

CONSOLIDATED WATER CO LTD  
Form 10-Q  
November 09, 2016

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended September 30, 2016**

**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**  
(State or other jurisdiction of

**98-0619652**  
(I.R.S. Employer Identification No.)

incorporation or organization)

**Regatta Office Park**

**Windward Three, 4th Floor, West Bay Road**

**P.O. Box 1114**

**Grand Cayman KY1-1102**

**Cayman Islands**

(Address of principal executive offices)

**N/A**

(Zip Code)

**(345) 945-4277**

(Registrant's telephone number, including area code)

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 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions 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 ☐ (Do not check if a smaller reporting company) 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 ☒

As of November 4, 2016, 14,818,699 shares of the registrant's common stock, with US\$0.60 par value, were outstanding.

## TABLE OF CONTENTS

	Description	Page
<b>PART I</b>	<b><u>FINANCIAL INFORMATION</u></b>	3
Item 1	<u>Financial Statements</u>	3
	<u>Condensed Consolidated Balance Sheets as of September 30, 2016 (Unaudited) and December 31, 2015</u>	3
	<u>Condensed Consolidated Statements of Income (Unaudited) for the Three and Nine Months Ended September 30, 2016 and 2015</u>	4
	<u>Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited) for the Three and Nine Months Ended September 30, 2016 and 2015</u>	5
	<u>Condensed Consolidated Statements of Cash Flows (Unaudited) for the Nine Months Ended September 30, 2016 and 2015</u>	6
	<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	7
Item 2	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
Item 3	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	41
Item 4	<u>Controls and Procedures</u>	41
<b>PART II</b>	<b><u>OTHER INFORMATION</u></b>	42
Item 1	<u>Legal Proceedings</u>	42
Item 1A	<u>Risk Factors</u>	43
Item 2	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	47
Item 6	<u>Exhibits</u>	47
	<b><u>SIGNATURES</u></b>	48

## **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.

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

**PART I - FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CONSOLIDATED WATER CO. LTD.****CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2016 (Unaudited)</b>	<b>December 31, 2015</b>
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 37,092,112	\$ 44,792,734
Certificate of deposit	-	5,637,538
Restricted cash	-	428,203
Accounts receivable, net	15,099,235	9,529,016
Inventory	2,087,716	1,918,728
Prepaid expenses and other current assets	1,622,789	1,282,660
Current portion of loans receivable	1,769,129	1,841,851
Costs and estimated earnings in excess of billings	1,448,393	-
<b>Total current assets</b>	<b>59,119,374</b>	<b>65,430,730</b>
Property, plant and equipment, net	52,742,944	53,743,170
Construction in progress	1,810,710	1,928,610
Inventory, non-current	4,817,933	4,558,374
Loans receivable	2,471,596	3,769,016
Investment in OC-BVI	3,942,869	4,548,271
Intangible assets, net	5,594,560	771,811
Goodwill	9,784,248	3,499,037
Land held for development	20,558,424	20,558,424
Other assets	2,446,865	2,767,583
<b>Total assets</b>	<b>\$ 163,289,523</b>	<b>\$ 161,575,026</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and other current liabilities	\$ 5,298,330	\$ 4,829,535
Dividends payable	1,183,222	1,177,246
Note payable to related party	490,000	-
Demand loan payable	-	6,958,328
Billings in excess of costs and estimated earnings	-	189,985

Edgar Filing: CONSOLIDATED WATER CO LTD - Form 10-Q

<b>Total current liabilities</b>	6,971,552	13,155,094
Deferred tax liability	2,061,438	-
Other liabilities	882,827	224,827
<b>Total liabilities</b>	9,915,817	13,379,921
<b>Commitments and contingencies</b>		
<b>Equity</b>		
Consolidated Water Co. Ltd. stockholders' equity		
Redeemable preferred stock, \$0.60 par value. Authorized 200,000 shares; issued and outstanding 35,739 and 38,804 shares, respectively	21,443	23,282
Class A common stock, \$0.60 par value. Authorized 24,655,000 shares; issued and outstanding 14,818,699 and 14,781,201 shares, respectively	8,891,219	8,868,721
Class B common stock, \$0.60 par value. Authorized 145,000 shares; none issued	-	-
Additional paid-in capital	85,131,881	84,597,349
Retained earnings	51,139,896	52,084,175
Cumulative translation adjustment	(549,555 )	(533,365 )
Total Consolidated Water Co. Ltd. stockholders' equity	144,634,884	145,040,162
Non-controlling interests	8,738,822	3,154,943
<b>Total equity</b>	153,373,706	148,195,105
<b>Total liabilities and equity</b>	\$ 163,289,523	\$ 161,575,026

