

CONSOLIDATED WATER CO LTD

Form 10-K/A

June 12, 2003

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549**

FORM 10-K/A

(Amendment No. 1)

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the fiscal year ended **December 31, 2002**

OR

o **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: **0-25248**

CONSOLIDATED WATER CO. LTD.

(Exact name of Registrant as specified in its charter)

CAYMAN ISLANDS

N/A

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification No.)

**Trafalgar Place, West Bay Road, P.O.
Box 1114GT, Grand Cayman, B.W.I.**

N/A

(Address of principal executive offices)

(Zip Code)

Registrant's Telephone number, including area code: **(345) 945-4277**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

ORDINARY SHARES, PAR VALUE CI\$1.00

(Title of Class)

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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 for 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this 10-K or any amendments to this Form 10-K. [**Not Applicable**]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of common stock held by non-affiliates of the registrant, based on the closing sales price for the registrant's ordinary shares, as reported on the Nasdaq National Market on June 9, 2003, was \$47,184,689.

As at June 2, 2003, there were 4,275,568 shares of the registrant's ordinary shares outstanding.

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CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350 AS ADOPTED

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Consent of KPMG

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Explanatory Note

This annual report on Form 10-K/A is being filed to amend Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations. Item 8. Financial Statements and Supplementary Data. and Item 14. Disclosure Controls and Procedures. Accordingly, pursuant to Rule 12b-15 under the Securities Act of 1934, as amended, this Form 10-K/A contains the complete text of Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations. Item 8. Financial Statements and Supplementary Data. and Item 14. Disclosure Controls and Procedures as amended.

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Our objective is to provide water services in areas where the supply of potable water is scarce and where the use of RO technology to produce potable water is economically feasible. By focusing on this market, we believe that we can provide a superior financial return to our investors. To increase share value and maintain dividend payouts in accordance with current company policy, we need to expand our revenues by developing new business opportunities both within our current service areas, and in new areas. We need to maintain our high operating efficiencies by adhering to our strict equipment maintenance and water loss mitigation programs in order to achieve gross profit margins between 40% and 45%. We further believe that many Caribbean basin and adjacent countries, while being water scarce, also present opportunities for operation of our plants in limited regulatory settings which are less restrictive than the highly regulated markets of North America, which promotes cost effective operation of our equipment.

Our business operations and activities after our acquisitions in February 2003, are conducted in five countries: the Cayman Islands, Belize, Barbados, the British Virgin Islands and the Bahamas. The recent acquisitions increase our daily water production capacity in the Cayman Islands and the Bahamas and expand our geographic presence to include Barbados and the British Virgin Islands.

Operations Before and After Recent Acquisitions

Operations Before Recent Acquisitions			Operations After Recent Acquisitions		
Location	Plants	Capacity*	Location	Plants	Capacity*
Cayman Islands	3	2.4	Cayman Islands	6	5.3
Bahamas	1	0.1	Bahamas	2	2.7
Belize	1	0.4	Belize	1	0.4
			Barbados	1	1.3
			British Virgin Islands	1	1.2
Total	5	2.9	Total	11	10.9

* Million U.S. gallons of water per day.

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Cayman Islands

We have been operating our business on Grand Cayman Island since 1973 and have been using RO technology to convert seawater to potable water since 1989. There is a limited natural supply of fresh water on the Cayman Islands. We currently have an exclusive license from the Cayman Islands government to process potable water from seawater and then sell and distribute that water by pipeline to Seven Mile Beach and West Bay, Grand Cayman. Prior to our acquisition of Ocean Conversion (Cayman) Limited, our Cayman Islands operations consisted of three reverse osmosis seawater conversion plants in Grand Cayman: the Governor's Harbour plant, the West Bay plant and the Britannia plant. The combined capacity of these plants is 2.4 million U.S. gallons per day. Our pipeline system in the Cayman Islands covers the Seven Mile Beach and West Bay areas of Grand Cayman and consists of approximately 65 miles of polyvinyl chloride pipe. Sales in Grand Cayman are made within our licensed area to approximately 3,100 customers. During 2002, we supplied approximately 523 million U.S. gallons of water in Grand Cayman.

As a result of our recent acquisition of Ocean Conversion (Cayman) Limited, we now operate an additional three reverse osmosis seawater conversion plants in Grand Cayman with a total installed capacity of 2.9 million U.S. gallons per day. Ocean Conversion (Cayman) Limited provides water on a take or pay basis to the Water Authority-Cayman, a government regulatory agency, and to us under various licenses and agreements. Revenues of Ocean Conversion (Cayman) Limited were \$6.2 million for the year ended December 31, 2002.

DesalCo Limited provides management, engineering and construction services for desalination projects and is the exclusive agent for sales of DWEER energy recovery systems for desalination plants in the Caribbean basin for the next seven years. DesalCo Limited, which is recognized by suppliers as an original equipment manufacturer, also acts as the purchasing agent for all companies affiliated with our company. DesalCo Limited's revenues were \$3.4 million for the year ended December 31, 2002.

Belize

Our Belize operation, which was acquired on July 21, 2000, consists of one reverse osmosis seawater conversion plant on Ambergris Caye, Belize, Central America, which is capable of producing 420,000 U.S. gallons per day. We sell water to one customer, Belize Water Services Limited, which then distributes the water through its own distribution system to residential, commercial and tourist properties on Ambergris Caye. During 2002, we supplied approximately 113 million U.S. gallons of water in Belize. Revenues of our wholly owned subsidiary, Belize Water Limited, were \$1.5 million for the year ended December 31, 2002.

Bahamas

Prior to our acquisition of operational control of Waterfields Company Limited, our Bahamas operations consisted of one reverse osmosis seawater conversion plant in Bimini, Bahamas. Our Bimini plant is capable of producing 115,000 U.S. gallons per day and provides potable water to Bimini Sands Resort and to the Bimini Beach Hotel. During 2002, we supplied approximately five million U.S. gallons of water in the Bahamas and revenues were \$0.1 million for the year ended December 31, 2002. We expect the demand for water from our plant in Bimini to increase as additional phases are completed at the Bimini Sands development.

