additional contract operations contracts entered into pursuant to Section 6.1 hereof and to be transferred to the Buyer pursuant to this Agreement. The Target Amounts for ConOps Revenue, and the necessary reductions if Seller elects to treat any of the Excludable Operations as an Excluded Asset, as contemplated by Section 1.3(a) of the Agreement, are set forth on Schedule 1.4(c) attached to this Exhibit.

At Closing, the parties shall compare the applicable Target Amount for ConOps Revenue with the level of contract operations revenues for the trailing twelve months calculated for the period ending on the last day of the month prior to Closing (the "Trailing Con Ops Revenue").

In the event that the Trailing Con Ops Revenues are less than the applicable Target Amount for Con Ops Revenue, then the Base Purchase Price shall be reduced as a result of this revenue shortfall. For each \$1 of revenue shortfall, the Base Purchase Price shall be reduced by \$4, but in no event shall any reduction resulting from this adjustment be greater than \$12.5 million.

For example, assume that the Trailing Con Ops Revenues for the period ending November 30, 2003 would equal \$6,500,000 in the case of a Closing that was occurring in December, 2003. Since the Trailing Revenues are less than the target Revenues by \$228,000, the Base Purchase Price would be reduced by \$912,000.

d. Adjustment #4 regarding Rate Initiatives.

For purposes of this analysis, the term "Rate Initiatives" shall mean the net increase in rates (stated on an annualized basis and applicable to the customers included in this transaction) resulting from those rate cases involving the Company that have been authorized by the applicable state regulatory commission through orders issued on or after January 1, 2002 (excluding amounts authorized in Texas pursuant to Seller's 2002 order which were implemented prior to 2002). The Target Amounts for Rate Initiatives, and the necessary reductions if Seller elects to treat any of the Excludable Operations as an Excluded Asset, as contemplated by Section 1.3(a) of the Agreement, are set forth on Schedule 1.4(d) attached to this Exhibit. The Target Amounts for Rate Initiatives, and the necessary reductions if a Condemnation Proceeding results in a governmental taking or settlement in lieu thereof, shall be determined in such manner as the parties may mutually agree. Rate Initiatives that were included in the Business Plan in the states of Indiana, Florida, Virginia, New York, Missouri and Texas are "Planned Rate Initiatives". Rate Initiatives in other states or otherwise not included in the Business Plan are "New Rate Initiatives".

At Closing, the parties shall determine the amount of Rate Initiatives (stated on an annualized basis and applicable to the customers included in this transaction) that have occurred and specify whether the Rate Initiative is a Planned Rate Initiative or New Rate Initiative.

The parties will then compare the Planned Rate Initiatives to the applicable Target Amount for Rate Initiatives. If the Planned Rate Initiatives exceed the applicable Target Amount for Rate Initiatives, then this positive difference shall be considered additional rates. If the Planned Rate Initiatives are less than the applicable Target Amounts for Rate Initiatives, then the parties will compare the Planned Rate Initiatives plus the New Rate Initiatives to the applicable Target Amount for Rate Initiatives. If the Planned Rate Initiatives plus the New Rate Initiatives are less than the applicable Target Amount for Rate Initiatives, then this negative difference shall be considered to result in missing rates. No additional rates will be generated by the sum of Planned Rate Initiatives and New Rate Initiatives exceeding the target Rate Initiatives. The Seller agrees that no settlement of a New Rate Initiative will include a requirement for any rate filing "stay out" extending beyond December 31, 2003, without the express written consent of the Buyer.

For each \$1 of additional rates, the Base Purchase Price will be increased by \$8, but in no event shall any increase resulting from this adjustment exceed \$10 million.

In the event there are missing rates, the Base Purchase Price shall be reduced by \$8 for each \$1 of missing rates, but in no event shall any reduction resulting from this adjustment be greater than \$10 million.

For example, if the Planned Rate Initiatives as of Closing are \$3,250,000 compared to a Target Amount for Rate Initiatives of \$2,850,000, the increase in Base Purchase Price shall be \$3,200,000, calculated as \$8 multiplied by the additional rates of \$400,000. In this example, there would be no need to calculate the sum of Planned Rate Initiatives and New Rate Initiatives.

