Project Mercury

Preliminary Red Flag Report

Reliance Restricted

03 October 2018 | Version 1.0 (Draft)

Building a better working world

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Preliminary observations

1 Preliminary observations

1 Preliminary observations

Topic	Description
Computation of tax expense for regulatory purposes	► The Company flows through certain temporary items for federal income tax purposes and utilize flow-through more extensively for Pennsylvania state income tax purposes including depreciation. ► The Company has elected out of bonus depreciation in recent years. ► The Company has not adopted a tax repairs method of accounting and continues to largely follow book methodology excluding software.
Impact of Tax Reform on rates	► All deferred tax assets and liabilities at the regulated entities were reset to 21% with the change being recorded to regulatory assets/liabilities for those amounts associated with PP&E (protected). For other amounts (non-protected) – restatement of this deferred tax liability went through income tax expense, as this amounts was deemed immaterial by management. ► It is expected that the amortization of the "protected" excess deferreds will be done via ARAM for the utilities with the exception of Delta which will utilize "reverse south Georgia method". The company is currently working with Powerplan determine the proper ARAM amortization. ► The Company has been deferring the impact of the lower tax rate on 2018 activity through July 1 and will continue to defer until the next rate case. Subsequent to July 1, the company is crediting customers bill for the difference between the 35% and 21% rate using an estimated benefit amount that is subject to true-up.
Other impacts of Tax Reform – Interest Deductibility	► Section 163(j) generally limits interest deductions to the sum of interest income plus 30% of "Adjusted Taxable Income" for the year. For consolidated groups, this interest deduction limitation is generally calculated treating the entire consolidated group as a single entity. Interest expense that is "properly allocable" to a regulated utility business is generally excepted from the limitation. However, where a holding company owns both regulated and non-regulated businesses, uncertainty exists as to determining the amount of the holding company's debt that is "properly allocable" to the regulated businesses. Consequently, there is uncertainty as to the amount of the Company's interest expense that could potentially be limited under Section 163(j). However, Management represented that it anticipates any such limitation to be minimal.

1 Preliminary observations

Topic	Description	Advice/Next steps
Changes in Ownership	▸ If applicable, Section 382 imposes a limitation on the ability for a corporation to utilize NOLs arising prior to an ownership change. For purposes of Section 382, an ownership change generally will arise where there is a shift of greater than 50% of a corporation's ownership during a specified testing period. Consequently, the Company will likely experience an ownership change for purposes of Section 382 as a result of the Proposed Transaction, and future use of NOLs generated prior to the Proposed Transaction may be limited. ▸ In addition, Management represented that the Company experienced an approximately 26.6% shift of ownership as a result of transactions associated with the acquisition of Equitable Gas Company. If there were any additional shifts of ownership with respect to SteelRiver within a limited time frame, the Company may have experienced an ownership change for purposes of Section 382, and use of the Company's NOLs could potentially have been limited in the following years.	▸ Obtain a schedule of NOLs showing the amount generated, utilized, and remaining for each taxable year. ▸ Consider the impact of a Section 382 limitation in the tax model.
▸ **Intercompany Loans**	▸ In 2010, in connection with the initial acquisition of Peoples Natural Gas from Dominion Resources, the Company issued debt between LDC funding LLC and LDC Parent LLC in the form of a note. Subsequent notes were issued in 2011, 2013, and 2017 with the respective acquisitions of T.W. Philips Gas and Oil Company (Peoples Gas LLC), Equitable Gas, and Delta Natural Gas Company Inc. ▸ 2010: \$106M, 10 year maturity, 12% coupon ▸ 2011: \$47M, 10 year maturity, 9% coupon ▸ 2013: \$150M, 10 year maturity, 8% coupon ▸ 2017: \$90M, 30 year maturity, 7.5% coupon ▸ Shareholder debt could give rise to potential concerns over debt versus equity characterization and potential interest limitations.	▸ Obtain requested documentation to understand the magnitude and potential implications of intercompany debt between LDC Funding LLC and LDC Parent LLC.

1 Preliminary observations

Topic	Description	Advice/Next steps
Employment tax fringe benefits for personal use of company vehicles	▸ Under federal tax rules, any fringe benefit provided to employees are taxable and must be included in the recipient's wages unless specifically excludable. In the case of an employer-provided vehicle, under IRS regulations, the employee generally must substantiate the amount of business versus personal use of the vehicle and any unsubstantiated amounts are includable in income as a taxable fringe benefit. However, the IRS does not require the collection of documentation if the company has a specific policy prohibiting personal use and it uses the IRS's commuting rule to calculate the amount of personal use included in taxable wages. ▸ Management represented that the Company does not collect documentation from its employees for personal use of company vehicles, but instead includes amounts related to its employees' daily commute in taxable wages. We requested, but have not been provided, the Company's policy regarding company-issued vehicles and its method to calculate amounts included in taxable wages in order to determine if an exposure exists relative the Company's failure to collect documentation related to employee's personal use of company vehicles.	▸ Review the Company's formal policy regarding company-issued vehicles and its calculation of amounts included in taxable wages to ensure that it conforms to the IRS regulations.

1 Preliminary observations

Topic	Description	Advice/Next steps
Pennsylvania sales and use tax audits	▸ Management stated that Peoples Natural Gas Company, LLC ("Peoples Natural Gas") is currently appealing a Pennsylvania sales and use tax audit for the 2010 through 2013 audit period. Additionally, Management stated that Peoples Gas Company is currently being audited in Pennsylvania for sales/use tax purposes for the 2012 through 2014 audit period. We expect that additional audits are also likely for the periods 2015 to the present. Although Pennsylvania does not impose sales tax on sales of natural gas to residential customers, these Pennsylvania sales and use tax audits are primarily related to assessments for the Company's inability to prove in every instance that residential gas sales were made to end-user residential customers and not, for example, to a landlord that included the cost of the natural gas in the lease of the property (which is not exempt as a residential sale). Management represented that the Company established a $3.9m ASC 450 / FAS 5 reserve for contingent sales taxes related to these audits. Management also stated that it believes that revised internal policies and procedures will mitigate this liability substantially in the future. ▸ We requested, but have not yet been provided with a complete summary of the Company's (a) Pennsylvania sales and use tax audit history by entity, (b) audit work papers and appeals, (c) work papers related to its sales tax reserve calculation and (d) insight as to rate making implications of the recurring tax assessments. The purpose of these requests is to better understand whether the Company's sales tax reserve is materially understated, and whether the Company has effectively mitigated future risk.	▸ Review the requested Pennsylvania sales tax audit documentation and reserve calculation and determine whether the current sales tax reserve is reasonable.
Pennsylvania net operating loss carryforwards	▸ The Company has a Pennsylvania net operating loss (NOL) carryforward balance of approximately $129 million as of December 31, 2017, and Management represented that it has not established a valuation allowance against these NOL carryforwards. In our review of Deloitte's external audit workpapers, we did not observe any indication that the Company provided or that Deloitte reviewed any analysis related thereto. We requested, but have not yet received detailed workpapers regarding the Company's Pennsylvania net operating loss schedule and analysis regarding whether a valuation allowance is required in order to evaluate whether the Company's NOL carryforwards should be subject to a valuation allowance and restricted in their use.	▸ Review the Company's Pennsylvania net operating loss carryforward schedule and valuation allowance analysis.

