

CONSOLIDATED WATER CO LTD  
Form 10-K  
March 13, 2013

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-K**

**(Mark One)**

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

**For the fiscal year ended December 31, 2012**

**OR**

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

**For the transaction period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 0-25248**

**CONSOLIDATED WATER CO. LTD.**

(Exact name of Registrant as specified in its charter)

**CAYMAN ISLANDS**

**98-0619652**

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(State or other jurisdiction of  
incorporation or organization)

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

Regatta Office Park  
Windward Three, 4th Floor, West Bay Road  
P.O. Box 1114  
Grand Cayman, KY1-1102, Cayman Islands 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:**

<b>Title of each class:</b>	<b>Name of each exchange on which registered:</b>
Common Stock, \$.60 Par Value	The NASDAQ Stock Market LLC (NASDAQ Global Select Market)

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Sec. 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

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 a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange 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 common shares, as reported on the NASDAQ Global Select Market on June 30, 2012, was \$118,114,639.

As of March 8, 2013, 14,593,011 shares of the registrant's common shares were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE:**

Portions of the registrant's Proxy Statement related to its Annual Shareholders' Meeting will be subsequently filed with the Securities and Exchange Commission as to Part III of this Form 10-K.

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## **CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K contains forward-looking statements, including but not limited to, statements regarding our future revenues, future plans, objectives, expectations and events, assumptions and estimates. Forward-looking statements can be identified by use of the words or phrases “will”, “will likely result”, “are expected to”, “will continue”, “estimate”, “project”, “potential”, “believe”, “plan”, “anticipate”, “expect”, “intend”, “may,” “believe, “ or similar expressions and variations of such words. Statements that are not historical facts are based on our current expectations, beliefs, assumptions, estimates, forecasts and projections for our business and the industry and markets related to our business.

The forward-looking statements contained in this report are not guarantees of future performance and involve certain risks, uncertainties and assumptions which are difficult to predict. Actual outcomes and results may differ materially from what is expressed in such forward-looking statements. Important factors which may affect these actual outcomes and results include, without limitation, tourism and weather conditions in the areas we service, scheduled new construction within our operating areas, the economies of the U.S. and the areas we service, regulatory matters, availability of capital to repay debt and for expansion of our operations, and other factors, including those set forth under Part I, Item 1A. “Risk Factors” in this Annual Report.

The forward-looking statements in this Annual Report speak as of its date. We expressly disclaim any obligation or undertaking to update or revise any forward-looking statement contained in this Annual Report to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any forward-looking statement is based, except as may be required by law.

Unless otherwise indicated, references to “we,” “our,” “ours” and “us” refer to Consolidated Water Co. Ltd. and its subsidiaries.

### **Note Regarding Currency and Exchange Rates**

Unless otherwise indicated, all references to “\$” or “US\$” are to United States dollars.

The exchange rate for conversion of Cayman Island dollars (CI\$) into US\$, as determined by the Cayman Islands Monetary Authority, has been fixed since April 1974 at US\$1.20 per CI\$1.00.

The exchange rate for conversion of Belize dollars (BZE\$) into US\$, as determined by the Central Bank of Belize, has been fixed since 1976 at US \$0.50 per BZE\$1.00.

The exchange rate for conversion of Bahamas dollars (B\$) into US\$, as determined by the Central Bank of The Bahamas, has been fixed since 1973 at US\$1.00 per B\$1.00.

The official currency of the British Virgin Islands is the United States dollar.

The exchange rate for conversion of Bermuda dollars (BMD\$) into US\$ as determined by the Bermuda Monetary Authority, has been fixed since 1970 at US\$1.00 per BMD\$1.00.

Our Netherlands subsidiary conducts business in US\$ and euros, our Indonesian subsidiary conducts business in US\$ dollars and Indonesian rupiahs, and our Mexico affiliate conducts business in US\$ and Mexican pesos. The exchange rates for conversion of euros, rupiahs and pesos into US\$ vary based upon market conditions.

## PART I

### ITEM 1. BUSINESS

#### Overview

We develop and operate seawater desalination plants (that utilize reverse osmosis technology) and water distribution systems in areas where naturally occurring supplies of potable water are scarce or nonexistent. Through our subsidiaries and affiliates, we provide the following services to our customers in the Cayman Islands, the Bahamas, Belize, and the British Virgin Islands:

*Retail Water Operations.* We produce and supply water to end-users, including residential, commercial and government customers in the Cayman Islands under an exclusive retail license issued by the Cayman Islands government to provide water in two of the most populated and rapidly developing areas in the Cayman Islands. In 2012, our retail water operations generated approximately 37% of our consolidated revenues.

*Bulk Water Operations.* We produce and supply water to government-owned distributors in the Cayman Islands, Belize and the Bahamas. In 2012, our bulk water operations generated approximately 62% of our consolidated revenues.

- *Services Operations.* We provide engineering and management services for desalination projects, including designing and constructing desalination plants and managing and operating desalination plants owned by other companies. In 2012, our services operations generated approximately 1% of our consolidated revenues.

*Affiliate Operations.* We have two affiliates. (1) We own 50% of the voting rights and 43.5% of the equity rights of Ocean Conversion (BVI) Ltd. ("OC-BVI"), which produces and supplies bulk water to the British Virgin Islands Water and Sewerage Department. (2) We own, through our wholly-owned Netherlands subsidiary, Consolidated Water Cooperatief, U.A., a 50% interest in N.S.C. Agua, S.A. de C.V., ("NSC") a Mexican company. NSC has been formed to pursue a project encompassing the construction, ownership and operation of a 100 million gallon per day seawater reverse osmosis desalination plant to be located in northern Baja California, Mexico and an accompanying pipeline to deliver water to the Mexican potable water system and the U.S. border. The project is in the development stage and NSC does not presently generate any operating revenues.

As of December 31, 2012, the number of plants we, or our affiliates, operate in each country and the production capacities of these plants are as follows:

Location	Plants	Capacity <sup>(1)</sup>
Cayman Islands	8	10.2
Bahamas	3	15.2
Belize	1	0.6
British Virgin Islands	2	0.8
Total	14	26.8

(1)In millions of gallons per day.

## Strategy

Our strategy is to provide water services in areas where the supply of potable water is scarce and we believe the production of potable water by reverse osmosis desalination is, or will be, profitable. We focus primarily on markets with the following characteristics that make them attractive for our business:

- inadequate sources of fresh water.
- favorable regulatory and tax environments.
- a large proportion of tourist properties (which historically have generated higher volume sales than residential properties).
- growing populations and economies.



We believe that our potential market includes any location with a demand for, but a limited supply of, potable water and access to seawater. The desalination of seawater is the most widely used process for producing fresh water in areas with an insufficient natural supply. In addition, in many locations, desalination is the only commercially viable means to expand the existing water supply. We believe that our experience in the development and operation of reverse osmosis desalination plants provides us with the capabilities to successfully expand our operations beyond our existing markets and we expect to do so in the coming years.

Key elements of our strategy include:

- **Expanding our existing operations in the Cayman Islands, Belize and The Bahamas.** We plan to continue to seek new water supply agreements and licenses and will also focus on renewing our existing service contracts with extended terms and greater production levels.
- **Penetrating new markets.** We plan to continue to seek opportunities to profitably expand our operations into new markets that have significant unfulfilled demands for potable water. These markets include the rest of the Caribbean, Mexico, Asia and other areas where we can provide water on a profitable basis and in favorable regulatory environments. We may pursue these opportunities either on our own or through joint ventures and strategic alliances.
- **Broadening our existing and future operations into complementary services.** We consider opportunities to leverage our water-related expertise to enter complementary service industries, such as wastewater management, as viable complements to our existing business and will pursue such opportunities as they arise.

## **Our Company**

We conduct our operations in the Cayman Islands, The Bahamas, the British Virgin Islands, Belize, and the United States through the following operating subsidiaries and affiliates:

***Cayman Water Company Limited (“Cayman Water”)***. Cayman Water operates under an exclusive retail license granted by the Cayman Islands government to provide water to customers within a prescribed service area on Grand Cayman that includes the Seven Mile Beach and West Bay areas, two of the three most populated areas in the Cayman Islands. The only non-government owned public water utility on Grand Cayman, Cayman Water owns and operates four desalination plants.

***Ocean Conversion (Cayman) Limited (“OC-Cayman”)***. OC-Cayman provides bulk water under various licenses and agreements to the Water Authority-Cayman, a government-owned utility and regulatory agency, which distributes the water to properties located outside our exclusive retail license service area in Grand Cayman. OC-Cayman operates four desalination plants owned by the Water Authority-Cayman.

***Consolidated Water (Bahamas) Limited (“CW-Bahamas”)***. We own a 90.9% equity interest in CW-Bahamas, which provides bulk water under long-term contracts to the Water and Sewerage Corporation of The Bahamas, a government agency. CW-Bahamas owns and operates our largest desalination plant and two other desalination plants. CW-Bahamas pays fees to two of our other subsidiaries for certain administrative services.

***Consolidated Water (Belize) Limited (“CW-Belize”)***. CW-Belize, (formerly Belize Water Limited), owns and operates one desalination plant and has an exclusive contract to provide bulk water to Belize Water Services Ltd., a water distributor that serves residential, commercial and tourist properties in Ambergris Caye, Belize.

***Aquilex, Inc.*** This subsidiary, a United States company, provides financial, engineering and supply chain management support services to our subsidiaries and affiliates.

***Ocean Conversion (BVI) Ltd. (“OC-BVI”)***. We own 50% of the voting stock of our affiliate, OC-BVI, a British Virgin Islands company, which sells bulk water to the Government of the British Virgin Islands Water and Sewerage Department. We own an overall 43.5% equity interest in OC-BVI’s profits and certain profit sharing rights that raise our effective interest in OC-BVI’s profits to approximately 45%. OC-BVI also pays our subsidiary DesalCo Limited fees for certain engineering and administrative services. We account for our investment in OC-BVI under the equity method of accounting.

***DesalCo Limited (“DesalCo”)***. A Cayman Islands company, DesalCo provides management, engineering and construction services for desalination projects.

***Consolidated Water (Bermuda) Limited (“CW-Bermuda”)***. In January 2007, our affiliate, Consolidated Water (Bermuda) Limited (“CW-Bermuda”) entered into a design, build, sale and operating agreement with the Government of Bermuda for a desalination plant to be built in two phases at Tynes Bay along the northern coast of Bermuda. Under the agreement, CW-Bermuda constructed and operated the plant from the second quarter of 2009 through the expiration of the agreement on June 30, 2011. We do not expect to receive any future fees or revenues from CW-Bermuda.

***Consolidated Water Cooperatief, U.A. (“CW-Coop”)*** and ***N.S.C. Agua, S.A. de C.V. (“NSC”)***. CW-Coop is a wholly-owned Netherlands subsidiary organized in 2010. In May 2010, CW-Coop acquired a 50% interest in NSC, a Mexican company. NSC has been formed to pursue a project encompassing the construction, ownership and operation of a 100 million gallon per day seawater reverse osmosis desalination plant to be located in northern Baja California, Mexico and accompanying pipeline to deliver water to the Mexican potable water system and the U.S. border. The project is currently in the development stage and NSC does not generate any operating revenues. As we have provided and will continue to provide all of NSC’s development funding we consolidate its results in our consolidated financial

statements.

*Consolidated Water (Asia) Pte. Limited (“CW-Asia”) and PT Consolidated Water Bali (“CW-Bali”)*. During 2012 we formed CW-Asia, a wholly-owned Singapore company, and CW-Bali, an Indonesian company which is 95% owned by CW-Asia. CW-Bali is presently engaged in the construction of a 500,000 gallon per day desalination plant that will provide water to resort properties in the Nusa Dua area of Bali, Indonesia.

## **Our Operations**

We have three principal business segments: retail water operations, bulk water operations and services operations. Our retail water operations supply water to end-users, including residential, commercial and government customers. Our bulk water operations supply water to government -owned distributors. Our retail and bulk operations serve customers in the Cayman Islands, Belize, the British Virgin Islands and The Bahamas. Our services operations provide engineering and management services, which include the design and construction of desalination plants and the management and operation of desalination plants owned by affiliated companies.

For fiscal year 2012, our retail water, bulk water and service operations generated approximately 37%, 62% and 1%, respectively, of our consolidated revenues. For information about our business segments and geographical information about our operating revenues and long-lived assets, see Note 16 to our consolidated financial statements at ITEM 8 of this Annual Report.

## **Retail Water Operations**

For fiscal years 2012, 2011 and 2010, our retail water operations accounted for approximately 37%, 42% and 43%, respectively, of our consolidated revenues. This business in the Cayman Islands produces and supplies water to end-users, including residential, commercial and government customers.

We sell water through our retail operations to a variety of residential and commercial customers through our wholly-owned subsidiary Cayman Water, which operates under an exclusive license issued to us by the Cayman Islands government under The Water Production and Supply Law of 1979. As discussed below, this license was set to expire in July 2010 but has since been extended while negotiations for a new license take place. Pursuant to the license, we have the exclusive right to produce potable water and distribute it by pipeline to our licensed service area which consists of the Seven Mile Beach and West Bay areas of Grand Cayman, two of the three most populated areas in the Cayman Islands.

Under our license, we pay a royalty to the government of 7.5% of our gross retail water sales revenues (excluding energy adjustments). The selling prices of water sold to our customers are determined by the license and vary 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 or 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 (“WAC”), on behalf of the government, reviews and confirms the calculations of the price adjustments for inflation and electricity costs. If we want to adjust our prices for any reason other than inflation or electricity costs, we have to request prior approval of the Cabinet of the Cayman Islands government. Disputes regarding price adjustments are referred to arbitration. Our last price increase, requested in June 1985, was granted in full.

This license was set to expire on July 10, 2010; however, we and the Cayman Islands government have extended the license several times in order to provide sufficient time to negotiate the terms of a new license agreement. The most recent extension of our license expires March 30, 2013.

In February 2011, the Water Production and Supply Law, 2011 (which replaces the Water (Production and Supply) Law (1996 Revision) under which the Company is licensed) and the Water Authority (Amendment) Law, 2011 (the “New Laws”) were published and are now in full force and effect. Under the New Laws, the WAC would issue any new license which could include a rate of return on invested capital model described below.

We have been advised in correspondence from the Cayman Islands government and the WAC that: (i) the WAC is now the principal negotiator, and not the Cayman Islands government, in these license negotiations, and (ii) the WAC has determined that a rate of return on invested capital model (“RCAM”) is in the best interest of the public and the Company’s customers. RCAM is the rate model currently utilized in the electricity transmission and distribution license granted by the Cayman Islands government to the Caribbean Utilities Company, Ltd.

In July 2012, in an effort to resolve several issues relating to our retail license renewal negotiations, we filed an Application for Leave to Apply for Judicial Review (the “Application”) with the Grand Court of the Cayman Islands (the “Court”), stating that: (i) certain provisions of The Water Authority Law, 2011 and The Water (Production and Supply) Law, 2011, appear to be incompatible, (ii) the WAC’s roles as the principal license negotiator, statutory regulator and our competitor put the WAC in a position of hopeless conflict, and (iii) the WAC’s decision to replace

the rate structure under our current exclusive license with RCAM was predetermined and unreasonable.

Throughout the course of the retail license renewal negotiations, we have objected to the use of RCAM on the basis that we believe such a model would not promote the efficient operation of our water utility and could ultimately increase water rates to our customers.

In October 2012, we were notified that the Court agreed to consider the issues raised in the Application. As a result, the Company, the Cayman Islands government and the WAC will have the opportunity to present their positions to the Court in a trial proceeding.

See further discussion of this matter at ITEM 1.A. RISK FACTORS and ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS - Material Commitments, Expenditures and Contingencies – *Renewal of Retail License*.

#### *Facilities*

Our retail operations in the Cayman Islands produce potable water at four reverse osmosis seawater conversion plants in Grand Cayman located at our Abel Castillo Water Works ("ACWW", formerly Governor's Harbour), Britannia and West Bay sites. We own the land for our ACWW and West Bay plants and have entered into a lease for the land for our Britannia plant until January 1, 2027. The current production capacity of the two plants located at ACWW is 2.2 million gallons of water per day. The production capacity of the Britannia plant is 715,000 gallons of water per day. The production capacity of the West Bay plant is 910,000 gallons of water per day.

Electricity to our plants is supplied by Caribbean Utilities Co. Ltd., a publicly traded utility company. At all of our four retail plant sites we maintain diesel driven, standby generators with sufficient capacity to operate our distribution pumps and other essential equipment during any temporary interruptions in electricity supply. Standby generation capacity is available at our West Bay Plant and ACWW plants to operate a portion of the water production capacity as well.

In the event of an emergency, our distribution system is connected to the distribution system of the Water Authority-Cayman. In prior years we have purchased water from the Water Authority-Cayman for brief periods of time. We have also sold potable water to the Water Authority-Cayman from our retail plants.

Our pipeline system in the Cayman Islands covers the Seven Mile Beach and West Bay areas of Grand Cayman and consists of approximately 77 miles of polyvinyl chloride and polyethylene pipeline. We extend our distribution system periodically as demand warrants. We have a main pipe loop covering the Seven Mile Beach and West Bay areas. We place extensions of smaller diameter pipe off our main pipe to service new developments in our service area. This system of building branches from the main pipe keeps construction costs low and allows us to provide service to new areas in a timely manner. Developers are responsible for laying the pipeline within their developments at their own cost, but in accordance with our specifications. When a development is completed, the developer then transfers operation and maintenance of the pipeline to us.

### *Customers*

We enter into contracts with hotels, condominiums, residential homes and other properties located in our existing licensed area to provide potable water. In the Seven Mile Beach area, our primary customers are the hotels and condominium complexes that serve the tourist industry. In the West Bay area, our primary customers are residential homes.

We bill our customers on a monthly basis based on metered consumption and bills are typically collected within 30 to 35 days after the billing date and receivables not collected within 45 days subject the customer to disconnection from water service. In 2012, 2011 and 2010, bad debts represented less than 1% of our total annual retail sales. In addition to their past due invoice balance, customers that have had their service disconnected must pay re-connection charges.

Historically, demand on our pipeline distribution has varied throughout the year. Demand depends upon the number of tourists visiting and the amount of rainfall during any particular time of the year. In general, the majority of tourists come from the United States during the winter months.

### *Prospective Retail Operations*

During the latter half of 2012, we commenced, through our newly formed 95% owned subsidiary, CW-Bali, the construction of a seawater reverse osmosis plant in Nusa Dua, one of the primary tourist areas of Bali, Indonesia. We believe the water demands of the tourist resorts in Nusa Dua will soon exceed the water supplies that can be provided to the area by the local public water utility, and that other areas of Bali will also eventually experience fresh water shortages. However, as seawater reverse osmosis has not been employed to any meaningful extent in Bali, we have concluded that to obtain customers in Bali we must first demonstrate the viability of seawater reverse osmosis as well as our capabilities and expertise. Consequently, we have elected to commence this plant's construction before obtaining contracts for its full production. We believe we will be able to sell 100% of the plant's initial capacity once it becomes operational, although we cannot assure that we will be able to do so. The initial capital investment for this

plant is estimated at approximately \$4.2 million, which will fund the first phase of production capacity of approximately 500,000 gallons per day. As of December 31, 2012 we had expended approximately \$1.9 million in construction costs for this phase. This plant has been designed for expansion in subsequent phases to a total production capacity of 1.5 million gallons per day should sufficient customer demand exist.

### **Bulk Water Operations**

For fiscal years 2012, 2011 and 2010, our bulk water operations accounted for approximately 62%, 56% and 50%, respectively, of our consolidated revenues and are comprised of businesses in the Cayman Islands, The Bahamas and Belize. These businesses produce potable water from seawater and sell this water to governments and private customers.



## **Bulk Water Operations in the Cayman Islands**

We sell bulk water in the Cayman Islands through our wholly-owned subsidiary OC-Cayman.

### *Facilities*

We operate and sell water to the Water Authority-Cayman (“WAC”) from reverse osmosis seawater conversion plants in Grand Cayman that are owned by the WAC: Three of these plants, the Red Gate, North Sound and North Side Water Works plants, which have production capacities of approximately 1.3 million, 1.6 million and 2.4 million gallons of water per day, respectively, are presently operated by us. The North Side Water Works plant was commissioned in June 2009. The Red Gate plant was temporarily de-commissioned in December 2009 in order to carry out extensive rehabilitative and upgrade work to the plant as part of a new seven year operating contract with the WAC. The refurbished Red Gate plant was re-commissioned in July 2010. We also operated and sold water from the Lower Valley plant, which is owned by the WAC and has a production capacity of 1.1 million gallons per day, through the January 2013 expiration date of our operating contract for that plant. The WAC has now assumed the operations of the Lower Valley plant. The plants that we operate for the WAC are located on land owned by the WAC.

### *Customers*

We provide bulk water on a take-or-pay basis to the WAC, a government owned utility and regulatory agency, under various licenses and agreements. The WAC in turn distributes that water to properties in the parts of Grand Cayman that are outside of our retail license area.

The current operating agreement for the Red Gate plant began on July 2, 2010 for a period of seven years.

The current operating agreement for the North Sound plant was extended on April 1, 2007 for a period of seven years.

The current operating agreement for the North Side Water Works plant was executed on March 11, 2008 for a period of ten years.



## **Bulk Water Operations in Belize**

In Belize, we sell bulk water through our wholly-owned subsidiary CW-Belize.

