

CONNECTICUT WATER SERVICE INC / CT

Form 10-Q

November 08, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549  
FORM 10-Q**

**(Mark One)**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED September 30, 2006 or**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

**Commission File Number 0-8084**

**Connecticut Water Service, Inc.**

(Exact name of registrant as specified in its charter)

Connecticut  
(State or other jurisdiction of  
incorporation or organization)

06-0739839  
(I.R.S. Employer  
Identification No.)

93 West Main Street, Clinton, CT  
(Address of principal executive offices)

06413-1600  
(Zip Code)

(860) 669-8636

(Registrant's telephone number, including area code)

Not Applicable

(Former name, address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" .

Large accelerated filer ☐ Accelerated Filer ☒ Non-Accelerated Filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes ☐ No ☒

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

8,254,816

Number of shares of common stock outstanding, September 30, 2006 (Includes 57,070 common stock equivalent shares awarded under the Performance Stock Programs)

Financial Report  
September 30, 2006 and 2005  
CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES  
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*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED BALANCE SHEETS**  
**At September 30, 2006 and December 31, 2005**  
**(In thousands)**

|  | September<br>30,<br>2006<br>(Unaudited) | December<br>31,<br>2005<br>(Unaudited) |
|--|---|--|
| <b>ASSETS</b>  |   |  |
| Utility Plant  | \$ 355,664                              | \$ 340,755                             |
| Construction Work in Progress                                    | 1,727                                   | 5,505                                  |
| Utility Plant Acquisition Adjustments                            | (1,273)                                 | (1,273)                                |
|  | 356,118                                 | 344,987                                |
| Accumulated Provision for Depreciation                           | (101,327)                               | (97,284)                               |
| Net Utility Plant  | 254,791                                 | 247,703                                |
| Other Property and Investments                                   | 4,374                                   | 4,542                                  |
| Cash and Cash Equivalents  | 3,257                                   | 4,439                                  |
| Restricted Cash  | 311                                     | 2,628                                  |
| Accounts Receivable (Less Allowance, 2006 - \$257; 2005 - \$256) | 6,261                                   | 5,888                                  |
| Accrued Unbilled Revenues  | 4,145                                   | 3,918                                  |
| Materials and Supplies, at Average Cost                          | 978                                     | 860                                    |
| Prepayments and Other Current Assets                             | 2,768                                   | 1,274                                  |
| Short-Term Investments   |   | 6,815                                  |
| Barlaco Assets Held for Sale                                     |   | 324                                    |
| Total Current Assets   | 17,720                                  | 26,146                                 |
| Unamortized Debt Issuance Expense                                | 7,437                                   | 7,823                                  |
| Unrecovered Income Taxes   | 17,323                                  | 12,986                                 |
| Post-retirement Benefits Other Than Pension                      | 2,569                                   | 1,595                                  |
| Goodwill   | 3,608                                   | 3,608                                  |
| Deferred Charges and Other Costs                                 | 2,010                                   | 1,632                                  |
| Total Regulatory and Other Long-Term Assets                      | 32,947                                  | 27,644                                 |
| <b>Total Assets</b>  | <b>\$ 309,832</b>                       | <b>\$ 306,035</b>                      |

**CAPITALIZATION AND LIABILITIES**

|   |                   |                   |
|---|-------------------|-------------------|
| Common Stockholders' Equity                                     | \$ 96,791         | \$ 94,076         |
| Preferred Stock   | 847               | 847               |
| Long-Term Debt  | 77,349            | 77,404            |
| <b>Total Capitalization</b>                                     | <b>174,987</b>    | <b>172,327</b>    |
| <br>  |                   |                   |
| Current Portion of Long Term Debt                               | 7                 | 2,331             |
| Interim Bank Loans Payable                                      | 6,250             | 4,750             |
| Accounts Payable and Accrued Taxes, Interest and Other Expenses | 2,711             | 5,629             |
| Other Current Liabilities                                       | 542               | 519               |
| <b>Total Current Liabilities</b>                                | <b>9,510</b>      | <b>13,229</b>     |
| <br>  |                   |                   |
| Advances for Construction                                       | 31,298            | 29,355            |
| Contributions in Aid of Construction                            | 45,795            | 45,709            |
| Deferred Federal and State Income Taxes                         | 25,651            | 24,915            |
| Unfunded Future Income Taxes                                    | 13,948            | 11,273            |
| Long-term Compensation Arrangements                             | 7,004             | 7,541             |
| Unamortized Investment Tax Credits                              | 1,639             | 1,686             |
| Commitments and Contingencies                                   |                   |                   |
| <b>Total Long-Term Liabilities</b>                              | <b>125,335</b>    | <b>120,479</b>    |
| <br>  |                   |                   |
| <b>Total Capitalization and Liabilities</b>                     | <b>\$ 309,832</b> | <b>\$ 306,035</b> |

The accompanying notes are an integral part of these financial statements.

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*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED STATEMENTS OF CAPITALIZATION**  
**At September 30, 2006 and December 31, 2005**  
(In thousands, except share data)

|  | September<br>30,<br>2006<br>(Unaudited) | December<br>31,<br>2005<br>(Unaudited) |
|--|---|--|
| Common Stockholders' Equity  |   |  |
| Common Stock Without Par Value Authorized - 15,000,000 Shares;<br>Shares Issued and Outstanding: 2006 - 8,254,816; 2005 - 8,169,627                                | \$ 61,182                               | \$ 59,604                              |
| Stock Issuance Expense   | (1,600)                                 | (1,599)                                |
| Retained Earnings  | 36,946                                  | 35,777                                 |
| Accumulated Other Comprehensive Income   | 263                                     | 294                                    |
| Total Common Stockholders' Equity  | 96,791                                  | 94,076                                 |
| Preferred Stock  |   |  |
| Cumulative Preferred Stock of Connecticut Water Service, Inc.  |   |  |
| Series A Voting, \$20 Par Value; Authorized, Issued and Outstanding 15,000<br>Shares, Redeemable at \$21.00 Per Share  | 300                                     | 300                                    |
| Series \$.90 Non-Voting, \$16 Par Value; Authorized 50,000 Shares Issued<br>and Outstanding 29,499 Shares, Redeemable at \$16.00 Per Share                         | 472                                     | 472                                    |
| Total Preferred Stock of Connecticut Water Service, Inc.   | 772                                     | 772                                    |
| Cumulative Preferred Stock of Barnstable Water Company Voting, \$100 Par<br>Value; Authorized, Issued and Outstanding 750 shares. Redeemable at \$105<br>per share | 75                                      | 75                                     |
| Total Preferred Stock  | 847                                     | 847                                    |
| Long-Term Debt   |   |  |
| Regulated Water Companies  |   |  |
| Unsecured Water Facilities Revenue Refinancing Bonds   |   |  |
| 5.05% 1998 Series A, due 2028  | 9,640                                   | 9,640                                  |
| 5.125% 1998 Series B, due 2028   | 7,635                                   | 7,685                                  |
| 4.40% 2003A Series, due 2020   | 8,000                                   | 8,000                                  |
| 5.00% 2003C Series, due 2022   | 14,930                                  | 14,930                                 |
| Var. 2004 Series Variable Rate, due 2029   | 12,500                                  | 12,500                                 |
| Var. 2004 Series A, due 2028   | 5,000                                   | 5,000                                  |
| Var. 2004 Series B, due 2028   | 4,550                                   | 4,550                                  |
| 5.00% 2005 A Series, due 2040  | 15,000                                  | 15,000                                 |

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|  |                   |                   |
|--|-------------------|-------------------|
| Secured Bonds                            |                   |                   |
| 8.125% Farmington Savings Bank, Due 2011 |                   | 842               |
| 3.56% State of Connecticut, Due 2023     |                   | 1,471             |
| Total Regulated Water Companies          | 77,255            | 79,618            |
| Unregulated Secured                      |                   |                   |
| 8.0% New London Trust, Due 2017          | 101               | 105               |
| Unregulated Note Payable                 |                   |                   |
| 6% Note Payable, Due 2006                |                   | 12                |
| Total Connecticut Water Service, Inc.    | 77,356            | 79,735            |
| Less Current Portion                     | (7)               | (2,331)           |
| Total Long-Term Debt                     | 77,349            | 77,404            |
| <b>Total Capitalization</b>              | <b>\$ 174,987</b> | <b>\$ 172,327</b> |

The accompanying notes are an integral part of these financial statements.