Project Mercury

Tax Due Diligence Red Flag Report

Reliance Restricted

12 October 2018 | DRAFT

Building a better working world

Reliance Restricted

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Aqua America, Inc.
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Bryn Mawr, PA 19010

Ernst & Young LLP
155 N Wacker Dr.
Chicago, IL 60606

Project Mercury

12 October 2018

Dear Mr. Schuller:

At the request and direction of Aqua America, Inc. ("Aqua" or "you") and in accordance with our Statement of Work dated September 12, 2018, Ernst & Young LLP ("we" or "EY") performed certain due diligence procedures in connection with Company's contemplated acquisition of all of the outstanding membership interests in LDC Funding, LLC (together with its subsidiaries, the "Company") (the "Proposed Transaction"). The procedures performed by us are included in this **draft** report ("Report"). Any differences between the procedures set forth in this Report and those set forth in our Statement of Work reflect modifications that were made at your request or discussed with you during the course of the engagement.

This Report is provided to you for the use and benefit of Aqua. EY expressly authorizes Aqua, and each employee, representative, or other agent thereof, to disclose to any and all persons without limitation of any kind, this Report, including the tax treatment and tax structure of the Proposed Transaction and all materials provided to Aqua relating to such tax treatment and tax structure. This Report, however, is issued to Aqua for the use set forth above and is not to be relied upon by any other person, used by any person in connection with any other transaction, or used for any other purpose without the prior written consent of EY. All such persons to whom disclosures are made must be informed that they may not rely upon our advice without our express written consent.

The Report was not prepared in anticipation of it being provided to third parties. We did not consider the interests of anyone other than the Aqua in performing our work and therefore we may not have addressed issues of relevance to any other party. EY assumes no responsibility to parties other than Aqua.

The procedures that we performed do not constitute an audit of the Company's historical financial statements in accordance with generally accepted auditing standards, nor do they constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants. Also, except for ascertaining that certain information in tabulations and reports received from the Company agreed with the accounting records (as specifically identified in the accompanying memoranda, summaries and schedules), we performed no procedures to evaluate the reliability or completeness of the information obtained. Accordingly, we express no opinion or any other form of assurance on the historical or prospective financial statements, management representations or other data of the Company included in or underlying the accompanying information. While we believe the information obtained is substantially responsive to your request, we are not in a position to assess its sufficiency for your purposes. In any event, this Report was prepared on your specific instructions solely for the purpose of assisting you in connection with the specific tax implications of the Proposed Transaction and should not be relied upon for any other purpose. In addition, we have no responsibility to update this Report for events or circumstances occurring after the date of this Report.

This Report may contain advice or communications that may be privileged under Internal Revenue Code Section 7525 or any similar state or local law. If such information is provided to persons other than Aqua's management, directors, or Aqua's legal counsel involved in its preparation or responsible for determining whether to implement the advice, Aqua may waive such privilege.

We appreciate this opportunity to serve you.

Very truly yours,

[DRAFT]

Dashboard
Table of contents

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Key findings

Key tax insights and recommendations

1 Key findings

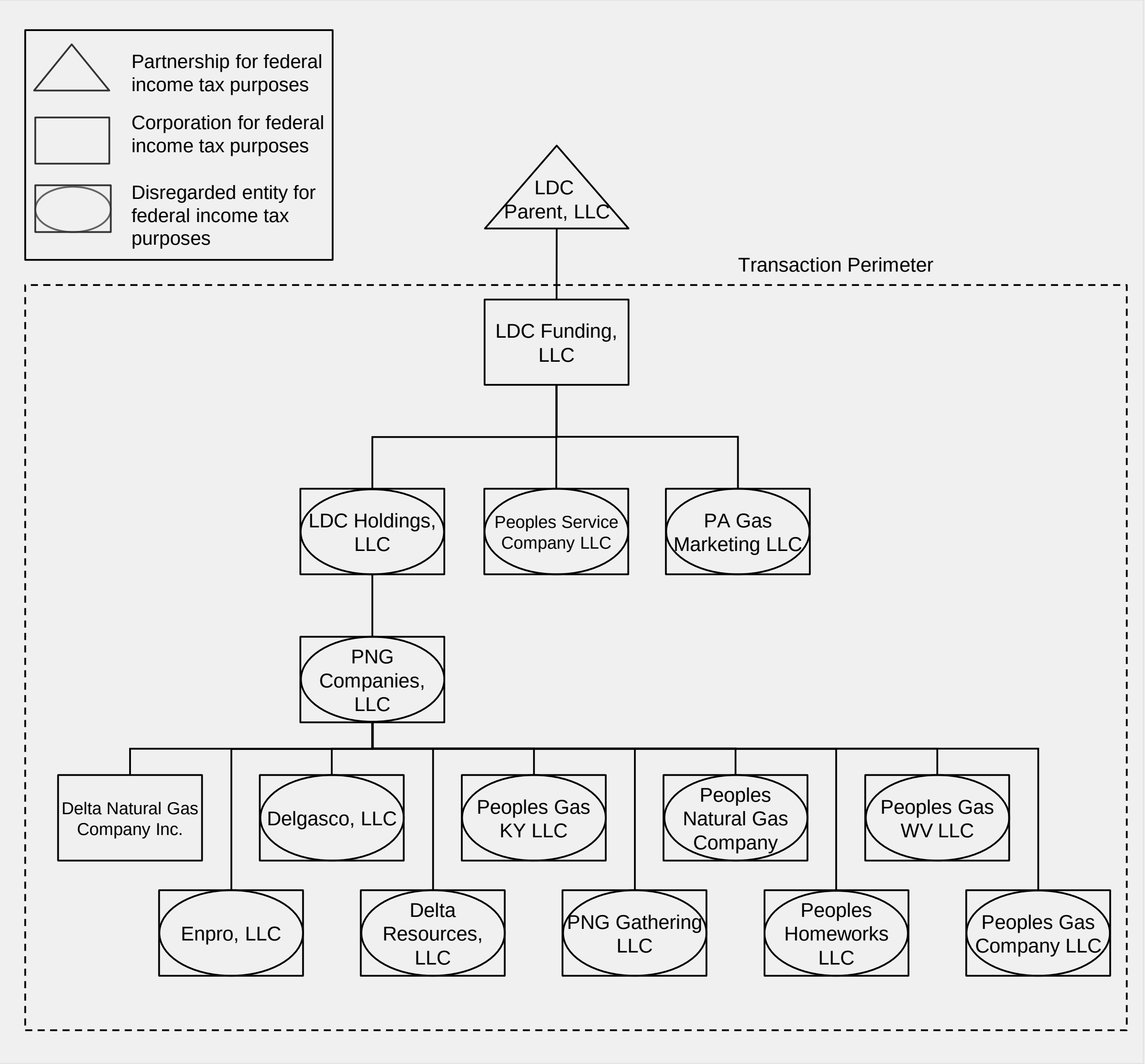
Proposed transaction and legal entity structure