### *Facilities*

We own the reverse osmosis seawater conversion plant in Belize and lease the land on which our plant is located from the Belize government at an annual rent of BZE\$1.00. The lease, which was entered into in April 1993 and extended in January 2004, expires in March 2026. The production capacity of the plant is 550,000 gallons of water per day.

Electricity to our plant is supplied by Belize Electricity Limited. At the plant site, we maintain a diesel driven, standby generator with sufficient capacity to operate our water production equipment during any temporary interruption in the electricity supply. Feed water for the reverse osmosis units is drawn from wells with associated pumps on the property. Reject water is discharged into a well on the property at a level below that of the feed water intakes.

### *Customers*

We are the exclusive provider of water in Ambergris Caye, Belize to Belize Water Services Ltd. (“BWSL”), a government controlled entity which distributes the water through its own pipeline system to residential, commercial and tourist properties. BWSL distributes our water primarily to residential properties, small hotels, and businesses that serve the tourist market. The base price of water supplied, and adjustments thereto, are determined by the terms of the contract, which provides for annual 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. Demand is less cyclical than in our other locations due to a higher proportion of residential to tourist demand.

We have an exclusive 23-year contract with BWSL to supply a minimum of 1.75 million gallons of water per week, or upon demand up to 2.1 million gallons per week, on a take-or-pay basis. This contract expires on March 23, 2026. BWSL has the right, with six months advance notice before the expiration date, to renew the contract for a further 25-year period on the same terms and conditions. The contract was amended on March 1, 2011 to increase the minimum supply to 290,000 gallons per day (equal to 2.03 million gallons per week), or upon demand up to approximately 12.7 million gallons per month.

## **Bulk Water Operations in The Bahamas**

In The Bahamas, we sell bulk water through our majority-owned subsidiary, CW-Bahamas.

### *Facilities*

We currently supply bulk water in The Bahamas from our Windsor, Blue Hills and Bimini plants. We supply water from our Windsor plant which has a capacity of 3.1 million gallons per day under the terms of a 15-year water supply agreement that expires the later of March 2013 or the date we deliver the total amount of water required under the agreement. We estimate we will deliver this total amount in May 2013. We supply water from our Blue Hills plant, our Company's largest seawater conversion facility, under the terms of a twenty-year water supply agreement. Prior to 2011, the Blue Hills plant was capable of producing 7.2 million gallons of potable water per day. The Blue Hills plant water supply agreement was amended effective January 31, 2011 pursuant to which we increased the production capacity of the Blue Hills plant to 12.0 million gallons per day during 2011 and the term of the agreement was extended to March 2032. The Bimini plant has a capacity of 115,000 gallons per day and the term for its water supply agreement expires in December 2020.

The high pressure pumps for our plants in the Bahamas are diesel-driven. Electricity for the remainder of our plant operations is supplied by Bahamas Electricity Corporation. We maintain a standby generator with sufficient capacity to operate essential equipment at our Windsor and Blue Hills plants and are able to produce water with these plants during temporary interruptions in the electricity supply.

Feed water for the reverse osmosis units are drawn from deep wells with associated pumps on the property. Reject water is discharged into wells on the property at a deeper level than the feed water intakes.

### *Customers*

We provide bulk water to the Water and Sewerage Corporation of The Bahamas (“WSC”), which distributes the water through its own pipeline system to residential, commercial and tourist properties on the Island of New Providence.

We are required to provide the WSC with at least 16.8 million gallons per week of potable water from our Windsor plant, and the WSC has contracted to purchase at least that amount from us on a take-or-pay basis. This water supply agreement expires the later of March 2013 or the date we deliver the total amount of water required under the agreement. We estimate we will deliver this total amount in May 2013. We have submitted a proposal to the WSC to extend the Windsor agreement for five years and are awaiting their reply. At the conclusion of the agreement, the WSC has the option to:

- extend the agreement for an additional five years at a rate to be negotiated;
- exercise a right of first refusal to purchase any materials, equipment and facilities that CW-Bahamas intends to remove from the site, and negotiate a purchase price with CW-Bahamas; or
- require CW-Bahamas to remove all materials, equipment and facilities from the site.

The Blue Hills plant water supply agreement was amended effective January 31, 2011. Under the terms of the amended agreement we increased the production capacity of the Blue Hills plant to 12.0 million gallons per day. With this expansion, we are required to deliver and the WSC is required to purchase a minimum of 63.0 million gallons per week. The term of the Blue Hills water supply agreement expires the later of March 2032 or the date we deliver the total amount of water required under the agreement. At the conclusion of the agreement, the WSC has the option to:

- extend the agreement for an additional five years at a rate to be negotiated;
- exercise a right of first refusal to purchase any materials, equipment and facilities that CW-Bahamas intends to remove from the site, and negotiate a purchase price with CW-Bahamas; or
- require CW-Bahamas to remove all materials, equipment and facilities from the site.

### **Services Operations**

For fiscal years 2012, 2011 and 2010, our services operations accounted for approximately 1%, 2% and 7%, respectively, of our consolidated revenues and are comprised of businesses providing services in the Cayman Islands, The Bahamas, the British Virgin Islands and (through June 30, 2011) Bermuda. These businesses provide engineering and management services, including designing and constructing desalination plants, and managing and operating plants owned by affiliated companies.

## **Engineering and Management Services Operations**

We provide design, engineering and construction services for desalination projects through DesalCo, which is recognized by suppliers as an original equipment manufacturer of reverse osmosis seawater desalination plants for our Company. DesalCo also provides management services to our affiliates.

Our engineering department also conducts research and development. We frequently test new components and the associated technology offered by suppliers in our business and at times collaborate with suppliers in the development of their products.

Aquilex, Inc., our wholly-owned U.S. subsidiary located in Coral Springs, Florida, provides financial, engineering and supply chain support services to our operating segments.

## **Affiliate Operations**

Our affiliate, OC-BVI, sells water to one government customer in the British Virgin Islands. We own 50% of the voting shares of OC-BVI and have an overall 43.5% equity interest in the profits of OC-BVI. We also own separate profit sharing rights in OC-BVI that raise our effective interest in OC-BVI's profits from 43.5% to approximately 45%. Sage Water Holdings (BVI) Limited ("Sage") owns the remaining 50% of the voting shares of OC-BVI and the remaining 55% interest in its profits. Under the Articles of Association of OC-BVI, we have the right to appoint three of the six directors of OC-BVI. Sage is entitled to appoint the remaining three directors. In the event of a tied vote of the directors, the President of the Caribbean Water and Wastewater Association, a regional trade association comprised primarily of government representatives, is entitled to appoint a junior director to cast a deciding vote.

We provide certain engineering and administrative services to OC-BVI for a monthly fee and a bonus arrangement which provides for payment of 4.0% of the net operating income of OC-BVI.

We account for our interests in OC-BVI using the equity method of accounting.

*Customer*

OC-BVI sells bulk water to the Government of the British Virgin Islands Water and Sewerage Department (“BVIW&S”), which distributes the water through its own pipeline system to residential, commercial and tourist properties on the islands of Tortola and Jost Van Dyke in the British Virgin Islands. During 2012, OC-BVI supplied BVIW&S with approximately 240 million gallons of water from desalination plants located at Bar Bay, Tortola, and the island of Jost Van Dyke in the British Virgin Islands.

*Facilities*

OC-BVI owns and operates a 720,000 gallons per day plant at Bar Bay, Tortola, in the British Virgin Islands that supplies water to the BVI government under a contract dated March 4, 2010 that has a term of seven years with a seven year renewal option exercisable by the BVI government. OC-BVI purchases electrical power to operate this plant from BVI Electric Co. and operate diesel engine driven emergency power generators when BVI Electric Co. is unable to provide power to the plant.

OC-BVI’s plant on the island of Jost Van Dyke has a capacity of 60,000 gallons per day. This plant operates under a 10-year contract with the BVI government that expires July 8, 2013. Pursuant to the contract, OC-BVI will operate the plant on a year-to-year basis until the BVI government informs OC-BVI of its intention to extend the existing, or enter into a new agreement. We purchase electrical power to operate this plant from BVI Electric Co.

## **Reverse Osmosis Technology**

The conversion of seawater to potable water is called desalination. The two primary forms of desalination are distillation and reverse osmosis. Both methods are used throughout the world and technologies are improving to lower the costs of production. Reverse osmosis is a fluid separation process in which the saline water is pressurized and the fresh water is separated from the saline water by passing through a semi-permeable membrane which rejects the salts. The saline water (i.e. seawater) is first passed through a pretreatment system, which generally consists of fine filtration and treatment chemicals, if required. Pre-treatment removes suspended solids and organics which could cause fouling of the membrane surface. Next, a high-pressure pump pressurizes the saline water thus enabling approximately 40% conversion of the saline water to fresh water as it passes through the membrane, while more than 99% of the dissolved salts are rejected and remain in the now concentrated saline water. This remaining feed water which has now been concentrated is discharged without passing through the membrane. The remaining hydraulic energy in the concentrated feed water is transferred to the initial saline feed water with an energy recovery device thus reducing the total energy requirement for the reverse osmosis system. The final step is post-treatment, which consists of stabilizing the produced fresh water (thereby removing undesirable dissolved gases), adjusting the pH and providing chlorination to prepare it for distribution.

We currently use reverse osmosis technology to convert seawater to potable water at all of the plants we construct and operate. We believe that this technology is the most effective and efficient conversion process for our market. However, we are always seeking ways to maximize efficiencies in our current processes and investigating new, more efficient processes to convert seawater to potable water. The equipment at our plants is among the most energy efficient available and we monitor and maintain the equipment in an efficient manner. As a result of our decades of experience in seawater desalination, we believe that we have the expertise and “know how” in the development and operation of desalination plants that is easily transferable to locations outside of our current operating areas.

## **Raw Materials and Sources of Supply**

All materials, parts and supplies essential to our business operations are obtained from multiple sources and we use the latest industry technology. We do not manufacture any parts or components for equipment essential to our business. Our access to seawater for processing into potable water is granted through our licenses and contracts with governments of the various jurisdictions in which we have our operations.

## **Seasonal Variations in Our Business**

Our operations are affected by the levels of tourism and are subject to seasonal variations in our service areas. Demand for our water in the Cayman Islands, Belize, and the Bahamas is affected by variations in the level of tourism



and local weather, primarily rainfall. Tourism in our service areas is affected by the economies of the tourists' home countries, primarily the United States and Europe, terrorist activity and perceived threats thereof, and increased costs of fuel and airfares. We normally sell more water during the first and second quarters, when the number of tourists is greater and local rainfall is less, than in the third and fourth quarters.

### **Government Regulations, Custom Duties and Taxes**

Our operations and activities are subject to the governmental regulations and taxes of the countries in which we operate. The following summary of regulatory developments and legislation does not purport to describe all present and proposed regulation and legislation that may affect our businesses. Legislative or regulatory requirements currently applicable to our businesses may change in the future. Any such changes could impose new obligations on us that may adversely affect our businesses and operating results.

### **The Cayman Islands**

The Cayman Islands are a British Overseas Territory and have had a stable political climate since 1670, when the Treaty of Madrid ceded the Cayman Islands to England. The Queen of England appoints the Governor of the Cayman Islands to make laws with the advice and consent of the legislative assembly. The legislative assembly consists of 15 elected members and three members appointed by the Governor from the Civil Service. The Cabinet is responsible for day-to-day government operations. The Cabinet consists of five ministers who are chosen by the Premier from its 15 popularly elected members, and the three Civil Service members. The elected members choose from among themselves a leader, who is designated the Premier, and is in effect the leader of the elected government. The Governor has reserved powers and the United Kingdom retains full control over foreign affairs and defense. The Cayman Islands are a common law jurisdiction and have adopted a legal system similar to that of the United Kingdom.

The Cayman Islands have no taxes on profits, income, distributions, capital gains or appreciation. We have exemptions from, or receive concessionaire rates of customs duties on capital expenditures for plant and major consumable spare parts and supplies imported into the Cayman Islands as follows:

We do not pay import duty or taxes on reverse osmosis membranes, electric pumps and motors and chemicals, but we do pay duty at the rate of 10% of the cost, including insurance and transportation to the Cayman Islands, of other plant and associated materials and equipment to manufacture or supply water in the Seven Mile Beach or West Bay areas. We have been advised by the Government of the Cayman Islands that we will not receive any duty concessions in our new retail water license; and

- OC-Cayman pays full customs duties in respect of all plants that it operates for the Water Authority-Cayman.

## **Belize**

Belize (formerly British Honduras) achieved full independence from the United Kingdom in 1981. Today, Belize is a constitutional monarchy with the adoption of a constitution in 1991. Based on the British model with three independent branches, the Queen of England is the constitutional head of state, represented by a Governor General in the government. A Prime Minister and cabinet make up the executive branch, while a 29 member elected House of Representatives and a nine member appointed Senate form a bicameral legislature. The cabinet consists of a prime minister, other ministers and ministers of state who are appointed by the Governor-General on the advice of the Prime Minister, who has the support of the majority party in the House of Representatives. Belize is an English common law jurisdiction with a Supreme Court, Court of Appeals and local Magistrate Courts.

The Government of Belize has exempted CW-Belize from certain customs duties and all revenue replacement duties until April 18, 2026, and had exempted CW-Belize from company taxes until January 28, 2006. Belize levies a gross receipts tax on corporations at a rate varying between 0.75% and 25%, depending on the type of business, and a corporate income tax at a rate of 25% of chargeable income. Gross receipts tax payable amounts are credited towards corporate income tax. The Government of Belize also implemented certain environmental taxes and a general sales tax effective July 1, 2006 and increased certain business and personal taxes and created new taxes effective March 1, 2005. Belize levies import duty on most imported items at rates varying between 0% and 45%, with most items attracting a rate of 20%. Under the terms of our water supply agreement with BWSL we are reimbursed by BWSL for all taxes and customs duties that we are required to pay and we record this reimbursement as an offset to our tax expense.

## **The Bahamas**

The Commonwealth of The Bahamas is an independent nation and a constitutional parliamentary democracy with the Queen of England as the constitutional head of state. The basis of the Bahamian law and legal system is the English common law tradition with a Supreme Court, Court of Appeals, and a Magistrates court.

Under the current laws of the Commonwealth of The Bahamas, no income, corporation, capital gains or other taxes are payable by the Company. The Company is required to pay an annual business license fee (the calculation of which is based on the Company's preceding year's financial statements) which to date has not been material to the results of our Bahamas operations.

## **The British Virgin Islands**

The British Virgin Islands (the “BVI”) is a British Overseas Territory, with the Queen as the Head of State and Her Majesty’s representative, the Governor, responsible for external affairs, defense and internal security, the Civil Service and administration of the courts. Since 1967, the BVI has held responsibility for its own internal affairs.

The BVI Constitution provides for the people of the BVI to be represented by a ministerial system of government, led by an elected Premier, a Cabinet of Ministers and the House of Assembly. The House of Assembly consists of 13 elected representatives, the Attorney General, and the Speaker.

The judicial system, based on English law, is under the direction of the Eastern Caribbean Supreme Court, which includes the High Court of Justice and the Court of Appeal. The ultimate appellate court is the Privy Council in London.

## **Market and Service Area**

Although we currently operate in the Cayman Islands, Belize, the British Virgin Islands, and The Bahamas, we believe that our potential market consists of any location where there is a need for potable water. The desalination of seawater, either through distillation or reverse osmosis, is the most widely used process for producing potable water in areas with an insufficient natural supply. We believe our experience in the development and operation of reverse osmosis desalination plants provides us with a significant opportunity to successfully expand our operations beyond the markets in which we currently operate.

*Cayman Islands.* The Cayman Islands Government, through the Water Authority-Cayman, supplies water to parts of Grand Cayman, which are not within our licensed area, as well as to Cayman Brac. We operate all but one of the reverse osmosis desalination plants owned by the Water Authority-Cayman on Grand Cayman and supply water under licenses and supply agreements held by OC-Cayman with the Water Authority-Cayman.

According to the most recent information published by the Economics and Statistics Office of the Cayman Islands Government, the population of the Cayman Islands was estimated in December 2011 to be approximately 55,517. According to the figures published by the Department of Tourism Statistics Information Center, during the year ended December 31, 2012, tourist air arrivals increased by 4.1% and tourist cruise ship arrivals increased by 7.6% compared to 2011.

Total visitors for the year increased from 1.7 million in 2011 to 1.8 million in 2012. We believe that our water sales in the Cayman Islands are more positively impacted by stay-over tourists that arrive by air than by those arriving by cruise ship, since cruise ship tourists generally only visit the island for one day or less and do not remain on the island overnight.

*Belize.* Our current operations in Belize are located on Ambergris Caye, which consists of residential, commercial and tourist properties in the town of San Pedro. This town is located on the southern end of Ambergris Caye, one of many islands located east of the Belize mainland and off the southeastern tip of the Yucatan Peninsula. Ambergris Caye is approximately 25 miles long and, according to the Central Statistical Office “Belize: 2010 National Census Overview”, has a population of about 11,510 residents. We provide bulk potable water to BWSL, which distributes this water to this market. BWSL currently has no other source of potable water on Ambergris Caye. Our contract with BWSL makes us their exclusive producer of desalinated water on Ambergris Caye through 2026.

A 185 mile long barrier reef, which is the largest barrier reef in the Western Hemisphere, is situated just offshore of Ambergris Caye. This natural attraction is a choice destination for scuba divers and tourists. According to information published by the Belize Trade and Investment Development Service, tourism is Belize’s second largest source of foreign income, next to agriculture.

*The Bahamas.* Our current operations in The Bahamas are located on South Bimini Island and in Nassau on New Providence. The Bimini Islands consist of North Bimini and South Bimini, and are two of 700 islands which comprise The Bahamas. The Bimini Islands are located approximately 50 miles east of Ft. Lauderdale, Florida and are a premier destination for sport fishing enthusiasts. The population of the Bimini Islands is approximately 1,600 persons and the islands have about 200 hotel and guest rooms available for tourists. The total land area of the Bimini Islands is approximately 9 square miles. New Providence, Lyford Caye and Paradise Island, connected by several bridges, are located approximately 150 miles east southeast of the Bimini Islands. With an area of 151 square miles and a population of approximately 211,000, Nassau is the political capital and commercial hub of The Bahamas, and accounts for more than two-thirds of the four million tourists who visit The Bahamas annually.

*British Virgin Islands.* The British Virgin Islands are a British Overseas Territory and are situated east of Puerto Rico. They consist of 16 inhabited and more than 20 uninhabited islands, of which Tortola is the largest and most populated island. The British Virgin Islands serve as a hub for many large yacht-chartering businesses.

## **Competition**

*Cayman Islands.* Pursuant to our license granted by the Cayman Islands government, we have the exclusive right to provide potable, piped water within our licensed service area on Grand Cayman. At the present time, we are the only non-government-owned public water utility on Grand Cayman. The Cayman Islands government, through the Water Authority-Cayman, supplies water to parts of Grand Cayman located outside of our licensed service area. Although we have no competition within our exclusive retail license service area, our ability to expand our service area is at the discretion of the Cayman Island government. Private residences and commercial multi-unit dwellings up to four units may install water making equipment for their own use. Water plants on premises within our license area and serving only their premises in existence prior to 1991 can be maintained but not replaced or expanded. We are aware of only one such plant currently in operation. The Cayman Islands government, through the Water Authority-Cayman,

supplies water to parts of Grand Cayman outside of our licensed service area. We have competed with such companies as GE Water, Veolia, and IDE for bulk water supply contracts with the Water Authority-Cayman.

*Belize.* On Ambergris Caye in Belize, our water supply contract with Belize Water Services Limited is exclusive, and Belize Water Services Limited can no longer seek contracts with other water suppliers, or produce water themselves, to meet their future needs in San Pedro, Ambergris Caye, Belize.

*The Bahamas.* On South Bimini Island in The Bahamas, we supply water to a private developer and do not have competitors. GE Water operates a seawater desalination plant on North Bimini Island and other small islands. We competed with companies such as GE Water, Veolia, IDE, OHL Inima and Biwater for the new contract with the Bahamian government to build and operate a seawater desalination plant at Blue Hills, New Providence, Bahamas. We expect to compete with these companies and others for future water supply contracts in The Bahamas.

*British Virgin Islands.* In the British Virgin Islands, GE Water operates seawater desalination plants in West End and Sea Cows Bay, Tortola, and on Virgin Gorda and generally bids against OC-BVI for projects. In 2010, Biwater PLC was awarded a 16 year contract to construct and operate a 2.75 million gallon per day desalination plant in Tortola for the British Virgin Islands government which has not yet commenced operations.

To implement our growth strategy outside our existing operating areas, we will have to compete with some of the same companies we competed with for the Blue Hills project in Nassau, Bahamas such as GE Water, Veolia, IDE Technologies, OHL Inima, and Biwater as well as other smaller companies. Some of these companies currently operate in areas in which we would like to expand our operations and already maintain worldwide operations having greater financial, managerial and other resources than our company. We believe that our low overhead costs, knowledge of local markets and conditions and our efficient manner of operating desalinated water production and distribution equipment provide us with the capabilities to effectively compete for new projects in the Caribbean basin and other select markets.

### **Environmental and Health Regulatory Matters**

*Cayman Islands.* With respect to our Cayman Islands operations, we operate our water plants in accordance with guidelines of the Cayman Islands Department of Environmental Health. We are licensed by the Water Authority-Cayman to discharge concentrated seawater, which is a byproduct of our desalination process, into deep disposal wells.