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

**CONSOLIDATED WATER CO. LTD.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(UNAUDITED)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Retail revenues	\$5,447,200	\$5,828,288	\$17,710,271	\$18,116,111
Bulk revenues	7,429,732	7,919,920	22,136,086	24,489,509
Services revenues	1,508,421	857,441	3,972,403	1,151,810
Total revenues	14,385,353	14,605,649	43,818,760	43,757,430
Cost of retail revenues	2,464,841	2,640,458	7,779,831	8,065,019
Cost of bulk revenues	4,922,162	5,661,247	14,345,747	16,777,236
Cost of services revenues	1,079,027	662,201	3,004,449	1,159,836
Total cost of revenues	8,466,030	8,963,906	25,130,027	26,002,091
Gross profit	5,919,323	5,641,743	18,688,733	17,755,339
General and administrative expenses	4,528,679	3,487,967	13,925,439	11,042,507
Impairment loss on long-lived assets	2,000,000	-	2,000,000	-
Impairment of goodwill	1,750,000	-	1,750,000	-
Income (loss) from operations	(2,359,356 )	2,153,776	1,013,294	6,712,832
Other income (expense):				
Interest income	137,806	270,830	514,532	762,613
Interest expense	(1,246 )	(66,566 )	(95,615 )	(204,027 )
Profit sharing income from OC-BVI	38,475	28,350	87,075	76,950
Equity in earnings of OC-BVI	101,301	73,294	232,523	211,117
Impairment loss on investment in OC-BVI	(875,000 )	(225,000 )	(925,000 )	(810,000 )
Unrealized loss on put/call option	(275,000 )	-	(275,000 )	-
Other	110,968	(383,511 )	507,183	(530,618 )
Other income (expense), net	(762,696 )	(302,603 )	45,698	(493,965 )
Income (loss) before income taxes	(3,122,052 )	1,851,173	1,058,992	6,218,867
Provision for (benefit from) income taxes	(146,198 )	-	(389,860 )	-
Net income (loss)	(2,975,854 )	1,851,173	1,448,852	6,218,867
Income (loss) attributable to non-controlling interests	(1,110,522 )	75,673	(944,790 )	294,006
Net income (loss) attributable to Consolidated Water Co. Ltd. stockholders	\$(1,865,332 )	\$1,775,500	\$2,393,642	\$5,924,861
Basic earnings (loss) per common share attributable to Consolidated Water Co. Ltd. common stockholders	\$(0.13 )	\$0.12	\$0.16	\$0.40
Diluted earnings (loss) per common share attributable to Consolidated Water Co. Ltd. common stockholders	\$(0.13 )	\$0.12	\$0.16	\$0.40
Dividends declared per common share	\$0.075	\$0.075	\$0.225	\$0.225



Weighted average number of common shares used in the determination of:

Basic earnings per share	14,815,248	14,749,249	14,803,216	14,734,799
Diluted earnings per share	14,852,967	14,802,322	14,940,635	14,787,904

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

**CONSOLIDATED WATER CO. LTD.**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

**(UNAUDITED)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income (loss)	\$(2,975,854)	\$1,851,173	\$1,448,852	\$6,218,867
Other comprehensive income (loss)				
Foreign currency translation adjustment	(11,208 )	(2,475 )	(17,042 )	(45,226 )
Total other comprehensive income (loss)	(11,208 )	(2,475 )	(17,042 )	(45,226 )
Comprehensive income (loss)	(2,987,062)	1,848,698	1,431,810	6,173,641
Comprehensive income (loss) attributable to non-controlling interests	(1,111,082)	75,550	(945,642 )	291,745
Comprehensive income (loss) attributable to Consolidated Water Co. Ltd. stockholders	\$(1,875,980)	\$1,773,148	\$2,377,452	\$5,881,896