Proposed transaction

- It is our understanding that Aqua America, Inc. is contemplating the acquisition of all of the outstanding membership interests in LDC Funding, LLC. LDC Funding, LLC has made an election to be classified as an association taxable as a corporation for US federal income tax purposes.
- The Proposed Transaction is intended to be treated as a taxable acquisition of stock for US federal income tax purposes. As such, the Company is expected to retain its historic tax attributes, including tax basis in its assets. However, utilization of the Company's tax attributes may be limited following the Proposed Transaction.

Legal entity structure

The legal entity structure of the Company is depicted to the right.



1 Key findings
Executive summary

Pennsylvania sales and use tax audits

$1.5m

The Company may have under-reserved its current ASC 450 / FAS 5 reserve for contingent sales tax liabilities.

More on page 9.

Debt versus equity – shareholder loans

Not quantified

The Company has $393m of outstanding shareholder loans which could be recharacterized as equity. Any such recharacterization would cause the associated interest expense deductions to be disallowed.

More on page 10.

Interest deductibility

Not quantified

New Section 163(j) limits interest deductibility to 30% of adjusted taxable income. However, the Company may have an exception available for interest expense properly allocable to its regulated subsidiaries.

More on page 11.

Section 382 limitations

Not quantified

Section 382 imposes a limitation on the utilization of NOLs generated prior to a change of ownership.

More on page 12.

1 Key findings

Scope of work and scope limitations

Scope of work

At your request, our procedures focused on evaluating the historical tax position of the Company and issues that could result in material tax liabilities you may wish to address prior to or in connection with the closing of the Proposed Transaction. For these purposes, materiality was defined as a cash tax exposure that exceeds $1,000,000 per issue (excluding interest and penalties) per year. In performing the tax due diligence review with respect to the Company, we limited our procedures to those outlined in Appendix C: Procedures performed and examined the documents listed in Appendix D: Documents reviewed for this Report. We relied on the information as provided, supplemented by discussions with and representations made by Management and Tax Advisor.

Our conclusions are based on the technical merits of the Company's various tax positions. Our determination is not intended to reflect the probability of any issue being raised during an audit by the tax authorities, nor is it intended to be an analysis for ASC 740-10 (which includes a codification of FIN 48), ASC 450-20 (formerly FAS 5), or other financial statement purposes or to reflect any particular level of authority for tax return reporting purposes.

Where, in this Report, the word "review" is used, that term is not intended to constitute a review within the scope of any specific standard of any particular regulatory body (e.g., the AICPA Standard for Accounting and Review Services).

The "What's Next?" sections of this Report describe the additional actions we recommend you consider prior to signing, and after closing the Proposed Transaction.

Scope Limitations

This Report does not address tax structuring or other tax advice in connection with the Proposed Transaction. Such advice will be provided separately as requested.

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Tax Analysis

Summary of tax findings

Pennsylvania sales and use tax audits

$1.5m

The Company may have under-reserved its current ASC 450 / FAS 5 reserve for contingent sales tax liabilities.

Peoples Natural Gas Company, LLC ("Peoples Natural Gas") is currently appealing a Pennsylvania sales and use tax audit for the 2010 through 2013 audit period. Additionally, Management stated that Peoples Gas Company, LLC ("Peoples Gas") is currently being audited in Pennsylvania for sales/use tax purposes for the 2012 through 2015 audit period. We expect that additional audits are also likely for tax periods that are open under Pennsylvania law. Management represented that the following statute of limitations remain open: (1) Peoples Natural Gas for 2014 to the present; and (2) Peoples Gas for 2012 to the present. Based upon our review of Deloitte's workpapers, it appears that the Company's ASC 450/FAS 5 positions were scoped outside of Deloitte's external audit.

Although Pennsylvania does not impose sales tax on sales of natural gas to residential customers, these Pennsylvania sales and use tax audits are primarily related to assessments for the Company's inability to prove in every instance that residential gas sales were made to end-user residential customers and not, for example, to a landlord that included the cost of the natural gas in the lease of the property (which is not exempt as a residential sale). Based on our review of the Peoples Natural Gas audit workpapers for the 2010 through 2013 period, it appears the Company was assessed approximately $1.265m in sales/use tax, of which approximately $791k was related to uncollected sales tax on non-exempt sales and approximately $474k related to the Company's failure to pay sales/use tax on taxable purchases.

The Company established a $3.95m ASC 450 / FAS 5 reserve in its financial statements for contingent sales taxes related to uncollected sales tax on non-exempt sales assessed in these audits as well as for post-audit periods. According to the Company's calculation, its ASC 450 reserve is overstated by approximately $400k. Based upon a preliminary review, we did not find a material flaw in the Company's methodology for calculating its ASC 450 reserve. However, we did ask the Company confirmatory questions to ensure that the calculation is consistent with our assumptions which have not been addressed at the date of this report. Depending upon the Company's response to our inquiries, we may need to revise our conclusions.

The sales tax reserve, however, does not appear to include any amounts for unpaid sales/use tax on purchases for either the $474k historical tax assessment or for other potentially open tax periods. Based on the amount assessed for unpaid sales/use tax on purchases during the 2010 through 2013 period, assuming that (i) purchases for Peoples Natural Gas were similar in post-audit periods, (ii) that Peoples Gas also made similar amounts of taxable purchases in 2010 – 2018 as Peoples Natural Gas, and (iii) that Equitable Gas Company, LLC had taxable purchases during these periods that would also result in assessment on audit, as a worst-case proposition, we estimate that the Company could be subject to an additional $1.9m sales/use tax assessment. As the Company's sales tax reserves appear overstated by approximately $400k, overall, we estimate the Company may be under-reserved by as much as $1.5m, exclusive of penalties and interest.