Our Cayman Islands license requires that our potable water quality meet the World Health Organization's Guidelines for Drinking Water Quality and contain less than 200 mg/l of total dissolved solids.

*Belize, The Bahamas, British Virgin Islands.* With respect to our Belize and Bahamas operations and OC-BVI's British Virgin Islands operations, we and OC-BVI are required by our water supply contracts to take all reasonable measures to prevent pollution of the environment. We are licensed by the Belize and Bahamian governments to discharge concentrated seawater, which is a byproduct of our desalination process, into deep disposal wells. OC-BVI is licensed by the British Virgin Islands government to discharge concentrated seawater into the sea. We operate our plants in a manner so as to minimize the emission of hydrogen sulfide gas into the environment.

We are not aware of any existing or pending environmental legislation which may affect our operations. To date we have not received any complaints from any regulatory authorities.

### **Employees**

As of March 8, 2013, we employed a total of 124 persons, 65 in the Cayman Islands, 22 in The Bahamas, 24 in the United States, seven in Belize and six in Asia. We also managed the eight employees of OC-BVI in the British Virgin Islands. We have 11 management personnel and 38 administrative and clerical employees. The remaining employees



are engaged in engineering, purchasing, plant maintenance and operations, pipe laying and repair, leak detection, new customer connections, meter reading and laboratory analysis of water quality. None of our employees is a party to a collective bargaining agreement. We consider our relationships with our employees to be good.

### **Available Information**

Our website address is <http://www.cwco.com>. Information contained on our website is not incorporated by reference into this Annual Report, and you should not consider information contained on our website as part of this Annual Report.

We have adopted a written code of conduct and ethics that applies to all of our employees and directors, including, but not limited to, our principal executive officer, principal financial officer, and principal accounting officer or controller, or persons performing similar functions. The Code of Conduct and Ethics, the charters of the Audit Committee, Compensation Committee, Nominations and Corporate Governance Committee and the Consolidated Water Co. Ltd. Corporate Governance Guidelines of our Board of Directors, are available at the Investors portion of our website.

You may access, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, plus amendments to such reports as filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, on our website and on the website of the Securities and Exchange Commission (the "SEC") as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. In addition, paper copies of these documents may be obtained free of charge by writing us at the following address: Consolidated Water Co. Ltd., Regatta Office Park, Windward Three, 4th Floor, West Bay Road, P.O. Box 1114, Grand Cayman, KY1-1102, Cayman Islands, Attention: Investor Relations; or by calling us at (345) 945-4277.

## ITEM 1A. RISK FACTORS

Investing in our common shares involves risks. Prior to making a decision about investing in our common shares, you should consider carefully the factors discussed below and the information contained in this Annual Report. Each of these risks, as well as other risks and uncertainties not presently known to us or that we currently deem immaterial, could adversely affect our business, results of operations, cash flows and financial condition, and cause the value of our common shares to decline, which may result in the loss of part or all of your investment.

### **Our exclusive license to provide water to retail customers in the Cayman Islands may not be renewed in the future.**

In the Cayman Islands, we provide water to retail customers under a license issued to us in July 1990 by the Cayman Islands government that grants us the exclusive right to provide water to retail customers within our licensed service area. Our service area is comprised of an area on Grand Cayman that includes the Seven Mile Beach and West Bay areas, two of the three most populated areas in the Cayman Islands. For the year ended December 31, 2012, we generated approximately 37% of our consolidated revenues and 52% of our consolidated gross profits from the retail water operations conducted pursuant to our exclusive license. If we are not in default of any terms of the license, we have a right of first refusal to renew the license on terms that are no less favorable than those that the government offers to any third party.

This license was set to expire on July 10, 2010; however, we and the Cayman Islands government have extended the license several times in order to provide sufficient time to negotiate the terms of a new license agreement. The most recent extension of our license expires March 30, 2013.

In February 2011, the Water Production and Supply Law, 2011 (which replaces the Water (Production and Supply) Law (1996 Revision) under which the Company is licensed) and the Water Authority (Amendment) Law, 2011 (the “New Laws”) were published and are now in full force and effect. Under the New Laws, the Water Authority-Cayman (“WAC”) would issue any new license which could include a rate of return on invested capital model described below.

We have been advised in correspondence from the Cayman Islands government and the WAC that: (i) the WAC is now the principal negotiator, and not the Cayman Islands government, in these license negotiations, and (ii) the WAC has determined that a rate of return on invested capital model (“RCAM”) is in the best interest of the public and the Company’s customers. RCAM is the rate model currently utilized in the electricity transmission and distribution license granted by the Cayman Islands government to the Caribbean Utilities Company, Ltd.

In July 2012, in an effort to resolve several issues relating to our retail license renewal negotiations, we filed an Application for Leave to Apply for Judicial Review (the “Application”) with the Grand Court of the Cayman Islands (the “Court”), stating that: (i) certain provisions of the Water Authority Law, 2011 and the Water (Production and Supply) Law, 2011, appear to be incompatible, (ii) the WAC’s roles as the principal license negotiator, statutory regulator and our competitor put the WAC in a position of hopeless conflict, and (iii) the WAC’s decision to replace the rate structure under our current exclusive license with RCAM was predetermined and unreasonable.

Throughout the course of the retail license renewal negotiations, we have objected to the use of RCAM on the basis that we believe such a model would not promote the efficient operation of our water utility and could ultimately increase water rates to our customers.

In October 2012, we were notified that the Court agreed to consider the issues raised in the Application. As a result, our Company, the Cayman Islands government and the WAC will have the opportunity to present their positions to the Court in a trial proceeding.

If we do not ultimately enter into a new license agreement and no other party is awarded a license, we expect to be permitted to continue to supply water to our service area.

The Cayman Islands government could offer a third party a license to service some or all of our present service area. In such event, we may assume the license offered to the third party by exercising our right of first refusal. However, the terms of any new license agreement may not be as favorable to us as the terms under which we are presently operating and could materially reduce the operating income and cash flows that we have historically generated from our retail license and could require us to record an impairment loss to further reduce the \$3,499,037 carrying value of our goodwill. Such impairment loss could be material to our results of operations.

**We rely on fixed-term water supply agreements with our bulk customers in the Cayman Islands, Belize and The Bahamas, which may not be renewed or may be renewed on terms less favorable to us.**

All of our bulk water supply agreements are for fixed terms ranging originally from seven to 23 years and with a range of less than one to 20 years remaining. Upon expiration, these agreements may not be renewed or may be renewed on terms less favorable to us. In addition, certain of these agreements for plants not owned by us provide for our customers to take over the operations of the plant upon expiration of the contract term. If this occurs, we may no longer generate income from such plants. In instances where we own the plant that produces the water under an agreement that is not renewed or renewed with lower production quantities, we may not be able to find a new customer for the plant's excess production capacity. If our fixed-term agreements are not renewed or are renewed on terms less favorable to us, our results of operations, cash flows and financial condition could be adversely affected.

**We have spent almost \$8 million to fund the development costs for a possible project in Mexico and expect to expend significant additional funds in 2013 and 2014 to continue to pursue this project. However, we may not be successful in completing this project.**

In May 2010, we acquired, through our wholly-owned Netherlands subsidiary, Consolidated Water Cooperatief, U.A., a 50% interest in N.S.C. Agua, S.A. de C.V., ("NSC") a Mexican company, and have since acquired the voting rights for, and an option to purchase, an additional 25% interest in this company. NSC has been formed to pursue a project encompassing the construction, ownership and operation of a 100 million gallon per day seawater reverse osmosis desalination plant to be located in northern Baja California, Mexico and an accompanying pipeline to deliver water to a Mexican potable water system and the U.S. border. We believe such a project can be successful due to what we anticipate will be a growing need for a new potable water supply for the areas of northern Baja California, Mexico and Southern California, United States. To complete this project, we have engaged two engineering groups with extensive regional and/or technical experience and have partnered with Doosan Heavy Industries and Construction ("DHIC"), a global leader in the engineering, procurement and construction of large seawater desalination plants. Once completed, one of our subsidiaries would operate the plant and we would retain a minority position in its ownership. NSC is in the development stage, and is presently involved in (i) purchasing additional land on which to build the plant, (ii) seeking contracts for the electric power and feed water sources for the plant's proposed operations, and (iii) conducting (under a Memorandum of Understanding with DHIC) an equipment piloting plant and water quality data collection program at the proposed feed water source. In addition to completing these activities, NSC will be required to complete various other steps before it can commence construction of the plant and pipeline including, but not limited to, obtaining approvals and permits from various governmental agencies in Mexico and the United States, securing contracts with its proposed customers to sell water in sufficient quantities and at prices that make the project financially viable, and obtaining equity and debt financing for the project. NSC's potential customers will also be required to obtain various governmental permits and approvals in order to purchase water from NSC.

For our 50% interest in NSC, we provided the initial funding of \$4.0 million in the form of equity for NSC's development activities and have also provided all subsequent funding for NSC. Because we exercise effective financial control over NSC and our partners in NSC have not participated in NSC's funding, we consolidate NSC's

results of operations. Included in our consolidated results of operations for the years ended December 31, 2012, 2011 and 2010 are approximately \$1.7 million, \$3.0 million and \$1.7 million, respectively, in general and administrative expenses from NSC, consisting of organizational, legal, accounting, engineering, consulting and other costs relating to its project development activities. The assets and liabilities of NSC included in our consolidated balance sheet amounted to approximately \$1,452,000 and \$116,000, respectively, as of December 31, 2012 and approximately \$121,000 and \$367,000, respectively, as of December 31, 2011.

In February 2012, we acquired an option, exercisable through February 7, 2014, to purchase the shares of one of the other shareholders of NSC along with an immediate power of attorney to vote those shares. As a result, we now have effective control of NSC.

In July 2012, NSC obtained an extension of the purchase contract for a portion of the land on which the proposed plant would be constructed. In exchange for additional prepayments of (i) \$500,000 paid at signing of the extension and (ii) a further \$500,000 payable on May 15, 2013, NSC was granted an extension of the purchase agreement until May 15, 2014. NSC is currently negotiating a purchase agreement for an additional parcel of land.

In August 2012, NSC and DHIC extended their Memorandum of Understanding for 18 months from August 19, 2012, pursuant to which DHIC provided and installed and is operating an equipment piloting plant and collecting water quality data from the proposed feed water source site in Rosarito Beach, Baja California, Mexico. This amended Memorandum of Understanding requires that NSC negotiate exclusively with DHIC for the construction of the 100 million gallon per day seawater reverse osmosis desalination plant and further requires payment by NSC to DHIC of up to \$500,000 as compensation for the operation and maintenance of the equipment piloting plant should NSC not award the engineering, procurement and construction contract for the project to DHIC.

We estimate that it will take at least through the second quarter of 2014 for NSC to complete all of the development activities (which include completing the site piloting plant activities, purchasing the land for the plant, securing feed water and power supplies, completing the engineering and feasibility studies, negotiating customer contracts, obtaining required regulatory permits and arranging the project financing) necessary to commence construction of the plant. During 2013, we expect to incur an additional \$5.7 million in expenses for these project development activities and to pay an additional \$2.2 million in deposits for the parcels of land for the project. We expect to incur additional development expenses for this project in 2014. However, NSC may ultimately be unable to complete all of the activities necessary to begin construction of the project.

**We do not have voting control over our affiliate, OC-BVI. Should our interests and the interests of OC-BVI's other voting shareholder diverge, the operations of OC-BVI could be adversely affected which could decrease the value of our investment in OC-BVI.**

We own 43.5% of the equity and 50% of the voting shares of OC-BVI. We and Sage, which owns the remaining 50% of the voting shares, are each entitled to appoint three of the six directors of OC-BVI. If a tie vote of the directors occurs on any matter, the president of the Caribbean Water and Wastewater Association, a regional trade association comprised primarily of government representatives, is entitled to appoint a temporary director to cast the deciding vote. As a result, although we provide operating management and engineering services to OC-BVI, we share the overall management of OC-BVI with Sage and do not fully control its operations. A divergence of our interests and the interests of Sage could adversely affect the operations of OC-BVI and in turn decrease the value of our investment in OC-BVI, in which case we could be required to record an impairment charge to reduce the carrying value of our investment in OC-BVI. Such an impairment charge would reduce our earnings and could have a significant adverse impact on our result of operations and financial condition.

**The profitability of our plants is dependent upon our ability to accurately estimate the costs of their construction and operation.**

The cost estimates we prepare in connection with the construction and operation of our plants are subject to inherent uncertainties. Additionally, the terms of our supply contracts may require us to guarantee the price of water on a per unit basis, subject to certain annual inflation and monthly energy cost adjustments, and to assume the risk that the costs associated with producing this water may be greater than anticipated. Because we base our contracted price of water in part on our estimation of future construction and operating costs, the profitability of our plants is dependent on our ability to estimate these costs accurately. The cost of materials and services and the cost of the delivery of such services may increase significantly after we submit our bid for a plant, which could cause the gross profit and net return on investment for a plant to be less than we anticipated when the bid was made. The profit margins we initially expect to generate from a plant could be further reduced if future operating costs for that plant exceed our estimates of such costs. These future operating costs could be affected by a variety of factors, including lower than anticipated production efficiencies and hydrological conditions at the plant site that differ materially from those we believe would exist at the time we submitted our bid. Any construction and operating costs for our plants that significantly exceed our initial estimates could adversely affect our results of operations, financial condition and cash flows.



**We could be required to record an impairment charge to further reduce the carrying value of our goodwill should we experience further weakness in the market price of our common shares.**

At times during the past two years the carrying value of our stockholders equity has exceeded our market capitalization. A decline in the market price of a company's common stock below its book value is one indication under U.S. generally accepted accounting principles that the carrying value of a company's goodwill may exceed its implied fair value.

We recorded an impairment charge of \$88,717 against our goodwill for the year ended December 31, 2012. Our remaining goodwill amounted to \$3,499,037 as of December 31, 2012. Should the market price of our common stock decline significantly in the future or should our common stock continue to trade at market prices lower than its book value, we may be required to record additional impairment charges for a portion or all of this goodwill. Such impairment charges could have an adverse impact on our results of operations.

**A significant portion of our consolidated revenues are derived from two customers. A loss of, or a less favorable relationship with, either of these customers could adversely affect us.**

Our top two bulk water customers, the Water Authority-Cayman and the Water and Sewerage Corporation of The Bahamas, accounted for approximately 14% and 44%, respectively, of our consolidated revenues for the year ended December 31, 2012. If either of these customers terminate or decide not to renew their contracts with us, or renew such contracts on terms that are less favorable to us, or become unable for financial or other reasons to comply with the terms of our contracts with them, our results of operations, cash flows and financial condition could be adversely affected. For additional information relating to this risk, see "Item 1. Business - Bulk Water Operations in The Bahamas - *Customers*".

**Possible future regulatory oversight and control could adversely impact our Belize operations.**

By Statutory Instrument No. 81 of 2009, the Minister of Public Utilities of the government of Belize published an order, the Public Utility Provider Class Declaration Order, 2009 (the "Order"), which as of May 1, 2009 designated CW-Belize as a public utility provider under the laws of Belize. With this designation, the Public Utilities Commission of Belize (the "PUC") has the authority to set the rates charged by CW-Belize and to otherwise regulate its activities. On November 1, 2010, CW-Belize received a formal complaint from the PUC alleging that CW-Belize was operating without a license under the terms of the Water Industry Act. CW-Belize applied for this license in December 2010. On July 29, 2011, the PUC issued the San Pedro Public Water Supply Quality and Security Complaint Order (the "Second Order") which among other things requires that (i) CW-Belize and its customer jointly make a submission to the responsible Minister requesting that the area surrounding CW-Belize's seawater abstraction wells be designated



a forest reserve or national park and be designated a Controlled Area under section 58 of the Water Industry Act, (ii) CW-Belize submit an operations manual for CW-Belize's desalination plant to the PUC for approval, (iii) CW-Belize and its customer modify the water supply agreement between the parties to (a) include new water quality parameters included in the Order and (b) cap the current exclusive water supply arrangement in the agreement at a maximum of 450,000 gallons per day, (iv) CW-Belize keep a minimum number of replacement seawater RO membranes in stock at all times and (v) CW-Belize take possession of and reimburse the PUC for certain equipment which the PUC purchased from a third-party in late 2010. CW-Belize has applied for declaratory judgment and has been granted a temporary injunction to stay the enforcement of the Second Order by the PUC until such time as the matter could be heard by the Belize courts. The initial hearing on this matter was conducted on October 30 and 31, 2012 with an additional hearing on November 29, 2012. The ruling on this case is pending. An unfavorable ruling on the Order or the Second Order could have an adverse impact on our results of operations, cash flows or financial condition.

**Our operations are affected by tourism and are subject to seasonal fluctuations which could affect the demand for our water.**

Our operations are affected by the levels of tourism and are subject to seasonal variations in our service areas. Demand for our water in the Cayman Islands, Belize, Bimini and the Bahamas is affected by variations in the level of tourism and local weather, primarily rainfall. Tourism in our service areas is affected by the economies of the tourists' home countries, primarily the United States and Europe, terrorist activity and perceived threats thereof, and increased costs of fuel and airfares. We normally sell more water during the first and second quarters, when the number of tourists is greater and local rainfall is less, than in the third and fourth quarters. A downturn in tourism or greater than expected rainfall in the locations we serve could adversely affect our revenues, cash flows and results of operations.

**We may have difficulty accomplishing our growth strategy within and outside of our current operating areas.**

Our expansion both within our current operating areas and into new areas involves significant risks, including, but not limited to, the following:

- regulatory risks, including government relations difficulties, local regulations, currency controls and fluctuations in currency exchange rates;
  - receiving and maintaining necessary permits, licenses and approvals;
- political instability, reliance on local economies, environmental problems, shortages of materials, immigration restrictions and limited skilled labor;
- risks related to development of new operations, including inaccurate assessment of the demand for water, engineering difficulties and inability to begin operations as scheduled; and
- risks relating to greater competition in these new territories, including the ability of our competitors to gain or retain market share by reducing prices.

Even if we successfully expand our operations, we may have difficulty managing our growth. We cannot assure you that any new operations within or outside of our current operating areas will attain or maintain profitability or that the results from these new operations will not adversely impact our results of operations, cash flows and financial condition.

**Production shortfalls under any of our bulk supply contracts could result in penalties or cancellation of the contract.**

Our bulk water supply contracts require us to deliver specified minimum volumes of water. Membrane fouling or other technical problems could occur at any of our plants, and if we are unable to meet the production minimums due to such operating issues, we could be in technical default of the supply contract and subject to various adverse consequences, including financial penalties or cancellation of the contract.

**Our operations could be harmed by hurricanes or tropical storms.**

A hurricane or tropical storm could cause major damage to our equipment and properties and the properties of our customers, including the large tourist properties in our areas of operation. For example, in September 2004 Hurricane Ivan caused significant damage to our plants and our customers' properties, which adversely affected our revenues. Any future damage could cause us to lose use of our equipment and properties and incur additional repair costs. Damage to our customers' properties and the adverse impact on tourism could result in a decrease in water demand. A

hurricane or tropical storm could also disrupt the delivery of equipment and supplies, including electricity, necessary to our operations. These and other possible effects of hurricanes or tropical storms could have an adverse impact on our results of operations, cash flows and financial condition.

**Contamination of our processed water may cause disruption in our services and adversely affect our revenues.**

Our processed water may become contaminated by natural occurrences and by inadvertent or intentional human interference, including acts of terrorism. In the event that a portion of our processed water is contaminated, we may have to interrupt the supply of water until we are able to install treatment equipment or substitute the flow of water from an uncontaminated water production source. In addition, we may incur significant costs in order to treat a contaminated source of plant feed water through expansion of our current treatment facilities, or development of new treatment methods. An inability by us to substitute processed water from an uncontaminated water source or to adequately treat the contaminated plant feed water in a cost-effective manner may have an adverse effect on our results of operations, cash flows and financial condition.

**Potential government decisions, actions and regulations could negatively affect our operations.**

We are subject to the local regulations of the Cayman Islands, Belize, the British Virgin Islands, and The Bahamas, all of which are subject to change. Any government that regulates our operations may issue legislation or adopt new regulations, including but not limited to:

- restricting foreign ownership (by us);
- providing for the expropriation of our assets by the government;
- providing for nationalization of public utilities by the government;
- providing for different water quality standards;
- unilaterally changing or renegotiating our licenses and agreements;
- restricting the transfer of U.S. currency; or
- causing currency exchange fluctuations/valuations or making changes in tax laws.

As new laws and regulations are issued, we may be required to modify our operations and business strategy, which we may be unable to do in a cost-effective manner. Failure by us to comply with applicable regulations could result in the loss of our licenses or authorizations to operate, the assessment of penalties or fines, or otherwise may have a material adverse effect on our results of operations.

**The rates we charge our retail customers in the Cayman Islands are subject to regulation. If we are unable to obtain government approval of our requests for rate increases, or if approved rate increases are untimely or inadequate to cover our projected expenses, our results of operations may be adversely affected.**

Under our exclusive retail license in the Cayman Islands, with the exception of annual inflation-related and monthly energy-related adjustments, we cannot increase the base rates we charge our retail customers without prior approval from the Cayman Islands government. However, the expenses we incur in supplying water under this license may increase due to circumstances that were unforeseen at the time we entered into the license. We may incur additional costs in attempting to obtain government approval of any rate increase, which may be granted on a delayed basis, if at all. Failure to obtain timely and adequate rate increases could have an adverse effect on our results of operations, cash flows and financial condition.