As a result of our acquisition of Waterfields Company Limited, we acquired an additional reverse osmosis seawater conversion plant in the Bahamas. Waterfields produces potable water from one reverse osmosis seawater conversion plant in New Providence and has a total installed capacity of 2.64 million U.S. gallons per day. Waterfields Company Limited provides water on a take or pay basis to the Water and Sewerage Corporation of the Bahamas under a long-term build, own and operate supply agreement. Revenues for Waterfields Company Limited were \$4 million for the year ended December 31, 2002.

Barbados

The recently acquired Barbados operation consists of one reverse osmosis seawater conversion plant with a capacity of 1.3 million U.S. gallons per day which is operated by DesalCo (Barbados) Ltd., the wholly

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owned subsidiary of DesalCo Limited. The plant provides water to the Sandy Lane Resort, and during 2002, supplied approximately 393 million U.S. gallons. DesalCo (Barbados) Ltd. had revenues of \$0.7 million for the year ended December 31, 2002.

British Virgin Islands

We recently entered the market in the British Virgin Islands when our wholly-owned subsidiary, DesalCo Limited acquired operational control and shared management control of Ocean Conversion (BVI) Ltd., which produces potable water from one reverse osmosis seawater conversion plant in Tortola, British Virgin Islands. The plant has a total installed capacity of 1.2 million U.S. gallons per day. Ocean Conversion (BVI) Ltd. provides water on a take or pay basis to the Department of Water and Sewerage of the Ministry of Communications and Works under an agreement with the Government of the British Virgin Islands. Ocean Conversion (BVI) Ltd. s revenues were \$5.4 million for the year ended December 31, 2002.

Our Operations Under the License in the Cayman Islands

Our exclusive operational license was issued to us by the Cayman Islands government under The Water (Production and Supply) Law of 1979. The license terminates, unless further renewed, on July 11, 2010.

Two years prior to the expiration of the license, we have the right to negotiate with the government to extend the license for an additional term. Unless we are in default under the license, the government may not grant a license to any other party without first offering the license to us on terms that are no less favorable than those which the government offers to a third party.

We must provide, within our licensed area, any requested piped water service which, in the opinion of the Executive Council of the Cayman Islands government, is commercially feasible. Where supply is not considered commercially feasible, we may require the potential customer to contribute toward the capital costs of pipe laying (Advances in Aid of Construction). We then repay these advances to the customer, without interest, by way of a discount of 10% on future billings for water sales until this advance in aid of construction has been repaid. We have been installing additional pipeline when we consider it to be commercially feasible, and the Cayman Islands government has never objected to our determination regarding commercial feasibility.

Under the license, we pay a royalty to the government of 7.5% of our gross US gallon potable water sales revenue. The base selling price of water under the license presently varies between \$8.50 and \$22.74 per 1,000 U.S. gallons, depending upon the type and location of the customer and the monthly volume of water purchased. The license provides for an automatic adjustment for inflation/deflation on an annual basis, subject to temporary limited exceptions, and an automatic adjustment for the cost of electricity on a monthly basis. The Water Authority (Cayman), on behalf of government, reviews and approves the calculations of the price adjustments for inflation and electricity costs.

If we want to increase our prices for any reason other than inflation, we have to request prior approval of the Executive Council of the Cayman Islands government. If the parties fail to agree, the matter is referred to arbitration. The last price increase that we requested, other than automatic inflation adjustments since 1990, was granted in full in June 1985.

Demand for Water in the Cayman Islands

In the past, demand on our pipeline distribution has varied throughout the year. However, an increase in year-round tourism in recent years has created more uniform demand for water throughout the year. Demand depends upon the number of tourists visiting the Cayman Islands and the amount of rainfall during any particular time of the year. In general, 75% of tourists come from the United States. Our operating results in any particular quarter are not indicative of the results to be expected for the full year. The table below lists the

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total volume of water we supplied on a quarterly basis for the five years ended December 31, 2002 to all of our customers:

	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
	(in thousands of U.S. gallons)				
First Quarter	140,808	119,115	125,869	107,031	109,255
Second Quarter	145,392	129,305	117,766	113,007	108,334
Third Quarter	118,687	118,733	100,259	90,888	90,950
Fourth Quarter	118,108	106,985	107,404	90,421	92,011
Total	<u>522,995</u>	<u>474,138</u>	<u>451,298</u>	<u>401,347</u>	<u>400,550</u>

Our Operations Under the Contract in Belize

We have entered into a contract with BWSL to supply a minimum of 135,000 US gallons of water per day to BWSL expiring in 2011. At the expiry of the contract, BWSL may at its option extend the term of the agreement or purchase the plant outright.

The base price of water supplied, and adjustments thereto, are determined by the terms of the contract, which provides for adjustments based upon the movement in the government price indices specified in the contract, as well as, monthly adjustments for changes in the cost of diesel fuel and electricity.

We bill on a monthly basis based on metered consumption. Receivables are due within 21 days after the billing date. Interest of 1.5% per year is charged on any delayed payments. As at the date of this Annual Report, BWSL is current on its outstanding balance. We had no bad debts for our Belize sales for the year ended December 31, 2002.

BWSL distributes our water primarily to residential properties, small hotels, and businesses which serve the tourist market.

Demand for Water in Belize

We believe that water sales in Belize are cyclical, and on a similar cycle to sales in the Cayman Islands, since both operations cater to similar tourist markets. We also believe that water sales will be higher in the future since sales were limited before March 2000 because the production capacity of the water plant was lower than demand.

Our sales in Belize were restricted in August, September and October 2001 because of several major component failures at our San Pedro plant. We believe that we could have sold more water during these months if our plant had been able to operate at full capacity. We have taken action to ensure this does not occur again by increasing our inventory of critical spare parts.