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*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED STATEMENTS OF INCOME**  
**For the Three Months Ended September 30, 2006 and 2005**  
(In thousands, except per share amounts)

|  | <b>2006</b><br><b>(Unaudited)</b> | <b>2005</b><br><b>(Unaudited)</b> |
|--|-----------------------------------|-----------------------------------|
| Operating Revenues   | \$ 13,346                         | \$ 14,088                         |
| Operating Expenses   |                                   |                                   |
| Operation and Maintenance  | 6,759                             | 6,506                             |
| Depreciation   | 1,464                             | 1,434                             |
| Income Taxes   | 509                               | 1,029                             |
| Taxes Other Than Income Taxes  | 1,396                             | 1,325                             |
| Total Operating Expenses   | 10,128                            | 10,294                            |
| Utility Operating Income   | 3,218                             | 3,794                             |
| Other Income, Net of Taxes   |                                   |                                   |
| Gain (Loss) on Property Transactions   | 976                               | 45                                |
| Non-Water Sales Earnings   | 223                               | 186                               |
| Allowance for Funds Used During Construction   | 104                               | 179                               |
| Other  | 84                                | 103                               |
| Total Other Income, Net of Taxes   | 1,387                             | 513                               |
| Interest and Debt Expense  |                                   |                                   |
| Interest on Long-Term Debt   | 841                               | 767                               |
| Other Interest Charges   | 168                               | 171                               |
| Amortization of Debt Expense   | 93                                | 87                                |
| Total Interest and Debt Expense  | 1,102                             | 1,025                             |
| Income from Continuing Operations  | 3,503                             | 3,282                             |
| Income from Discontinued Operations, Net of Tax (Benefit) Expense of \$(253)<br>and \$57 in 2006 and 2005 respectively | 215                               | 46                                |
| Net Income   | 3,718                             | 3,328                             |
| Preferred Stock Dividend Requirement   | 10                                | 10                                |
| Net Income Applicable to Common Stock  | \$ 3,708                          | \$ 3,318                          |

Weighted Average Common Shares Outstanding:

|         |       |       |
|---------|-------|-------|
| Basic   | 8,243 | 8,108 |
| Diluted | 8,250 | 8,141 |

Earnings Per Common Share:

|                               |         |         |
|-------------------------------|---------|---------|
| Basic-Continuing Operations   | \$ 0.42 | \$ 0.40 |
| Basic-Discontinued Operations | 0.03    | 0.01    |

|             |         |         |
|-------------|---------|---------|
| Basic-Total | \$ 0.45 | \$ 0.41 |
|-------------|---------|---------|

|                               |         |         |
|-------------------------------|---------|---------|
| Diluted-Continuing Operations | \$ 0.42 | \$ 0.40 |
|-------------------------------|---------|---------|

|                                 |      |      |
|---------------------------------|------|------|
| Diluted-Discontinued Operations | 0.03 | 0.01 |
|---------------------------------|------|------|

|               |         |         |
|---------------|---------|---------|
| Diluted-Total | \$ 0.45 | \$ 0.41 |
|---------------|---------|---------|

|                            |           |           |
|----------------------------|-----------|-----------|
| Dividends Per Common Share | \$ 0.2150 | \$ 0.2125 |
|----------------------------|-----------|-----------|

The accompanying notes are an integral part of these financial statements.

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*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED STATEMENTS OF INCOME**  
**For the Nine Months Ended September 30, 2006 and 2005**  
**(In thousands, except per share amounts)**

|   | <b>2006</b><br><b>(Unaudited)</b> | <b>2005</b><br><b>(Unaudited)</b> |
|---|-----------------------------------|-----------------------------------|
| Operating Revenues  | \$ 35,232                         | \$ 35,999                         |
| Operating Expenses  |                                   |                                   |
| Operation and Maintenance                                     | 19,685                            | 17,890                            |
| Depreciation  | 4,393                             | 4,304                             |
| Income Taxes  | 732                               | 2,099                             |
| Taxes Other Than Income Taxes                                 | 4,053                             | 3,969                             |
| Total Operating Expenses                                      | 28,863                            | 28,262                            |
| Utility Operating Income                                      | 6,369                             | 7,737                             |
| Other Income, Net of Taxes                                    |                                   |                                   |
| Gain on Property Transactions                                 | 1,880                             | 306                               |
| Non-Water Sales Earnings                                      | 747                               | 644                               |
| Allowance for Funds Used During Construction                  | 355                               | 450                               |
| Other   | 430                               | 177                               |
| Total Other Income, Net of Taxes                              | 3,412                             | 1,577                             |
| Interest and Debt Expense                                     |                                   |                                   |
| Interest on Long-Term Debt                                    | 2,747                             | 2,166                             |
| Other Interest Charges  | 529                               | 426                               |
| Amortization of Debt Expense                                  | 328                               | 260                               |
| Total Interest and Debt Expense                               | 3,604                             | 2,852                             |
| Income from Continuing Operations                             | 6,177                             | 6,462                             |
| Income from Discontinued Operations, Net of Tax (Benefit)     |                                   |                                   |
| Expense of \$(236), and \$1,847 in 2006 and 2005 respectively | 240                               | 2,939                             |
| Net Income  | 6,417                             | 9,401                             |
| Preferred Stock Dividend Requirement                          | 29                                | 29                                |
| Net Income Applicable to Common Stock                         | \$ 6,388                          | \$ 9,372                          |

Weighted Average Common Shares Outstanding:

|         |       |       |
|---------|-------|-------|
| Basic   | 8,217 | 8,078 |
| Diluted | 8,227 | 8,123 |

Earnings Per Common Share:

|                               |         |         |
|-------------------------------|---------|---------|
| Basic-Continuing Operations   | \$ 0.75 | \$ 0.80 |
| Basic-Discontinued Operations | 0.03    | 0.36    |

|             |         |         |
|-------------|---------|---------|
| Basic-Total | \$ 0.78 | \$ 1.16 |
|-------------|---------|---------|

|                               |         |         |
|-------------------------------|---------|---------|
| Diluted-Continuing Operations | \$ 0.75 | \$ 0.79 |
|-------------------------------|---------|---------|

|                                 |      |      |
|---------------------------------|------|------|
| Diluted-Discontinued Operations | 0.03 | 0.36 |
|---------------------------------|------|------|

|               |         |         |
|---------------|---------|---------|
| Diluted-Total | \$ 0.78 | \$ 1.15 |
|---------------|---------|---------|

|                            |           |           |
|----------------------------|-----------|-----------|
| Dividends Per Common Share | \$ 0.6400 | \$ 0.6325 |
|----------------------------|-----------|-----------|

The accompanying notes are an integral part of these financial statements.