**We rely on the efforts of key employees. Our failure to retain these employees could adversely affect our results of operations.**

Our success depends upon the abilities of our executive officers. In particular, the loss of the services of Fredrick W. McTaggart, our President and Chief Executive Officer, could be detrimental to our operations and our continued success. Mr. McTaggart has an employment agreement expiring on December 31, 2015. Each year, the term of this agreement may be extended for an additional year. However, we cannot guarantee that Mr. McTaggart will continue to work for us during the term of his agreement or will enter into any extensions thereof.

**We are exposed to credit risk through our relationships with several customers.**

We are subject to credit risk posed by possible defaults in payment by our bulk water customers in the Cayman Islands, Belize, the British Virgin Islands and The Bahamas and by possible defaults in payment by the Water Authority-Cayman on their loans payable to us. Adverse economic conditions affecting, or financial difficulties of, those parties could impair their ability to pay us or cause them to delay payment. We depend on these parties to pay us on a timely basis. Our outstanding accounts receivable are not covered by collateral or credit insurance. Any delay or default in payment could adversely affect our results of operations, cash flows, and financial condition.

**We are exposed to the risk of variations in currency exchange rates.**

Although we report our results in United States dollars, the majority of our revenues are earned in other currencies. Although many of these of the currencies have been fixed to the United States dollar for more than 20 years others

(the Mexico peso, Indonesian rupiah and the euro) are not. We do not employ hedging strategies against the foreign current exchange rate risk associated with conducting business in foreign currencies while reporting in United States dollars. If any of the fixed exchange rates becomes a floating exchange rate, or the other currencies in which we conduct business depreciate significantly against the United State dollar, our results of operations and financial condition could be adversely affected.

**We may enter new markets in the future in which we do not have a contractual commitment for our products or existing customers.**

Our strategy contemplates potential entry into new markets (such as Mexico, Indonesia and other countries) where we believe a demand for potable water exists beyond the current supply of potable water in those markets. We may incur significant business development expenses in the pursuit of new markets prior to obtaining a contract for services in these markets, and such expenses could have an adverse impact on our results of operations and cash flows. We may decide to enter such markets by building new reverse osmosis desalination plants before we have obtained a contract for the sale of water produced by the new plant or before we have established a customer base for the water produced by the new plant. If after completing such plant we are unable to obtain a contract or sufficient number of customers for the plant, we may be unable to recover the cost of our investment in the plant, which could have a material adverse effect on our results of operations, cash flows and financial condition.

**We may not pay dividends in the future. If dividends are paid, they may be in lesser amounts than past dividends.**

Our shareholders may receive dividends out of legally available funds if, and when, they are declared by our Board of Directors. We have paid dividends in the past, but may cease to do so at any time. We may incur increased operating or development expenses or capital requirements or additional indebtedness in the future that may restrict our ability to declare and pay dividends. We may also be restricted from paying dividends in the future due to restrictions imposed by applicable corporate laws, our results of operations, cash flows and financial condition, covenants contained in our financing agreements, and other factors considered by our Board of Directors. We may not continue to pay dividends in the future or, if dividends are paid, they may not be in amounts similar to past dividends.

**Service of process and enforcement of legal proceedings commenced against us in the United States may be difficult to obtain.**

We are incorporated under the laws of the Cayman Islands and most of our assets are located outside of the United States. In addition, 10 of our 16 directors and executive officers reside outside the United States. As a result, it may be difficult for investors to affect service of process within the United States upon us and such other persons, or to enforce judgments obtained against such persons in United States courts, and bring any action, including actions predicated upon the civil liability provisions of the United States securities laws. In addition, it may be difficult for investors to enforce, in original actions brought in courts or jurisdictions located outside of the United States, rights predicated upon the United States securities laws.

Based on the advice of our Cayman Islands legal counsel, we believe there is no reciprocal statutory enforcement of foreign judgments between the United States and the Cayman Islands, and that foreign judgments originating from the United States are not directly enforceable in the Cayman Islands. A prevailing party in a United States proceeding against us or our officers or directors would have to initiate a new proceeding in the Cayman Islands using the United States judgment as evidence of the party's claim. A prevailing party could rely on the summary judgment procedures available in the Cayman Islands, subject to available defenses in the Cayman Islands courts, including, but not limited to, the lack of competent jurisdiction in the United States courts, lack of due service of process in the United States proceeding and the possibility that enforcement or recognition of the United States judgment would be contrary to the public policy of the Cayman Islands.

Depending on the nature of damages awarded, civil liabilities under the Securities Act of 1933, as amended (or the Securities Act), or the Securities Exchange Act of 1934, as amended (or the Exchange Act), for original actions instituted outside the Cayman Islands may or may not be enforceable. For example, a United States judgment awarding remedies unobtainable in any legal action in the courts of the Cayman Islands, such as treble damages, would likely not be enforceable under any circumstances.

**Low trading volume of our stock may limit your ability to sell your shares at or above the price you pay for them.**

During the year ended December 31, 2012, the average daily trading volume of our common shares was approximately 76,000 shares, a much lower trading volume than the stock of many other companies listed on the NASDAQ Global Select Market. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the market of willing buyers and sellers of our common shares at any given time. This presence in turn depends on the individual decisions of investors and general economic and market conditions over which we have no control. As a consequence of the limited volume of trading in our common shares, an investor in our stock may have difficulty selling a large number of our common shares in the manner or at the price that might be attainable if our common shares were more actively traded. In addition, as a result of our low trading

volume, the market price of our common shares may not accurately reflect their value.

**We are subject to anti-takeover measures that may discourage, delay or prevent a change of control of our Company.**

*Classified Board of Directors.* We have a classified Board of Directors that consists of three groups. Only one group of directors is elected each year. Our classified Board may increase the length of time necessary for an acquirer to change the composition of a majority of directors in order to gain control of our Board.



*Option Deed.* Our Board of Directors has adopted an Option Deed that is intended to improve the bargaining position of our Board of Directors in the event of an unsolicited offer to acquire our outstanding stock. Under the terms of the Option Deed, a stock purchase right is attached to each of our current or future outstanding common shares issued prior to the time the purchase rights become exercisable, are redeemed or expire. The purchase rights will become exercisable only if an individual or group has acquired, or obtained the right to acquire, or announced a tender or exchange offer that if consummated would result in such individual or group acquiring beneficial ownership of 20% or more of our outstanding common shares. Upon the occurrence of a triggering event, the rights will entitle every holder of our common shares, other than the acquirer, to purchase our shares or shares of our successor on terms that would likely be economically dilutive to the acquirer. Under certain circumstances, instead of common shares, our Board of Directors may issue cash or debt securities. Our Board of Directors, however, has the power to amend the Option Deed so that it does not apply to a particular acquisition proposal or to redeem the rights for a nominal value before they become exercisable. These features will likely encourage an acquirer to negotiate with our Board of Directors before commencing a tender offer or to condition a tender offer on our Board of Directors taking action to prevent the purchase rights from becoming exercisable. In March 2007, our Board extended the expiration date of the Option Deed through July 2017.

As a result of these anti-takeover measures, we could deter efforts to make changes to, or exercise control over, current management. In addition, our shareholders may not have an opportunity to sell their common shares to a potential acquirer at the acquirer's offering price, which is typically at a premium to market price.

**Restrictive covenants in our credit facilities and trust deeds could adversely affect our business by limiting our flexibility; our failure to comply with these covenants could cause foreclosure on our assets.**

Our credit facilities and the trust deeds governing the terms of our debt securities contain restrictive covenants. These covenants and requirements limit our ability, without approval of the lender or trustee, to take various actions, including incurring additional debt, making capital expenditures, guaranteeing indebtedness, engaging in various types of transactions, including mergers and sales of assets, and paying dividends and making distributions or other restricted payments. These covenants could place us at a disadvantage compared to some of our competitors which may not be required to operate under these or similar restrictions. Further, these covenants could have an adverse effect on our business by limiting our ability to take advantage of financing, acquisition or investment opportunities. A material breach of any of these covenants would constitute a default under our credit facilities or trust deeds. In the event of default, the lender or trustee may accelerate repayment of our outstanding indebtedness. If we are unable to repay the amounts accelerated, the lender or trustee has the right to foreclose on substantially all of our assets, which we have pledged to secure that indebtedness. Foreclosure upon our assets would have a significant adverse effect on our results of operations, cash flows, financial condition and ability to continue operations.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

### **Cayman Island Properties**

#### **Abel Castillo Water Works (formerly Governor's Harbour)**

We own our Abel Castillo Water Works ("ACWW") site and the 12,812 square feet of buildings, which contain two reverse osmosis water treatment plants, a distribution pump house and warehouse space, and operate and maintain the site through our wholly-owned subsidiary, Cayman Water. The site is located on 3.2 acres, including 485 feet of waterfront. The current water production capacity of our site is 2.2 million gallons per day by two separate water plants designated GHB-1 and GHB-2 with rated production capacities of 1.2 million and 1.0 million gallons per day, respectively. On this site we also have three 1.0 million gallon potable water storage tanks and a high service distribution pump house.

We own an approximately one acre property adjacent to our ACWW plant which we purchased in 2007 to provide space for future additional water production and storage facilities.

### West Bay Plant

We own, operate and maintain our West Bay plant in Grand Cayman, which is located on 6.1 acres in West Bay. The plant began operating in 1995 and was expanded in 1998, 2000 and 2008. On this site we have a 2,600 square foot building which houses our water production facilities, a 2,400 square foot building which houses the potable water distribution pumps, a water quality testing laboratory, and office space and water storage capacity consisting of three 1.0 million gallon potable water tanks. The capacity of our West Bay plant was expanded to 910,000 gallons per day in 2008.

### Britannia Plant

We own the Britannia seawater desalination plant in Grand Cayman, which consists of a seawater reverse osmosis production plant with a capacity of 715,000 gallons of water per day, an 840,000 gallon bolted steel water tank, potable water high service pumps, and various ancillary equipment to support the operation. We have entered into a lease of the 0.73 acre site and steel frame building which houses the plant from Cayman Hotel and Golf Inc., for a term that ends in 2027 at an annual rent of \$1.00.

### Distribution System

We own our Seven Mile Beach and West Bay potable water distribution systems in Grand Cayman. The combined systems consist of polyvinyl chloride and polyethylene water pipes, valves, curb stops, meter boxes, and water meters installed in accordance to accepted engineering standards in the United States of America.

### Corporate Office

We lease approximately 5,500 square feet of office space at the Regatta Office Park, West Bay Road, Grand Cayman, Cayman Islands. In October 2007, we exercised an option to extend this lease through April 30, 2011. In 2011, we extended the lease again through April 30, 2014.

### Red Gate Plant

Under the terms of the water production and supply license between OC-Cayman and the government of the Cayman Islands, OC-Cayman is allowed to use the property and the plant for the Red Gate plant to produce approximately 1.3 million gallons of desalinated water per day for sale to the Water Authority-Cayman. On November 30, 2008, the license was extended for a period of one year, during which time OC-Cayman was required to continue to operate and maintain the plant. In August 2008, the Water Authority-Cayman asked OC-Cayman to refurbish and make other improvements to the plant. The work was completed in July 2010. OC-Cayman was granted a new seven year license and operating agreement for the plant that commenced on that date.

#### Lower Valley Plant

OC-Cayman provided the plant and equipment to the Water Authority-Cayman under a vendor-financed sale and operating agreement which has been extended on two occasions. OC-Cayman operates the electrically-powered plant and supplies water to the Water Authority-Cayman.

In 2005, the Water Authority-Cayman accepted our proposal to increase the capacity of the Lower Valley plant to 1.1 million gallons per day in exchange for a seven-year extension of the license.

OC-Cayman leased the property on which the plant is located from the Water Authority-Cayman for a minimal annual rent for the duration of the operating agreement, which originally was set to expire on March 9, 2006, but was extended effective January 2006 with the seven-year extension of the license. Responsibility for operation of the Lower Valley plant passed to the Water Authority-Cayman upon expiration of the operating agreement in January 2013.

#### North Sound Plant

Construction of this plant was completed in November 2002. OC-Cayman provided the plant and equipment to the Water Authority-Cayman under a seven-year vendor-financed sale and operating agreement. OC-Cayman operates the electrically powered plant and supplies approximately 1.6 million gallons of desalinated water per day to the Water Authority-Cayman. OC-Cayman leases the property on which the plant is located from the Water Authority-Cayman for a minimal annual rent, for the duration of the sale and operating agreement. The sale and operating agreement and property lease were recently extended and expire in the first quarter of 2014. Responsibility for operation of the plant passes to the Water Authority-Cayman upon expiration of the sale and operating agreement.

#### North Side Water Works Plant

Construction of this plant was completed in June 2009. OC-Cayman provided the plant and equipment to the Water Authority-Cayman under a ten-year vendor-financed sale and operating agreement. OC-Cayman operates the electrically powered plant which can supply up to approximately 2.4 million gallons of desalinated water per day to the Water Authority-Cayman. OC-Cayman leases the property on which the plant is located from the Water Authority-Cayman for a minimal annual rent, for the duration of the sale and operating agreement. Responsibility for operation of the plant passes to the Water Authority-Cayman upon expiration of the sale and operating agreement.

#### **Belize Properties**

We own our San Pedro water production facility in Ambergris Caye, Belize. The plant consists of a one story concrete block building, which contains a seawater reverse osmosis water production plant with a production capacity of 550,000 gallons per day and a 1.0 million gallon storage tank. We lease the land on which our plant is located from the Government of Belize at an annual rent of BZE\$1.00. This lease expires in April 2026.

#### **Bahamas Properties**

We own the water production facility in South Bimini. The facility consists of a 250,000 gallon bolted steel potable water tank and two 40 foot long standard shipping containers which contain a seawater reverse osmosis production plant with a rated capacity of 115,000 gallons per day, a high service pump skid and an office. The facility is located on a parcel of land owned by South Bimini International Ltd., and we are allowed, under the terms of our agreement, to utilize the land for the term of the agreement without charge.

We own a water production facility, the Windsor plant, located in Nassau, New Providence, with a production capacity of 3.1 million gallons per day. The plant is powered by a combination of diesel engine-driven high-pressure pumps, and electrical power purchased from the Bahamas Electricity Corporation to power all other loads in the plant. The plant is contained within a 13,000 sq. ft. concrete and steel building that also contains a warehouse, workshop and offices. It is located on land owned by the Water and Sewerage Corporation of The Bahamas and our 15-year water sales agreement gives us a license to use the land throughout the term of that agreement. This water supply agreement expires the later of March 2013 or the date we deliver the total amount of water required under the agreement. We estimate we will deliver this total amount in May 2013.

In July 2006, we substantially completed construction of a second water production facility in Nassau, New Providence: the Blue Hills plant. With a production capacity of 7.2 million gallons per day this plant is the largest desalination plant we have built or operated to date. The plant is powered by a combination of diesel engine-driven high-pressure pumps, and electrical power purchased from the Bahamas Electricity Corporation to power all other loads in the plant. The plant is contained within a 16,000 sq. ft. concrete and steel building that also contains a warehouse, workshop and offices. It is located on land owned by the Water and Sewerage Corporation of The Bahamas and our 20-year water sales agreement gives us a license to use the land throughout the term of that agreement. The Blue Hills plant water supply agreement was amended in January, 2011 and extended through 2032. Pursuant to this amendment we increased the production capacity of the Blue Hills plant to 12.0 million gallons per day.

### **U.S. Properties**

Our Aquilex office consists of 6,500 square feet located in Coral Springs, Florida that has been leased through May 2016. Our U.S. warehouse consists of 4,100 square feet warehouse in Sunrise, Florida that has been leased through October 2015.

### ITEM 3. LEGAL PROCEEDINGS

By Statutory Instrument No. 81 of 2009, the Minister of Public Utilities of the government of Belize published an order, the Public Utility Provider Class Declaration Order, 2009 (the “Order”), which as of May 1, 2009 designated CW-Belize as a public utility provider under the laws of Belize. With this designation, the Public Utilities Commission of Belize (the “PUC”) has the authority to set the rates charged by CW-Belize and to otherwise regulate its activities. On November 1, 2010, CW-Belize received a formal complaint from the PUC alleging that CW-Belize was operating without a license under the terms of the Water Industry Act. CW-Belize applied for this license in December 2010. On July 29, 2011, the PUC issued the San Pedro Public Water Supply Quality and Security Complaint Order (the “Second Order”) which among other things requires that (i) CW-Belize and its customer jointly make a submission to the responsible Minister requesting that the area surrounding CW-Belize’s seawater abstraction wells be designated a forest reserve or national park and be designated a Controlled Area under section 58 of the Water Industry Act, (ii) CW-Belize submit an operations manual for CW-Belize’s desalination plant to the PUC for approval, (iii) CW-Belize and its customer modify the water supply agreement between the parties to (a) include new water quality parameters included in the Order and (b) cap the current exclusive water supply arrangement in the agreement at a maximum of 450,000 gallons per day, (iv) CW-Belize keep a minimum number of replacement seawater RO membranes in stock at all times and (v) CW-Belize take possession of and reimburse the PUC for certain equipment which the PUC purchased from a third-party in late 2010. CW-Belize has applied for declaratory judgment and has been granted a temporary injunction to stay the enforcement of the Second Order by the PUC until such time as the matter could be heard by the Belize courts. The initial hearing on this matter was conducted on October 30 and 31, 2012 with an additional hearing on November 29, 2012. The ruling on this case is pending. We are presently unable to determine what impact the Order and the Second Order will have on our results of operations, financial position or cash flows.

In July 2012, in an effort to resolve several issues relating to our retail license renewal negotiations, we filed an Application for Leave to Apply for Judicial Review (the “Application”) with the Grand Court of the Cayman Islands (the “Court”), stating that: (i) certain provisions of The Water Authority Law, 2011 and The Water (Production and Supply) Law, 2011, appear to be incompatible, (ii) the Water Authority- Cayman’s roles as the principal license negotiator, statutory regulator and our competitor put the WAC in a position of hopeless conflict, and (iii) the WAC’s decision to replace the rate structure under our current exclusive license with RCAM was predetermined and unreasonable.

Throughout the course of the retail license renewal negotiations, we have objected to the use of RCAM on the basis that we believe such a model would not promote the efficient operation of our water utility and could ultimately increase water rates to our customers.

In October 2012, we were notified that the Court agreed to consider the issues raised in the Application. As a result, our Company, the Cayman Islands government and the WAC will have the opportunity to present their positions to the Court in a trial proceeding.

**ITEM 4. MINE SAFETY DISCLOSURE**

Not applicable.

**PART II**

**ITEM MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS  
5. AND ISSUER PURCHASES OF EQUITY SECURITIES**

**Market Information**

Our Class A common stock is listed on the NASDAQ Global Select Market and trades under the symbol “CWCO.” Listed below, for each quarter of the last two fiscal years, are the high and low closing prices for our Class A common stock on the NASDAQ Global Select Market.

	High	Low
First Quarter 2012	\$9.16	\$7.44
Second Quarter 2012	8.29	6.99
Third Quarter 2012	8.70	7.93
Fourth Quarter 2012	8.29	6.78
First Quarter 2011	\$11.43	\$9.44
Second Quarter 2011	10.78	8.58
Third Quarter 2011	9.55	7.66
Fourth Quarter 2011	9.78	7.26

No trading market exists for our redeemable preferred shares, which are only issued to, or purchased by, long-term employees of our company and must be held by these employees for a period of four years before they vest.

On December 19, 2012, we issued 10,886 shares of common stock to our directors under the Non-Executive Directors’ Share Plan in consideration for their service on our Board of Directors and the committees thereof. See “Item 11. Executive Compensation.”

On September 27, 2005, the Company entered into a Second Deed of Amendment (the “Amendment”) to its Option Deed dated as of August 6, 1997 and as amended on August 8, 2005 between the Company and American Stock Transfer & Trust Company (the “Option Deed”). In March 2007, our Board extended the expiration date of the Option



Deed through July 31, 2017.

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The Option Deed grants to each holder of a common and preferred share an option to purchase one one-hundredth of a class B common share at an exercise price of \$100.00 subject to adjustment. If an attempt to take over control of the Company occurs, each shareholder of the Company would be able to exercise the option and receive common shares with a value equal to twice the exercise price of the option. Under circumstances described in the Option Deed, as amended, instead of receiving common shares, the Company may issue to each shareholder (i) cash; (ii) other equity or debt securities of the Company; or (iii) the equity securities of the acquiring company, as the case may be, with a value equal to twice the exercise price of the option.

Pursuant to the Amendment to the Option Deed, each holder of a common and redeemable preferred share has the option to purchase one one-hundredth of a class B common share at an exercise price of \$50.00, subject to adjustment. The Amendment does not modify the Option Deed in any other material respect.

The options are attached to each common share and redeemable preferred share, and presently have no monetary value. The options will not trade separately from the Company's shares unless and until they become exercisable. The options, which expire on July 31, 2017, may be redeemed, at the option of the Company's Board of Directors, at a price of CI\$.01 per option at any time until ten business days following the date that a group or person acquires ownership of 20% or more of the Company's outstanding common shares.

Currently 2,023,850 Bahamian Depository Receipts ("BDRs") that constitute ownership of 404,770 shares of our common stock are listed and traded on the Bahamian International Stock Exchange. Our common shares that underlie these BDRs are held in a custodial account in The Bahamas. The BDRs are entitled to dividend payments, if and when declared on our common shares, in proportion to their relative value to our common shares.

## **Holder**s

On March 8, 2013, we had 813 holders of record of our common stock.