- **Prior to closing, we recommend obtaining appropriate representations, warranties and indemnifications for any pre-close sales and use tax liabilities. Post-closing, we recommend establishing appropriate reserves for taxable purchases and any resulting interest and penalty, as necessary.**

2 Tax Analysis
Key tax observations

Debt versus equity – shareholder loans

The Company currently has outstanding $393m in loans owed to its shareholder, LDC Parent LLC, as a result of four separate notes issued during the years FY10, FY11, FY13 and FY17 in connection with significant acquisitions made by the Company.

Section 385 of the Internal Revenue Code provides that certain interests may be recharacterized as equity rather than debt. Section 385 authorizes the Treasury to prescribe regulations for determining whether an interest should be treated as stock or indebtedness, and lays out five primary factors to be considered:

1. Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
2. Whether there is subordination to or preference over any indebtedness of the corporation,
3. The ratio of debt to equity of the corporation,
4. Whether there is convertibility into the stock of the corporation, and
5. The relationship between holdings of stock in the corporation and holdings of the interest in question.

The Treasury Regulations, however, do not provide specific tests to determine characterization as debt versus equity except in limited circumstances not relevant here. Rather, Treas. Reg. Section 1.385-1(b), provides that treatment of an interest as debt or equity for purposes of the Code is determined based on common law. Common law determinations look to the factors noted above, as well as to a variety of other factors, the most relevant of which include:

- The term of the debt, with a longer term more indicative of equity.
- The interest rate, with a higher rate more indicative of equity.
- Industry standards
- Additional factors related to a company's general credit-worthiness, such as a company's investment grade and debt capacity (including a company's historical ability to service the debt).

Ultimately, the determination of whether an instrument is treated as debt or equity is a balance of all the factors examined.

With respect to the Company's shareholder loans, we have received formal loan documents indicating unconditional promises to pay, on specified dates, specified amounts of money at fixed rates of interest. While we were only provided with financial statements for the Company through FY16, these statements show total long term debt of approximately $1.35b and EBITDA of approximately $273m, indicating an EBITDA multiple of 5 which is within the range of typical EBITDA multiples for regulated utilities. Assuming an EV of approximately $4.7b would indicate a debt to EV percentage of 29%, which is also within the typical range for regulated utilities. Further, the Company has historically been able to service the debt, a strong factor in supporting its debt capacity. Each of the above factors weigh in favor of the debt being treated as true debt for tax purposes, but these factors are not dispositive.

On the other hand, the shareholder loans are subordinated to the rest of the third party debt of the Company, and LDC Parent LLC is both the creditor and the 100% shareholder of the Company. Additionally, the interest rate charged on the loans ranges as high as 12%, slightly higher than typical for a debt instrument and a rate of return more closely associated with equity. However, these facts alone will not disqualify treatment of the loans as true debt.

Additionally, while the two loans made in FY10 and FY11 have a term of 10 years, the loans made in FY13 and FY17 have terms of 20 and 30 years, respectively, which are atypical in the industry except with respect to investment-grade securities, which require a minimum credit rating of BBB-. Here, the Company maintains a credit rating of BBB+, lessening the concern raised by the terms of the FY13 and FY17 loans. However, the credit rating for mezzanine debt would presumably be lower than BBB+.

In balancing the above noted factors, the Company has several factors in favor of treating the shareholder loans as true debt, while the factors indicating equity may potentially be mitigated. Consequently, we would expect a low risk associated with the potential recharacterization of the shareholder loans.

- **We recommend obtaining the appropriate representations and warranties with respect to deductions taken for interest expense related to the Company's shareholder loans.**

2 Tax Analysis
Key tax observations

Interest deductibility

In FY15 and FY16, the Company deducted approximately $79.7m and $77.9m, respectively, of interest expenses. Section 163(j) provides certain limitations on the deductibility of interest, which were modified as a result of the recently enacted Tax Reform.

Old Section 163(j) limitation

Historically, Section 163(j) limited the deductibility of disqualified interest paid or accrued by a corporation to the extent of its excess interest expense, provided that its ratio of debt to equity exceeds 1.5 to 1. For these purposes, disqualified interest includes interest paid to a related person if no tax would be imposed with respect to such interest. Excess interest expense is generally defined to mean the excess of the corporation's net interest expense over the sum of the corporation's adjusted taxable income plus any excess limitation carryforward. Any amount disallowed carries forward to the succeeding taxable year.

Management indicated that the Company was limited under Section 163(j) during FY14, resulting in a carryforward of disallowed interest. During FY15 and FY16, the Company indicated on its federal Form 8926 disqualified interest of approximately $30m each year. However, during these years, the Company reported that it did not have excess interest expense, and consequently, no amount of the disqualified interest was disallowed. Further, the Company has utilized all disallowed interest carryforwards.

New Section 163(j) limitation

As a result of the Tax Cuts and Jobs Act, the new Section 163(j) generally limits the deductibility of interest to 30% of adjusted taxable income for tax years beginning after December 31, 2017. Adjusted taxable income for purposes of the new Section 163(j) limitation is generally equivalent to EBITDA for taxable years beginning before January 1, 2022, and is generally equivalent to EBIT (i.e., taxable income before interest deductions) for the taxable years beginning afterward. However, exceptions to the limitation apply to interest expense which is properly allocable to the trade or business of certain regulated utilities. Where a holding company owns both regulated utilities and other businesses, as is the case with the Company, uncertainty exists as to how the holding company's interest expense is properly allocable. Consequently, we are not able to determine the potential impact of the new Section 163(j) impact on the Company. However, Management represented that it anticipates approximately 90% of the Company's interest to fall under the exception for regulated utilities, and that any limitation under Section 163(j) with respect to the remaining interest expense will be minimal.