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*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**  
**For the Three Months Ended September 30, 2006 and 2005**  
**(In thousands)**

|   | <b>2006</b><br><b>(Unaudited)</b> | <b>2005</b><br><b>(Unaudited)</b> |
|---|-----------------------------------|-----------------------------------|
| Net Income Applicable to Common Stock   | \$ 3,708                          | \$ 3,318                          |
| Other Comprehensive Income, net of tax<br>Qualified Cash Flow Hedging Instrument (Expense) Benefit, net of tax expense<br>(benefit) of \$(85) in 2006; \$78 in 2005 | (127)                             | 122                               |
| Comprehensive Income  | \$ 3,581                          | \$ 3,440                          |

*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**  
**For the Nine Months Ended September 30, 2006 and 2005**  
**(In thousands)**

|  | <b>2006</b><br><b>(Unaudited)</b> | <b>2005</b><br><b>(Unaudited)</b> |
|--|-----------------------------------|-----------------------------------|
| Net Income Applicable to Common Stock  | \$ 6,388                          | \$ 9,372                          |
| Other Comprehensive Income, net of tax<br>Qualified Cash Flow Hedging Instrument (Expense) Benefit, net of tax expense<br>(benefit) of \$(13) in 2006; \$105 in 2005 | (31)                              | 170                               |
| Comprehensive Income   | \$ 6,357                          | \$ 9,542                          |

The accompanying notes are an integral part of these financial statements.

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*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED STATEMENTS OF RETAINED EARNINGS**  
**For the Three Months Ended September 30, 2006 and 2005**  
(In thousands, except per share amounts)

|  | <b>2006</b><br><b>(Unaudited)</b> | <b>2005</b><br><b>(Unaudited)</b> |
|--|-----------------------------------|-----------------------------------|
| Balance at Beginning of Period                               | \$ 35,001                         | \$ 34,955                         |
| Net Income Before Preferred Dividends of Parent              | 3,718                             | 3,328                             |
|  | 38,719                            | 38,283                            |
| Dividends Declared:  |                                   |                                   |
| Cumulative Preferred, Class A, \$.20 per share               | 3                                 | 3                                 |
| Cumulative Preferred, Series \$.90, \$.225 per share         | 7                                 | 7                                 |
| Common Stock - 2006 \$.215 per share; 2005 \$.2125 per share | 1,763                             | 1,713                             |
|  | 1,773                             | 1,723                             |
| Balance at End of Period                                     | \$ 36,946                         | \$ 36,560                         |

*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED STATEMENTS OF RETAINED EARNINGS**  
**For the Nine Months Ended September 30, 2006 and 2005**  
(In thousands, except per share amounts)

|   | <b>2006</b><br><b>(Unaudited)</b> | <b>2005</b><br><b>(Unaudited)</b> |
|---|-----------------------------------|-----------------------------------|
| Balance at Beginning of Period                              | \$ 35,777                         | \$ 32,264                         |
| Net Income Before Preferred Dividends of Parent             | 6,417                             | 9,401                             |
|   | 42,194                            | 41,665                            |
| Dividends Declared:   |                                   |                                   |
| Cumulative Preferred, Class A, \$.60 per share              | 9                                 | 9                                 |
| Cumulative Preferred, Series \$.90, \$.675 per share        | 20                                | 20                                |
| Common Stock - 2006 \$.64 per share; 2005 \$.6325 per share | 5,219                             | 5,076                             |
|   | 5,248                             | 5,105                             |
| Balance at End of Period                                    | \$ 36,946                         | \$ 36,560                         |

The accompanying notes are an integral part of these financial statements.



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*Connecticut Water Service, Inc. and Subsidiaries*  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Nine Months Ended September 30, 2006 and 2005**  
**(In thousands)**

|   | <b>2006</b><br><b>(Unaudited)</b> | <b>2005</b><br><b>(Unaudited)</b> |
|---|-----------------------------------|-----------------------------------|
| Operating Activities:   |                                   |                                   |
| Net Income  | \$ 6,417                          | \$ 9,401                          |
| Discontinued Operations   | 240                               | 2,939                             |
| Income from Continuing Operations   | 6,177                             | 6,462                             |
| Adjustments to Reconcile Net Income to Net Cash   |                                   |                                   |
| Provided by Operating Activities:   |                                   |                                   |
| Gain on Sale of Barlaco Assets Held for Sale  | (921)                             |                                   |
| Allowance for Funds Used During Construction  | (418)                             | (547)                             |
| Depreciation (including \$203 in 2006, \$140 in 2005 charged to other accounts)           | 4,596                             | 4,444                             |
| Change in Assets and Liabilities:   |                                   |                                   |
| Decrease in Accounts Receivable and Accrued Unbilled Revenues                             | (600)                             | (1,321)                           |
| (Increase) Decrease in Other Current Assets   | (1,329)                           | 1,714                             |
| Decrease in Other Non-Current Items   | (1,502)                           | (1,186)                           |
| Decrease in Accounts Payable, Accrued Expenses and Other Current Liabilities              | (1,732)                           | (4,811)                           |
| Increase (Decrease) in Deferred Income Taxes and Investment Tax Credits, Net              | (973)                             | 559                               |
| Total Adjustments   | (2,879)                           | (1,148)                           |
| Net Cash and Cash Equivalents Provided by Continuing Operations                           | 3,298                             | 5,314                             |
| Net Cash and Cash Equivalents Provided by Discontinued Operations                         | 240                               | 1,399                             |
| Net Cash and Cash Equivalents Provided by Operating Activities                            | 3,538                             | 6,713                             |
| Investing Activities:   |                                   |                                   |
| Net Additions to Utility Plant Used in Continuing Operations                              | (10,782)                          | (11,215)                          |
| Proceeds from Sale of Barnstable Water Company Assets (Net of \$78 in Transaction Costs)  |                                   | 9,922                             |
| Sale (Purchase) of Short-term Investments   | 6,815                             | (6,724)                           |
| Release of Restricted Cash  | 2,373                             |                                   |
| Proceeds from Sale of Barlaco Assets Held for Sale (Net of \$3 in Transaction Costs)      | 998                               |                                   |
| Net Cash and Cash Equivalents Used in Investing Activities in Continuing Operations       | (596)                             | (8,017)                           |
| Net Cash and Cash Equivalents Provided by Investing Activities in Discontinued Operations |                                   | (62)                              |



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|   |          |          |
|---|----------|----------|
| Net Cash Used in Investing Activities   | (596)    | (8,079)  |
| Financing Activities:   |          |          |
| Net Proceeds from Interim Bank Loans  | 6,250    | 12,500   |
| Net Repayment of Interim Bank Loans   | (4,750)  | (5,650)  |
| Proceeds from Issuance of Common Stock  | 1,430    | 1,654    |
| Proceeds from Exercise of Stock Options   | 148      |          |
| Repayment of Long-Term Debt Including Current Portion   | (2,380)  | (606)    |
| Costs Incurred to Issue Long-Term Debt and Common Stock   | (1)      | 394      |
| Advances from (Refunds to) Others for Construction  | 432      | 1,488    |
| Cash Dividends Paid   | (5,253)  | (5,105)  |
| Net Cash and Cash Equivalents (Used in) Provided by Financing Activities in Continuing Operations | (4,124)  | 4,675    |
| Net Cash and Cash Equivalents Used in Financing Activities in Discontinued Operations             |          | (3,181)  |
| Net Cash and Cash Equivalents Used in Financing Activities  | (4,124)  | 1,494    |
| Net Increase (Decrease) in Cash and Cash Equivalents  | (1,182)  | 128      |
| Cash and Cash Equivalents at Beginning of Year  | 4,439    | 707      |
| Cash and Cash Equivalents at End of Period  | \$ 3,257 | \$ 835   |
| Non-Cash Investing and Financing Activities Non-Cash Contributed Utility Plant                    | \$ 1,658 | \$ 2,236 |
| Supplemental Disclosures of Cash Flow Information:  |          |          |
| Cash Paid for Continuing Operations During the Year for:  |          |          |
| Interest  | \$ 3,663 | \$ 3,035 |
| State and Federal Income Taxes  | \$ 876   | \$ 3,922 |
| Cash Paid for Discontinued Operations During the Year for:  |          |          |
| Interest  | \$       | \$ 106   |
| State and Federal Income Taxes  | \$ 73    | \$ 410   |

The accompanying notes are an integral part of these financial statements.