The table below lists the total volume of water we supplied to BWSL on a quarterly basis for the three years ended December 31, 2002:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands of U.S. gallons)		
First Quarter	24,751	24,589	17,455*
Second Quarter	30,206	26,519	20,928*
Third Quarter	30,028	21,404	19,507
Fourth Quarter	27,552	21,266	19,624
Total	<u>112,537</u>	<u>93,778</u>	<u>77,514</u>

* Sales made pre-acquisition by Seatec Belize Ltd. Used only for comparison purposes.

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In 2000, we entered into a water supply agreement with South Bimini International Ltd. and began supplying water under this contract on July 11, 2001. Under our agreement South Bimini International Ltd. is committed to pay for a minimum of 3,000 US gallons of water per customer per month (36,000 US gallons per customer per year) on a take or pay basis in relation to the Bimini Sands Resort property in South Bimini Island, Bahamas. The price of water supplied is adjusted for inflation annually based on Bahamas government indices, and adjusted monthly for changes in the cost of electricity.

Demand for Water in Bahamas

We have only been supplying water in Bimini for approximately twenty-one months, to a resort property, which is partially completed and a small 40-room hotel. Currently the resort is comprised of 72 condominiums, and a developing 150-slip marina. By the end of 2003, we anticipate that we will be providing water to an additional 42 condominiums. The resort property is ultimately expected to include over 300 condominium units, a large hotel casino, and a marina that can accommodate twice as many boats as the existing facility. We believe that water sales in Bimini will be cyclical. We expect that our sales will be higher during the summer months when tourists and fisherman arrive from the United States by boat, and when several large angling tournaments are traditionally held in Bimini. We expect that our sales will be lower during winter months when the weather is not conducive to pleasure boat travel from the United States.

The table below lists the total volume of water we supplied to South Bimini International Ltd. on a quarterly basis for the year ended December 31, 2002 and the six month period ended December 31, 2001:

	2002	2001
	(in thousands of U.S. gallons)	
First Quarter	751	
Second Quarter	1,096	
Third Quarter	1,514	449
Fourth Quarter	1,123	551
	—	—
Total	4,484	1,000

Critical Accounting Policies

The preparation of our financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to trade accounts receivable, deferred expenditures, property, plant and equipment and intangible assets. Our company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies are the most important to the portrayal of our financial condition and results and require management's more significant judgments and estimates in the preparation of our company's consolidated financial statements.

Trade accounts receivable: We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Management continuously evaluates the collectibility of accounts receivable and recorded allowances for doubtful accounts based on estimates of the level of actual write-offs which might be experienced. These estimates are based on, among other things, comparisons of the relative age of accounts and consideration of actual write-off history.

Deferred expenditures: These costs were incurred in connection with the recent acquisitions and pending financing transactions. Costs relating to the acquisition will be included as part of the purchase price allocation and our company will seek to repay our existing debt with either new debt, equity or a hybrid financing. If we

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do not proceed with new financing, we may be required to expense the amounts relating to the financing transaction.

Property, plant and equipment: Management makes estimates for the useful life of assets and reviews its policies from time to time. In 2001, we carried out an extensive engineering analysis of our potable water production and distribution equipment in Grand Cayman. As a result of the analysis, management reassessed the useful economic lives of certain assets. The reassessment resulted in reduced depreciation of \$197,472, or \$0.05 per share on a basic and fully diluted basis for the year ended December 31, 2001.

Intangible asset: Intangible assets recorded are amortized over their estimated useful lives and reviewed for impairment in accordance with SFAS No. 142. Management tests for impairment by evaluating the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. Impairment is tested based on projected discounted future cash flows using a discount rate reflecting our average cost of funds. If our estimated projections are greater than our actual results there may be an impairment that has not been reflected in the accounts.

Total Income

Our total income includes water sales and other income from all of our business segments. Water sales income is comprised of retail water sales, via pipeline, to our individual Cayman Islands customers, and bulk water sales to Belize Water Services Limited and South Bimini International Ltd. Other income consists of monthly meter rental charges, sales to companies that deliver water by truck, connection and re-connection charges and interest income. Until February 1, 2002, other income also included settlement fee payments for the supply of water to the Britannia development by the operators of the Hyatt Hotel, which had its own water production facility.

Expenses

Expenses include the cost of water sales (direct expenses) and our indirect, or general and administrative expenses. Direct expenses include royalty payments to the Cayman Islands government; electricity and chemical expenses; payments to Ocean Conversion (Cayman) Limited relating to the operation of the Governor s Harbour plant; production equipment and facility depreciation costs; equipment maintenance and expenses and operational staff costs. Indirect, or general and administrative, expenses consist primarily of salaries and employee benefits for administrative personnel, stock compensation expenses, office lease payments, depreciation on fixed assets used for administrative purposes, legal and professional fees and financing costs. There are no income taxes in the Cayman Islands and we are currently exempt from taxes in Belize. We may be liable for gross revenue tax in the Bahamas as disclosed in Part I, Item 1, under our discussion of our Bahamas operations.

Results of Operations

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001

Total Income

Total income increased by 6.4% from \$11,473,706 to \$12,206,477 for the years ended December 31, 2001 and 2002, respectively. Total income is comprised of water sales and other income.

The Cayman operations increased total income by \$420,901 for the year ended December 31, 2002, which is an increase of 4.1% over the prior year and represents 57.4% of the increase in total income.

The Belize operations increased total income by \$220,618 for the year ended December 31, 2002, which is an increase of 17.5% over the prior year and represents 30.1% of the increase in total income.

The addition of the Bahamas operations as of July 11, 2001 increased total income by \$91,252 for the year ended December 31, 2002, which is an increase of 340.8% over the prior year and represents 12.5% of the increase in total income.