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

**CONSOLIDATED WATER CO. LTD.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

	Nine Months Ended September 30,	
	2016	2015
Net cash provided by operating activities	\$4,516,088	\$11,703,961
Cash flows from investing activities		
Purchase of certificate of deposit	-	(5,637,538 )
Maturity of certificate of deposit	5,637,538	5,000,000
Additions to property, plant and equipment and construction in progress	(2,569,066 )	(2,498,275 )
Proceeds from sale of equipment	547,332	10,160
Acquisition of business, net of cash acquired	(7,742,853 )	-
Collections on loans receivable	1,370,142	1,284,191
Release/(restriction) of cash balance	398,744	(42,715 )
Net cash used in investing activities	(2,358,163 )	(1,884,177 )
Cash flows from financing activities		
Dividends paid to CWCO common shareholders	(3,322,793 )	(3,312,050 )
Dividends paid to non-controlling interests	(182,663 )	(183,372 )
Dividends paid to CWCO preferred shareholders	(9,151 )	(8,944 )
Repurchase of redeemable preferred stock	(9,599 )	(2,960 )
Proceeds received from exercise of stock options	174,853	244,368
Issuance of note payable to related party	490,000	-
Repayments of demand loan payable	(7,000,000 )	(1,500,000 )
Net cash used in financing activities	(9,859,353 )	(4,762,958 )
Effect of exchange rate changes on cash	806	(4,390 )
Net increase (decrease) in cash and cash equivalents	(7,700,622 )	5,052,436
Cash and cash equivalents at beginning of period	44,792,734	35,713,689
Cash and cash equivalents at end of period	\$37,092,112	\$40,766,125
Interest paid in cash	\$67,689	\$113,244
Non-cash investing and financing activities		
Issuance of 8,421 and 8,615, respectively, shares of redeemable preferred stock for services rendered	\$111,410	\$110,703
Issuance of 9,964 and 0, respectively, shares of common stock for services rendered	\$106,415	\$-
Conversion (on a one-to-one basis) of 11,558 and 7,195, respectively, shares of redeemable preferred stock to common stock	\$6,935	\$4,317

Edgar Filing: CONSOLIDATED WATER CO LTD - Form 10-Q

Dividends declared but not paid	\$ 1,114,083	\$ 1,109,248
Transfers from (to) inventory to (from) property, plant and equipment and construction in progress	\$ 134,362	\$ 114,733
Transfers from construction in progress to property, plant and equipment	\$ 1,787,580	\$ 1,606,314

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

**CONSOLIDATED WATER CO. LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**1. Principal activity**

Consolidated Water Co. Ltd., and its subsidiaries (collectively, the “Company”) use reverse osmosis technology to produce potable water from seawater. The Company processes and supplies water and provides water-related products and services to its customers in the Cayman Islands, Belize, The Bahamas, the British Virgin Islands, Indonesia and the United States. 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 retail license and bulk water supply contracts which provide for adjustments based upon the movement in the government price indices specified in the license and contracts as well as monthly adjustments for changes in the cost of energy. The Company also manufactures and services a wide range of products and provides design, engineering, management, operating and other services applicable to commercial and municipal water production, supply and treatment, and industrial water and wastewater treatment.

**2. Accounting policies**

**Basis of presentation:** The accompanying condensed consolidated financial statements include the accounts of the Company’s (i) wholly-owned subsidiaries, Aquilex, Inc., Cayman Water Company Limited (“Cayman Water”), Consolidated Water (Belize) Limited (“CW-Belize”), Ocean Conversion (Cayman) Limited (“OC-Cayman”), DesalCo Limited (“DesalCo”), Consolidated Water Cooperatief, U.A. (“CW-Cooperatief”), Consolidated Water U.S. Holdings, Inc. (“CW-Holdings”); and (ii) majority-owned subsidiaries Consolidated Water (Bahamas) Ltd. (“CW-Bahamas”), Aerex Industries, Inc. (“Aerex”), Consolidated Water (Asia) Pte. Limited, PT Consolidated Water Bali (“CW-Bali”) and N.S.C. Agua, S.A. de C.V. (“NSC”). The Company’s investment in its 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.

The accompanying interim condensed consolidated financial statements are unaudited. These condensed consolidated financial statements reflect all adjustments (which are of a normal recurring nature) that, in the opinion of management, are necessary to fairly present the Company’s financial position, results of operations and cash flows as of and for the periods presented. The results of operations for these interim periods are not necessarily indicative of the operating results for future periods, including the fiscal year ending December 31, 2016.