**Schedule 1.4(a)  
to Exhibit 1.4**

| Month<br>End | Total<br>Customer Connection<br>Target <sup>1</sup> | Reduction to Target if Assets are Excluded |       |       |     |
|--------------|---|--|-------|-------|-----|
|              |   | HI   | CT/NY | NJ    | KY  |
| Dec-01       | 129,829   | 491  | 3,318 | 2,541 | 428 |
| Jan-02       | 130,497   | 492  | 3,324 | 2,546 | 429 |
| Feb-02       | 131,165   | 493  | 3,330 | 2,551 | 430 |
| Mar-02       | 131,833   | 494  | 3,336 | 2,556 | 431 |
| Apr-02       | 132,501   | 495  | 3,342 | 2,561 | 432 |
| May-02       | 133,169   | 496  | 3,348 | 2,566 | 433 |
| Jun-02       | 133,837   | 497  | 3,354 | 2,571 | 434 |
| Jul-02       | 134,505   | 498  | 3,360 | 2,576 | 435 |
| Aug-02       | 135,173   | 499  | 3,366 | 2,581 | 436 |
| Sep-02       | 135,841   | 500  | 3,372 | 2,586 | 437 |
| Oct-02       | 136,509   | 501  | 3,378 | 2,591 | 438 |
| Nov-02       | 137,177   | 502  | 3,384 | 2,596 | 439 |
| Dec-02       | 137,845   | 503  | 3,390 | 2,601 | 440 |
| Jan-03       | 138,622   | 504  | 3,397 | 2,606 | 441 |
| Feb-03       | 139,399   | 505  | 3,404 | 2,611 | 442 |
| Mar-03       | 140,176   | 506  | 3,411 | 2,616 | 443 |
| Apr-03       | 140,953   | 507  | 3,418 | 2,621 | 444 |
| May-03       | 141,730   | 508  | 3,425 | 2,626 | 445 |
| Jun-03       | 142,507   | 509  | 3,432 | 2,631 | 446 |
| Jul-03       | 143,284   | 510  | 3,439 | 2,636 | 447 |
| Aug-03       | 144,061   | 511  | 3,446 | 2,641 | 448 |
| Sep-03       | 144,838   | 512  | 3,453 | 2,646 | 449 |
| Oct-03       | 145,615   | 513  | 3,460 | 2,651 | 450 |
| Nov-03       | 146,392   | 514  | 3,467 | 2,656 | 451 |
| Dec-03       | 147,169   | 515  | 3,474 | 2,661 | 452 |

Note: A closing on September 16, 2003, excluding Hawaii and Connecticut/New York would result in the following pro-rated customer connection target:

$$\begin{aligned}
 &= (144,061 + (15/30 \times 777)) - (511 + (15/30 \times 1)) - (3446 + (15/30 \times 7)) \\
 &= 144,449 - 512 - 3450 \\
 &= 140,487
 \end{aligned}$$

---

<sup>1</sup> Water and Sewer investor owned utility customer connections

**Schedule 1.4(b)  
to Exhibit 1.4**

(000's Omitted)

| Target Closing | Reductions to Target Amounts if Assets are Excluded |                     |                  |                                 |
|----------------|---|---------------------|------------------|---------------------------------|
| Rate Base      | HI Operations                                       | CT/NY<br>Operations | NJ<br>Operations | KY<br>Operations <sup>(1)</sup> |
| 240,000        | 6,925   | 4,712               | (822)            | 563                             |

<sup>(1)</sup> Rate Base as of 6/30/02. No capital expenditures projected through year end 2003. To be adjusted by a supplemental schedule to provide best estimate as of 12/31/03.

Schedule 1.4(c)  
to Exhibit 1.4

(000's Omitted)

| Target Closing<br>TTM ConOps<br><br>Revenue | Deductions from Closing TTM ConOps Revenue<br>Target for asset exclusions |                     |                  |                  |
|---|---|---------------------|------------------|------------------|
|   | HI<br>Operations  | CT/NY<br>Operations | NJ<br>Operations | KY<br>Operations |
| 6,728                                       | 0   | 2,291               | 40               | 0                |

Schedule 1.4(d)  
to Exhibit 1.4

(000's omitted)

| Target Rate Initiative | Reduction to Target Level |                     |               |                  |
|------------------------|---------------------------|---------------------|---------------|------------------|
|                        | HI<br>Operations          | CT/NY<br>Operations | NJ Operations | KY<br>Operations |
| 2,850                  | 0                         | 6                   | 0             | 0                |

(425075)



**Bill of Sale**

THIS BILL OF SALE, is made as of the \_\_ day of \_\_\_\_, 200\_ by AquaSource, Inc., a Delaware corporation (the "Seller"), for the benefit of Aqua Acquisition Corporation, a Pennsylvania corporation ("Acquisition").