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Water Sales

Total water sales increased by 8.0% from \$11,026,923 to \$11,910,720 for the years ended December 31, 2001 and 2002, respectively. Total water sales increased as a result of several factors detailed below.

Our Cayman operation added \$551,783 to water sales for the year ended December 31, 2002, which is an increase of 5.6% over the prior year and represents 62.4% of the total increase in water sales. The number of U.S. gallons we sold during the year ended December 31, 2002 increased by 10.3% over the prior year. This is the result of supplying water to the Hyatt Hotel and the Britannia golf course. Our water sales to customers other than the Hyatt Hotel and the Britannia golf course were essentially flat when compared to the prior year, despite a 9.4% reduction in tourist air arrivals to the Cayman Islands due to continued air travel concerns and the downturn of the U.S. economy during the year ended December 31, 2002.

Our Belize operation added \$240,323 to water sales for the year ended December 31, 2002, which is an increase of 19.5% over the prior year and represents 27.2% of the total increase in water sales. In June 2002, the automatic inflation adjustment decreased our Belize water rates by an average of 0.08%. This was more than offset by a 20.0% increase in the number of U.S. gallons sold for the year ended December 31, 2002 over the prior year. This increase occurred because during the year ended December 31, 2001, we experienced equipment malfunctions which temporarily reduced the production capacity of our plant by 50%.

The addition of the Bahamas operations as of July 11, 2001 increased water sales by \$91,691 for the year ended December 31, 2002, which is an increase of 348.2% over the prior year and represents 10.4% of the total increase in water sales. This was the result of a 348.4% increase in the number of U.S. gallons sold for the year ended December 31, 2002 over the prior year.

Other Income

Other income decreased by 33.8% from \$446,783 to \$295,757 for the years ended December 31, 2001 and 2002, respectively. This decrease was a result of the February 1, 2002 termination of the dispute settlement agreement with Cayman Hotel and Golf Inc., the owner of the Hyatt Grand Cayman Resort and Britannia golf course. These decreases were partially offset by small increases in meter rental fees, reconnection fees and interest income from excess cash balances and on overdue receivables in our Belize operations.

Cost of Water Sales

Cost of water sales increased by 12.7% from \$6,109,117 to \$6,882,177 for the years ended December 31, 2001 and 2002, respectively, while water sales revenues increased by 8.0% for the year ended December 31, 2002.

Our Cayman operations increased cost of water sales by \$526,748 for the year ended December 31, 2002, which is an increase of 9.9%, compared to an increase of 5.6% in water sales revenue, over the prior year and represents 68.1% of the total increase in cost of water sales. The cost of water sales increased as a result of direct costs incurred to operate the Britannia plant, which was acquired on February 1, 2002. These costs included salaries and benefits for additional staff, equipment maintenance costs, electricity, chemicals and insurance, which will continue now that we operate the Britannia plant. Higher insurance costs also increased cost of water sales due to higher premium rates from our insurance provider, and additional insured values following the purchase of the Britannia plant and the insurance for the full replacement value of all our reverse osmosis desalination plants. Some of this increase was offset, after the Britannia plant was purchased, by a decrease in water purchase costs resulting from lower volume purchases from Ocean Conversion (Cayman) Limited. We were unable to take full advantage of the lower per gallon production costs of the Britannia plant as it only operated at 47.6% capacity in the eleven months that we owned the Britannia plant due to contractual minimum purchase requirements from Ocean Conversion (Cayman) Limited.

Our Belize operation increased cost of water sales by \$144,334 for the year ended December 31, 2002, which is an increase of 20.1%, compared to a 19.5% increase in water sales revenue over the prior year and represents 18.7% of the total increase in cost of water sales. During the year ended December 31, 2002, we completed rebuilding the second diesel engine, in accordance with the engine manufacturer's preventive

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maintenance recommendations, which increased our cost of water sales. Also increasing our cost of water sales in 2002 were additional repairs and maintenance on the existing reverse osmosis equipment. During the year ended December 31, 2002, we also settled various claims for compensation made by our customer in Belize in March 2002. These claims were the result of our equipment failures that occurred in August and September 2001 and a minor miscalculation in the annual inflation adjustment formula in our contract. The miscalculation dated back to November 1995, which was prior to our acquisition of Belize Water Limited, and upon correction, reduced our unit rate for water to our customer by \$0.09 per 1,000 U.S. gallons.

The addition of the Bahamas operations as of July 11, 2001 increased cost of water sales by \$101,978 for the year ended December 31, 2002, which is an increase of 218.7%, compared to an increase of 348.2% in water sales revenue, over the prior year and represents 13.2% of the total increase in cost of water sales. Although this plant still only operated at 17.3% of capacity in 2002, the 2002 improved gross margin illustrates the economies of scale that have been and will continue to be achieved.

Gross Profit

Gross profit margins decreased from 44.6% to 42.2% for the years ended December 31, 2001 and 2002, respectively.

Gross profit margins for our Cayman operations decreased from 45.3% to 43.1% for the years ended December 31, 2001 and 2002, respectively. The primary reasons for this decrease are (i) approximately two thirds of the water produced by our Britannia plant was sold to the Hyatt Hotel and Britannia golf course at a lower rate than our standard commercial water rate, (ii) due to flat water sales to other customers, we were only able to utilize approximately 47.6% of the production capacity of the Britannia plant and (iii) we were not able to acquire water from our lowest priced source as a result of the minimum water purchase obligation we have with Ocean Conversion (Cayman) Limited.

Gross profit margins for our Belize operations decreased from 41.7% to 41.4% for the years ended December 31, 2001 and 2002, respectively. The reason for the decrease in the gross profit margin is increased cost of water sales over prior year periods due to the settlement costs with Belize Water Services Ltd. as discussed above and additional repairs and maintenance on the reverse osmosis equipment in Belize.