These condensed consolidated financial statements and notes are presented in accordance with the rules and regulations of the United States Securities and Exchange Commission (“SEC”) relating to interim financial statements and in conformity with accounting principles generally accepted in the United States of America (“US GAAP”). Certain information and note disclosures normally included in annual financial statements prepared in accordance with US GAAP have been condensed or omitted in these condensed financial statements pursuant to SEC rules and regulations, although the Company believes that the disclosures made herein are adequate to make the information not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

**Foreign currency:** The Company’s reporting currency is the United States dollar (“US\$”). The functional currency of the Company and its foreign operating subsidiaries (other than NSC and CW-Cooperatief) is the currency for each respective country. Effective as of October 1, 2016, the Company changed the functional currency of CW-Bali to the US\$ as further discussed in Note 9. The functional currency for NSC and CW-Cooperatief is the US\$. The exchange rates for the Cayman Islands dollar, the Belize dollar and the Bahamian dollar are fixed to the US\$. CW-Cooperatief conducts business in US\$ and euros, CW-Bali conducts business in US\$ and Indonesian rupiahs, and NSC conducts business in US\$ and Mexican pesos. The exchange rates for conversion of euros, rupiahs and Mexican pesos into US\$ vary based upon market conditions. Net foreign currency gains (losses) arising from transactions and re-measurements were \$1,734 and (\$388,456) for the three months ended September 30, 2016 and 2015, respectively, and \$92,030 and (\$660,989) for the nine months ended September 30, 2016 and 2015, respectively, and are included in “Other income (expense) - Other” in the accompanying condensed consolidated statements of income.

**Comprehensive income:** Comprehensive income (loss) is defined as the change in equity during a period from transactions and other events from non-owner sources. Comprehensive income (loss) is the total of net income and other comprehensive income (loss) which, for the Company, is comprised entirely of foreign currency translation adjustments related to CW-Bali.

**Cash and cash equivalents:** Cash and cash equivalents consist of demand deposits and highly liquid deposits at banks with an original maturity of three months or less. Cash and cash equivalents as of September 30, 2016 and December 31, 2015 include \$4.2 million and \$13.6 million, respectively, of certificates of deposits with an original maturity of three months or less.

Transfers from the Company’s bank accounts in The Bahamas and Belize to Company bank accounts in other countries require the approval of the Central Bank of the Bahamas and Belize, respectively. As of September 30, 2016, the equivalent United States dollar cash balances for deposits held in the Bahamas and Belize were approximately \$6.6 million and \$5.3 million, respectively.

**Comparative amounts:** Certain amounts reported in the financial statements issued in prior periods have been reclassified herein to conform to the current period’s presentation. These reclassifications had no effect on consolidated

net income.

7

### 3. Purchase of interest in Aerex Industries, Inc.

On February 11, 2016 (the “Closing Date”), the Company, through its wholly-owned subsidiary, CW-Holdings, entered into a stock purchase agreement (the “Purchase Agreement”) with Aerex and Thomas Donnicks, Jr. (“Donnick”), Aerex’s sole shareholder prior to the Closing Date. Pursuant to the terms of the Purchase Agreement, CW-Holdings purchased a 51% ownership interest in Aerex for an aggregate purchase price of approximately \$7.7 million in cash. After giving effect to the transactions contemplated by the Purchase Agreement, CW-Holdings owns 51% of the outstanding capital stock of Aerex and Donnick owns 49% of the outstanding capital stock of Aerex. CW-Holdings also acquired from Donnick an option to compel Donnick to sell, and granted to Donnick an option to require CW-Holdings to purchase, Donnick’s 49% ownership interest in Aerex at a price based upon the fair market value of Aerex at the time of the exercise of the option. The options are exercisable on or after the third anniversary of the Closing Date. In connection with the Purchase Agreement, the Company guaranteed the obligations of CW-Holdings with respect to the option granted to Donnick to require CW-Holdings to purchase Donnick’s 49% ownership interest in Aerex.

Aerex is an original equipment manufacturer and service provider of a wide range of products and services applicable to municipal water treatment and industrial water and wastewater treatment. Its products include membrane separation equipment, filtration equipment, piping systems, vessels and custom fabricated components. Aerex also offers engineering, design, consulting, inspection, training and equipment maintenance services to its customers. Aerex is an American Society of Mechanical Engineers (ASME) code accredited manufacturer and maintains the ASME U and S and the National Board NB and R Certificates of Authorization. Its corporate offices and manufacturing facilities are located in Fort Pierce, Florida.

In connection with the Purchase Agreement, CW-Holdings, Aerex and Donnick entered into a shareholders agreement pursuant to which CW-Holdings and Donnick agreed to certain rights and obligations with respect to the governance of Aerex. Immediately following the acquisition, Donnick and the Company loaned \$490,000 and \$510,000, respectively, to Aerex. These loans bear interest at 1% per annum and mature June 30, 2017.