**WITNESSETH**

WHEREAS, pursuant to that certain Purchase Agreement dated July 29, 2002 (as amended, supplemented or otherwise modified from time to time, the "Purchase Agreement"), by and among Seller, DQE, Inc., a Pennsylvania corporation, on the one hand, and Philadelphia Suburban Corporation, a Pennsylvania corporation, and Acquisition, on the other hand, the Seller has agreed to convey all the Integrated Assets (as defined in the Purchase Agreement) listed on Schedule 1.1 of the Purchase Agreement, and attached hereto as Exhibit A; and

WHEREAS, pursuant to the Purchase Agreement, the Seller is required to execute and deliver this Bill of Sale in order to effectuate the assignment, conveyance, transfer and delivery of the Integrated Assets to Acquisition.

NOW, THEREFORE, in consideration of the foregoing premises and for other good and valuable consideration, the receipt and adequacy of which is hereby acknowledged, the Parties hereto hereby agree as follows:

1. **Defined Terms.** Capitalized terms which are used but not defined in this Bill of Sale shall have the meaning ascribed to such terms in the Purchase Agreement.
2. **Assignment.** The Seller does hereby assign, convey, transfer and deliver to Acquisition, all of the Seller's right, title and interest in and to all of the Integrated Assets.
3. **Binding Effect.** This Bill of Sale and all of the provisions hereof shall be binding upon the Seller and its successors and permitted assigns and shall inure to the benefit of Acquisition, and its successors and permitted assigns.
4. **Governing Law.** This Bill of Sale shall be governed by and construed in accordance with the laws of the Commonwealth of Pennsylvania (without giving effect to conflict of law principles).

5. Construction. This Bill of Sale is delivered pursuant to and is subject to the Purchase Agreement. In the event of any conflict between the terms of the Purchase Agreement and terms of this Bill of Sale, the terms of the Purchase Agreement shall prevail.

IN WITNESS WHEREOF, this Bill of Sale has been duly executed and delivered by the duly authorized officer of AquaSource, Inc. hereto as of the date first above written.

ATTEST:

AQUASOURCE, INC.

\_\_\_\_\_  
Name:  
Title:

\_\_\_\_\_  
Name:  
Title:

**Exhibit A**

COMMONWEALTH OF PENNSYLVANIA     )  
   )  
COUNTY OF ALLEGHENY                         )        SS

\_\_\_\_\_, being duly sworn, says that he or she is the \_\_\_\_\_ of AquaSource, Inc., a Delaware corporation, the corporation which has executed the forgoing instrument, and acknowledged that he or she did sign said instrument on behalf of said corporation and by authority of its Board of Directors, and that said instrument is his or her free act and deed as such officer and the free corporate act of the corporation.

\_\_\_\_\_

Sworn to before me and subscribed in my presence this \_\_\_\_ day of \_\_\_\_\_, 200\_\_.

\_\_\_\_\_   Notary Public

**Assignment and Assumption Agreement**

ASSIGNMENT AND ASSUMPTION AGREEMENT dated as of \_\_\_\_\_, 200\_ (the "Assignment Agreement") by and between AquaSource, Inc., a Delaware corporation (the "Seller"), on the one hand, and Aqua Acquisition Corporation, a Pennsylvania corporation ("Acquisition"), on the other hand. The Seller, on the one hand, and Acquisition, on the other hand, are referred to individually as a "Party," and collectively as the "Parties."

WITNESSETH:

WHEREAS, the Seller and DQE, Inc., a Pennsylvania corporation, on the one hand, and Philadelphia Suburban Corporation, a Pennsylvania corporation, and Acquisition, on the other hand, are Parties to that certain Purchase Agreement, dated as of July 29, 2002 (the "Purchase Agreement");

WHEREAS, pursuant to the Purchase Agreement, Acquisition has agreed to assume certain Integrated Liabilities (as defined in the Purchase Agreement); and

WHEREAS, it is the intention of the Parties that by the execution and delivery of this Assignment Agreement, the Seller will assign to Acquisition its ownership rights and interests in and to, and Acquisition will assume and agree to discharge when due, without recourse to the Seller.