## **Dividends**

We have paid dividends to owners of our common shares and redeemable preferred shares since we began declaring dividends in 1985. However, the payment of any future cash dividends will depend upon our earnings, financial condition, cash flows, capital requirements and other factors our Board of Directors deems relevant in determining the amount and timing of such dividends.

The Board of Directors declares and approves all dividends.

Listed below, for each quarter of the last two fiscal years, is the amount of dividends declared on our issued and outstanding shares of common shares and redeemable preferred shares.

Fourth Quarter 2012	\$0.075	Per Share
Third Quarter 2012	0.075	Per Share
Second Quarter 2012	0.075	Per Share
First Quarter 2012	0.075	Per Share

Fourth Quarter 2011	\$0.075	Per Share
Third Quarter 2011	0.075	Per Share
Second Quarter 2011	0.075	Per Share
First Quarter 2011	0.075	Per Share

#### **Exchange Controls and Other Limitations Affecting Security Holders**

Our Company is not subject to any governmental laws, decrees or regulations in the Cayman Islands which restrict the export or import of capital, or that affect the remittance of dividends, interest or other payments to non-resident holders of our securities. The Cayman Islands does not impose any limitations on the right of non-resident owners to hold or vote our common stock. There are no exchange control restrictions in the Cayman Islands.

## **Taxation**

The Cayman Islands presently impose no taxes on profit, income, distribution, capital gains, or appreciations of our Company and no taxes are currently imposed in the Cayman Islands on profit, income, capital gains, or appreciations of the holders of our securities or in the nature of estate duty, inheritance, or capital transfer tax. The United States and the Cayman Islands do not have an income tax treaty.

The information required by Item 201(d) of Regulation S-K is provided under ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS of this Annual Report.

**ITEM 6. SELECTED FINANCIAL DATA**

The table below contains selected financial data, derived from our audited consolidated financial statements for each of the years in the five-year period ended December 31, 2012. Our consolidated financial statements are prepared in accordance with the accounting principles generally accepted in the United States of America (“US-GAAP”). As a result, all financial information presented herein has been prepared in accordance with US-GAAP. This selected financial data should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and with our consolidated financial statements and related notes thereto contained elsewhere in this Annual Report.

	Year Ended December 31,				
	2012	2011	2010	2009	2008
<b>Statement of Income Data:</b>					
Revenue	\$65,450,702	\$55,154,492	\$50,708,554	\$58,019,517	\$65,678,959
Net Income attributable to Consolidated Waters Co. Ltd. stockholders	9,315,514	6,113,218	6,292,025	6,098,571	7,209,716
<b>Balance Sheet Data:</b>					
Total Assets	150,449,086	160,859,431	152,201,566	154,475,781	154,656,574
Long Term Debt Obligations (including current portion)	6,852,660	24,383,794	18,306,785	21,129,267	22,358,340
Redeemable Preferred Stock	18,159	13,456	10,070	10,315	10,420
Non-controlling interests	1,928,024	1,556,529	1,600,167	1,449,030	2,020,721
Dividends Declared Per Share	\$0.30	\$0.30	\$0.30	\$0.28	\$0.33
Basic Earnings Per Share	\$0.64	\$0.42	\$0.43	\$0.42	\$0.50
Weighted Average Number of Shares	14,578,518	14,560,259	14,547,065	14,535,192	14,519,847
Diluted Earnings Per Share	\$0.64	\$0.42	\$0.43	\$0.42	\$0.50
Weighted Average Number of Shares	14,606,148	14,596,013	14,597,894	14,588,144	14,538,971

**ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Overview**

Our objective is to provide water services in areas where the supply of potable water is scarce and where the use of reverse osmosis technology to produce potable water is economically feasible.

We intend to increase revenues by developing new business opportunities both within our current service areas and in new areas. We expect to maintain operating efficiencies by continuing to focus on our successful business model and

by properly executing our equipment maintenance and water loss mitigation programs. We believe that many water scarce countries in the Caribbean basin, and other select markets present opportunities for our business model.

Our operations and activities, and those of our affiliate OC-BVI, are presently conducted at 14 plants in four countries: the Cayman Islands, The Bahamas, Belize and the British Virgin Islands. The following table sets forth the comparative combined production capacity of our retail, bulk and affiliate operations as of December 31 of each year.

Comparative Operations

2012			2011		
Location	Plants	Capacity <sup>(1)</sup>	Location	Plants	Capacity <sup>(1)</sup>
Cayman Islands	8	10.2	Cayman Islands	8	10.2
Bahamas	3	15.2	Bahamas	3	15.2
Belize	1	0.6	Belize	1	0.6
British Virgin Islands	2	0.8	British Virgin Islands	2	0.8
Bermuda	-	-	Bermuda <sup>(2)</sup>	-	-
	14	26.8		14	26.8

(1) In millions of gallons per day.

(2) Operated one plant in Bermuda through the expiration of the agreement on June 30, 2011.

## **Cayman Islands**

We have been operating our business on Grand Cayman Island since 1973 and have been using reverse osmosis technology to convert seawater to potable water since 1989. The Cayman Islands have a limited natural supply of fresh water. 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. Our operations consist of eight reverse osmosis seawater conversion plants which provide water to approximately 5,300 retail residential and commercial customers within a government licensed area and bulk water sales to the Water Authority-Cayman (“WAC”). Our pipeline system in the Cayman Islands covers the Seven Mile Beach and West Bay areas of Grand Cayman and consists of approximately 77 miles of polyvinyl chloride and high density polyethylene pipe.

Our exclusive license from the Cayman Islands government was set to expire on July 30, 2010, however we and the Cayman Islands government have extended the license several times in order to provide sufficient time to negotiate the terms of a new license. The most recent extension of our license expires March 30, 2013. In 2011 the Cayman Islands government enacted new water regulation laws pursuant to which the WAC will issue any new retail license. We have been informed during our retail license negotiations that the Cayman Islands government seeks to restructure the terms of our license to employ a rate of return on invested capital model, the implementation of which could significantly reduce the operating income and cash flows we have historically generated from our retail license. See further discussion of this matter at ITEM 1A. RISK FACTORS and ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS - Material Commitments, Expenditures and Contingencies – *Renewal of Retail License*.

## **Bahamas**

CW-Bahamas produces potable water from three reverse osmosis seawater conversion plants. Two of these plants, the Windsor plant and the Blue Hills plant, are located in New Providence and have a total installed capacity of 15.1 million gallons per day. CW-Bahamas supplies water from these plants on a take-or-pay basis to the Water and Sewerage Corporation of The Bahamas (“WSC”) under long-term build, own and operate supply agreements. During 2012, we supplied approximately 4.6 billion gallons (2011: 3.2 billion gallons) of water to the WSC from these plants. The Windsor water supply agreement expires the later of March 2013 or the date we deliver the total amount of water required under the agreement. We estimate we will deliver this total amount in May 2013. CW-Bahamas’ third plant is located in Bimini, has a capacity of 115,000 gallons per day, and provides potable water to the Bimini Sands Resort and to the Bimini Beach Hotel. We have also sold water intermittently to the WSC from our Bimini plant when their regular supply was unavailable.

From time to time, CW-Bahamas has experienced delays in collecting its accounts receivable due to financial difficulties experienced by the WSC. CW-Bahamas was due approximately \$7.6 million from the WSC as of December 31, 2012. Representatives of the Bahamas government have informed us that the delay in paying our accounts receivables is due to operating issues within the WSC, that the delay does not reflect any type of dispute with us with respect to the amounts owed, and that the amounts will ultimately be paid in full. We believe that the accounts receivable from the WSC are fully collectible and therefore have not provided any allowance for possible non-payment of these receivables as of December 31, 2012.

## **Belize**

CW-Belize was acquired on July 21, 2000, and consists of one reverse osmosis seawater conversion plant on Ambergris Caye, Belize, Central America capable of producing 550,000 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.

In 2009, the Minister of Public Utilities of the government of Belize published a declaratory order designating CW-Belize as a public utility provider. With this order the Public Utilities Commission of Belize ("PUC") has the authority to regulate CW-Belize's activities. In 2011, the PUC issued a second order that requires CW-Belize to take various actions mandated by the PUC that would be significant to its operations. Hearings on this matter have been conducted in a Belize court and the ruling on the matter is pending. See further discussion of this matter at ITEM 1A. RISK FACTORS.



## **Bermuda**

In January 2007, our affiliate, Consolidated Water (Bermuda) Limited (“CW-Bermuda”) entered into a design, build, sale and operating agreement with the Government of Bermuda for a desalination plant to be built in two phases at Tynes Bay along the northern coast of Bermuda. Under the agreement, CW-Bermuda constructed and operated the plant from the second quarter of 2009 through the expiration of the agreement on June 30, 2011. We entered into a management services agreement with CW-Bermuda for the design, construction and operation of the Tynes Bay plant, under which we received fees for direct services, purchasing activities and proprietary technology. Although we own only 40% of the common shares of CW-Bermuda, we consolidate its results in our consolidated financial statements as we are its primary financial beneficiary. As a result of the expiration of its agreement with the Bermuda government, we do not expect to receive any future fees or revenues from CW-Bermuda.

## Critical Accounting Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Our actual results could differ significantly from such estimates and assumptions.

Certain of our accounting estimates or assumptions constitute “critical accounting estimates” for us due to the fact that:

the nature of these estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and

- the impact of the estimates and assumptions on financial condition and results of operations is material.

Our critical accounting estimates relate to (i) the valuation of our equity investment in our affiliate, OC-BVI; (ii) goodwill and intangible assets; and (iii) plant construction revenues and costs.

*Valuation of Equity Investment in OC-BVI.* We account for our investment in OC-BVI under the equity method of accounting for investments in common stock. This method requires recognition of a loss on an equity investment that is other than temporary, and indicates that a current fair value of an equity investment that is less than its carrying amount may indicate a loss in the value of the investment. OC-BVI's dispute and resulting litigation with the BVI government relating to the Baughers Bay plant have resulted in a fair value of our investment in OC-BVI that was at one time less than our carrying value for this investment, as discussed in the paragraphs that follow.

As a quoted market price for OC-BVI's stock is not available, to test for possible impairment of our investment in OC-BVI we estimate its fair value through use of the discounted cash flow method, which relies upon seven-year discrete projections of OC-BVI's operating results, working capital and capital expenditures. The use of this method requires us to estimate the cash flows from OC-BVI's contract with the BVI government to supply water from its Bar Bay plant. For the year ended December 31, 2011 and prior years, the use of this method also required us to estimate the cash flows OC-BVI expected to obtain from the resolution of its dispute and resulting litigation with the BVI government over the ownership and operation of the Baughers Bay plant by (i) identifying various possible outcomes of the Baughers Bay litigation and estimating the cash flows associated with each possible outcome; and (ii) assigning a probability to each Baughers Bay outcome and associated expected cash flows based upon discussions held by OC-BVI's management with the BVI government and OC-BVI's legal counsel. The resulting probability weighted sum represented the expected cash flows, and our best estimate of future cash flows, to be derived by OC-BVI from the

Baughers Bay litigation. This sum was then added to OC-BVI's estimated cash flows from its Bar Bay plant and the total was present-valued to estimate OC-BVI's fair value.

The identification of the possible outcomes for the Baughers Bay dispute, the projections of cash flows for each outcome, and the assignment of relative probabilities to each outcome all represented significant estimates made by us. While we used our best judgment to identify the possible outcomes and expected cash flows for these outcomes and assign relative probabilities to each outcome, these estimates were by their nature highly subjective and were also subject to material change by our management over time based upon additional information from OC-BVI's management and legal counsel, and a change in the status of OC-BVI's litigation with the BVI government. After considering the September and October 2009 rulings of the Eastern Caribbean Supreme Court (the "Court") relating to the Baughers Bay litigation and an announcement by the BVI government in February 2010 that it had signed a contract with another company to construct and operate a plant to provide potable water to the greater Tortola area served by the Baughers Bay plant, we determined that the carrying value of our investment in OC-BVI exceeded the estimated fair value for our investment in OC-BVI and therefore recognized impairment losses aggregating approximately \$4.7 million for the year ended December 31, 2009.

The remaining carrying value of our investment in OC-BVI of \$6.6 million as of December 31, 2011 assumed that the BVI government would ultimately pay OC-BVI the full amount awarded by the Court in its 2009 rulings and fulfill its obligations to purchase water under the Bar Bay plant agreement. In June 2012, the Eastern Caribbean Court of Appeals issued the final ruling with respect to the Baughers Bay litigation. This ruling dismissed the BVI government's appeal against the previous judgment of the Court awarding \$10.4 million for the water supplied, and also awarded OC-BVI compensation for improvements made to the plant in the amount equal to the difference between (i) the value of the Baughers Bay plant at the date OC-BVI transferred possession of the plant to the BVI government and (ii) \$1.42 million (the purchase price for the Baughers Bay plant under the 1990 Agreement). OC-BVI was also awarded all of its court costs at the trial level and two-thirds of such costs incurred on appeal. Prior to the final ruling the BVI government had paid only \$5.0 of the original \$10.4 million, and the remaining \$5.4 million amount due had increased to approximately \$6.7 million by the fourth quarter of 2012 due to the court costs awarded by the Appellate Court and the accrued interest due on the aggregate unpaid balance. The BVI government paid OC-BVI \$4.7 million of this amount during the fourth quarter of 2012 and the remaining \$2.0 million in January 2013.

The remaining carrying value of our investment in OC-BVI of \$6.9 million as of December 31, 2012 assumes that the BVI government will honor its obligations under Bar Bay plant water supply agreement. If the BVI government fails to honor the terms of this agreement, the actual cash flows from OC-BVI could vary materially from the expected cash flows we used in determining OC-BVI's fair value as of December 31, 2012, and we would be required to record an additional loss to reduce the carrying value of our investment in OC-BVI. Such impairment loss would reduce our earnings and could have a material adverse impact on our results of operations and financial condition.

*Goodwill and intangible assets.* Goodwill represents the excess cost over the fair value of the assets of an acquired business. Goodwill and intangible assets acquired in a business combination accounted for as a purchase and determined to have an indefinite useful life are not amortized, but are tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values and reviewed periodically for impairment. We evaluate the possible impairment of goodwill annually as part of our reporting process for the fourth quarter of each fiscal year. Management identifies our reporting units and determines the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units. We determine the fair value of each reporting unit and compare the fair value to the carrying amount of the reporting unit. To the extent the carrying amount of the reporting unit exceeds the fair value of the reporting unit, we are required to perform the second step of the impairment test, as this is an indication that the reporting unit goodwill may be impaired. In this step, we compare the implied fair value of the reporting unit goodwill with the carrying amount of the reporting unit goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit to all the assets (recognized and unrecognized) and liabilities of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. If the implied fair value is less than its carrying amount, the impairment loss is recorded.

For the years in the three-year period ended December 31, 2012 we estimated the fair value of our reporting units by applying the discounted cash flow method, the subject company stock price method, the guideline public company method, the mergers and acquisitions method and, on an exception basis and where necessary and appropriate, the net asset value method.

The discounted cash flow method relied upon seven-year discrete projections of operating results, working capital and capital expenditures, along with a terminal value subsequent to the discrete period. These seven-year projections were based upon historical and anticipated future results, general economic and market conditions, and considered the impact of planned business and operational strategies. The discount rates for the calculations represented the estimated cost of capital for market participants at the time of each analysis. In preparing these seven year projections for 2012 for our retail unit we (i) identified various possible outcomes of our on-going negotiations with the Cayman Islands government for the renewal of our retail license; (ii) estimated the cash flows associated with each possible outcome; and (iii) assigned a probability to each outcome and associated estimated cash flows. The weighted average estimated cash flows were then summed to determine the overall fair value of the retail unit under this method. The possible outcomes used for the discounted cash flow method for the retail unit included the implementation of a rate of return on invested capital model, the methodology proposed by Cayman Islands government representatives for the new retail license.

We also estimated the fair value of each of our reporting units for each of the years in the three-year period ended December 31, 2012 through reference to the quoted market prices for our Company and guideline companies and the market multiples implied by guideline merger and acquisition transactions. For the year ended December 31, 2012 we also relied upon net asset values to estimate the fair value of our services unit.

We weighted the fair values estimated for each of our reporting units under each method and summed such weighted fair values to estimate the overall fair value for each reporting unit. In recognition of the fact that our common stock has traded at prices less than its book value per share during the past two years we changed the relative weightings for 2012 from those used for 2011 to increase the weightings applied to those methods that resulted in more conservative estimates of fair value. The respective weightings we applied to each method for the years ended December 31, 2012 and 2011 are as follows:

Method	2012			2011		
	Retail	Bulk	Services	Retail	Bulk	Services
Discounted cash flow	20 %	30 %		20 %	10 %	20 %
Subject company stock price	60 %	50 %	10 %	40 %	10 %	80 %
Guideline public company	10 %	10 %		20 %	40 %	
Mergers and acquisitions	10 %	10 %		20 %	40 %	
Net asset value			90 %			
	100 %	100 %	100 %	100 %	100 %	100 %

The fair values we estimated for our retail, bulk and services units exceeded their carrying amounts for the year ended December 31, 2011. The fair values we estimated for our retail and bulk units exceeded their carrying amounts by 39% and 6%, respectively, for the year ended December 31, 2012. The fair value we estimated for our services unit for the year ended December 31, 2012 was 10% less than its carrying amount. As a result of this estimate and our subsequent step 2 analysis of the implied fair value of the goodwill recorded for our services unit, we recorded an impairment charge for the services unit goodwill of \$88,717 for the year ended December 31, 2012. Based upon the discounted cash flows and market approach methodologies employed in our analyses, no other impairment charges were required for our goodwill for any of the years in the three-year period ended December 31, 2012.

We also performed an analysis reconciling the conclusions of value for our reporting units to our market capitalization at October 1, 2012. This reconciliation resulted in an implied control premium for our Company of 32.6 %.

*Plant construction revenue and cost of plant construction revenue.* We recognize revenue and related costs as work progresses on fixed price contracts for the construction of desalination plants to be sold to third parties using the percentage-of-completion method, which relies on contract revenue and estimates of total expected costs. We follow this method since we can make reasonably dependable estimates of the revenue and costs applicable to various stages of a contract. Under the percentage-of-completion method, we record revenue and recognize profit or loss as work on the contract progresses. Our engineering personnel estimate total project costs and profit to be earned on each long term, fixed price contract prior to commencement of work on the contract and update these estimates as work on the contract progresses. The cumulative amount of revenue recorded on a contract at a specified point in time is that percentage of total estimated revenue that incurred costs to date comprise of estimated total contract costs. As work progresses, if the actual contract costs exceed estimates, the profit recognized on revenue from that contract decreases. We recognize the full amount of any estimated loss on a contract at the time the estimates indicate such a loss. To date we have not experienced a material adverse variation from our cost estimates for plants constructed for sale to third parties.

We assume the risk that the costs associated with constructing the plant may be greater than we anticipated in preparing our bid. However, the terms of each of the sales contracts with our customers require us to guarantee the sales price for the plant at the bid amount. Because we base our contracted sales price in part on our estimation of future construction costs, the profitability of our plant sales is dependent on our ability to estimate these costs accurately. The cost estimates we prepare in connection with the construction of plants to be sold to third parties are subject to inherent uncertainties. The cost of materials and construction may increase significantly after we submit our bid for a plant due to factors beyond our control, which could cause the gross margin for a plant to be less than we anticipated when the bid was made. The gross profit we initially expect to generate from a plant sale could be further affected by other factors, such as hydro-geologic conditions at the plant site that differ materially from those we believe exist and relied upon when we submitted our bid.

**Quarterly Results of Operations**

The following table presents unaudited quarterly results of operations for the eight quarters ended December 31, 2012. We believe that all adjustments, consisting only of normal recurring adjustments, necessary to present fairly such quarterly information have been included in the amounts reported below.

	Year Ended December 31, 2012			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Total revenues	\$16,728,727	\$16,230,779	\$15,840,136	\$16,651,060
Gross profit	5,947,849	5,405,410	5,241,284	5,397,899
Net income attributable to Consolidated Water Co. Ltd. stockholders	2,342,666	1,957,492	1,304,843	3,710,513
Diluted earnings per share	0.16	0.13	0.09	0.25

	Year Ended December 31, 2011			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Total revenues	\$13,906,620	\$14,835,872	\$12,806,652	\$13,605,348
Gross profit	5,250,555	5,251,205	4,008,850	4,511,457
Net income attributable to Consolidated Water Co. Ltd. stockholders	1,993,010	1,929,662	1,286,068	904,478
Diluted earnings per share	0.14	0.13	0.09	0.06

## Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our audited consolidated financial statements and accompanying notes included under Part II, Item 8. Financial Statements and Supplementary Data, of this Annual Report.

### Year Ended December 31, 2012 Compared to Year Ended December 31, 2011

#### Consolidated Results

Net income attributable to Consolidated Water Co. Ltd. common stockholders for 2012 was \$9,315,514 (\$0.64 per share on a fully-diluted basis), as compared to \$6,113,218 (\$0.42 per share on a fully-diluted basis) for 2011.

Total revenues for 2012 were \$65,450,702, up from the \$55,154,492 in revenues for 2011, as revenue increases for our bulk segment and, to a much lesser extent our retail segment, more than offset a decline in services segment revenues. Gross profit for 2012 was \$21,992,442 or 34% of total revenues, as compared to \$19,022,067, or 34% of total revenues, for 2011. Gross profit for the retail and bulk segments improved while gross profit for the services segment declined in 2012 from 2011. For further discussion of revenues and gross profit for 2012, see the “Results by Segment” analysis that follows.