The purchase price for Aerex is summarized as follows:

	February 11, 2016
Cash consideration	
Purchase price (excluding working capital)	\$7,140,000
Working capital adjustment	605,179
Cash acquired	(2,326 )
Total cash consideration	\$7,742,853



Edgar Filing: CONSOLIDATED WATER CO LTD - Form 10-Q

The following table summarizes the estimated fair values of the assets and liabilities assumed at the acquisition date:

	February 11, 2016
Financial assets	\$456,664
Inventory	70,487
Costs and estimated earnings in excess of billings	784,465
Property, plant and equipment	2,159,401
Identifiable intangible assets	5,900,000
Deferred tax liability	(2,451,298)
Accounts payable and accrued liabilities	(116,893 )
Net liability arising from put/call options	(383,000 )
Total identifiable net assets	6,419,826
Non-controlling interest in Aerex	(6,712,184)
Goodwill	8,035,211
	\$7,742,853

The identifiable intangible assets consist of the following items with amortization calculated using a straight line method over the useful life of the asset:

	February 11, 2016	Accumulated Amortization	September 30, 2016	Useful life
Non-compete agreement	\$ 400,000	\$ 53,333	\$ 346,667	5 years
Trade name	1,400,000	62,223	1,337,777	15 years
Certifications/programs	2,000,000	444,444	1,555,556	3 years
Customer backlog	100,000	66,667	33,333	1 year
Customer relationships	2,000,000	333,333	1,666,667	4 years
	\$ 5,900,000	\$ 960,000	\$ 4,940,000	

Aerex's actual results of operations for the period subsequent to its acquisition by the Company on February 11, 2016 fell significantly short of the projected results for this period that were included in the overall cash flow projections utilized by the Company to determine the purchase price for Aerex and the fair values of its assets and liabilities. Due to this negative variance in actual results compared to projected results, the Company tested Aerex's goodwill for possible impairment as of September 30, 2016 by estimating its fair value using the discounted cash flow method. As a result of this impairment testing, the Company determined that the carrying value of its Aerex reporting unit exceeded its fair value, and recorded an impairment loss for the three months ended September 30, 2016 of \$1,750,000 for the goodwill associated with the Aerex acquisition.

The results of operations of Aerex are included in the services segment of the Company's consolidated financial statements from the date of acquisition. The total revenue and net income (loss) included for Aerex in the Company's consolidated results of operations for the three months ended September 30, 2016 were approximately \$1.4 million and (\$956,000), respectively. The total revenue and net income (loss) included for Aerex in the Company's consolidated results of operations for the period February 11, 2016 to September 30, 2016, were approximately \$3.3 million and (\$1,275,000), respectively. General and administrative expenses incurred by the Company for the Aerex acquisition reflected in the results of operations for the three and nine months ended September 30, 2016 were \$0 and approximately \$144,000, respectively.

The following pro forma financial information presents the results of operations of the Company for the nine months ended September 30, 2016 and 2015, as if the acquisition of Aerex had taken place on January 1, 2015. The pro forma results have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which would have actually occurred had the transaction taken place on January 1, 2015, or of future results of operations:

Edgar Filing: CONSOLIDATED WATER CO LTD - Form 10-Q

	Nine Months Ended September 30,	
	2016	2015
Revenues	\$44,324,477	\$60,383,276
Cost of revenues	25,397,444	38,135,655
Gross profit	18,927,033	22,247,621
General and administrative expenses	14,240,156	12,601,144
Impairment loss on long-lived assets	2,000,000	-
Impairment of goodwill	1,750,000	-
Income from operations	936,877	9,646,477
Other income (expense), net	47,202	(487,401 )
Income before income taxes	984,079	9,159,076
Provision for (benefit from) income taxes	(462,773 )	1,027,589
Net income	1,446,852	8,131,487
Income (loss) attributable to non-controlling interests	(920,277 )	1,417,703
Net income attributable to Consolidated Water Co. Ltd. stockholders	\$2,367,129	\$6,713,784
Basic earnings per common share attributable to Consolidated Water Co. Ltd. common stockholders	\$0.16	\$0.46
Diluted earnings per common share attributable to Consolidated Water Co. Ltd. common stockholders	\$0.16	\$0.45
Weighted average number of common shares used in the determination of:		
Basic earnings per share	14,803,216	14,734,799
Diluted earnings per share	14,940,635	14,787,904

#### 4. Fair value measurements

As of September 30, 2016 and December 31, 2015, the carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and other current liabilities, the note payable to related party, the demand loan payable and dividends payable approximate their fair values due to the short term maturities of these instruments. Management considers that the carrying amounts for loans receivable as of September 30, 2016 and December 31, 2015 approximate their fair value as the stated interest rates approximate market rates.