- **We recommend conducting an analysis of the Company's interest expense in order to determine the amount properly allocable to the Company's regulated utility businesses, and to determine the potential impact of interest deductibility limitations.**

2 Tax Analysis
Key tax observations

Section 382 limitations

Federal NOLs ($000s)	Generated	Utilized	Remaining
FY10	$51,387	$51,387	-
FY11	$118,039	$46,200	$71,839
FY12	$48,000	-	$48,000
FY13	-	-	-
FY14	$3,873	-	$3,873
FY15	-	-	-
FY16	$9,663	-	$9,663
FY17	-	-	-
Total	**$230,962**	**$97,587**	**$133,375**

**Note, tax returns for the years ending December 31, 2010, December 31, 2011, and December 31, 2012 were subject to an IRS audit in which the Company's NOLs were adjusted. The total presented above for NOLs generated within these respective years account for this adjustment by the IRS. The amount of the IRS adjustments for the years FY10-FY12 were, respectively, $2.00m, $1.41m, and $18.31m.*

Since its formation, the Company has generated approximately $231m total NOLs, of which Management estimates $133m remain to potentially offset future taxable income following FY17. However, where applicable, Section 382 imposes a limitation on the ability for a corporation to utilize NOLs arising prior to an ownership change. For purposes of Section 382, an ownership change may be deemed to occur where, immediately after any owner shift involving a 5-percent shareholder, the percentage of stock owned by one or more 5-percent shareholders has increased by more than 50% over the lowest percentage of stock owned by such shareholders during the testing period. For purposes of determining an ownership change, the testing period is generally three years.

Where an ownership change has occurred, the Section 382 limitation is generally determined as a function of the value of the corporation multiplied by the long-term tax-exempt rate. However, the limitation may be adjusted if the corporation has a net unrealized built-in gain.

Management represented that, in connection with the acquisition of Equitable Gas Company in FY13, the Company experienced a shift of ownership of approximately 26.6% when SteelRiver contributed the Company to a partnership. The Company could possibly have experienced an ownership change if, during the testing period, SteelRiver had also experienced a sufficient shift of ownership. However, Management represented that the ownership of SteelRiver has been stable, and we have no reason to believe that an ownership change took place during the testing period that included the contribution of the Company.

The Proposed Transaction, however, contemplates the acquisition of 100% of the outstanding interests of the Company. Consequently, the Company will likely experience an ownership change for purposes of Section 382, and future use of NOLs generated prior to the Proposed Transaction may be limited. To the extent that the Company is in a net unrealized built-in gain position, however, the Section 382 limitation may be raised.

- **We recommend the Company perform a Section 382 analysis to determine the amount of US NOL carryforwards that will be available post-close.**

2 Tax Analysis
Additional state and local tax matters

Additional state and local tax matters

Pennsylvania net operating loss carryforwards

The Company has a Pennsylvania net operating loss (NOL) carryforward balance of approximately $147m as of December 31, 2017, and Management represented that it has not established a valuation allowance against these NOL carryforwards.

In our review of Deloitte's external audit workpapers, we did not observe any indication that the Company provided or that Deloitte reviewed any analysis related thereto.

We requested, but have not yet received, detailed workpapers regarding the Company's Pennsylvania net operating loss schedule and analysis regarding whether a valuation allowance is required in order to evaluate whether the Company's NOL carryforwards should be subject to a valuation allowance and restricted in their use.

- **Post-closing, we recommend obtaining and reviewing the Company's Pennsylvania net operating loss carryforward schedule and valuation allowance analysis to determine if there is an exposure related to the Company's failure to account for a valuation allowance.**

Employment tax fringe benefits for personal use of company vehicles

Under federal tax rules, any fringe benefit provided to employees are taxable and must be included in the recipient's wages unless specifically excludable. In the case of an employer-provided vehicle, under IRS regulations, the employee generally must substantiate the amount of business versus personal use of the vehicle and any unsubstantiated amounts are includable in income as a taxable fringe benefit.

The Company has a fleet of several vehicles issued to employees for usage in performing services on behalf of the Company, all of which are equipped with GPS systems to track the employee's location and mileage. Management stated that it is the Company's express policy that employees are prohibited from using company-issued vehicles for any personal use, and that the Company includes an amount related to its employees' commute to and from work in taxable wages.

We requested, but have not yet received, the Company's formal written policy statement concerning Company vehicles as well as additional supporting information. Although the Company's policies are generally sufficient to support/substantiate its deduction of vehicle costs for income tax purposes as ordinary and necessary for its business, there is some risk that on audit, the Company could be assessed unpaid employment tax on any amounts deemed taxable wages to the employees in the event the Company cannot adequately support Management's representations.

- **Prior to closing, we recommend obtaining appropriate representations, warranties and indemnifications for any pre-close employment tax liabilities. Post-close, we recommend obtaining all open document requests and perform a detailed review of this information as well as the Company's methodology used to calculate amounts included in employees' taxable wages in order to ensure compliance with federal tax rules.**

2 Tax Analysis

Additional state and local tax matters

Additional state and local tax matters

Potential material amounts of escheatable abandoned/unclaimed property on the Company's balance sheet

Items that a company owes to unrelated third parties may be deemed abandoned (and subject to remittance to the state) after the amount remains unclaimed by the apparent owner for a statutorily defined period of time. For instance, Pennsylvania's general dormancy period for escheatable amounts is three years. The most common items deemed abandoned by holders of unclaimed property are uncashed checks, balances outstanding in the accounts payable ledger, and credit balances within the accounts receivable ledgers.

Based on the EY financial due diligence team's draft report, the Company has an approximately $1m current liability related to uncashed checks since 2016. In general, Management stated that the Company periodically reviews its uncashed check ledger and re-issues checks after they remain uncashed for 90 – 120 days.

Management also represented that the Company will annually "escheat" (or turn over) to Pennsylvania uncashed check balances outside the required dormancy period. As the Company's year-end uncashed check balance continued to increase during 2016, 2017 and 2018 (current), the Company could hold a material amount of escheatable property that may be subject to escheat in 2019.

- **Post-closing, we recommend obtaining and reviewing the Company's historical abandoned/unclaimed property reports as well as its current liability account of uncashed checks. We also recommend reviewing customer deposit account balances that may be subject to special escheat rules. The Company should establish appropriate policies and procedures to evaluate and escheat these and other potential sources of abandoned/unclaimed property and file reports, as required.**

3

What's Next?

Key next steps

3 What's Next?

Timing of recommended next steps

1 Pre-signing

- We recommend Aqua receive a purchase price adjustment for its current under-reserved ASC 450 / FAS 5 for contingent sales tax liabilities. We estimate the Company may be under-reserved by as much as $1.5m, exclusive of penalties and interest.
- We recommend obtaining the appropriate representations and warranties with respect to deductions taken for interest expense related to the Company's shareholder loans.