General and administrative (“G&A”) expenses on a consolidated basis were \$14,542,817 and \$13,651,650 for 2012 and 2011, respectively. The growth of approximately 7% in General and Administrative expenses in 2012 resulted from (i) incremental employee expenses of approximately \$486,000 attributable to additional management and information technology personnel and base salary increases; (ii) additional research and development costs of approximately \$277,000; (iii) an increase in other business development costs (i.e. - for projects other than NSC’s Mexico initiative) of approximately \$821,000; (iv) incremental depreciation expense of approximately \$170,000; and (v) smaller increases in various miscellaneous expense categories. The overall increase in 2012 consolidated G&A expenses was in part offset by a decrease of approximately \$1.3 million in the project development expenses incurred by NSC, our consolidated Mexico affiliate.

Interest expense decreased to \$876,971 for 2012 from \$1,141,744 for 2011 as a result of the prepayment on March 31, 2012 of the remaining \$8.5 million of our 7.5% bonds payable and declining principal balances on our remaining bonds payable.



We recognized earnings and profit sharing on our investment in OC-BVI for 2012 and 2011 of \$2,464,773 and \$838,652, respectively. Our earnings from OC-BVI increased from 2011 due to the receipt by OC-BVI during the fourth quarter of 2012 of approximately \$4.7 million of the amount awarded in the Baughers Bay litigation. See further discussion of OC-BVI at “Liquidity and Capital Resources — Material Commitments, Contingencies and Expenditures — OC-BVI Litigation.”

## Results by Segment

### *Retail Segment:*

The retail segment contributed \$1,370,112 and \$2,757,449 to our income from operations for 2012 and 2011, respectively.

Revenues generated by our retail water operations were \$24,222,895 and \$23,356,338 for 2012 and 2011, respectively. The number of gallons of water sold by our retail segment decreased by almost 2% from 2011 to 2012. We believe this decrease in the volume of water sold by our retail segment resulted from abnormally high rainfall on Grand Cayman during the three months ended June 30, 2012. As reported by the Cayman Islands National Weather Service, Grand Cayman received approximately 28 inches of rainfall during the three months ended June 30, 2012, as compared to just over four inches during the three months ended June 30, 2011 and a 30 year average for the second quarter ended June 30 of approximately 13 inches. The impact of the decrease in the volume of water sold in 2012 on retail revenues was mitigated by the annual first quarter adjustment to our base rates, which was an increase of approximately 4% in 2012 as a result of upward movements in the consumer price indices used to determine such rate adjustments.

Retail segment gross profit was \$12,674,640 (52% of revenues) and \$11,859,740 (51% of revenues) for 2012 and 2011, respectively.

Consistent with prior periods, we record all non-direct G&A expenses in our retail business segment and do not allocate any of these non-direct costs to our other two business segments. Retail G&A expenses for 2012 and 2011 were \$11,304,528 and \$9,102,291, respectively. G&A expenses increased from 2011 to 2012 principally as a result of incremental (i) employee expenses of approximately \$412,000 attributable primarily to additional management and information technology personnel and base salary increases; (ii) research and development costs of approximately \$277,000; (iii) non-Mexico related business development costs of approximately \$821,000; and (iv) depreciation expense of approximately \$170,000.

During the latter half of 2012, we commenced, through our newly formed 95% owned subsidiary, PT Consolidated Water Bali, the construction of a seawater reverse osmosis (“SWRO”) plant in Nusa Dua, one of the primary tourist areas of Bali, Indonesia. We believe the water demands of the tourist resorts in Nusa Dua will soon exceed the water supplies that can be provided to the area by the local public water utility, and that other areas of Bali will also eventually experience fresh water shortages. However, as SWRO has not been employed to any meaningful extent in Bali, we have concluded that to obtain customers in Bali we must first demonstrate the viability of SWRO as well as our capabilities and expertise. Consequently, we have elected to commence this plant’s construction before obtaining contracts for its full production. We believe we will be able to sell 100% of the plant’s capacity once it becomes operational, although we cannot assure that we will be able to do so. The initial capital investment for this plant is estimated at approximately \$4.2 million, which will fund production capacity of approximately 500,000 gallons per day. As of December 31, 2012 we had expended approximately \$1.9 million in construction costs for this plant.

*Bulk Segment:*

The bulk segment contributed \$7,261,041 and \$5,345,265 to our income from operations for 2012 and 2011, respectively.

Bulk segment revenues were \$40,758,182 and \$30,757,874 for 2012 and 2011, respectively. The increase in bulk revenues of approximately \$10 million from 2011 to 2012 resulted from a 32% increase in the number of gallons of water sold, which was attributable to the expansion of our Blue Hills plant in the Bahamas during the fourth quarter of 2011.

Gross profit for our bulk segment was \$9,078,295 and \$6,630,386 for 2012 and 2011, respectively. The increase in the bulk segment's gross profit for 2012 was derived from the increased volume of water sold. Gross profit as a percentage of bulk revenues remained consistent at approximately 22% for both 2012 and 2011.

Bulk segment G&A expenses were \$1,384,527 and \$1,285,121 for 2012 and 2011, respectively. The increase in these expenses from 2011 to 2012 reflects approximately \$77,000 in additional employee costs for our Bahamas and Belize operations.

During the fourth quarter of 2012 we determined, after assessing the economic prospects for our Bimini subsidiary, that the carrying value of Bimini's desalination plant assets were likely not recoverable from its undiscounted future cash flows. Accordingly, we recorded an impairment loss of \$432,727 during the fourth quarter of 2012 to reduce the carrying value of the Bimini plant to its estimated fair value.

Our agreement with the WAC to operate and sell water from the Lower Valley plant on Grand Cayman expired in January 2013 and the WAC elected to assume the responsibility for operating this plant at that time. Consequently we will no longer generate any revenues from this plant. Our sales and gross profit from this plant were \$2,061,741 and \$213,347, respectively for 2012, and \$2,024,461 and \$100,511, respectively, for 2011.

*Services Segment:*

The services segment incurred losses from operations of (\$1,702,972) and (\$2,732,297) for 2012 and 2011, respectively. We anticipate that the services segment will continue to incur losses from operations while we continue

to fund the project development activities of NSC and/or until such time as we obtain significant new management services or plant construction contracts. As a result of the decline in profitability of our services segment and its current economic prospects, our 2012 goodwill impairment testing resulted in an impairment charge against all of the services segment goodwill of \$88,717 for 2012.

Services segment revenues were \$469,625 and \$1,040,280 for 2012 and 2011, respectively. Services revenues decreased from 2011 to 2012 due to the expiration of the management services contract for the Bermuda plant on June 30, 2011 and a \$163,000 reduction in plant sales revenues due to a lack of customer plant construction activity in 2012. Serving to slightly offset these revenue decreases were higher fees earned on our management agreement for OC-BVI due to the higher earnings recognized by this affiliate in 2012 as compared to 2011.

Gross profit for our services segment was \$239,507 and \$531,941 for 2012 and 2011, respectively. The lower gross profit for 2012 reflects the decrease in revenues discussed above.

G&A expenses for the services segment were \$1,853,762 and \$3,264,238 for 2012 and 2011, respectively. The decrease in G&A expenses is primarily attributable to a reduction in the expenses related to the project development activities of our consolidated Mexico affiliate, NSC, of approximately \$1.3 million.

As noted above, our management contract for the Bermuda plant expired on June 30, 2011, and we do not expect to generate any further fees or revenues from this plant. We generated revenues and gross profits from our Bermuda affiliate of \$723,000 and \$457,000, respectively, for the year ended December 31, 2011.

### **Year Ended December 31, 2011 Compared to Year Ended December 31, 2010**

#### **Consolidated Results**

Net income attributable to Consolidated Water Co. Ltd. common stockholders for 2011 was \$6,113,218 (\$0.42 per share on a fully-diluted basis), as compared to \$6,292,025 (\$0.43 per share on a fully-diluted basis) for 2010.

Total revenues for 2011 were \$55,154,492, up from the \$50,708,554 in revenues for 2010, as revenue increases for our bulk segment and, to a lesser extent our retail segment, more than offset a decline in services segment revenues. Gross profit for 2011 was \$19,022,067 or 34% of total revenues, as compared to \$16,610,495, or 33% of total revenues, for 2010. Gross profit for retail and bulk segments improved while gross profit for the services segment declined in 2011 from 2010. For further discussion of revenues and gross profit for 2011 see the "Results by Segment" analysis that follows.



General and administrative expenses on a consolidated basis were \$13,651,650 and \$11,329,648 for 2011 and 2010, respectively. This increase in G&A expenses of approximately \$2.3 million in 2011 resulted from incremental expenses of approximately \$1,286,000 for the project development activities of our consolidated Mexico affiliate, NSC, and an increase of approximately \$1,045,000 in employee costs due to approximately \$270,000 in additional management bonuses, incremental stock based compensation of approximately \$237,000, the hiring of additional personnel and salary increases.

Interest expense decreased to \$1,141,744 for 2011 from \$1,584,771 for 2010 as a result of \$246,851 in interest capitalized for the expansion of our Blue Hills plant and the prepayment on September 30, 2010 of \$1.5 million of our 7.5% bonds payable.

We recognized earnings on our investment in OC-BVI for 2011 and 2010 of \$838,652 and \$1,235,146, respectively. See further discussion of OC-BVI at “Liquidity and Capital Resources — Material Commitments, Contingencies and Expenditures — OC-BVI Litigation.”

## Results by Segment

### *Retail Segment:*

The retail segment contributed \$2,840,613 and \$3,397,210 to our income from operations for 2011 and 2010, respectively.

Revenues generated by our retail water operations were \$23,356,338 and \$21,864,252 for 2011 and 2010, respectively. The number of gallons sold by the retail segment decreased by approximately 4% from 2010 to 2011 due to water sales made in the first quarter of 2010 at bulk water rates to the Water Authority Cayman (“WAC”) to replace water previously supplied by the Red Gate plant while such plant was under refurbishment. Excluding this water sold to the WAC, the number of gallons sold by the retail segment increased by approximately 3% from 2010 to 2011. The increase in retail revenues from 2010 to 2011 is due to (i) the annual first quarter adjustment to our base rates, as our retail segment increased its base rates by approximately 2% due to an upward movement in the consumer price indices used to determine such rate adjustment; and (ii) higher energy prices in 2011 which resulted in energy pass through charges to our retail customers that were approximately \$890,000 higher in 2011 than in 2010.

Retail segment gross profit was \$11,859,740 (51% of revenues) and \$11,502,950 (53% of revenues) for 2011 and 2010, respectively. The slight decline in gross profit as a percentage of revenues from 2010 to 2011 reflects the

increased energy pass through charges and higher non-revenue water volumes for 2011.

Consistent with prior periods, we record all non-direct G&A expenses in our retail business segment and do not allocate any of these non-direct costs to our other two business segments. Retail G&A expenses for 2011 and 2010 were \$9,102,291 and \$8,105,740, respectively. G&A expenses increased from 2010 to 2011 due to additional employee costs of approximately \$1,002,000 due to approximately \$270,000 in additional management bonuses, incremental stock based compensation of approximately \$237,000, the hiring of additional personnel and salary increases.

*Bulk Segment:*

The bulk segment contributed \$5,262,101 and \$3,147,036 to our income from operations for December 31, 2011 and 2010, respectively.

Bulk segment revenues were \$30,757,874 and \$25,302,093 for 2011 and 2010, respectively. The increase in bulk revenues of approximately \$5.5 million from 2010 to 2011 resulted from a 6% increase in the number of gallons of water sold and energy pass-through increases to our rates due to higher energy prices. Our bulk revenues for 2011 benefited from \$770,000 in revenues generated in the fourth quarter from the expansion of CW-Bahamas' Blue Hills plant.

Gross profit for our bulk segment was \$6,630,386 and \$4,394,112 for 2011 and 2010, respectively. Gross profit as a percentage of bulk revenues increased to approximately 22% for 2011 as compared to approximately 17% for 2010. The improvement in the bulk segment's gross profit as a percentage of revenues in 2011 from 2010 is attributable to the increase in revenues, as a significant portion of our production costs are relatively fixed in nature and do not increase proportionately with an increase in the volume of water sold.

Bulk segment G&A expenses were \$1,285,121 and \$1,247,076 for 2011 and 2010, respectively. The increase in these expenses from 2010 to 2011 is primarily due to approximately \$86,000 in additional taxes paid by our Belize operations during the first quarter of 2011.

*Services Segment:*

The services segment incurred losses from operations of (\$2,732,297) and (\$1,263,399) for 2011 and 2010, respectively.

Services segment revenues were \$1,040,280 and \$3,542,209 for 2011 and 2010, respectively. Services revenues decreased from 2010 to 2011 due to (i) substantially lower plant sales revenues, which declined by approximately \$1.7 million due to a lack of customer plant construction activity in 2011; (ii) the expiration of the management services contract for the Bermuda plant on June 30, 2011; and (iii) lower fees earned on our management agreement for OC-BVI due to the incremental fees earned on the higher earnings generated by this affiliate in 2010 as compared to 2011.



Gross profit for our services segment was \$531,941 and \$713,433 for 2011 and 2010, respectively. The lower gross profit for 2011 reflects the decrease in revenues discussed above.

G&A expenses for the services segment were \$3,264,238 and \$1,976,832 for 2011 and 2010, respectively. The increase in G&A expenses is attributable to the project development activities of our consolidated Mexico affiliate, NSC.

As noted above, our management contract for the Bermuda plant expired on June 30, 2011. We generated revenues and gross profits from our Bermuda affiliate of \$723,000 and \$457,000, respectively, for the year ended December 31, 2011.

## LIQUIDITY AND CAPITAL RESOURCES

### Overview

Our sources of cash are (i) revenues generated from our retail license, plant operating contracts and management agreements; (ii) borrowings under term loans, credit facilities and debt securities; and (iii) sales of equity securities.

Our cash flows from operations are affected by tourism, rainfall patterns, weather conditions (such as hurricanes), changes in our customer base, the timing and level of rate increases, overall economic conditions and other factors and the timing of the collection of these revenues from our customers.

Our ability to access the debt and equity capital markets is impacted by our current and anticipated financial results, financial condition, existing level of borrowings, credit rating, the terms of our debt agreements (including our compliance therewith), and by conditions in the debt and equity markets. We are presently in compliance with the terms of our debt agreements.

Our primary uses of cash other than for operations are construction costs and capital expenditures, including plant expansion and new plant construction. Other significant uses include payment of dividends, repayment of debt and the pursuit of new business opportunities.

Net cash of approximately \$26.2 million has been provided by our operating activities over the last three years. As of December 31, 2012, we had cash balances totaling approximately \$33.9 million and working capital of approximately \$52.6 million. We believe our cash on hand and cash to be generated from operations will be sufficient to meet our liquidity requirements for 2013, which include approximately \$2.1 million in principal and interest payments on debt, budgeted capital expenditures for our existing operations of approximately \$5.9 million, estimated capital expenditures to complete our plant in Bali, Indonesia of approximately \$2.3 million, and projected expenditures of approximately \$7.9 million for the project development activities of our Mexico affiliate, NSC. Our liquidity requirements for 2013 may also include quarterly dividends, if such dividends are declared by our Board. Our dividend payments amounted to approximately \$4.4 million in 2012.

We may be required to seek new financing should we obtain any new projects or plant expansions in 2013. We believe we have a sufficient credit standing and adequate funding sources to obtain additional financing.

While we are not presently aware of anything that would lead us to believe that we will not have sufficient liquidity to meet our needs for 2013 and thereafter, we expect our available cash and working capital to decline during 2013 from their December 31, 2012 balances if we continue, as we presently anticipate, to fund the project development activities of NSC and CW-Bali.

### **Discussion of Cash Flows for the Year Ended December 31, 2012**

Our cash and cash equivalents decreased to \$33.9 million as of December 31, 2012 from \$37.6 million as of December 31, 2011.

#### *Cash Flows from Operating Activities*

Our operating activities provided net cash for the year ended December 31, 2012 of \$11.5 million. This cash provided reflects net income generated for the year of \$9.6 million as adjusted for (i) various items included in the determination of net income that do not affect cash flows during the year and (ii) changes in the other components of working capital. The more significant of such items for 2012 included depreciation and amortization of approximately \$7.7 million and a net increase in accounts receivable of approximately \$4.1 million.

#### *Cash Flows from Investing Activities*

Our investing activities provided \$6.7 million in net cash for the year ended December 31, 2012. Approximately \$4.6 million was used for construction in progress and property, plant and equipment additions and we collected \$1.8 million on our loans receivable and received \$2.3 million in cash from our investment in OC-BVI. We paid off our non-revolving credit facility in April 2012, which allowed for the release of the restriction on \$7.5 million that was pledged as collateral on our \$10,000,000 non-revolving credit facility with Scotiabank (Cayman) Ltd.

#### *Cash Flows from Financing Activities*

Our financing activities used approximately \$21.9 million in net cash for the year ended December 31, 2012. During the year, we made \$1.6 million in scheduled debt repayments on our 5.95% secured bonds, the redemption of the \$8.5 million balance of the Series A bonds, dividends of \$4.4 million and the repayment of a \$7.5 million non-revolving credit facility with Scotiabank (Cayman) Ltd.



## Financial Position

Accounts receivable as of December 31, 2012 were approximately \$12.5 million, up approximately \$4.0 million from December 31, 2011. Approximately \$3.2 million of the increase reflects an increase in accounts receivable due from the WSC.

Loans receivable decreased approximately \$1.8 million from approximately \$12.6 million as of December 31, 2011 to approximately \$10.8 million as of December 31, 2012 due to scheduled payments by the WAC.

## Borrowings Outstanding

As of December 31, 2012, our borrowings outstanding with an aggregate unamortized balance of \$6,852,660 consisted entirely of bonds payable bearing interest at a contractual rate of 5.95%. These bonds were issued in August 2006 in the principal amount of \$15,771,997 in a private offering. We received net proceeds (excluding issuance costs and after the offering discount) from this issuance of \$14,445,720. These bonds are repayable in quarterly principal and interest installments of \$526,010, and mature in 2016. We have the right to redeem the bonds in full at any time after August 4, 2009 at a premium of 1.5% of the outstanding principal and accrued interest on the bonds on the date of redemption. As of December 31, 2012, \$7,025,353 in principal amount was outstanding on these secured bonds. Our obligations under the bonds are secured by fixed and floating charges (i) on all of our assets, including an equitable charge of all of the shares of Cayman Water, and (ii) on all of Cayman Water's assets including its real estate.

The trust deed for these bonds restricts our ability to enter into new borrowing agreements or any new guarantees without prior approval of the trustee and limits our capital expenditures, with the exception of capital expenditures to be incurred on certain defined projects, to \$2,000,000 annually without prior approval by the trustee. The trust deed also contains financial covenants that require us to maintain a debt service coverage ratio of not less than 1.25 to 1, a ratio of long term debt to EBITDA (i.e. earnings before interest, taxes, depreciation and amortization) for the 12 months preceding the ratio calculation date not greater than 2.5 to 1 and a ratio of long term debt to equity equal to or less than 1.5 to 1. As of December 31, 2012, we were in compliance with the covenants under the trust deed.

## Material Commitments, Expenditures and Contingencies

### *Renewal of Retail License*

In the Cayman Islands, we provide water to retail customers under a license issued to us in July 1990 by the Cayman Islands government that grants us the exclusive right to provide water to retail customers within our licensed service area. Our service area is comprised of an area on Grand Cayman that includes the Seven Mile Beach and West Bay areas, two of the three most populated areas in the Cayman Islands. For the years ended December 31, 2012 and 2011, we generated approximately 37% and 42%, respectively, of our consolidated revenues and 52% and 51%, respectively, of our consolidated gross profits from the retail water operations conducted pursuant to our exclusive license. If we are not in default of any terms of the license, we have a right of first refusal to renew the license on terms that are no less favorable than those that the government offers to any third party.

This license was set to expire on July 10, 2010; however, we and the Cayman Islands government have agreed in correspondence to extend the license several times in order to provide sufficient time to negotiate the terms of a new license agreement. The most recent extension of our license expires March 30, 2013.

In February 2011, the Water Production and Supply Law, 2011 (which replaces the Water (Production and Supply) Law (1996 Revision) under which the Company is licensed) and the Water Authority (Amendment) Law, 2011 (the “New Laws”) were published and are now in full force and effect. Under the New Laws, the Water Authority-Cayman (“WAC”) would issue any new license which could include a rate of return on invested capital model described below.

We have been advised in correspondence from the Cayman Islands government and the WAC that: (i) the WAC is now the principal negotiator, and not the Cayman Islands government, in these license negotiations, and (ii) the WAC has determined that a rate of return on invested capital model (“RCAM”) is in the best interest of the public and the Company’s customers. RCAM is the rate model currently utilized in the electricity transmission and distribution license granted by the Cayman Islands government to the Caribbean Utilities Company, Ltd.

In July 2012, in an effort to resolve several issues relating to our retail license renewal negotiations, we filed an Application for Leave to Apply for Judicial Review (the “Application”) with the Grand Court of the Cayman Islands (the “Court”), stating that: (i) certain provisions of the Water Authority Law, 2011 and the Water (Production and Supply) Law, 2011, appear to be incompatible, (ii) the WAC’s roles as the principal license negotiator, statutory regulator and our competitor put the WAC in a position of hopeless conflict, and (iii) the WAC’s decision to replace the rate structure under our current exclusive license with RCAM was predetermined and unreasonable.