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**CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1.** The consolidated financial statements included herein have been prepared by CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES (the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission and reflect all adjustments that are of a normal recurring nature which are, in the opinion of management, necessary to a fair statement of the results for interim periods. Certain information and footnote disclosures have been omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. It is suggested that these consolidated financial statements be read in conjunction with the financial statements and the notes thereto included in the Company's latest annual report on Form 10-K for the period ended December 31, 2005 and as updated in the Company's March 31, 2006 and June 30, 2006 Form 10-Qs.

The results for interim periods are not necessarily indicative of results to be expected for the year since the consolidated earnings are subject to seasonal factors.

Certain reclassifications have been made to conform previously reported data to the current presentation.

Within the Statements of Cash Flows we have revised the classification of certain items to more clearly reflect the Developer Advances and Contributions that regularly occurred within the regulated water subsidiaries for 2005. The non-cash contribution of completed utility plant by developers to the Company has been eliminated from both Investing Activities and Financing Activities. In addition, we have eliminated AFUDC and any accrual of construction costs that had been included in the Operating Activities and Investing Activities sections of the Statements of Cash Flows. The resulting revised classifications have no effect on Net Increase (Decrease) in Cash and Cash Equivalents during the three and nine months ended September 30, 2005.

**2. Stock-Based Compensation**

The Company's 2004 Performance Stock Program (2004 PSP), approved by shareholders in 2004, authorizes the issuance of up to 700,000 shares of Company Common Stock. As of September 30, 2006, there were 644,270 shares available for grant. There are four forms of awards under the 2004 PSP. Stock Options are one form of award. The Company has not issued any stock options since 2003, and does not anticipate issuing any more for the foreseeable future. The other three forms of award which the Company has continued to issue are: Restricted Stock, Performance Shares and Cash Units.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)). SFAS 123(R) replaces SFAS No. 123, Accounting for Stock-Based Compensation and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees.

**STOCK OPTIONS** The Company adopted the provisions of SFAS 123(R) as of January 1, 2006 using the modified prospective transition method, which does not require restatement of prior year results. The resulting impact on the income statement for the three month period ended September 30, 2006 was an expense of approximately \$14,500, net of taxes of \$12,000. The resulting impact on the income statement for the nine month period ended September 30, 2006 was an expense of approximately \$43,500, net of taxes of \$36,000. SFAS 123(R) requires that all share-based payments to employees, including grants of stock options, be recognized as compensation expense in the financial statements based on their fair value.

Prior to January 1, 2006, the Company followed APB 25 and the disclosure requirements for SFAS 123 with pro forma disclosures of net income and earnings per share, as if the fair value-based method of accounting as defined in SFAS 123 has been applied. The Company's consolidated financial statements as of and for the first, second and third quarters of 2006 reflect the impact of adopting SFAS 123(R). The total compensation cost related to non-vested stock option awards not yet recognized is approximately \$25,500, net of tax. These costs are expected to be recognized over the next two years.

For purposes of calculating the fair value of each stock grant at the date of grant, the Company used the Black Scholes Option



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**CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES**

Pricing model. Under the Plans, options begin to become exercisable one year from the date of grant. Vesting periods range from one to five years. The maximum term ranges from five to ten years.

The following table illustrates the effect on Net Income and Earnings Per Share if the Company had applied the fair value recognition provisions of SFAS 123(R) to the stock-based employee compensation for the three and nine months ended September 30, 2005.

|  | Three Months<br>Ended<br>September 30,<br>2005 |
|--|--|
| (in thousands, except for per share data)  |  |
| Net income available to common shareholders  | \$ 3,318                                       |
| Add: Total stock-based employee compensation expense determined under intrinsic value based method for all awards, net of \$18 in related tax effects  | 26   |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of \$22 in related tax effects    | (32)   |
| Pro forma net income   | \$ 3,312                                       |
| Earnings per share:  |  |
| Basic Total, as reported   | \$ 0.41  |
| Basic Total, pro forma   | \$ 0.41  |
| Diluted Total, as reported   | \$ 0.41  |
| Diluted Total, pro forma   | \$ 0.41  |
|  | Nine Months<br>Ended<br>September 30,<br>2005  |
| (in thousands, except for per share data)  |  |
| Net income available to common shareholders  | \$ 9,372                                       |
| Add: Total stock-based employee compensation expense determined under intrinsic value based method for all awards, net of \$117 in related tax effects | 175  |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of \$145 in related tax effects   | (217)  |
| Pro forma net income   | \$ 9,330                                       |
| Earnings per share:  |  |
| Basic Total, as reported   | \$ 1.16  |
| Basic Total, pro forma   | \$ 1.15  |
| Diluted Total, as reported   | \$ 1.15  |
| Diluted Total, pro forma   | \$ 1.15  |

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A summary of option activity under the Company's Stock Option Program as of September 30, 2006, and changes during the nine month period ended September 30, 2006 were as follows:

| <b>Options</b>                    | <b>Number<br/>of<br/>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|-----------------------------------|---------------------------------|--|--|--|
| Outstanding at January 1, 2006    | 202,271                         | \$ 24.04   |  |  |
| Granted                           |                                 |  |  |  |
| Forfeited                         |                                 |  |  |  |
| Exercised                         | (16,962)                        | 16.76  |  |  |
| Outstanding at September 30, 2006 | 185,309                         | \$ 24.70   | 4.9 years  | \$ 100,991                               |
| Exercisable at September 30, 2006 | 158,723                         | \$ 24.15   | 4.7 years  | \$ 100,991                               |

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## CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES

A summary of the status of the Company's non-vested option shares as of September 30, 2006 is presented below:

|                                  | Number<br>of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Price |
|----------------------------------|------------------------|--|
| <b>Non-vested Shares</b>         |                        |  |
| Non-vested at January 1, 2006    | 26,586                 | \$ 28.00                                   |
| Granted                          |                        |  |
| Vested                           |                        |  |
| Forfeited                        |                        |  |
| Non-vested at September 30, 2006 | 26,586                 | \$ 28.00                                   |

**RESTRICTED STOCK** The Company has granted restricted shares of Common Stock and Performance Shares to key members of management under the 2004 PSP. These Common Stock share 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. The value of these restricted shares is based on the market price of the Company's Common Stock on the date of grant and compensation expense is recorded on a straight-line basis over the awards' vesting periods. The adoption of SFAS No. 123(R) had no impact on the Company's recognition of stock-based compensation expense associated with the restricted stock awards. The Company expects future forfeitures of restricted stock to be de minimus. There were no forfeitures during the nine months ended September 30, 2006 nor have there been forfeitures prior to the adoption of SFAS No. 123(R) for the grants that were under restriction as of January 1, 2006.

**RESTRICTED STOCK (non-performance-based awards)** The following tables summarize the non-performance-based restricted stock amounts and activity (in thousands, except for per share data):

|                                  | Number<br>of<br>Shares | Weighted<br>Average<br>Fair<br>Value |
|----------------------------------|------------------------|--------------------------------------|
| <b>Non-vested Shares</b>         |                        |                                      |
| Non-vested at January 1, 2006    | 21,988                 | \$ 25.24                             |
| Granted                          | 4,507                  | \$ 25.00                             |
| Vested                           |                        |                                      |
| Forfeited                        |                        |                                      |
| Non-vested at September 30, 2006 | 26,495                 | \$ 25.20                             |

There were no vested restricted stock shares as of September 30, 2006. The shares start vesting in 2007.