Gross profit margin for our Bahamas operations increased from a negative 77.1% to a negative 25.9% for the year ended December 31, 2002. The negative gross profit margins were due to lower than expected water sales resulting from a reduction in tourism and a relatively higher proportion of fixed costs such as depreciation, which we expected in the early phases of the Bimini Sands Resort development project. Both of these are temporary factors and are not expected to continue in the future. Our Bahamas operation has generated positive cash flow since January 2002.

Indirect Expenses

Indirect expenses increased by 5.7% from \$2,600,016 to \$2,747,990 for the years ended December 31, 2001 and 2002, respectively. Indirect expenses were at 22.7% and 22.5% of total income for the year ended December 31, 2001 and 2002, respectively.

Our Cayman operations increased indirect expenses by \$107,890 for the year ended December 31, 2002, which is an increase of 4.5% over the prior year and represents 72.9% of the total increase in indirect expenses. We attribute this increase to our accounting for stock compensation costs, unanticipated professional fees relating to our December 31, 2001 audit and Form 10-K review together with increased insurance premiums on our commercial and directors and officers insurance. Stock compensation costs increased \$266,773 for the year ended December 31, 2002 as a result of an increase in our shares price during the last fiscal quarter. Unanticipated professional fees relating to our December 31, 2001 audit and 10-K review were \$59,311 and our commercial and directors and officers insurance increased by \$78,503. We also had additional reporting costs in 2002 due to increased demand for our annual report and proxy statements. These increases were mostly offset by a reduction in bonus costs and subscription costs for the year ended December 31, 2002 compared to the prior year.

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Our Belize operations increased indirect expenses by \$35,273 for the year ended December 31, 2002, which is an increase of 18.5% over the prior year and represents 23.8% of the total increase in indirect expenses. During the year ended December 31, 2002, we had additional costs as a result of higher insurance premiums and increased costs to repatriate funds.

The addition of the Bahamas operations as of July 11, 2001 increased indirect expenses by \$4,811 for the year ended December 31, 2002 which is an increase of 116.6% over the prior year and represents 3.3% of the total increase in indirect expenses. These costs relate to the administration of the Bahamas operations for a full year.

Net Income

Net income decreased by 6.8% from \$2,764,573 to \$2,576,310 for the years ended December 31, 2001 and 2002, respectively, as a result of the factors indicated above.

Dividends

In December 2001, we increased our per share dividend from \$0.10 to \$0.105 per quarter and have paid dividends in this amount during the year ended December 31, 2002

We have consistently paid dividends to owners of our ordinary and redeemable preferred shares since we began declaring dividends in 1985. Our board of directors has established a policy, but not a binding obligation, that we will seek to maintain a dividend pay out ratio in the range of 50% to 60% of net income. While this policy is subject to modification by our board of directors, we expect to continue increasing our dividends, if our earnings grow. Our payment of any future cash dividends, however, will depend upon our earnings, financial condition, capital demand and other factors, including the condition in our new loan agreement effective February 7, 2003, with Scotiabank (Cayman Islands) Ltd. that dividends be paid only from current cash flows.

Year Ended December 31, 2001 Compared To Year Ended December 31, 2000

Total Income

Total income increased by 14.4% from \$10,025,686 to \$11,473,706 for the years ended December 31, 2000 and 2001, respectively. Total income is comprised of water sales and other income.

Our Cayman operations increased total income by \$626,843 for the year ended December 31, 2001, which is an increase of 6.6% over the prior year and represents 43.3% of the increase in total income.

The addition of the operations of Belize Water Limited as of July 21, 2000 increased total income by \$794,401 for the year ended December 31, 2001, which is an increase of 170.9% over the prior year and represents 54.9% of the increase in total income.

The addition of the Bahamas operations as of July 11, 2001 increased total income by \$26,776 for the year ended December 31, 2001, which represents 1.8% of the increase in total income.

Water Sales

Total water sales increased by 15.1% from \$9,576,959 to \$11,026,923 for the years ended December 31, 2000 and 2001, respectively. Total water sales increased as a result of several factors detailed below.

Our Cayman operation added \$657,784 to water sales for the year ended December 31, 2001, which is an increase of 7.2% over the prior year and represents 45.4% of the total increase in water sales. Of this increase, 70.1% was due to a 5.1% increase in the number of U.S. gallons sold. This increase was due to a larger customer base and increased usage by commercial, residential and government customers, primarily Water Authority-Cayman, which experienced temporary shortfalls in its production capacity. The remaining 29.9% of the increase was due to an

increase in water rates of approximately 2.5% in accordance with our license agreement.

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Our Cayman Island average water rate for the first nine months of 2001 was \$20.54 per thousand U.S. gallons. For the final three months of 2001, our rates were reduced by 1.2% using the Cayman Islands Consumer Price Index automatic adjustment formula contained in our license. Our rates were automatically reduced by 0.39% in January 2002.

Our Belize operation added \$765,847 to water sales for the year ended December 31, 2001, which is an increase of 164.7% over the prior year and represents 52.8% of the total increase in water sales. Virtually all of the increase was due to an additional six months of operations over the prior period. The number of U.S. gallons sold in 2001 was however 21% higher than the annual figures of the prior year due to increased demand from an expansion of the plant completed in March 2000.

The addition of the Bahamas operations as of July 11, 2001 increased water sales by \$26,333 for the year ended December 31, 2001, which represents 1.8% of the total increase in water sales.

Other Income

Other income decreased by 0.4% from \$448,727 to \$446,783 for the years ended December 31, 2000 and 2001, respectively, as a result of a slight decrease in interest income on available cash balances.

Cost of Water Sales

Cost of water sales increased by 12.6%, compared to an increase of 15.1% in water sales revenue, from \$5,423,297 to \$6,109,117 for the years ended December 31, 2000 and 2001, respectively, while our water sales revenue increased by 15.1% for the year ended December 31, 2001.

Our Cayman operations increased cost of water sales by \$171,425 for the year ended December 31, 2001, which is an increase of 3.3%, compared to an increase of 7.2% in water sales revenue, over the prior year and represents 25.0% of the total increase in cost of water sales.