2 Post-closing

- We recommend establishing appropriate reserves for taxable purchases and any resulting interest and penalty, as necessary.
- We recommend obtaining and reviewing the Company's Pennsylvania net operating loss carryforward schedule and valuation allowance analysis to determine if there is an exposure related to the Company's failure to account for a valuation allowance.
- We recommend obtaining all open document requests and perform a detailed review of this information as well as the Company's methodology used to calculate amounts included in employees' taxable wages in order to ensure compliance with federal tax rules related to business deductions for Company vehicle expenses.
- We recommend obtaining and reviewing the Company's historical abandoned/unclaimed property reports as well as its current liability account of uncashed checks. We also recommend reviewing customer deposit account balances that may be subject to special escheat rules. The Company should establish appropriate policies and procedures to evaluate and escheat these and other potential sources of abandoned/unclaimed property and file reports, as required.
- We recommend conducting an analysis of the Company's interest expense in order to determine the amount properly allocable to the Company's regulated utility businesses, and to determine the potential impact of interest deductibility limitations.
- Consider performing a Section 382 analysis for the Company to determine the amount of US NOL carryforwards that will be available post-close.

4

Appendices

Additional tax background, abbreviations, documents reviewed and procedures

4 Appendices

Appendix A: Additional Company background

Company background

LDC Funding, LLC is a limited liability company formed under the laws of Delaware in 2008. LDC Funding, LLC, ultimately owns an interest in PNG Companies, LLC, which owns the operating companies which are primarily a natural gas distribution utility operating in Pennsylvania, West Virginia, and Kentucky.

The PNG Companies, LLC owns five regulated local gas distribution companies: Peoples Natural Gas Company LLC, Peoples Gas Company LLC, Peoples Gas WV LLC, Peoples Gas KY LLC, and Peoples Delta (formerly Delta Natural Gas Company Inc.). In addition, the PNG Companies, LLC owns five nonregulated subsidiaries: Peoples Homeworks LLC, PNG Gathering LLC, Delta Resources, LLC, Delgasco, LLC, and Enpro, LLC.

Tax function

The Company's US federal and state income tax, sales and use tax, and property tax returns are prepared in-house. Tax Advisor reviews the Company's US federal income tax return prior to filing. The Company utilizes a third-party payroll service provider, ADP, to manage its federal and state employment tax filing and payment obligations.

Tax profile

LDC Funding, LLC is an eligible entity which has elected to be treated as an association taxable as a corporation for US federal income tax purposes under the rules of Treas. Reg. §301.7701-3. Each of the subsidiaries of LDC Funding, LLC is treated as an entity disregarded as separate from its owner for US federal income tax purposes, with the exception of Delta Natural Gas Company, Inc., which is taxable as a corporation.

Prior to the acquisition of Delta Natural Gas Company, Inc. in FY17, LDC Funding, LLC had historically filed as a standalone C corporation. However, the Company expects to file a consolidated return prospectively.

The Company files its returns using the accrual method of accounting, and has a fiscal year end of December 31. The Company reported taxable income for the Historical Tax Period as follows:

Taxable income	FY15	FY16
Taxable income before NOL (line 28)	**$66.3m**	**$(9.7m)**
NOL deduction (line 29)	**$(66.3m)**	**$0**
Taxable income (line 30)	**$0**	**$(9.7m)**

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Appendix A: Additional Company background

Significant acquisitions

In February of 2010, the Company acquired Peoples Natural Gas Company for an adjusted purchase price of approximately $916.6m, according to the Company's FY16 federal Form 1120. In connection with the acquisition, the parties jointly made a Section 338(h)(10) election to treat the acquisition as a purchase of assets.

In May of 2011, the Company acquired T.W. Phillips Gas & Oil Company for an adjusted purchase price of approximately $209.2m, according to the Company's FY16 federal Form 1120. In connection with the acquisition, the parties jointly made a Section 338(h)(10) election to treat the acquisition as a purchase of assets.

In December 2013, the Company acquired Equitable Gas Company LLC and Equitable Homeworks, LLC for an aggregate consideration of $885.1m, according to the Company's FY16 federal Form 1120. A portion of the consideration transferred related to assets of the Company in a transaction treated as a like kind exchange under the rules of Section 1031. In connection with the like kind exchange, the Company obtained a private letter ruling pertaining to the treatment of the like kind exchange for certain regulatory accounting purposes. Each of the entities acquired had been treated as disregarded for US federal income tax purposes, and consequently, the remainder of the acquisition was treated as a purchase of assets.

In September of 2017, the Company acquired Delta Natural Gas Company, Inc. and its subsidiaries for a purchase price of approximately $217.6m, according to the Company's audited financial statements. No election was filed in connection with the acquisition, and the acquisition was treated as a purchase of stock.

Pre-transaction restructuring

In May 2017, a revised structure was proposed while also approving, acquiring, and integrating Delta and its subsidiaries.

<u>Pre-transaction restructuring of the disregarded entities</u>

The May 2017 pre-transaction restructuring was intended to streamline the Company and its subsidiaries. All entities that sit below the Company are disregarded for US federal income tax purposes. Accordingly, the changes to the structure of the Company noted below should also be disregarded for US federal tax purposes.

The following pre-transaction movements have been executed:
- Ownership in Peoples TWP LLC was transferred from LDC Holdings II to PNG Companies LLC, and renamed as Peoples Gas Company LLC.
- LDC Holdings II merged into LDC Holdings.

It is our understanding the following movements are planned but have not yet occurred:
- Liquidation of PA Gas Marketing
- Ownership in Peoples Service Company LLC to be transferred from LDC Funding LLC to PNG Companies, LLC.

<u>Pre-transaction restructuring of Delta</u>

In addition, it is our understanding Delta has caused its subsidiaries to file check-the-box elections to be treated as disregarded entities, and has distributed these entities to PNG Companies, LLC. It is our understanding that each of the Delta Subsidiaries has been 100% owned by Delta. Consequently, each of these elections to be disregarded will likely be treated as a liquidation of a corporate subsidiary under the rules of Sections 332 and 337, causing no gain or loss to be recognized. Further, as Delta was historically a consolidated group, and expects to file consolidated returns with LDC Funding LLC prospectively, under the rules of Treas. Reg. § 1.1502-15, we anticipate no gain or loss to be recognized on the distribution of the Delta Subsidiaries.