Total stock-based compensation recorded in the statement of income related to the non-performance-based restricted stock awards was \$16,974 and \$49,794 during the three and nine months ended September 30, 2006, respectively. There was no expense recognized in the first nine months of 2005 because the program was initiated in the fourth quarter of 2005.

As of September 30, 2006, \$613,255 of unrecognized compensation costs related to restricted stock is expected to be recognized over a straight-line basis for a period of 6 years. The aggregate intrinsic value of restricted stock as of September 30, 2006 was \$585,000. The aggregate intrinsic value of restricted stock is based on the number of shares

of restricted stock and the market value of the Company's common stock as of the period end date.

*RESTRICTED STOCK (performance-based)* In 2006, 10,875 shares of restricted stock were issued to certain key members of management. The Company is estimating a forfeiture rate of 30%. Upon meeting specific performance targets, 5,510 shares, reduced for actual performance targets achieved in 2006, will begin vesting in the first quarter of 2007 and the remaining earned shares will vest over four years. The cost is being recognized ratably over the vesting period. Total stock-based compensation recorded in the Statements of Income related to the performance-based restricted stock awards was \$29,589 and \$88,751 during the three and nine months ended September 30, 2006, respectively.

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## CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES

**3. Pension and Other Postretirement Benefits****Pension Benefits****Components of Net Periodic Cost**

Three months ended September 30

|                                       | 2006   | 2005   |
|---------------------------------------|--------|--------|
| Service Cost                          | \$ 307 | \$ 262 |
| Interest Cost                         | 420    | 388    |
| Expected Return on Plan Assets        | (386)  | (411)  |
| Amortization of Transition Obligation | 1      | 3      |
| Amortization of Prior Service Cost    | 18     | 24     |
| Amortization of Net (Gain) Loss       | 123    | 81     |
| Net Periodic Benefit Cost             | \$ 483 | \$ 347 |

**Pension Benefits****Components of Net Periodic Cost**

Nine months ended September 30

|                                       | 2006     | 2005     |
|---------------------------------------|----------|----------|
| Service Cost                          | \$ 921   | \$ 787   |
| Interest Cost                         | 1,261    | 1,164    |
| Expected Return on Plan Assets        | (1,377)  | (1,234)  |
| Amortization of Transition Obligation | 2        | 8        |
| Amortization of Prior Service Cost    | 56       | 73       |
| Amortization of Net (Gain) Loss       | 368      | 242      |
| Net Periodic Benefit Cost             | \$ 1,231 | \$ 1,040 |

The Company made a contribution of \$2,450,000 in September 2006 for plan year 2005. In 2007, the Company also anticipates it will make a contribution of approximately \$3,600,000 for plan year 2006.

**Other Postretirement Benefits****Components of Net Periodic Cost**

Three months ended September 30

|   | Connecticut Water |        | Barnstable Water |      |
|---|-------------------|--------|------------------|------|
|   | 2006              | 2005   | 2006             | 2005 |
| Service Cost  | \$ 179            | \$ 145 | \$               | \$ 1 |
| Interest Cost   | 141               | 118    | 1                | 1    |
| Expected Return on Plan Assets                                | (44)              | (40)   |                  |      |
| Amortization of Transition Obligation                         | 30                | 30     | 1                | 1    |
| Recognized Net (Gain) Loss                                    | 104               | 68     | (1)              | (1)  |
| Net Periodic Benefit Cost, Prior to FAS 88 Event              | 410               | 321    | 1                | 2    |
| Additional Amount Recognized Due to Settlement or Curtailment |                   |        |                  |      |



|                           |        |        |      |      |
|---------------------------|--------|--------|------|------|
| Net Periodic Benefit Cost | \$ 410 | \$ 321 | \$ 1 | \$ 2 |
|---------------------------|--------|--------|------|------|

**Other Postretirement Benefits**  
**Components of Net Periodic Cost**  
 Nine months ended September 30

|   | Connecticut Water |        | Barnstable Water |      |
|---|-------------------|--------|------------------|------|
|   | 2006              | 2005   | 2006             | 2005 |
| Service Cost  | \$ 449            | \$ 345 | \$               | \$ 2 |
| Interest Cost   | 364               | 304    | 3                | 4    |
| Expected Return on Plan Assets                                | (134)             | (126)  |                  |      |
| Amortization of Transition Obligation                         | 90                | 90     | 1                | 4    |
| Recognized Net (Gain) Loss                                    | 205               | 123    | (2)              | (2)  |
| Net Periodic Benefit Cost, Prior to FAS 88 Event              | 974               | 736    | 2                | 8    |
| Additional Amount Recognized Due to Settlement or Curtailment |                   |        | 30               |      |
| Net Periodic Benefit Cost                                     | \$ 974            | \$ 736 | \$ 32            | \$ 8 |

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## CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES

**4. Earnings per Share**

Earnings per average common share are calculated by dividing net income applicable to common stock by the average number of shares of common stock outstanding during the respective periods as detailed below (diluted shares include the effect of unexercised stock options):

|   | 3 Months Ended |           | 9 Months Ended |           |
|---|----------------|-----------|----------------|-----------|
|   | 09/30/06       | 09/30/05  | 09/30/06       | 09/30/05  |
| Common Shares Outstanding:                            |                |           |                |           |
| End of period:  | 8,254,816      | 8,124,886 | 8,254,816      | 8,124,886 |
| Weighted Average Shares Outstanding:                  |                |           |                |           |
| Days outstanding basis                                |                |           |                |           |
| Basic   | 8,243,136      | 8,107,567 | 8,217,255      | 8,077,786 |
| Fully Diluted   | 8,249,745      | 8,140,603 | 8,227,465      | 8,122,544 |
| Basic Earnings Per Share from Continuing Operations   | \$ 0.42        | \$ 0.40   | \$ 0.75        | \$ 0.80   |
| Dilutive Effect of Unexercised Stock Options          | \$ 0.00        | \$ 0.00   | \$ 0.00        | \$ 0.01   |
| Diluted Earnings Per Share From Continuing Operations | \$ 0.42        | \$ 0.40   | \$ 0.75        | \$ 0.79   |

**5. Accounting Pronouncements**

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes which prescribes a recognition and measurement threshold process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. This interpretation is effective for fiscal years beginning after December 15, 2006, as such we will be required to adopt this interpretation in the first quarter of 2007. We are in the process of determining the impact, if any, the adoption of FIN 48 will have on our consolidated financial statements and related disclosures.

In September 2006, the SEC staff issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 was issued in order to eliminate the diversity of practice in how public companies quantify misstatements of financial statements, including misstatements that were not material to prior years financial statements. We will initially apply the provisions for SAB 108 in connection with the preparation of our audited financial statements for the fiscal year ending December 31, 2006. We have evaluated the potential impact SAB 108 may have on our financial position and results of operations and do not believe that there will be any impact.

In September 2006, The FASB issued SFAS No. 157 Fair Value Measurements (SFAS 157), which provides guidance on how to measure assets and liabilities that use fair value. SFAS 157 will apply whenever another US GAAP standard requires (or permits) assets or liabilities to be measured at fair value but does not expand the use of

fair value to new circumstances. This standard will also require additional disclosures in both annual and quarterly reports. SFAS 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and as such will be adopted by the Company in the first quarter of 2008. We are currently evaluating the potential impact this standard may have on our financial position and results of operations, but do not believe the impact of the adoption will be material.