The addition of the operations of Belize Water Limited as of July 21, 2000 increased the cost of water sales by \$467,769 for the year ended December 31, 2001, which is an increase of 186.8%, compared to an increase of 164.7% in water sales revenue, over the prior year and represents 68.2% of the total increase in cost of water sales. This increase in cost of water sales was due to increased water production to meet increased sales and machinery repairs related to the August and September 2001 equipment malfunctions, all of which were remedied in 2002.

The addition of the Bahamas operations as of July 11, 2001 increased cost of water sales by \$46,626 for the year ended December 31, 2001, which represents 6.8% of the total increase in cost of water sales.

Gross Profit

Gross profit margins increased from 43.4% to 44.6% for the years ended December 31, 2000 and 2001, respectively.

Gross profit margins for our Cayman operations increased from 43.2% to 45.3% for the years ended December 31, 2000 and 2001, respectively, as a result of decreased depreciation expense of approximately \$197,000 from our reassessment of the useful economic lives of certain assets and increased plant efficiencies. These lower expenses were offset by additional labor costs associated with plant maintenance, increased insurance premiums and an additional six months of intangible amortization of the purchase price of the Belize water supply contract.

Gross profit margins for our Belize operations decreased from 46.2% to 41.7% for the years ended December 31, 2000 and 2001, respectively, as a result of diesel engine repair costs and higher electricity costs resulting from the temporary utilization of a less efficient electric motor during the repair period.

Gross profit margin for our Bahamas operations for the year ended December 31, 2001 was a negative 77.1%. This was due to low water sales and a relatively higher proportion of fixed costs such as depreciation,

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which we expected in the early phases of the Bimini Sands Resort development project. Both of these are temporary factors and are not expected to continue in the future.

Indirect Expenses

Indirect expenses increased by 18.3% from \$2,197,569 to \$2,600,016 for the years ended December 31, 2000 and 2001, respectively. Indirect expenses were at 21.9% and 22.7% of total income for the years ended December 31, 2000 and 2001, respectively.

Our Cayman operations increased indirect expenses by \$240,830 for the year ended December 31, 2001, which is an increase of 11.1% over the prior year and represents 59.9% of the total increase in indirect expenses. Of this increase, 49.0% is due to the creation of a new executive position, Director of Special Projects.

Our acquisition of Belize Water Limited as of July 21, 2000 increased indirect expenses by \$157,491 for the year ended December 31, 2001, which is an increase of 471.2% over the prior year and represents 39.1% of the total increase in indirect expenses. This increase was primarily due to an additional six months of indirect expenses over the previous period and the reallocation of certain employee duties.

The addition of the Bahamas operations as of July 11, 2001 increased indirect expenses by \$4,126 for the year ended December 31, 2001, which represents 1.0% of the total increase in indirect expenses. These costs related to the administration of the Bahamas operations.

Net Income

Net income increased by 15.0% from \$2,404,820 to \$2,764,573 for the years ended December 31, 2000 and 2001, respectively as a result of the movements indicated above.

Dividends

In December 2000, we increased our per share dividend to ordinary shareholders from \$0.08 to \$0.10 per quarter and have paid dividends in the amount during the year ended December 31, 2001.

Reassessment of Useful Economic Lives of Property, Plant and Equipment

During the year ended December 31, 2001, we carried out an extensive engineering analysis of our potable water production and distribution equipment in Grand Cayman. As a result of the analysis, management reassessed the useful economic lives of certain assets. The reassessment resulted in reduced depreciation of \$197,472, or \$0.05 per share on a basic and fully diluted basis for the year ended December 31, 2001. The assets affected and the basis for management's decisions are described below:

Seven Mile Beach Distribution System

During 2001, we revised our master distribution plan that was originally set out in 1997. In doing so, we determined that a previously planned relocation of our Governor's Harbour reverse osmosis plant was no longer advantageous. Therefore, the removal and relaying of pipeline to the service area in conjunction with this relocation was no longer needed. Furthermore, we determined that certain planned pipeline replacements were not necessary. Finally, the government revised its plans for significant road improvements in the service area, therefore, alleviating anticipated major changes to our Seven Mile Beach distribution system.

As a result of the above plan reassessments, we concluded that a pipeline with the characteristics of our Seven Mile Beach Distribution System would have a useful economic life of 40 years. We, therefore, extended the useful economic life of this system from 20 to 40 years. Fourteen years have elapsed to date.

Governor's Harbour Vapor Compression (VC) Building

As discussed above, we previously planned to relocate our Governor's Harbour plant, which would have resulted in the removal of the VC building in which it was housed. When we determined that the plant should

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remain in its current location in 2001, we reassessed the building's useful life. Giving consideration to our plans to use the building in the future, the high-quality construction and foundation of the building, as well as the fact that it accommodates large high-pressure pumps for the plant, we concluded that the building had a remaining useful economic life of 20 years from 2001. Two years have elapsed since this useful economic life was determined.

Distribution System Meters

Our policy is to replace customer water meters according to manufacturer recommendations, which suggest replacement based on service years or water volume. The manufacturer of our water meters advised us that they were extending the guarantee for a certain model to cover higher volumes and a longer period of time. Based on the revised guarantee, we reassessed the useful economic lives of all such models in service, to 10 years being the mid-point of a guaranteed time-frame of 6 to 15 years.

Vermeer Trencher

We own a Vermeer trencher to construct water distribution pipelines within our franchise area. As discussed above, we originally planned to make major changes to our distribution system as a result of a proposed relocation of our Governor's Harbour plant and significant road improvements planned by the government. These projects would have required heavy utilization of this asset. Given the changes in plans identified above and the minor projects for which the trencher will be required, we reassessed the useful economic life to be 20 years. Four years have elapsed to date.