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Appendix B: Definitions and abbreviations

Definitions and abbreviations	
AICPA	American Institute of Certified Public Accountants
ASC 450	Accounting Standards Codification 450 (formerly FAS 5), Accounting for Contingencies
ASC 740	Accounting Standards Codification 740 (including codification of FIN48), Accounting for Income Taxes
b	Billion
Client or you	Aqua America, Inc.
Company	Collectively, LDC Funding, LLC and its subsidiaries
Delta	Delta Natural Gas Company, Inc.
Delta Subsidiaries	Delta Resources, Inc.; Delgasco, Inc.; Enpro Inc.
EBIT	Earnings Before Interest & Tax
EBITDA	Earnings Before Interest, Taxes, Depreciation, & Amortization
EV	Enterprise Value
EY or we	Ernst & Young LLP
FAS 5	Financial Accounting Standards No. 5, Accounting for Contingencies
FASB	Financial Accounting Standards Board
FIN 48	FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes
FMV	Fair market value
FYXX	Fiscal Year ended December 31, 20XX
Historical Tax Period	Tax years ended December 31, 2015, 2016, 2017 and the most recent interim period.
IRC or the Code	Internal Revenue Code of 1986, as amended
IRS	Internal Revenue Service
k	Thousand
LLC	Limited Liability Company

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Appendix B: Definitions and abbreviations

Definitions and abbreviations (continued)	
m	Million
Management	Preston Poljak, Senior VP and CFO; Morgan O'Brien, President; Matt Wesolosky, Director, Finance and Regulation
NOL	Net Operating Loss
Proposed Transaction	The acquisition of all of the outstanding stock of LDC Funding, LLC
Report	This tax due diligence report
Section or §	All Section references are to the Code or Regulations issued pursuant to the Code thereunder, unless provided otherwise
SteelRiver	SteelRiver Infrastructure Partners
Tax Advisor	Deloitte Tax LLP
Tax Reform	Tax Cuts and Jobs Act of 2017
Treasury	U.S. Department of the Treasury
US	The United States of America
$	US dollars

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Appendix C: Procedures performed

Tax due diligence procedures performed	Status
General	
Read background materials regarding the Company's operations, including audited financial statements for the Historical Tax Period and any confidential information memoranda and management presentations.	Complete.
Prepare an information request list with respect to tax matters and lead a conference call on tax matters with the Company's management and/or external tax advisors.	Complete.
Inquire as to the Company's legal entity structure, the make-up of current shareholders (e.g., US, foreign, trusts), and changes in recent corporate history, including tax planning strategies implemented or planned.	Complete.
Inquire as to the tax reporting and administrative functions of the Company and the extent the Company relies on external advisors for tax advice, planning, and tax return preparation. Inquire of and discuss with such advisors any significant exposure items or issues.	Complete.
Read copies of tax planning opinions or memoranda, including those provided by third parties, and summaries of tax planning issues.	N/A.
Understand which tax years are open for the Company by jurisdiction and type of tax.	Complete.
Obtain an understanding of significant acquisitions and dispositions during the Historical Tax Period	Complete.
Inquire regarding significant/material related-party transactions, including deferred intercompany transactions, loans, advances, management fees and royalties.	Complete.
Inquire as to the status of any federal, state and local income or non-income tax examinations (whether current, settled, or pending) during the past three years.	Complete.
Inquire as to the Company's tax reserves and any analysis for the Historical Tax Period (FIN 48/ASC 740 and FAS 5/ASC 450 analysis) for US federal, state and local tax purposes.	Complete.
US federal income tax	
Read the Company's federal income tax returns for the Historical Tax Period (or open periods, if longer) including attachments and disclosures, as well as any amended returns or carryback claims for the same periods.	Complete.
Read tax return workpapers for significant income/deduction items and book/tax differences during the Historical Tax Period.	Complete.
Obtain a summary of the Company's tax attributes (e.g., net operating losses and tax credits) utilized during the Historical Tax Period or available at closing, including a description of any expirations or limitations on the utilization of such attributes and roll-out of such attributes. Read prior analyses, if any, with respect to prior ownership changes, IRC Sections 382, 383, 384, SRLY, and whether the Company has a net unrealized built-in gain ("NUBIG") or a net unrealized built-in loss ("NUBIL").	Complete.
Inquire regarding unique accounting methods, changes in accounting methods filed for the Historical Tax Period, and a rollout of any Internal Revenue Code ("IRC") Section 481 adjustments. Read copies of filings to the IRS (Form 3115, Application for Change in Accounting Method) and correspondence from the IRS, if any.	Complete.
With respect to any significant acquisitions, dispositions or internal restructuring transactions undertaken during the Historical Tax Period, read any tax due diligence reports and/or legal opinions prepared in connection with those transactions.	N/A.

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Appendix C: Procedures performed

Tax due diligence procedures performed	Status
US federal income tax (cont'd)	
▶ Read the material terms (e.g., principal, accrued interest, etc.) of the Company's outstanding debt obligations. Understand any differences between the accrual and payment of interest with respect to each obligation. Understand the Company's debt transactions/amendments during the Historical Tax Period and whether they constituted a "significant modification" for US tax purposes.	▶ Complete.
▶ Read correspondence with respect to significant IRS examinations (whether current, settled, or pending) during the Historical Tax Period.	▶ Complete.
▶ Read ruling requests submitted to the IRS within the Historical Tax Period.	▶ Complete.
▶ Understand the Company's revenue recognition policies for US federal income tax purposes.	▶ Complete.
▶ Read any written tax sharing/allocation agreements (including amendments) or a summary of any unwritten tax sharing agreement.	▶ N/A.
▶ Obtain calculations of estimated taxable income for the tax year ended December 31, 2018 and estimated tax payments made. Obtain projected tax calculations, including roll-out of significant deferred tax items (if available).	▶ N/A.
▶ Inquire as to whether the Company has entered into, or was required to report, any listed, reportable, or substantially similar transaction under IRC Section 6011, the Treasury Regulations promulgated thereunder, or as described in recent Internal Revenue Service notices.	▶ Complete.
State and local taxes	
▶ Read state and local income, franchise, gross receipts, and net worth tax returns for the Historical Tax Period, for the five most material states by revenue, including amended returns or carryback claims for the same periods.	▶ Incomplete. Returns only provided for PA income taxes for LDC Funding, LLC and KY income taxes for Delta, for FY15 and FY16.
▶ Inquire whether the Company has filed appropriate state extensions for the most recent tax year.	▶ Complete.
▶ Gain an understanding of the Company's activities in relation to potential state income tax nexus issues and whether the Company is deriving revenue in states, but where the Company is not filing state income/franchise tax returns. Inquire as to the status of any state and local income/franchise/gross receipts/net worth tax examinations (whether current, settled, or pending) during the Historical Tax Period and review the revenue agent reports with respect to such examinations. Evaluate potential exposure/risk associated with such audits.	▶ Complete.
▶ Inquire as to the manner in which the Company distributes its goods and services, including where title passes.	▶ Complete.
▶ Inquire as to how the Company's sales forces are deployed.	▶ Complete.