In September 2006, the FASB issued SFAS No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment to FASB Statements Nos. 87, 88, 106, and 132(R) (SFAS 158). A portion of SFAS 158 will be effective as of December 31, 2006, and requires companies that have defined benefit pension plans and other postretirement benefit plans to recognize the funded status of those plans on the balance sheet on a prospective basis from the effective date. The funded status of these plans is determined as of the plans measurement dates and represents the difference between the amount of the obligations owed to participants under each plan (including the effects of future salary increases for defined benefit plans) and the fair value of each plans assets dedicated to paying those obligations. To record the funded status of those plans, unrecognized prior service costs, the unrecognized transition obligation and net actuarial gains or losses experienced by the plans will likely be recorded as a regulatory asset, reflecting the appropriate accounting under SFAS 71. We are currently consulting with our actuaries to determine the impact SFAS 158 will have on our December 31, 2006 Balance Sheets.

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## CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES

**6. Segment Reporting**

The Company operates principally in three business segments: water activities, real estate transactions, and services and rentals. Financial data for the segments was as follows in thousands of dollars:

Three Months Ended September 30, 2006

| Segment                  | Revenues  | Pre-tax<br>Income<br>(Loss) | Income<br>Tax | Income<br>from<br>Continuing<br>Operations |
|--------------------------|-----------|-----------------------------|---------------|--|
| Water Activities         | \$ 13,346 | \$ 2,803                    | \$ 499        | \$ 2,304                                   |
| Real Estate Transactions |           | (1)                         | (977)         | 976  |
| Services & Rentals       | 1,043     | 370                         | 147           | 223  |
| Total                    | \$ 14,389 | \$ 3,172                    | \$ (331)      | \$ 3,503                                   |

Three Months Ended September 30, 2005

| Segment                  | Revenues  | Pre-tax<br>Income | Income<br>Tax | Income<br>from<br>Continuing<br>Operations |
|--------------------------|-----------|-------------------|---------------|--|
| Water Activities         | \$ 14,088 | \$ 4,150          | \$ 1,099      | \$ 3,051                                   |
| Real Estate Transactions |           |                   | (45)          | 45   |
| Services & Rentals       | 1,000     | 322               | 136           | 186  |
| Total                    | \$ 15,088 | \$ 4,472          | \$ 1,190      | \$ 3,282                                   |

Nine Months Ended September 30, 2006

| Segment                  | Revenues  | Pre-tax<br>Income | Income<br>Tax | Income<br>from<br>Continuing<br>Operations |
|--------------------------|-----------|-------------------|---------------|--|
| Water Activities         | \$ 35,232 | \$ 4,240          | \$ 690        | \$ 3,550                                   |
| Real Estate Transactions | 1,005     | 573               | (1,307)       | 1,880                                      |
| Services & Rentals       | 3,741     | 1,247             | 500           | 747  |
| Total                    | \$ 39,978 | \$ 6,060          | \$ (117)      | \$ 6,177                                   |

Nine Months Ended September 30, 2005

Income  
from

| Segment                  | Revenues  | Pre-tax  |            | Continuing |
|--------------------------|-----------|----------|------------|------------|
|                          |           | Income   | Income Tax |            |
| Water Activities         | \$ 35,999 | \$ 7,734 | \$ 2,222   | \$ 5,512   |
| Real Estate Transactions | 475       | 427      | 121        | 306        |
| Services & Rentals       | 2,945     | 1,076    | 432        | 644        |
| Total                    | \$ 39,419 | \$ 9,237 | \$ 2,775   | \$ 6,462   |

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## CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES

Assets (by segment) at:

|                                    | <b>September<br/>30,<br/>2006</b> | December<br>31,<br>2005 |
|------------------------------------|-----------------------------------|-------------------------|
| Total Plant and Other Investments: |                                   |                         |
| Water                              | <b>\$ 258,548</b>                 | \$ 251,511              |
| Non-Water                          | <b>617</b>                        | 733                     |
|                                    | <b>259,165</b>                    | 252,244                 |
| Other Assets:                      |                                   |                         |
| Water                              | <b>37,389</b>                     | 46,746                  |
| Non-Water                          | <b>13,278</b>                     | 7,045                   |
|                                    | <b>50,667</b>                     | 53,791                  |
| Total Assets                       | <b>\$ 309,832</b>                 | \$ 306,035              |

**7. Income Tax**

In the third quarter of 2006, the Company reversed \$976,335 of reserves related to its Real Estate Segment. The reserves were initially recorded in relation to an examination by the Internal Revenue Service (IRS) of the Company's Federal Income Tax Returns for the years 2002 - 2004, which focused primarily on the value of land donated by the Company. The Company does not expect to make similar reversals related to tax reserves in future years.

**8. Sale of Barnstable Water Company Assets - Discontinued Operations**

On May 20, 2005, the Company completed the sale of the assets of one of its Massachusetts subsidiaries, the Barnstable Water Company ( BWC ), to the Town of Barnstable, Massachusetts. Upon the closing of the deal, the Town of Barnstable and BWC entered into a one year management contract for BWC to provide the Town with full operating and management services for the water system's operations. Under the terms of the one year management contract, BWC was paid \$130,000 a month for operating and management services performed by BWC for the Town of Barnstable. This management contract could be terminated within the 12 month period by 30 days written notice by either party. In January 2006, the Company received notice of termination. The management contract was terminated on February 7, 2006.

The Company received \$10.0 million in gross proceeds from the sale of its water utility assets, advances, and contribution in aid of construction. The gain, net of income taxes of \$1.6 million, was \$3.0 million in 2005 and has been included in Net Income from Discontinued Operations.

The sale of BWC's assets has been classified as Discontinued Operations in the Consolidated Statements of Income as there will be no continuing involvement due to the termination of the management contract with the Town of Barnstable. All of the results of BWC, including current and prior years and the gain on the sale of the utility's assets, have been reclassified and are included as Discontinued Operations.

**9. Sale of Barlaco Assets**

The agreement the Town of Barnstable entered into with the Company to purchase the BWC assets also included a provision whereby the Town of Barnstable would acquire, through a bargain purchase, all the land owned by BARLACO, another of our Massachusetts subsidiaries, for an additional \$1,000,000. The BARLACO land was sold

in February 2006. The Company has recorded a gain on the bargain land sale for 2006 of \$921,000.

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## CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES

**Part I, Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations  
Regulatory Matters and Inflation**

In February 2006, the Company filed an application with the DPUC to merge all of its Connecticut subsidiaries into Connecticut Water. On April 20, 2006, the DPUC approved these mergers. The Company completed these mergers on May 31, 2006. On July 18, 2006, the Company filed a rate application with the Connecticut Department of Utility Control (DPUC) for the newly merged Connecticut Water requesting an increase in rates of approximately \$14.6 million or 30%. No assurance can be given that the DPUC will approve all of the rate relief requested by the Company. The Company expects a decision in this rate case in mid-January 2007.

In November 2005, the Company announced its plans to acquire South Coventry Water Supply Company, a water company with 131 customers. On June 30, 2006 the Company filed an application with the DPUC for approval of the acquisition. The DPUC approved the merger in September 2006. The acquisition was completed on October 6, 2006.

**Critical Accounting Policies and Estimates**

The Company maintains its accounting records in accordance with accounting principles generally accepted in the United States of America and as directed by the regulatory commissions to which the Company's subsidiaries are subject. Significant accounting policies employed by the Company, including the use of estimates, were presented in the Notes to Consolidated Financial Statements of the Company's Annual Report on Form 10-K.

Critical accounting policies are those that are the most important to the presentation of the Company's financial condition and results of operations. The application of such accounting policies requires management's most difficult, subjective, and complex judgments and involves uncertainties and assumptions. The Company's most critical accounting policies pertain to public utility regulation related to Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation (FAS 71), revenue recognition, and pension plan accounting. Each of these accounting policies and the application of critical accounting policies and estimates was discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 and first and second quarter Forms 10-Q. There were no significant changes in the application of critical accounting policies or estimates during the third quarter of 2006.