West Bay Reverse Osmosis Plant

Our West Bay reverse osmosis plant was manufactured and installed in 1995 and expanded in 1998 with state-of-the-art technology. At the time, we had concerns about potential accelerated obsolescence of the equipment because of continuing research and development in the reverse osmosis field, and as such, the original useful economic life was determined to be 10 years. In 2001, we concluded with management that there were no indicators that significant changes were pending in the industry. Given the like-new condition of the plant, its three year history of meeting operational requirements and expected future use, management reassessed the remaining useful economic life of the West Bay Plant to be 12 years. Two years have elapsed to date.

Liquidity and Capital Resources

Overview

Prior to our completion of the recent acquisitions, we generated cash primarily from our operations in the Cayman Islands, the Bahamas and Belize and, to a lesser extent, from the sale of our shares and through loans and credit facilities obtained from two banks. As a result of our recent acquisitions, we began to generate cash from our recently acquired operations in the Cayman Islands, the British Virgin Islands, the Bahamas and Barbados. Cash flow is affected by the timely receipt of customer payments, by operating expenses, the timeliness and adequacy of rate increases (excluding automatic adjustments to our rates for inflation and electricity costs), and various factors affecting tourism in the Cayman Islands, Belize, the British Virgin Islands, Barbados and the Bahamas, such as weather conditions and the economy. We use cash to fund our operations in the Cayman Islands, Belize, the British Virgin Islands, Barbados and the Bahamas, to fund capital projects, to expand our infrastructure, to pay dividends, to repay principal on our loans, to repurchase our shares when appropriate and to take advantage of new investment opportunities which expand our operations.

Operating Activities

Cash generated from operating activities for the years ended December 31, 2001 and 2002 was \$4,364,447 and \$4,115,090, respectively. We generate cash through the utilization of our existing plants, equipment and resources in all segments of the business, minimization of water losses and operating

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efficiencies created by our management team. Through our recent acquisitions, we expect our water sales to approximately double. In addition, we believe that our administrative staff will be able to manage all our combined operations so that our indirect costs will not increase in proportion to water sales. In our Bahamas operations, we experienced positive operating cash flow of \$14,397 for the year ended December 31, 2002.

Cash generated from operating activities for the years ended December 31, 2000 and 2001 was \$3,874,453 and \$4,364,447, respectively. The negative operating cash flow in the Bahamas operation for the year ended December 31, 2001 was \$24,590.

Working Capital

At December 31, 2002, we had a working capital surplus of \$138,401. This surplus relates mainly to the cash we generated from our operating activities and management of our accounts payable and other liabilities. At December 31, 2002, 69.7% of our cash was denominated in Belize dollars. We must obtain approval from the Central Bank of Belize in order to purchase United States dollars for repatriation to the Cayman Islands. Since we commenced operations in Belize, the Central Bank of Belize has never denied our repatriation requests.

At December 31, 2001, we had a working capital surplus of \$325,996. This surplus related to the cash generated from our operating activities. At December 31, 2001, 72.2% of our cash was denominated in Belize dollars.

Investing Activities

Cash used in investing activities during the years ended December 31, 2001 and 2002 was \$1,904,237 and \$3,568,723, respectively. Cash was used in investing activities for expenditures for new property, plant and equipment, including \$1,500,000 on the purchase of the Britannia reverse osmosis plant in 2002. We also continued to expand our water distribution system in the Cayman Islands by constructing additional pipelines to service new developments within our exclusive licensed area. During the same period in 2001, our investing activities consisted of construction costs relating to our new water production and distribution system in Bimini, the Bahamas, as well as expansion costs relating to our water distribution system in the Cayman Islands.

Cash used in investing activities during the years ended December 31, 2000 and 2001 was \$6,268,738 and \$1,904,237, respectively. Cash was used in investing activities for expenditures for new property, plant and equipment with the majority associated with the construction of our new water production and distribution system in Bimini, the Bahamas. The investment in the Bahamas operation totaled \$1,085,759 in 2001 of which \$307,395 relates to costs from 2000. We also continued to expand our water distribution system in the Cayman Islands by constructing pipelines to service several new developments within our franchise area. During the similar period in 2000, investing activities consisted of the purchase of our Belize subsidiary for \$3,966,979, the installation of a new energy recovery system and the expansion of our water production plant in West Bay, Cayman Islands, and the completion of a major pipeline extension within our franchise area in the Cayman Islands.

Financing Activities

On February 7, 2003, we utilized a credit facility with Scotiabank (Cayman Islands) Ltd. in order to complete our recent acquisitions and refinance our existing debt. Cash used in financing activities for the years ended December 31, 2001 and 2002 was \$2,194,601 and \$494,509, respectively. During the year ended December 31, 2002, our primary financing activity was a draw down of our Royal Bank of Canada credit facility for an additional \$1,500,000 in order to finance the investment in the Britannia reverse osmosis plant, plus an increase in our short-term bank indebtedness. We also had proceeds from an issuance of ordinary shares to certain directors and officers who exercised stock options. These were offset by the payment of our quarterly dividends and principal payments on our term loans.

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Cash generated from financing activities for the year ended December 31, 2000 was \$2,622,976, compared to cash used of \$2,194,601 for the year ended December 31, 2001. During 2001, the primary financing activity was the payment of four interim quarterly dividends totaling \$0.40 per share. This was offset by proceeds from a draw down on our credit facility, in order to fund the Bahamas development and the exercise of stock options. During the same period in 2000, we received \$4,962,731, net of share issue costs, from a public issuance of ordinary shares, which was primarily used for the purchase of the Belize subsidiary. These cash amounts were offset by the payment of four interim quarterly dividends in 2000 totaling \$0.34 per share and the repayment of both short-term and long-term debt, including the balance due on the Governor's Harbour plant purchase pursuant to our agreement with Ocean Conversion (Cayman) Limited.