NOW, THEREFORE, in consideration of the foregoing premises and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Seller and Acquisition hereby agree as follows:

1. Capitalized terms which are used in this Assignment Agreement but are not defined herein shall have the meaning ascribed to such terms in the Purchase Agreement.
2. The Seller hereby assigns, conveys, transfers and sets over to Acquisition all of the Integrated Liabilities.
3. Acquisition hereby assumes and agrees to discharge when due, without recourse to the Seller, all liabilities and obligations of the Seller constituting the Integrated Liabilities.
4. Nothing in this Assignment Agreement, express or implied, is intended or

shall be construed to confer upon or give to any Person, other than Acquisition or the Seller, as the case may be, their respective successors and assigns, any remedy or claim under or by reason of this instrument or any term, covenant or condition hereof, and all of the terms, covenants, conditions, promises and agreements in this Assignment Agreement shall be for the sole and exclusive benefit of Acquisition or the Seller, as the case may be, and their respective successors and assigns.

5. Neither the making nor the acceptance of this Assignment Agreement shall enlarge, restrict or otherwise modify the terms of the Purchase Agreement or constitute a waiver or release by the Seller or Acquisition of any liabilities, duties or obligations imposed upon either of them by the terms of the Purchase Agreement, including, without limitation, the representations and warranties and other provisions which the Purchase Agreement provides shall survive the date hereof.

6. In the event that any provision of this Assignment Agreement be construed to conflict with a provision of the Purchase Agreement, the provision in the Purchase Agreement shall be deemed controlling.

7. This Assignment Agreement shall bind and shall inure to the benefit of the respective Parties and their assigns, transferees and successors.

8. This Assignment Agreement shall be construed and enforced in accordance with the laws (other than the conflict of law rules) of the Commonwealth of Pennsylvania.

9. This Assignment Agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together will constitute one and the same instrument.

IN WITNESS WHEREOF, the undersigned have executed this Assignment Agreement as of the date first above written.

AQUASOURCE, INC.

AQUA ACQUISITION  
CORPORATION

By: \_\_\_\_\_  
Name:  
Title:

By: \_\_\_\_\_  
Name:  
Title:



**Exhibit 6.1(n)**

**Monthly Capital Expenditures**

|       |          |
|-------|----------|
| 12/02 | \$20,197 |
| 1/03  | \$22,470 |
| 2/03  | \$24,743 |
| 3/03  | \$27,016 |
| 4/03  | \$29,288 |
| 5/03  | \$31,561 |
| 6/03  | \$33,834 |
| 7/03  | \$36,107 |
| 8/03  | \$38,380 |
| 9/03  | \$40,653 |
| 10/03 | \$42,925 |
| 11/03 | \$45,198 |
| 12/03 | \$47,471 |

**Allocation Schedule**

To be determined by mutual agreement of the Seller and PSC prior to the Closing.

Non-Cancellable Bonds\*

| <u>Principal</u>            | <u>Bond No.</u> | <u>Amount</u> | <u>Prem.</u> | <u>Premium Eff. Date</u> | <u>Premium Exp. Date</u> | <u>Obligee</u>          | <u>Description</u> | <u>Cancellation</u>                    |
|-----------------------------|-----------------|---------------|--------------|--------------------------|--------------------------|-------------------------|--------------------|--|
| <b>COMMERCIAL BONDS:</b>    |                 |               |              |                          |                          |                         |                    |  |
| Earlsville Forest Water Co. | 929 182 355     | \$ 10,000     | \$ 50        | 03/20/02                 | 03/20/03                 | Commonwealth of VA      | **Land Use Permit  | No – It specific permit                |
| Francis L. Paul             | 929 238 016     | \$ 5,000      | \$ 50        | 03/20/02                 | 03/20/10                 | State of Indiana        | Notary             | No<br>Public Service                   |
| AquaSource Utility, Inc.    | 929 131 661     | \$ 30,000     | \$ 53        | 02/22/02                 | 02/22/03                 | Commission So. Carolina | Permit             | No – Release by obligee required       |
| Associated Water Service    | 929 118 003     | \$ 5,000      | \$ 50        | 12/17/01                 | 12/17/02                 | State of Connecticut    | **Permit           | No                                     |
| Cherry Hill Water Company   | 142 453 948     | \$ 25,000     | \$ 63        | 07/14/01                 | 07/14/02                 | Commonwealth of VA      | **Permit           | No – It specific permit                |
| Maxim Sewerage Corporation  | 929 118 013     | \$ 25,000     | \$ 50        | 10/31/00                 | 10/31/02                 | Howell Township         | Permit             | No – continuation certificate annually |

\*Bonds set forth herein are Excepted Liabilities, regardless of the name in which they are held.