Management must use informed judgments and best estimates to properly apply these critical accounting policies. Because of the uncertainty in these estimates, actual results could differ from estimates used in applying the critical accounting policies. The Company is not aware of any reasonably likely events or circumstances which would result in different amounts being reported that would materially affect its financial condition or results of operations.

**Outlook**

The following modifies and updates the Outlook sections of the Company's 2005 Form 10-K filed on March 31, 2006, the first quarter Form 10-Q filed on May 10, 2006 and the second quarter Form 10-Q filed on August 9, 2006.

The Company's earnings and profitability are primarily dependent upon the sale and distribution of water, the amount of which is dependent on seasonal weather fluctuations, particularly during the summer months when water demand will vary with rainfall and temperature levels. The Company's earnings and profitability in current and future years will also depend upon a number of other factors, such as the ability to maintain our operating costs at lower levels, customer growth in the Company's core regulated water utility business, growth in revenues attributable to non-water sales operations, and the timing and adequacy of rate relief when requested, from time to time by our regulated water companies, including the outcome of our rate application to the DPUC which was filed on July 18, 2006. The Company expects a decision in this rate case in mid-January 2007.

The Company believes that the factors described above, as well as those described in Commitments and Contingencies in Item 7 of its Annual Report on Form 10-K may have significant impact, either alone or in the aggregate, on the Company's earnings and profitability



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**CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES**

in fiscal years 2006 and beyond. Please also review carefully the risks and uncertainties described below under the heading "Forward Looking Information".

The projected decline in the Company's 2006 Net Income for Continuing Operations, excluding the gain from the sale of BARLACO assets in February 2006, is primarily attributable to lower net income from the Company's Water Activities segment. The decline in the Water Activities segment is due primarily to increased operating costs, including depreciation on its investment in utility plant, and has required the Company's primary subsidiary, The Connecticut Water Company, to seek rate relief. Based upon appropriate recovery of these costs in a timely manner through DPUC approval of the recent rate increase application, and taking into account the other factors discussed impacting the profitability and earnings, the Company believes that its net income should return to levels achieved in recent years. However, there can be no assurance that the Company will be able to recover costs in an appropriate and timely manner in the DPUC rate proceeding.

**Liquidity and Capital Resources**

The Company is not aware of demands, events, or uncertainties that will result in a decrease of liquidity or a material change in the mix or relative cost of capital resources.

Interim Bank Loans Payable at September 30, 2006 was \$6.25 million.

We consider the current \$15 million lines of credit with three banks adequate to finance any expected short-term borrowing requirements that may arise during the next twelve months. We expect to renew the lines in 2007 and 2008, as appropriate. Interest expense charged on interim bank loans will fluctuate based on market interest rates.

The Company's 2005 year end balances that were in Short-Term Investments of approximately \$6.8 million, and Restricted Cash of approximately \$2.6 million, have been liquidated with the exception of \$311,000 remaining in Restricted Cash. The funds were used to decrease the amount of Interim Bank Loans Payable which otherwise would have increased due to the Company's investment in new Utility Plant.

**Results of Operations**

**The following factors had a significant effect upon the Company's net income for the three months ended September 30, 2006 as compared with the net income for the same period last year.**

Income from continuing operations for the three months ended September 30, 2006 increased from that of the prior year by \$221,000, which led to an increase in earnings from continuing operations per basic average common share of \$0.02 to \$0.42. This increase in income is broken down by business segment as follows:

| <b>Business Segment</b>     | <b>Increase<br/>(Decrease)<br/>Income</b> |
|-----------------------------|---|
| <b>Water Activities</b>     | \$ (747,000)                              |
| <b>Real Estate</b>          | 931,000                                   |
| <b>Services and Rentals</b> | 37,000                                    |
| <b>Total</b>                | \$ 221,000                                |

**Water Activities**

- a \$742,000 decrease in Operating Revenue primarily due to a large decrease in residential revenue due to a decline in consumption directly associated with an unusually hot and dry summer in 2005. Partially off-setting the decrease in residential revenue was an increase in commercial and fire protection revenues.

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**CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES**

- a \$253,000 increase in Operation and Maintenance expense due primarily to the following expense increases (decreases) (in thousands):

|                        |               |
|------------------------|---------------|
| Employee Benefit Costs | \$ 342        |
| Labor                  | 286           |
| Utility Costs          | 51            |
| Outside Services       | (356)         |
| Other                  | (70)          |
| <b>Total</b>           | <b>\$ 253</b> |

- a \$77,000 increase in Interest and Debt Expense due primarily to two new long-term debt issuances in the fourth quarter of 2005 and higher interest rates on the variable rate debt.

Partially offset by the following:

- a \$600,000 decrease in Operating Income Tax Expense primarily due to lower pretax net income and a lower effective tax rate due to flow through accounting related to book/tax timing differences.

**Real Estate**

The \$931,000 increase in the Real Estate Segment's Net Income was due to the completion of the Internal Revenue Service (IRS) examination of the Company's 2002-2004 Federal Income Tax Returns. The Company had recorded reserves for items relating to its Real Estate Segment. The completion of the IRS examination required no adjustment to the Company's 2002-2004 tax liability, as a result, those reserves were eliminated. The impact of this tax benefit has been reported in this quarter's financial results and will not impact future years.

**The following factors had a significant effect upon the Company's net income for the nine months ended September 30, 2006 as compared with the net income for the same period last year.**

Income from continuing operations for the nine months ended September 30, 2006 decreased from that of the prior year by \$285,000, or \$0.05 per basic average common share. This decrease in income is broken down by business segment as follows:

|                             | <b>Increase<br/>(Decrease)<br/>Income</b> |
|-----------------------------|---|
| <b>Business Segment</b>     |   |
| <b>Water Activities</b>     | <b>\$ (1,962,000)</b>                     |
| <b>Real Estate</b>          | <b>1,574,000</b>                          |
| <b>Services and Rentals</b> | <b>103,000</b>                            |
| <b>Total</b>                | <b>\$ (285,000)</b>                       |

**Water Activities**

- a \$1,795,000 increase in Operation and Maintenance expense due primarily to the following expense increases (decreases) (in thousands):

|                        |          |
|------------------------|----------|
| Employee Benefit Costs | \$ 1,130 |
| Labor                  | 891      |
| Utility Costs          | 247      |
| Outside Services       | (681)    |
| Other                  | 208      |

|       |          |
|-------|----------|
| Total | \$ 1,795 |
|-------|----------|

- a \$752,000 increase in Interest and Debt Expense due primarily to two new long-term debt issuances in the fourth quarter of 2005 and higher interest rates on the variable rate debt.

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**CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES**

- a \$767,000 decrease in Operating Revenue primarily due to an unusually hot and dry summer in 2005 which led to lower residential consumption in the first nine months of 2006 as compared to the same period last year. Partially off-setting the decrease in residential revenue was an increase in commercial and fire protection revenues.
- partially offset by a \$1,532,000 decrease in Operating Income Tax Expense primarily due to lower pretax net income and a lower effective tax rate due to flow through accounting related to book/tax timing differences.

**Real Estate**

The \$1,574,000 increase in the Real Estate Segment was primarily due to the sale of the Barlaco land that was sold to the Town of Barnstable in February 2006 and the completion of the IRS examination of the 2002 - 2004 tax years resulting in the elimination of tax reserves associated with the Real Estate Segment. The impact of this tax benefit has been reported in this period's financial results and will not impact future years.