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Appendix C: Procedures performed

Tax due diligence procedures performed	Status
State and local taxes (cont'd)	
▸ Review correspondence with respect to significant state and local income and franchise tax examinations (whether current, settled, or pending) during the Historical Tax Period.	▸ N/A.
▸ Consider whether there are significant sales made to states where the Company may have sales and use tax filing obligations, but is not collecting and remitting sales or use tax or filing returns.	▸ Complete.
▸ Inquire as to whether the Company maintains adequate and current resale exemption certificates and other documentation to support any claimed exemption from sales or use tax collection (e.g., government and non-profit exemptions).	▸ Complete.
▸ Inquire whether taxable purchases subject to sales and use tax are reported on the Company's sales and use tax returns.	▸ Complete.
▸ Inquire about asset acquisitions during the Historical Tax Period, and determine whether material sales or use tax was due and paid.	▸ Complete.
▸ Read a sampling of sales and use tax filings for the five most material states for the most recent tax period, if available.	▸ N/A.
▸ Review correspondence with respect to significant sales and use tax examinations (whether current, settled, or pending) during the Historical Tax Period.	▸ Complete.
▸ Read a sampling of real and personal property tax returns/renditions and assessments for the five most material states for the most recent tax period, if available.	▸ Complete.
▸ Inquire about real property transfer taxes or real property tax revaluations that may occur upon a transfer or change in control.	▸ Complete.
▸ Review correspondence with respect to significant real and personal property tax examinations (whether current, settled, or pending) during the Historical Tax Period.	▸ N/A.
▸ Read federal and material state employment tax returns for the Historical Tax Period.	▸ Complete.
▸ Inquire as to the Company's expense reimbursement and/or per diem policies and procedures (i.e., lodging, food, travel, etc.).	▸ Complete.
▸ Inquire as to employee travel and the necessary state income tax withholding.	▸ Complete.
▸ Inquire about personal use of Company property (e.g., Company owned automobiles) by employees and shareholders of the Company and how such use is treated for employment tax purposes.	▸ Complete.
▸ Review correspondence with respect to significant employment tax examinations (whether current, settled, or pending) during the Historical Tax Period.	▸ N/A.

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Appendix D: Documents reviewed

Documents reviewed

General

- PNG Companies LLC 2013, 2014, 2015, 2016, and 2017 Financial Statements
- PNG Companies LLC Q4 2017 Financial Statement
- LDC Funding LLC 2015 and 2016 Financial Statements
- LDC Parent Q4 2017 Financial Statements
- PNG Companies LLC & Peoples TWP LLC Business Review Meeting, May 11, 2017
- Peoples Management Presentation, September 2018
- Tax Reform Memo LDC Funding Group
- 2017 Q4 BOD Meeting
- 2016 Peoples Annual Report

US federal income tax

- LDC Funding 2015 and 2016 1120 Combined Return
- Delta 2015, 2016, and 2017 1120 Combined Return
- $106m LDC Funding LLC Note Purchase Agreement, dated February 1, 2010
- $106m LDC Funding LLC 1st Amendment to Note Purchase Agreement dated February 1, 2010, dated May 24, 2011
- $106m LDC Funding LLC Transfer Certificate, dated April 4, 2016
- $106m LDC Funding LLC Senior Note, dated April 1, 2016
- $150m LDC Funding LLC Note Purchase Agreement, dated December 16, 2013
- $150m LDC Funding LLC Transfer Certificate, dated April 4, 2016
- $150m LDC Funding LLC Senior Note, dated April, 1, 2016
- $47m LDC Funding LLC Note Purchase Agreement, dated May 24, 2011

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Appendix D: Documents reviewed

US federal income tax (continued)

- $47m LDC Funding LLC Transfer Certificate, dated April 4, 2016
- $47m LDC Funding LLC Senior Note, dated April 1, 2016
- $90m LDC Funding LLC Note Purchase Agreement, dated December 14, 2017
- $90m LDC Funding LLC Senior Note, dated December 14, 2017
- SteelRiver PNG Companies LLC Note Purchase Agreement, dated February 26, 2010
- PNG Companies LLC Incremental Revolving Amendment & First Amendment, dated December 20, 2017
- PNG Companies LLC Executed First Supplement to Note Purchase Agreement, dated December 12, 2013
- PNG Companies LLC Executed Second Supplement to Note Purchase Agreement, dated July 14, 2017
- PNG Companies LLC Executed Third Supplement to Note Purchase Agreement, dated September 20, 2017
- PNG Companies LLC Executed Fourth Supplement to Note Purchase Agreement, dated November 9, 2017
- PNG Companies LLC Executed Fifth Supplement to Note Purchase Agreement, dated December 20, 2017
- PNG Companies LLC First Amendment to Note Purchase Agreement, dated August 10, 2011
- PNG Companies LLC Second Amendment to Note Purchase Agreement, dated August 23, 2013
- PNG Companies LLC Second Amendment to Note Purchase Agreement, dated November 9, 2010
- PNG Companies LLC Second Amendment and Restated Credit Agreement, dated June 8, 2017
- Joint Ruling Request for LDC Funding LLC and EQT Corporation, dated October 31, 2014
- Joint Ruling Request on Behalf of LDC Funding LLC, dated April 27, 2015
- 2012 LDC Funding RAR, response dated June 22, 2015
- 2010-2011 LDC Funding RAR, response dated September 5, 2014

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Appendix D: Documents reviewed

US federal income tax (continued)

- LDC Funding Carryforwards (.xlsx)
- LDC Funding NOLs (.xlsx)
- Bad Debt Reserve

State and local taxes

- Form RCT 101 (Pennsylvania income/franchise tax return) for tax years 2015 and 2016 (LDC Funding, LLC)
- Form 720 (Kentucky income/franchise tax return) for tax years 2015 and 2016 (Delta Natural Gas Company, LLC)
- Peoples Natural Gas tax calendar and filing summary
- Peoples Natural Gas property tax summary
- Peoples Natural Gas PURTA property tax assessment for tax year 2017
- Peoples WV property tax rendition for tax year 2017
- Delta Natural Gas Company, LLC property tax assessment for tax year 2017
- Delta Natural Gas Company, LLC tax summary by jurisdiction
- Peoples rent expense detail
- Federal Forms 941 for tax years 2016 and 2017
- Sales tax reserve calculation
- Peoples Natural Gas 2010 through 2013 sales tax audit report and schedules