\*\*Request Replacement Bond effective date of the Closing.

Forfeiture Obligation – Bond is called if Replacement Bond is not issued before termination grace period of 60 days

(425078)

**Exhibit 7.15(b)**  
**of the Seller Disclosure Schedule**

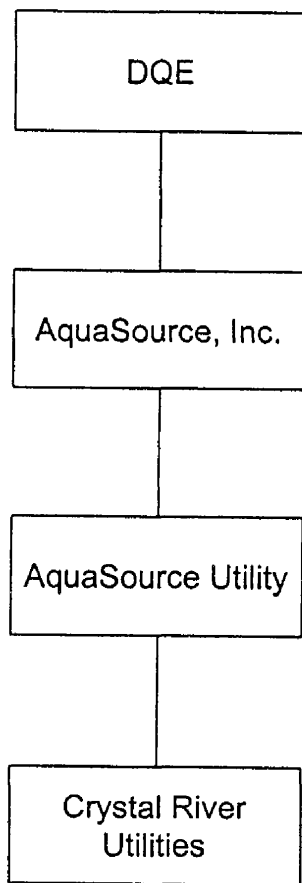
**Cancellable Bonds\***

| <u>Principal</u>                | <u>Bond No.</u> | <u>Amount</u> | <u>Prem.</u> | <u>Premium</u><br><u>Eff. Date</u> | <u>Premium</u><br><u>Exp. Date</u> | <u>Obligee</u>                            | <u>Description</u> | <u>Cancellation</u>   |
|---------------------------------|-----------------|---------------|--------------|------------------------------------|------------------------------------|---|--------------------|---|
| <b><u>COMMERCIAL BONDS:</u></b> |                 |               |              |                                    |                                    |   |                    |   |
| AquaSource                      | 929 182 337     | \$ 5,000      | \$ 50        | 01/11/02                           | 01/11/03                           | City of Ft Wayne                          | Permit             | Yes – 30 days   |
| AquaSource Utility, Inc.        | 929 117 988     | \$200,000     | \$350        | 11/22/01                           | 11/22/02                           | State of North Carolina                   | Permit             | Yes – 60 days – forfeiture  |
| AquaSource Utility, Inc.        | 929 142 054     | \$ 20,000     | \$ 50        | 05/03/01                           | 05/03/02                           | Public Service<br>State of North Carolina | Permit             | Yes – 60 days – forfeiture  |
| Rayco Utilities, Inc.           | 929 219 662     | \$ 10,000     | \$ 50        | 09/13/01                           | 09/13/02                           | State of North Carolina                   | Permit             | Yes – 60 days – forfeiture  |
| AquaSource                      | 929 182 340     | \$ 10,000     | \$ 50        | 01/01/02                           | 01/01/03                           | State of Hawaii                           | Self-Insurer's     | Yes – no specific number days -<br>24 months after cancellation request |
| AquaSource Utility, Inc.        | 929 131 634     | \$ 10,000     | \$ 50        | 01/26/02                           | 01/26/03                           | State of North Carolina                   | Surety             | Yes – 60 days – forfeiture  |
| AquaSource Utility, Inc.        | 929 131 635     | \$260,000     | \$455        | 01/26/02                           | 01/26/03                           | State of North Carolina                   | Surety             | Yes – 60 days – forfeiture  |
| Dolomite Utilities Corp.        | 929 142 051     | \$ 4,825      | \$ 50        | 04/27/01                           | 04/27/02                           | Florida Power & Light                     | Utility Payment    | Yes – 30 days   |

\*Bonds set forth herein are Excepted Liabilities, regardless of the name in which they are held.

(425078)

## PRE-ACQUISITION



## POST-ACQUISITION