During the year ended December 31, 2002, we repurchased 2,184 ordinary shares from a long-term employee at an average price of \$15.05 and 702 redeemable preference shares from a former employee at an average price of \$5.47. During the year ended December 31, 2001, we repurchased 25,000 ordinary shares under a stock repurchase program at an average price of \$10.86. During the year ended December 31, 2000, we repurchased 79,100 ordinary shares at \$6.25 per share from a shareholder whose assets were being liquidated. All of the shares repurchased were cancelled in accordance with Cayman Islands law.

Material Commitments for Capital Expenditures and Contingencies

At December 31, 2002, we had committed approximately \$1,080,000 for capital expenditures for the purchase, construction and site preparation of two water storage tanks at our Governors Harbour plant. We intend to finance these projects using cash from operations.

On February 7, 2003, we entered into a loan agreement with Scotiabank (Cayman Islands) Ltd. to finance the recent acquisitions and refinance our existing debt. The facilities are comprised of the following:

\$2 million revolving line of credit bearing interest at the floating base rate as established by Cayman Island Class A licensed banks from time to time. The present interest rate is 5.25%

\$20 million seven-year term loan bearing interest at an annually adjusted floating rate of LIBOR plus 1.5% to 3%, depending on the ratio of our consolidated debt to our consolidated earnings before interest, taxes and depreciation. The present interest rate is 4.08%.

\$17.1 million six-month term loan bearing interest on the same basis as the seven-year term loan. The present interest rate is 4.08%.

We have used the proceeds from these facilities to refinance our existing debt, for working capital and to finance our recent acquisitions.

As of February 7, 2003, we have drawn down \$28,056,126 from our Scotiabank facilities. We anticipate drawing down approximately \$8,113,020 in additional funds to complete our acquisitions of Waterfields Company Limited. We intend to replace a portion of this debt with other debt, equity or hybrid financing.

We will be required to make monthly payments of interest for all borrowings under the revolving line of credit and quarterly payments of interest for all amounts drawn down under the two term loans. We will be obligated to make 28 equal quarterly payments of principal under the seven-year term loan and all amounts borrowed under the six-month term loan must be repaid at the maturity date for this facility.

We have collateralized all borrowings under the three facilities by providing Scotiabank with a first lien on all of our assets, including the capital stock we acquired in our recent acquisitions.

The loan agreement for the three facilities contains standard terms and conditions for similar bank loans made in the Cayman Islands, including acceleration of the repayment of all borrowings either upon the demand of Scotiabank (Cayman Islands) Ltd. or in the event of default under the loan agreement.

As part of our acquisition of Ocean Conversion (Cayman) Limited, with the approval of Scotiabank (Cayman Islands) Ltd., we have guaranteed the performance of Ocean Conversion (Cayman) Limited to the Cayman Islands government, pursuant to the water supply contract with the Water Authority-Cayman dated April 25, 1994 as amended.

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As part of the acquisition of our interests in Ocean Conversion (Cayman) Limited, we agreed to indemnify the seller in respect of a guarantee given by the seller to the bank of N.T. Butterfield & Son Ltd. for 100% of the borrowings of Ocean Conversion (Cayman) Limited totaling US\$2.4 million. This borrowing is being refinanced with Scotiabank (Cayman Islands) Ltd. and we will guarantee 100% thereof.

As part of the acquisition of our interests in Ocean Conversion (BVI) Ltd., we agreed to indemnify the seller in respect of a guarantee given by the seller to the bank of N. T. Butterfield & Son Ltd. for 55% of the borrowings of Ocean Conversion (BVI) Ltd. totaling US\$1.25 million. This borrowing is being refinanced with Scotiabank (Cayman Islands) Ltd. and we will guarantee 50% thereof.

As a result of our pending acquisition of a controlling interest in Waterfields Company Limited, we will be required to provide a performance guarantee to the Water and Sewerage Corporation of the Bahamas in relation to the water supply contract between Waterfields Company Limited and the Water and Sewerage Corporation.

Impact of Inflation

Under the terms of our Cayman Islands license, Belize, Bahamas, British Virgin Islands and Barbados water sales agreements, there is an automatic price adjustment for inflation on an annual basis, subject to temporary exceptions. We, therefore, believe that the impact of inflation on our net income, measured in consistent dollars, will not be material.

Exchange Rates

The official exchange rate for conversion of United States dollars into Cayman Islands dollars, as determined by the Cayman Islands Monetary Authority, has been fixed since 1974 at U.S. \$ 1.00 = CI\$ 0.83.

The official exchange rate for conversion of United States dollars into Belizean dollars, as determined by the Central Bank of Belize, has been fixed since 1976 at U.S.\$ 1.00 = BZE\$ 2.00.

The official fixed exchange rate for conversion of United States dollars into Bahamian dollars as determined by the Central Bank of The Bahamas, has been fixed since 1973 at U.S.\$ 1.00 = BAH\$ 1.00.

The official fixed exchange rate for conversation of United States dollars into Barbadian dollars as determined by the Central Bank of Barbados has been fixed since 1975 at U.S.\$ 1.00 = BDSS\$ 2.00.

The British Virgin Islands currency is United States dollars.

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Item 8. *Financial Statements and Supplementary Data*

CONSOLIDATED WATER CO. LTD.

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INDEPENDENT AUDITORS REPORT

The Board of Directors and Stockholders

Consolidated Water Co. Ltd

We have audited the accompanying consolidated balance sheets of Consolidated Water Co. Ltd. and subsidiaries (the Company) as of December 31, 2002 and 2001, and the related consolidated statements of income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2002. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material aspects, the financial position of Consolidated Water Co. Ltd. and subsidiaries as of December 31, 2002 and 2001, and the results of their operations and cash flows for each of the three years in the three-year period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

/s/ KPMG Chartered Accountants

George Town, Cayman Islands

March 18, 2003 except for notes 2, 8 and 21
which are dated June 11, 2003

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CONSOLIDATED WATER CO. LTD.

CONSOLIDATED BALANCE SHEETS

(Expressed in United States dollars)