Throughout the course of the retail license renewal negotiations, we have objected to the use of RCAM on the basis that we believe such a model would not promote the efficient operation of our water utility and could ultimately increase water rates to our customers.

In October 2012, we were notified that the Court agreed to consider the issues raised in the Application. As a result, our Company, the Cayman Islands government and the Water Authority-Cayman will have the opportunity to present their positions to the Court in a trial proceeding.

If we do not ultimately enter into a new license agreement and no other party is awarded a license, we expect to be permitted to continue to supply water to our service area.

It is possible that the Cayman Islands government could offer a third party a license to service some or all of our present service area. In such event, we may assume the license offered to the third party by exercising our right of first refusal. However, the terms of any new license agreement may not be as favorable to us as the terms under which we are presently operating and could materially reduce the operating income and cash flows that we have historically generated from our retail license and could require us to record an impairment loss to further reduce the \$3,499,037 carrying value of our goodwill. Such impairment loss could be material to our results of operations.

Under the New Laws, the Governor in Cabinet sets the rates and rate adjustment mechanisms for water and sewerage services of the WAC. On October 30, 2012 by order of Cabinet, the regulations which govern the base water and sewerage rates charged by the WAC were amended to include an annual inflation adjustment mechanism which is functionally the same as the inflation adjustment mechanism included in our extended 1990 License agreement. In addition, the rates charged by the WAC for sewerage services now include a monthly energy adjustment charge which allows the WAC to increase or decrease their sewerage charges to reflect monthly changes in energy costs. This new energy adjustment charge is also functionally similar to the energy adjustment charge contained in our 1990 License agreement. And finally, WAC's base water and sewerage rates were immediately increased by an average of 9.2%. We believe that as a result of these fundamental changes, the WAC's rate structure is now consistent with the rate structure of our 1990 License. In our opinion, such changes are inconsistent with the WAC's previous assertion that a rate of return on invested capital model is in the best interests of the public.

*Mexico Affiliate*

In May 2010, we acquired, through our wholly-owned Netherlands subsidiary, Consolidated Water Cooperatief, U.A., a 50% interest in N.S.C. Agua, S.A. de C.V., (“NSC”) a Mexican company, and have since acquired the voting rights for, and an option to purchase, an additional 25% interest in this company. NSC has been formed to pursue a project encompassing the construction, ownership and operation of a 100 million gallon per day seawater reverse osmosis desalination plant to be located in northern Baja California, Mexico and an accompanying pipeline to deliver water to a Mexican potable water system and the U.S. border. We believe such a project can be successful due to what we anticipate will be a growing need for a new potable water supply for the areas of northern Baja California, Mexico and Southern California, United States. To complete this project, we have engaged two engineering groups with extensive regional and/or technical experience and have partnered with Doosan Heavy Industries and Construction (“DHIC”), a global leader in the engineering, procurement and construction of large seawater desalination plants. Once completed, one of our subsidiaries would operate the plant and we would retain a minority position in its ownership. NSC is in the development stage, and is presently involved in (i) purchasing additional land on which to build the plant, (ii) seeking contracts for the electric power and feed water sources for the plant’s proposed operations, and (iii) conducting (under a Memorandum of Understanding with DHIC) an equipment piloting plant and water quality data collection program at the proposed feed water source. In addition to completing these activities, NSC will be required to complete various other steps before it can commence construction of the plant and pipeline including, but not limited to, obtaining approvals and permits from various governmental agencies in Mexico and the United States, securing contracts with its proposed customers to sell water in sufficient quantities and at prices that make the project financially viable, and obtaining equity and debt financing for the project. NSC’s potential customers will also be required to obtain various governmental permits and approvals in order to purchase water from NSC.

For our 50% interest in NSC, we provided the initial funding of \$4.0 million in the form of equity for NSC’s development activities and have also provided all subsequent funding for NSC. Because we exercise effective financial control over NSC and our partners in NSC have not participated in NSC’s funding, we consolidate NSC’s results of operations. Included in our consolidated results of operations for the years ended December 31, 2012, 2011 and 2010 are approximately \$1.7 million, \$3.0 million and \$1.7 million, respectively, in general and administrative expenses from NSC, consisting of organizational, legal, accounting, engineering, consulting and other costs relating to its project development activities. The assets and liabilities of NSC included in our consolidated balance sheet amounted to approximately \$1,452,000 and \$116,000, respectively, as of December 31, 2012 and approximately \$121,000 and \$367,000, respectively, as of December 31, 2011.

In February 2012, we acquired an option, exercisable through February 7, 2014, to purchase the shares of one of the other shareholders of NSC along with an immediate power of attorney to vote those shares. As a result, we now have effective control of NSC.

In July 2012, NSC obtained an extension of the purchase contract for a portion of the land on which the proposed plant would be constructed. In exchange for additional prepayments of (i) \$500,000 paid at signing of the extension



and (ii) a further \$500,000 payable on May 15, 2013, NSC was granted an extension of the purchase agreement until May 15, 2014. NSC is currently negotiating a purchase agreement for an additional parcel of land.

In August 2012, NSC and DHIC extended their Memorandum of Understanding for 18 months from August 19, 2012, pursuant to which DHIC provided and installed and is operating an equipment piloting plant and collecting water quality data from the proposed feed water source site in Rosarito Beach, Baja California, Mexico. This amended Memorandum of Understanding requires that NSC negotiate exclusively with DHIC for the construction of the 100 million gallon per day seawater reverse osmosis desalination plant and further requires payment by NSC to DHIC of up to \$500,000 as compensation for the operation and maintenance of the equipment piloting plant should NSC not award the engineering, procurement and construction contract for the project to DHIC.

In November 2012, NSC signed a letter of intent with Otay Water District in Southern California to deliver no less than 20 million and up to 40 million gallons of water per day from the plant to the Otay Water District at the border between Mexico and the United States.

NSC has entered into a 20 year lease, effective November 2012, for approximately 5,000 square meters of land on which it plans to construct the water intake and outtake works for the plant. The amounts due on this lease are payable in Mexican pesos at an amount that is currently equivalent to approximately \$20,000 per month. This lease is cancellable should NSC ultimately not proceed with the project.

We estimate that it will take at least through the second quarter of 2014 for NSC to complete all of the development activities (which include completing the site piloting plant activities, purchasing the land for the plant, securing feed water and power supplies, completing the engineering and feasibility studies, negotiating customer contracts, obtaining required regulatory permits and arranging the project financing) necessary to commence construction of the plant. During 2013, we expect to incur an additional \$5.7 million in expenses for these project development activities and to pay an additional \$2.2 million in deposits for the parcels of land for the project. We expect to incur additional development expenses for this project in 2014. However, NSC may ultimately be unable to complete all of the activities necessary to begin construction of the project.

#### *CW-Belize*

By Statutory Instrument No. 81 of 2009, the Minister of Public Utilities of the government of Belize published an order, the Public Utility Provider Class Declaration Order, 2009 (the "Order"), which as of May 1, 2009 designated CW-Belize as a public utility provider under the laws of Belize. With this designation, the Public Utilities Commission of Belize (the "PUC") has the authority to set the rates charged by CW-Belize and to otherwise regulate its activities. On November 1, 2010, CW-Belize received a formal complaint from the PUC alleging that CW-Belize was operating without a license under the terms of the Water Industry Act. CW-Belize applied for this license in December 2010. On July 29, 2011, the PUC issued the San Pedro Public Water Supply Quality and Security Complaint Order (the "Second Order") which among other things requires that (i) CW-Belize and its customer jointly make a submission to the responsible Minister requesting that the area surrounding CW-Belize's seawater abstraction wells be designated a forest reserve or national park and be designated a Controlled Area under section 58 of the Water Industry Act, (ii) CW-Belize submit an operations manual for CW-Belize's desalination plant to the PUC for approval, (iii) CW-Belize and its customer modify the water supply agreement between the parties to (a) include new water quality parameters included in the Order and (b) cap the current exclusive water supply arrangement in the agreement at a maximum of 450,000 gallons per day, (iv) CW-Belize keep a minimum number of replacement seawater RO membranes in stock at all times and (v) CW-Belize take possession of and reimburse the PUC for certain equipment which the PUC purchased from a third-party in late 2010. CW-Belize has applied for declaratory judgment and has been granted a temporary injunction to stay the enforcement of the Second Order by the PUC until such time as the matter could be heard by the Belize courts. The initial hearing on this matter was conducted on October 30 and 31, 2012 with an additional hearing on November 29, 2012. The ruling on this case is pending. We are presently unable to determine what impact the outcome of this matter will have on our results of operations, financial position or cash flows.

Transfers of U.S. dollars from CW-Belize to our other subsidiaries require authorization in advance from the Central Bank of Belize.

*Material Expenditures and Commitments*

The following table summarizes our contractual obligations as of December 31, 2012:

	Total	2013	2014-2016	2017-2019	2020 and Thereafter
Secured 5.95% bonds <sup>(1)</sup> <sup>(2)</sup>	\$7,890,150	\$2,104,040	\$5,786,110	\$-	\$-
Land purchase commitments	500,000	500,000	-	-	-
Employment agreements	2,850,192	1,669,159	1,181,033	-	-
Operating leases	6,449,787	1,199,008	1,321,276	744,537	3,184,966
Purchase orders	450,101	450,101	-	-	-
Security deposits	312,350	22,958	114,565	124,827	50,000
Total	\$18,452,580	\$5,945,266	\$8,402,984	\$869,364	\$3,234,966

(1) Includes interest costs to be incurred.

(2) Secured 5.95% bonds are shown gross of discount.

*CW-Bahamas Liquidity*

CW-Bahamas was due approximately \$7.6 million from the WSC as of December 31, 2012. We have been informed previously by representatives of the Bahamas government that the delay in paying our accounts receivables is due to operating issues within the WSC, that the delay does not reflect any type of dispute with us with respect to the amounts owed, and that the amounts will ultimately be paid in full. We believe that the accounts receivable from the WSC are fully collectible and therefore have not provided any allowance for possible non-payment of these receivables as of December 31, 2012.

Transfers of U.S. dollars from CW-Bahamas to our other subsidiaries require authorization in advance from the Central Bank of the Bahamas.

*CW-Bahamas Performance Bonds*

We have two contracts, one for our Windsor plant and one for our Blue Hills plant, to supply water to the WSC. Each contract requires us to guarantee delivery of a minimum quantity of water per week. If we do not meet this minimum, we are required to pay the WSC for the difference between the minimum and actual gallons delivered at a per gallon rate equal to the price per gallon that WSC is currently paying us under the contract. The Windsor and Blue Hills contracts expire in 2013 and 2032, respectively and require us to deliver 16.8 million gallons and 63.0 million gallons, respectively, of water each week. We are required to provide the WSC with performance and operating guarantees, in the form of bank-issued letters of credit, to secure any payments we may be required to make under the minimum delivery requirements of the Windsor contract. A performance bond in the amount of \$1,910,775 for the Windsor plant has expired and was not subsequently replaced. We expect to obtain a performance bond for the Blue Hills plant once CW-Bahamas has received payment of its delinquent accounts receivable from the WSC.

## **Dividends**

- On January 31, 2012, we paid a dividend of \$0.075 to shareholders of record on January 1, 2012.
  - On April 30, 2012, we paid a dividend of \$0.075 to shareholders of record on April 1, 2012.
  - On July 31, 2012, we paid a dividend of \$0.075 to shareholders of record on July 1, 2012.
  - On October 31, 2012, we paid a dividend of \$0.075 to shareholders of record on October 1, 2012.
  - On January 31, 2013, we paid a dividend of \$0.075 to shareholders of record on January 1, 2013.
- On February 19, 2013, our Board declared a dividend of \$0.075 payable on April 30, 2013 to shareholders of record on April 1, 2013.

We have paid dividends to owners of our common shares and redeemable preferred shares since we began declaring dividends in 1985. Our payment of any future cash dividends will depend upon our earnings, financial condition, cash flows, capital requirements and other factors our Board deems relevant in determining the amount and timing of such dividends.

## **Dividend Reinvestment and Common Stock Purchase Plan.**

This program is available to our shareholders, who may reinvest all or a portion of their common cash dividends into shares of common stock at prevailing market prices and may also invest optional cash payments to purchase additional shares at prevailing market prices as part of this program.

## **Impact of Inflation**

Under the terms of our Cayman Islands license and our water sales agreements in Belize, The Bahamas and the British Virgin Islands, our water rates are automatically adjusted for inflation on an annual basis, subject to temporary exceptions. We, therefore, believe that the impact of inflation on our gross profit, measured in consistent dollars, will not be material. However, significant increases in items such as fuel and energy costs could create additional credit risks for us, as our customers' ability to pay our invoices could be adversely affected by such increases.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

### **Credit Risk**

We are not exposed to significant credit risk on retail customer accounts in the Cayman Islands as our policy is to cease supply of water to customers whose accounts are more than 45 days overdue. Our primary exposure to credit risk is from accounts receivable arising from bulk water sales to the governments of Belize, The Bahamas, the British Virgin Islands, and the Cayman Islands.

As of December 31, 2012, we had approximately \$10.8 million in loans receivable due from the Water Authority-Cayman. These loans were current as to scheduled principal and interest payments as of December 31, 2012.

### **Interest Rate Risk**

We are not exposed to significant interest rate risk as the interest rate on our 5.95% bonds is fixed at 5.95%.

### **Foreign Exchange Risk**

All of the currencies in our operating areas other than the Mexican peso, Indonesian rupiah and the euro have been fixed to the dollar for over 20 years and we do not employ a hedging strategy against exchange rate risk associated with our reporting in dollars. If any of these fixed exchange rates becomes a floating exchange rate or if any of the foreign currencies in which we conduct business depreciate significantly against the dollar, our results of operations and financial condition could be adversely affected.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Consolidated Water Co. Ltd.

We have audited the accompanying consolidated balance sheets of Consolidated Water Co. Ltd. as of December 31, 2012 and 2011, 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, 2012. We also have audited Consolidated Water Co. Ltd.'s internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Consolidated Water Co. Ltd.'s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Consolidated Water Co. Ltd. as of December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Consolidated Water Co. Ltd. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

**/s/ Marcum LLP**

Fort Lauderdale, Florida

March 13, 2013

**CONSOLIDATED WATER CO. LTD.****CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2012	2011
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$33,892,655	\$37,624,179
Restricted cash	-	7,500,000
Marketable securities	8,570,338	8,496,372
Accounts receivable, net	12,516,466	8,537,232
Inventory	1,757,601	1,451,639
Prepaid expenses and other current assets	2,709,185	1,880,105
Current portion of loans receivable	1,812,532	1,843,600
Total current assets	61,258,777	67,333,127
Property, plant and equipment, net	58,993,406	64,185,110
Construction in progress	2,612,800	141,204
Inventory, non-current	3,970,241	3,861,470
Loans receivable	9,028,279	10,758,873
Investment in OC-BVI	6,925,346	6,634,598
Intangible assets, net	1,455,015	1,501,824
Goodwill	3,499,037	3,587,754
Other assets	2,706,185	2,855,471
Total assets	\$150,449,086	\$160,859,431
<b>LIABILITIES AND EQUITY</b>		
Current liabilities		
Accounts payable and other current liabilities	\$5,867,456	\$4,617,770
Dividends payable	1,158,967	1,156,081
Current portion of long term debt	1,647,493	17,531,134
Total current liabilities	8,673,916	23,304,985
Long term debt	5,205,167	6,852,660
Other liabilities	435,413	420,430
Total liabilities	14,314,496	30,578,075
Equity		
Consolidated Water Co. Ltd. stockholders' equity		
Redeemable preferred stock, \$0.60 par value. Authorized 200,000 shares; issued and outstanding 30,265 and 22,427 shares, respectively	18,159	13,456
Class A common stock, \$0.60 par value. Authorized 24,655,000 shares; issued and outstanding 14,593,011 and 14,568,696 shares, respectively	8,755,807	8,741,217
Class B common stock, \$0.60 par value. Authorized 145,000 shares; none issued or outstanding	-	-
Additional paid-in capital	82,467,421	81,939,211

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Retained earnings	42,965,179	38,030,943
Total Consolidated Water Co. Ltd. stockholders' equity	134,206,566	128,724,827
Non-controlling interests	1,928,024	1,556,529
Total equity	136,134,590	130,281,356
Total liabilities and equity	\$ 150,449,086	\$ 160,859,431

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

**CONSOLIDATED WATER CO. LTD.****CONSOLIDATED STATEMENTS OF INCOME**

	Year Ended December 31,		
	2012	2011	2010
Retail water revenues	\$24,222,895	\$23,356,338	\$21,864,252
Bulk water revenues	40,758,182	30,757,874	25,302,093
Services revenues	469,625	1,040,280	3,542,209
Total revenues	65,450,702	55,154,492	50,708,554
Cost of retail revenues	11,548,255	11,496,598	10,361,302
Cost of bulk revenues	31,679,887	24,127,488	20,907,981
Cost of services revenues	230,118	508,339	2,828,776
Total cost of revenues	43,458,260	36,132,425	34,098,059
Gross profit	21,992,442	19,022,067	16,610,495
General and administrative expenses	14,542,817	13,651,650	11,329,648
Impairment losses	521,444	-	-
Income from operations	6,928,181	5,370,417	5,280,847
Other income (expense):			
Interest income	835,941	1,200,999	1,375,827
Interest expense	(876,971 )	(1,141,744 )	(1,584,771 )
Profit sharing income from OC-BVI	343,454	-	-
Equity in earnings of OC-BVI	2,121,319	838,652	1,235,146
Other income	272,085	283,656	136,113
Other income, net	2,695,828	1,181,563	1,162,315
Net income	9,624,009	6,551,980	6,443,162
Income attributable to non-controlling interests	308,495	438,762	151,137
Net income attributable to Consolidated Water Co. Ltd. stockholders	\$9,315,514	\$6,113,218	\$6,292,025
Basic earnings per common share attributable to Consolidated Water Co. Ltd. common stockholders	\$0.64	\$0.42	\$0.43
Diluted earnings per common share attributable to Consolidated Water Co. Ltd. common stockholders	\$0.64	\$0.42	\$0.43
Dividends declared per common share	\$0.30	\$0.30	\$0.30
Weighted average number of common shares used in the determination of:			
Basic earnings per share	14,578,518	14,560,259	14,547,065
Diluted earnings per share	14,606,148	14,596,013	14,597,894

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



**CONSOLIDATED WATER CO. LTD.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

	<b>Redeemable</b>		<b>Common stock</b>		<b>Additional</b>	<b>Retained</b>	<b>Non-controlling</b>	<b>Total</b>
	<b>preferred stock</b>		<b>Shares</b>	<b>Dollars</b>	<b>paid-in</b>			
	<b>Shares</b>	<b>Dollars</b>						<b>capital</b>
Balance as of December 31, 2009	17,192	\$10,315	14,541,878	\$8,725,127	\$80,990,686	\$34,365,640	\$1,449,030	\$125,540,798
Issue of share capital	5,899	3,539	8,565	5,139	117,441	-	-	126,119
Conversion of preferred stock	(4,950)	(2,970)	4,950	2,970	-	-	-	-
Buyback of preferred stock	(1,357)	(814)	-	-	(15,982)	-	-	(16,796)
Net income	-	-	-	-	-	6,292,025	151,137	6,443,162
Dividends declared	-	-	-	-	-	(4,367,959)	-	(4,367,959)
Stock-based compensation	-	-	-	-	257,799	-	-	257,799
Balance as of December 31, 2010	16,784	10,070	14,555,393	8,733,236	81,349,944	36,289,706	1,600,167	127,983,123
Issue of share capital	8,345	5,007	11,158	6,694	99,284	-	-	110,985
Conversion of preferred stock	(2,145)	(1,287)	2,145	1,287	-	-	-	-
Buyback of preferred stock	(557)	(334)	-	-	(4,665)	-	-	(4,999)
Net income	-	-	-	-	-	6,113,218	438,762	6,551,980
Dividends declared	-	-	-	-	-	(4,371,981)	(482,400)	(4,854,381)
Stock-based compensation	-	-	-	-	494,648	-	-	494,648
Balance as of December 31,	22,427	13,456	14,568,696	8,741,217	81,939,211	38,030,943	1,556,529	130,281,356

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2011								
Issue of share capital	11,417	6,850	21,686	13,013	164,391	-	-	184,254
Conversion of preferred stock	(2,629 )	(1,577 )	2,629	1,577	-	-	-	-
Buyback of preferred stock	(950 )	(570 )	-	-	(7,219 )	-	-	(7,789 )
Net income	-	-	-	-	-	9,315,514	308,495	9,624,009
Dividends declared	-	-	-	-	-	(4,381,278 )	(72,000 )	(4,453,278 )
Capital contribution	-	-	-	-	-	-	135,000	135,000
Stock-based compensation	-	-	-	-	371,038	-	-	371,038
Balance as of December 31, 2012	30,265	\$18,159	14,593,011	\$8,755,807	\$82,467,421	\$42,965,179	\$1,928,024	\$136,134,590

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

**CONSOLIDATED WATER CO. LTD.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended December 31,		
	2012	2011	2010
Cash flows from operating activities			
Net income	\$9,624,009	\$6,551,980	\$6,443,162
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	7,728,568	5,998,319	6,279,551
Stock compensation on share and option grants	453,686	566,593	305,002
Net (gain) loss on disposal of fixed assets	(12,082 )	15,195	126,066
Profit sharing and equity from earnings of OC-BVI	(2,464,773 )	(588,331 )	(1,274,527 )
Impairment losses	521,444	-	-
Unrealized gain on marketable securities	(73,966 )	3,628	-
Change in:			
Marketable securities	-	(8,500,000 )	-
Accounts receivable	(4,092,859 )	3,709,123	(3,950,213 )
Inventory	(922,840 )	(239,386 )	210,895
Prepaid expenses and other assets	(679,794 )	609,037	(339,878 )
Accounts payable and other liabilities	1,459,223	420,601	(1,699,578 )
Net cash provided by operating activities	11,540,616	8,546,759	6,100,480
Cash flows from investing activities			
Additions to property, plant and equipment and construction in progress	(4,574,173 )	(14,057,876)	(1,266,084 )
Distribution of earnings from OC-BVI	2,287,650	202,631	1,537,725
Collections on loans receivable	1,753,771	1,733,746	1,426,732
Collections on loan receivable from OC-BVI	-	1,450,000	1,225,000
Payment for NSC option agreement	(300,000 )	-	-
Release of (restriction) on cash balances for non-revolving credit facility	7,500,000	(7,500,000 )	-
Net cash provided by (used in) investing activities	6,667,248	(18,171,499)	2,923,373
Cash flows from financing activities			
Dividends paid	(4,450,392 )	(4,850,914 )	(4,368,047 )
Issuance (repurchase) of redeemable preferred stock, net	1,154	1,542	(10,674 )
Principal repayments of long term debt	(10,125,150)	(1,531,946 )	(2,944,085 )
Capital contribution from non-controlling interest	135,000	-	-
(Repayment of ) borrowing on non-revolving credit facility	(7,500,000 )	7,500,000	-
Net cash provided by (used in) financing activities	(21,939,388)	1,118,682	(7,322,806 )
Net increase (decrease) in cash and cash equivalents	(3,731,524 )	(8,506,058 )	1,701,047
Cash and cash equivalents at beginning of period	37,624,179	46,130,237	44,429,190



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Cash and cash equivalents at end of period	\$33,892,655	\$37,624,179	\$46,130,237
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The accompanying notes are an integral part of these consolidated financial statements.