**Services and Rentals**

The \$103,000 increase in the Services and Rentals segment's net income was primarily due to higher revenues from the Company's Linebacker® Service Line Maintenance program and revenues received through the partnership with the University of Connecticut.

**Commitments and Contingencies**

There were no material changes under this subheading to any of the other items previously disclosed by the Company in its Annual Report on Form 10-K for the period ended December 31, 2005 and as updated in the Company's March 31, 2006 and June 30, 2006 Form 10-Qs, other than the item mentioned below.

On July 18, 2006, Connecticut Water Company filed a rate application with the DPUC, requesting an increase in rates of \$14.6 million or approximately 30%. The need for the rate increase is, in part, based upon an investment of approximately \$130 million in Utility Plant since 1991, the time of the Company's last rate increase. In addition, increased operating costs for power, labor and general operating needs are being requested. No assurance can be given that the DPUC will approve all of the rate relief requested by the Company. The Company expects a decision on this rate case in mid-January 2007.

**Forward Looking Information**

This report, including management's discussion and analysis, contains certain forward-looking statements regarding the Company's results of operations and financial position. These forward-looking statements are based on current information and expectations, and are subject to risks and uncertainties, which could cause the Company's actual results to differ materially from expected results.

Our water companies are subject to various federal and state regulatory agencies concerning water quality and environmental standards. Generally, the water industry is materially dependent on the adequacy of approved rates to allow for a fair rate of return on the investment in utility plant. The ability to maintain our operating costs at the lowest possible level, while providing good quality water service, is beneficial to customers and stockholders. Profitability is also dependent on the timeliness and amount of rate relief, including the rate relief sought in the Company's rate case application to the DPUC filed on July 18, 2006, and numerous factors over which we have little or no control, such as the quantity of rainfall and temperature, industrial demand, financing costs, energy rates, tax rates, stock market trends which may affect the return earned on pension assets, and compliance with environmental and water quality regulations. The profitability of our other revenue sources is subject to the amount of land we have available for sale and/or donation, the demand for the land, the continuation of the current state tax benefits relating to the donation of land for open space purposes, regulatory approval of land dispositions, the demand for telecommunications antenna site leases and the successful extensions and expansion of our service contract work. We undertake no obligation to update or revise forward-looking statements, whether as a result of new information, future events, or otherwise.

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**Part I, Item 3: Quantitative and Qualitative Disclosure About Market Risk**

The primary market risk faced by the Company is interest rate risk. The Company has exposure to derivative financial instruments through an interest rate swap agreement. The Company has no other financial instruments with significant credit risk or off-balance sheet risks and is not subject in any material respect to any currency or other commodity risk.

The Company is subject to the risk of fluctuating interest rates in the normal course of business. The Company's exposure to interest fluctuations is managed at the Company and subsidiary operations levels through the use of a combination of fixed rate long-term debt, variable long-term debt and short-term variable borrowings under financing arrangements entered into by the Company and its subsidiaries and its use of the interest rate swap agreement discussed below. The Company has \$15,000,000 of variable rate lines of credit with three banks, under which interim bank loans payable at September 30, 2006 were \$6,250,000.

During March 2004, The Connecticut Water Company entered into a five-year interest rate swap transaction in connection with the refunding of its First Mortgage Bonds (Series V). The swap agreement provides for The Connecticut Water Company's exchange of floating rate interest payment obligations for fixed rate interest payment obligations on a notional principal amount of \$12,500,000. The purpose of the interest rate swap is to manage the Company's exposure to fluctuations in prevailing interest rates. The Company does not enter into derivative financial contracts for trading or speculative purposes and does not use leveraged instruments.

Management does not believe that changes in interest rates will have a material effect on income or cash flow during the next twelve months, although there can be no assurances that interest rates will not significantly change.

**Part I, Item 4: Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

As of September 30, 2006, management, including the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)). Based upon, and as of the date of that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective, in all material respects, to ensure that information required to be disclosed in the reports the Company files and submits under the Securities Exchange Act of 1934 is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding disclosure to be made within the time periods specified in the SEC's rules and forms.

**Changes in Internal Control Over Financial Reporting**

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ending September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

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CONNECTICUT WATER SERVICE, INC. AND SUBSIDIARIES

**Part II, Item 1: Legal Proceedings**

We are involved in various legal proceedings. Although the results of legal proceedings cannot be predicted with certainty, there are no pending legal proceedings to which we or any of our subsidiaries are a party or to which any of our properties is the subject that presents a reasonable likelihood of a material adverse impact on the Company.

**Part II, Item 1A: Risk Factors**

Information regarding risk factors appeared in Item 1A of Part I of our Report on Form 10-K for the fiscal year ended December 31, 2005. There have been no material changes to our risk factors from those disclosed in our Annual Report of Form 10-K for the fiscal year ended December 31, 2005.

**Part II, Item 2: Unregistered Sales of Equity Securities and Use of Proceeds**

No stock repurchases were made during the quarter ended September 30, 2006.

**Part II, Item 5: Other Information**

In May 2006, the Company filed with the DPUC a supply contract application to purchase water from the Regional Water Authority and to treat this purchased water as a receivable from customers, a regulatory asset on which the Company may earn a return. The purpose of the supply contract is to allow the Company to meet future supply needs in a cost-effective manner. On October 25, 2006, the DPUC approved the supply contract, including the treatment of the purchased water as a regulatory asset. It is expected that the contract will become effective in 2008 after securing necessary permits from other state agencies.

In October 2006, the Company announced an agreement with the Avery Heights Water Association (AHWA) to transfer ownership of AHWA's assets and customers to The Connecticut Water Company. The Company intends to interconnect AHWA with the Northern Region. The Company is required to submit a letter of intent with the DPUC outlining the details of the transfer. It will likely take several months before final approval of the transfer is given.

In November 2005, the Company announced its plans to acquire South Coventry Water Supply Company, a water company with 131 customers. On June 30, 2006, the Company filed an application with the DPUC for approval of the acquisition. The DPUC approved the merger in September 2006. The acquisition was completed on October 6, 2006.

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**Part II, Item 6: Exhibits**

| Exhibit<br>Number | Description   |
|-------------------|---|
| 3.1               | Certificate of Incorporation of Connecticut Water Service, Inc. amended and restated as of April, 1998. (Exhibit 3.1 to Form 10-K for the year ended 12/31/98).   |
| 3.2               | By-Laws, as amended, of Connecticut Water Service, Inc. as amended and restated as of August 12, 1999. (Exhibit 3.2 to Form 10-K for the year ended 12/31/99).  |
| 3.3               | Certification of Incorporation of The Connecticut Water Company effective April, 1998. (Exhibit 3.3 to Form 10-K for the year ended 12/31/98).  |
| 3.4               | Certificate of Amendment to the Certificate of Incorporation of Connecticut Water Service, Inc. dated August 6, 2001 (Exhibit 3.4 to Form 10-K for the year ended 12/31/01).                                |
| 3.5               | Certificate of Amendment to the Amended and Restated Certificate of Incorporation of Connecticut Water Service, Inc. dated April 23, 2004. (Exhibit 3.5 to Form 10-Q for the quarter ended March 31, 2003.) |
| 31.1*             | Rule 13a-14 Certification of Eric W. Thornburg, Chief Executive Officer.  |
| 31.2*             | Rule 13a-14 Certification of David C. Benoit, Chief Financial Officer.  |
| 32*               | Certification of Eric W. Thornburg, Chief Executive Officer, and David C. Benoit, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                       |

\* filed herewith

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Connecticut Water Service, Inc.  
(Registrant)

Date: November 8, 2006

By: /s/ David C. Benoit

David C. Benoit  
Vice President Finance, and  
Chief Financial Officer

Date: November 8, 2006

By: /s/ Trudie M. Edwards

Trudie M. Edwards  
Controller