## CONSOLIDATED WATER CO. LTD.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Principal activity

Consolidated Water Co. Ltd., and its subsidiaries (collectively, the “Company”) use reverse osmosis technology to produce fresh water from seawater. The Company processes and supplies water to its customers in the Cayman Islands, Belize and the Bahamas. The Company sells water to a variety of customers, including public utilities, commercial and tourist properties, residential properties and government facilities. The base price of water supplied by the Company, and adjustments thereto, are determined by the terms of a license and supply contracts, which provide for adjustments based upon the movement in the government price indices specified in the licenses and contracts, as well as monthly adjustments for changes in the cost of energy. The Company also provides engineering and design services for water plant construction, and manages and operates water plants owned by others.

#### 2. Accounting policies

**Basis of preparation:** The consolidated financial statements presented are prepared in accordance with the accounting principles generally accepted in the United States of America.

**Use of estimates:** The preparation of consolidated financial statements in conformity with the accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to estimates and assumptions include the carrying value of property, plant and equipment, intangible assets, goodwill and the fair value of the Company’s investment in affiliate. Actual results could differ significantly from such estimates.

**Basis of consolidation:** The accompanying consolidated financial statements include the accounts of the Company’s (i) wholly-owned subsidiaries, Aquilex, Inc., Cayman Water Company Limited (“Cayman Water”), Consolidated Water (Asia) Pte Ltd. (“CW-Asia”), Consolidated Water (Belize) Limited (“CW-Belize”), Ocean Conversion (Cayman) Limited (“OC-Cayman”), DesalCo Limited (“DesalCo”), Consolidated Water Cooperatief, U.A. (“CW-Coop”); (ii) majority-owned subsidiaries Consolidated Water (Bahamas) Ltd. (“CW-Bahamas”) and PT Consolidated Water Bali (“CW-Bali”); and (iii) affiliates Consolidated Water (Bermuda) Limited (“CW-Bermuda”) and N.S.C. Agua, S.A. de C.V. (“NSC”), which are

consolidated for financial reporting purposes because the Company has a controlling financial interest in these companies. The Company's investment in its other affiliate, Ocean Conversion (BVI) Ltd. ("OC-BVI"), is accounted for using the equity method of accounting. All significant intercompany balances and transactions have been eliminated in consolidation.

**Foreign currency:** The Company's reporting currency is the United States dollar. The functional currency of the Company and its foreign subsidiaries (other than its consolidated affiliate NSC) is the currency for each respective country. The functional currency for NSC is the United States dollar. The exchange rates between the Cayman Islands dollar, the Belize dollar, the Bahamian dollar, and the Bermuda dollar are fixed to the United States dollar. Foreign currency gains/losses arising from transactions conducted in foreign currencies were immaterial for each of the years in the three year period ended December 31, 2012.

**Cash and cash equivalents:** Cash and cash equivalents consist of demand deposits at banks and highly liquid deposits at banks with an original maturity of three months or less.

As of December 31, 2012, the Company had deposits in U.S. banks in excess of federally insured limits of approximately \$303,000. As of December 31, 2012, the Company held cash in foreign bank accounts of approximately \$36.1 million.

**Marketable securities:** Marketable securities consist primarily of marketable debt obligations with maturities of less than one year, are accounted for as trading securities and stated at fair value. Any unrealized gains and losses on these securities are recognized in the consolidated statement of income.

**Accounts receivable and allowance for doubtful accounts:** Accounts receivable are recorded at invoiced amounts based on meter readings or minimum take-or-pay amounts per contractual agreements. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable balance. The Company determines the allowance for doubtful accounts based on historical write-off experience and monthly review of delinquent accounts. Past due balances are reviewed individually for collectability and disconnection. Account balances are charged off against the allowance for doubtful accounts after all means of collection have been exhausted and the potential for recovery is considered by management to be remote.

**Inventory:** Inventory primarily includes consumables stock and spare parts stock that are valued at the lower of cost or net realizable value with cost determined on the first-in, first-out basis. Inventory also includes potable water held in the Company's reservoirs. The carrying amount of the water inventory is the lower of the average cost of producing water during the year or its net realizable value.

**Loans receivable:** Loans receivable relate to notes receivable from customers arising from the construction and sale of water desalination plants. The allowance for loan losses, if any, is the Company's best estimate of the amount of probable credit losses in the Company's existing loans and is determined on an individual loan basis.

**Property, plant and equipment:** Property, plant and equipment is stated at cost less accumulated depreciation. Depreciation is calculated using a straight line method with an allowance for estimated residual values. Rates are determined based on the estimated useful lives of the assets as follows:

Buildings	5 to 40 years
Plant and equipment	4 to 40 years
Distribution system	3 to 40 years
Office furniture, fixtures and equipment	3 to 10 years
Vehicles	3 to 10 years
Leasehold improvements	Shorter of 5 years or operating lease term outstanding
Lab equipment	5 to 10 years

Additions to property, plant and equipment are comprised of the cost of the contracted services, direct labor and materials. Assets under construction are recorded as additions to property, plant and equipment upon completion of the projects. Depreciation commences in the month the asset is placed in service.

**Long-lived Assets:** Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets might not be recoverable. Conditions that would necessitate an impairment assessment include a significant decline in the observable market value of an asset, a significant change in the extent or manner in which an asset is used, or a significant adverse change that would indicate that the carrying amount of an asset or group of assets is not recoverable. For long-lived assets to be held and used, the Company recognizes an impairment loss only if its carrying amount is not recoverable through its undiscounted cash flows and measures the impairment loss based on the difference between the carrying amount and fair value.

During 2012, the Company determined, after assessing the economic prospects for one of CW-Bahamas' reverse osmosis desalination plants, that the carrying value of this plant's assets were likely not recoverable from its undiscounted future cash flows. Accordingly, the Company recorded an impairment loss of \$432,727 for the year ended December 31, 2012 to reduce the carrying value of this plant to its estimated fair value.

**Construction in progress:** Interest costs directly attributable to the acquisition and construction of qualifying assets, which are assets that necessarily take a substantial period of time to be ready for their intended use, are added to the cost of those assets until such time as the assets are substantially ready for use. Interest capitalized on assets constructed during the year ended December 31, 2011 was \$246,851.

**Goodwill and intangible assets:** Goodwill represents the excess cost over the fair value of the assets of an acquired business. Goodwill and intangible assets acquired in a business combination and determined to have an indefinite useful life are not amortized, but are tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values and reviewed periodically for impairment. The Company annually evaluates the possible impairment of goodwill as part of its financial reporting process for the fourth quarter of each fiscal year. Management identifies its reporting units and determines the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units. The Company determines the fair value of each reporting unit and compares it to the carrying amount of the reporting unit. To the extent the carrying amount of the reporting unit exceeds the fair value of the reporting unit, the Company is required to perform the second step of the impairment test, as this is an indication that the reporting unit goodwill may be impaired. In this step, the Company compares the implied fair value of the reporting unit goodwill with the carrying amount of the reporting unit goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit to all the assets (recognized and unrecognized) and liabilities of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. If the implied fair value is less than its carrying amount, an impairment loss is recorded.

For the years in the three-year period ended December 31, 2012 the Company estimated the fair value of its reporting units by applying the discounted cash flow method, the subject company stock price method, the guideline public company method, the mergers and acquisitions method and, on an exception basis and where necessary and appropriate, the net asset value method.

The discounted cash flow method relied upon seven-year discrete projections of operating results, working capital and capital expenditures, along with a terminal value subsequent to the discrete period. These seven-year projections were based upon historical and anticipated future results, general economic and market conditions, and considered the impact of planned business and operational strategies. The discount rates for the calculations represented the estimated cost of capital for market participants at the time of each analysis. In preparing these seven year projections for 2012 for the retail unit the Company (i) identified various possible outcomes of its on-going negotiations with the Cayman Islands government for the renewal of its retail license; (ii) estimated the cash flows associated with each possible outcome; and (iii) assigned a probability to each outcome and associated estimated cash flows. The weighted average estimated cash flows were then summed to determine the overall fair value of the retail unit under this method. The possible outcomes used for the discounted cash flow method for the retail unit included the implementation of a rate of return on invested capital model, the methodology proposed by Cayman Islands government representatives for the new retail license.

The Company also estimated the fair value of each of its reporting units for each of the years in the three-year period ended December 31, 2012 through reference to the quoted market prices for the Company and guideline companies and the market multiples implied by guideline merger and acquisition transactions. For the year ended December 31, 2012, the Company also relied upon net asset values to estimate the fair value of its services unit.

The Company weighted the fair values estimated for each of its reporting units under each method and summed such fair values to estimate the overall fair value for each reporting unit. In recognition of the fact that its common stock has traded during the past two years at prices less than its book value per share the Company changed the relative weightings for 2012 from those used for 2011 to increase the weightings applied to those methods that resulted in more conservative estimates of fair value. The respective weightings the Company applied to each method for the years ended December 31, 2012 and 2011 are as follows:

Method	2012			2011		
	Retail	Bulk	Services	Retail	Bulk	Services
Discounted cash flow	20 %	30 %		20 %	10 %	20 %
Subject company stock price	60 %	50 %	10 %	40 %	10 %	80 %
Guideline public company	10 %	10 %		20 %	40 %	
Mergers and acquisitions	10 %	10 %		20 %	40 %	
Net asset value			90 %			
	100 %	100 %	100 %	100 %	100 %	100 %

The fair values the Company estimated for its retail, bulk and services units exceeded their carrying amounts for the year ended December 31, 2011. The fair values the Company estimated for its retail and bulk units exceeded their carrying amounts by 39% and 6%, respectively, for the year ended December 31, 2012. The fair value the Company estimated for its services unit for the year ended December 31, 2012 was 10% less than its carrying amount. As a result of this estimate and the Company's subsequent step 2 analysis of the implied fair value of the goodwill recorded for its services unit, the Company recorded an impairment charge for the services unit goodwill of \$88,717 for the year ended December 31, 2012. Based upon the discounted cash flows and market approach methodologies employed in the Company's analyses, no other impairment charges were required for its goodwill for any of the years in the three-year period ended December 31, 2012.

The Company also performed an analysis reconciling the conclusions of value for its reporting units to its market capitalization at October 1, 2012. This reconciliation resulted in an implied control premium for the Company of 32.6%.

**Investments:** Investments where the Company does not exercise significant influence over the operating and financial policies of the investee and holds less than 20% of the voting stock are recorded at cost. The Company uses the equity method of accounting for investments in common stock where the Company holds 20% to 50% of the voting stock of the investee and has significant influence over its operating and financial policies but does not meet the criteria for

consolidation. The Company recognizes impairment losses on declines in the fair value of the stock of investees that are other than temporary.

**Other assets:** Under the terms of the contract with the Water and Sewerage Corporation of The Bahamas for the purchase of water from the Company's Blue Hills desalination plant, the Company was required to reduce the amount of water lost by the public water distribution system on New Providence Island, The Bahamas, over a one year period by 438 million gallons, a requirement the Company met during 2007. The Company was solely responsible for the engineering, labor and materials costs incurred to effect the reduction in lost water, which were capitalized and are being amortized on a straight-line basis over the original remaining life of the Blue Hills contract. Such costs are included in other assets and aggregated approximately \$3.5 million as of December 31, 2012 and 2011. Accumulated amortization for these costs was approximately \$1.1 million and \$923,000 as of December 31, 2012 and 2011, respectively.

**Other liabilities:** Other liabilities consist of security deposits and advances in aid of construction. Security deposits are received from large customers as security for trade receivables. Advances in aid of construction are recognized as a liability when advances are received from condominium developers in the licensed area to help defray the capital expenditure costs of the Company. These advances do not represent loans to the Company and are interest free. However, the Company allows a discount of ten percent on future supplies of water to these developments until the aggregate discounts allowed are equivalent to advances received. Discounts are charged against advances received.

**Income taxes:** The Company accounts for the income taxes arising from the operations of its United States subsidiary, Aquilex, Inc., under the asset and liability method. Deferred tax assets and liabilities, if any, are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided to the extent any deferred tax asset may not be realized.

Consolidated Water (Belize) Limited (“CW-Belize”) is liable for business and corporate income taxes. Under the terms of its water supply agreement with Belize Water Services Ltd. (“BWSL”), its sole customer, CW-Belize is reimbursed by BWSL for all taxes that it is required to pay and records this reimbursement as an offset to its tax expense.

The Company is not subject to income taxes in the other countries in which it operates.

**Plant construction revenue and cost of plant construction revenue:** The Company recognizes revenue and related costs as work progresses on fixed price contracts for the construction of desalination plants to be sold to third parties using the percentage-of-completion method, which relies on contract revenue and estimates of total expected costs. The Company follows this method since it can make reasonably dependable estimates of the revenue and costs applicable to various stages of a contract. Under the percentage-of-completion method, the Company records revenue and recognizes profit or loss as work on the contract progresses. The Company estimates total project costs and profit to be earned on each long term, fixed price contract prior to commencement of work on the contract and updates these estimates as work on the contract progresses. The cumulative amount of revenue recorded on a contract at a specified point in time is that percentage of total estimated revenue that incurred costs to date comprises of estimated total contract costs. If, as work progresses, the actual contract costs exceed estimates, the profit recognized on revenue from that contract decreases. The Company recognizes the full amount of any estimated loss on a contract at the time the estimates indicate such a loss. Any costs and estimated earnings in excess of billings are classified as current assets. Billings in excess of costs and estimated earnings on uncompleted contracts, if any, are classified as current liabilities.

The Company assumes the risk that the costs associated with constructing the plant may be greater than it anticipated in preparing its bid. However, the terms of each of the sales contracts with its customers require the Company to



guarantee the sales price for the plant at the bid amount. Because the Company bases its contracted sales price in part on its estimation of future construction costs, the profitability of its plant sales is dependent on its ability to estimate these costs accurately. The cost estimates the Company prepares in connection with the construction of plants to be sold to third parties are subject to inherent uncertainties. The cost of materials and construction may increase significantly after the Company submits its bid for a plant due to factors beyond the Company's control, which could cause the gross margin for a plant to be less than the Company anticipated when the bid was made. The profit margin the Company initially expects to generate from a plant sale could be further affected by other factors, such as hydro-geologic conditions at the plant site that differ materially from those the Company believes exist and relied upon when the Company submitted its bid.

**Revenue from water sales:** The Company recognizes revenues from water sales at the time water is supplied to the customer's facility or storage tank. The amount of water supplied is determined based upon water meter readings performed at the end of each month. Under the terms of both its license agreement with the government of the Cayman Islands and its bulk water supply contracts, the Company is entitled to charge its customers the greater of a minimum monthly charge or the price for water supplied during the month.

**Comparative amounts:** Certain amounts presented in the financial statements previously issued for 2011 and 2010 have been reclassified to conform to the current year's presentation.

**3. Cash and cash equivalents and restricted cash**

Cash and cash equivalents are not restricted as to withdrawal or use. As of December 31, 2012 and 2011, the equivalent United States dollars are denominated in the following currencies:

	December 31,	
	2012	2011
Bank accounts:		
United States dollar	\$7,139,591	\$4,719,808
Cayman Islands dollar	10,907,483	12,360,952
Bahamian dollar	13,308,338	2,250,883
Belize dollar	2,007,243	1,723,264
Bermudian dollar	11,930	142,363
Mexican Peso	14,198	10,459
Euro	14,264	8,453
Singapore dollar	8,190	-
Indonesian Rupiah	112,442	-
	33,523,679	21,216,182
Short term deposits:		
United States dollar	368,976	7,809,598
Bahamian dollar	-	8,598,399
	368,976	16,407,997
Total cash and cash equivalents	\$33,892,655	\$37,624,179

In addition, restricted cash as of December 31, 2011 of \$7.5 million represented cash in a short term deposit account that was pledged as collateral for \$7.5 million in borrowings under the Company's non-revolving credit facility. The Company paid off this non-revolving credit facility in April 2012 which allowed for the release of the restriction on the \$7.5 million that was pledged as collateral on the \$10,000,000 non-revolving credit facility with Scotiabank (Cayman) Ltd.

**4. Accounts receivable**

	December 31,	
	2012	2011
Trade accounts receivable	\$ 12,098,566	\$ 8,079,194
Receivable from affiliate	110,544	144,291
Other accounts receivable	530,399	473,881
	12,739,509	8,697,366
Allowance for doubtful accounts	(223,043 )	(160,134 )
	\$ 12,516,466	\$ 8,537,232

The activity for the allowance for doubtful accounts consisted of:

	December 31,	
	2012	2011
Opening allowance for doubtful accounts	\$ 160,134	\$ 160,134
Provision for doubtful accounts	62,909	-
Ending allowance for doubtful accounts	\$ 223,043	\$ 160,134

Significant concentrations of credit risk are disclosed in Note 20.

**5. Inventory**

	December 31,	
	2012	2011
Water stock	\$32,515	\$33,436
Consumables stock	276,568	275,119
Spare parts stock	5,418,759	5,004,554
Total inventory	5,727,842	5,313,109
Less current portion	1,757,601	1,451,639
Inventory (non-current)	\$3,970,241	\$3,861,470

**6. Loans receivable**

	December 31	
	2012	2011
All loans receivable are due from the Water Authority-Cayman and consisted of:		
Two loans originally aggregating \$10,996,290, bearing interest at 6.5% per annum, receivable in aggregate monthly installments of \$124,827 to May 2019, and secured by the machinery and equipment of the North Side Water Works plant.	\$7,925,386	\$8,798,106
Two loans originally aggregating \$1,738,000, bearing interest at 5% per annum, receivable in aggregate monthly installments of \$24,565 to March 2014, and secured by the machinery and equipment of the North Sound plant.	356,474	626,070
Two loans originally aggregating \$3,671,039, bearing interest at 6.5% per annum, receivable in aggregate monthly installments of \$54,513 to June 2017, and secured by the machinery and equipment of the Red Gate plant.	2,546,325	3,018,190
Two loans originally aggregating \$897,000, bearing interest at 5% per annum, receivable in aggregate monthly installments of \$12,678 to January 2013, and secured by the machinery and equipment of the Lower Valley plant.	12,626	160,107
Total loans receivable	10,840,811	12,602,473
Less current portion	1,812,532	1,843,600
Loans receivable, excluding current portion	\$9,028,279	\$10,758,873

**7. Property, plant and equipment and construction in progress**

	December 31,	
	2012	2011
Land	\$3,223,361	\$3,223,361
Buildings	17,751,797	16,732,298
Plant and equipment	57,635,523	58,758,920
Distribution system	24,213,390	24,099,566
Office furniture, fixtures and equipment	2,644,900	2,492,913
Vehicles	1,182,782	1,283,037
Leasehold improvements	228,007	222,829
Lab equipment	19,192	34,874
	106,898,952	106,847,798
Less accumulated depreciation	47,905,546	42,662,688
Property, plant and equipment, net	\$58,993,406	\$64,185,110
Construction in progress	\$2,612,800	\$141,204

As of December 31, 2012, the Company had outstanding capital commitments of approximately \$132,000. The Company maintains insurance for loss or damage to all fixed assets that it deems susceptible to loss. The Company does not insure its underground distribution system as the Company considers the possibility of material loss or damage to this system to be remote. During the years ended December 31, 2012 and 2011, \$278,214 and \$13,576,895, respectively, of construction in progress was placed in service. Depreciation expense was \$7,381,759, \$5,789,401, and \$6,195,266 for the years ended December 31, 2012, 2011 and 2010, respectively.