Under US GAAP, fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. US GAAP guidance also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs market participants would use in valuing the asset or liability and are developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the factors market participants would use in valuing the asset or liability. The guidance establishes three levels of inputs that may be used to measure fair value:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurements. The Company reviews its fair value hierarchy classifications on a quarterly basis. Changes in the observability of valuation inputs may result in a reclassification of levels for certain securities within the fair value hierarchy.

The following table presents the Company's fair value hierarchy for assets and liabilities measured at fair value as of September 30, 2016 and December 31, 2015:

September 30, 2016				
	Level 1	Level 2	Level 3	Total
Assets				
Recurring				
Restricted cash	\$-	\$ -	\$-	\$-
Certificate of deposit	\$-	\$ -	\$-	\$-
Nonrecurring				
Investment in OC-BVI	\$-	\$ -	\$3,942,869	\$3,942,869
Liabilities				
Recurring				
Net liability arising from put/call options	\$-	\$ -	\$658,000	\$658,000

December 31, 2015				
	Level 1	Level 2	Level 3	Total
Assets				
Recurring				
Restricted cash	\$428,203	\$-	\$-	\$428,203
Certificate of deposit	-	5,637,538	-	5,637,538
Total recurring	\$428,203	\$5,637,538	\$-	\$6,065,741
Nonrecurring				
Investment in OC-BVI	\$-	\$-	\$4,548,271	\$4,548,271

The activity for the Level 3 asset and liability for the nine months ended September 30, 2016 was as follows:

Investment in OC-BVI	
Balance as of December 31, 2015	\$4,548,271
Profit sharing and equity from earnings of OC-BVI	319,598
Distributions received from OC-BVI	-
Impairment of investment in OC-BVI	(925,000 )
Balance as of September 30, 2016	\$3,942,869

**Net liability arising from put/call options<sup>[1]</sup>**

Balance as of December 31, 2015	\$-
Issuance	383,000
Unrealized loss	275,000
Balance as of September 30, 2016	\$658,000

---

(1) The net liability arising from the put/call options is included other liabilities in the accompanying condensed consolidated balance sheets as of September 30, 2016.

## 5. Segment information

The Company has three reportable segments: retail, bulk and services. The retail segment operates the water utility for the Seven Mile Beach and West Bay areas of Grand Cayman Island pursuant to an exclusive license granted by the Cayman Islands government and also sells water to resort properties in Bali, Indonesia. The bulk segment supplies potable water to government utilities in Grand Cayman, The Bahamas and Belize under long-term contracts. The services segment manufactures and services a wide range of water-related products and provides design, engineering, management, operating and other services applicable to commercial and municipal water production, water supply and treatment, and industrial water and wastewater treatment. The services segment includes the operations of Aerex beginning February 11, 2016. Consistent with prior periods, the Company records all non-direct general and administrative expenses in its retail business segment and does not allocate any of these non-direct expenses to its other two business segments.

The accounting policies of the segments are consistent with those described in Note 2. The Company evaluates each segment's performance based upon its income from operations. All intercompany transactions are eliminated for segment presentation purposes.

Edgar Filing: CONSOLIDATED WATER CO LTD - Form 10-Q

The Company's segments are strategic business units that are managed separately because, while all segments derive their revenues from water-related activities, each segment sells different products and/or services, serves customers with distinctly different needs and generates different gross profit margins.

	Three Months Ended September 30, 2016			
	Retail	Bulk	Services	Total
Revenues	\$5,447,200	\$7,429,732	\$1,508,421	\$14,385,353
Cost of revenues	2,464,841	4,922,162	1,079,027	8,466,030
Gross profit	2,982,359	2,507,570	429,394	5,919,323
General and administrative expenses	2,811,262	425,000	1,292,417	4,528,679
Impairment loss on long-lived assets	2,000,000	-	-	2,000,000
Impairment of goodwill	-	-	1,750,000	1,750,000
Income (loss) from operations	\$(1,828,903)	\$2,082,570	\$(2,613,023)	(2,359,356)
Other income (expense), net				(762,696)
Loss before income taxes				(3,122,052)
Provision for (benefit from) income taxes				(146,198)
Net loss				(2,975,854)
Loss attributable to non-controlling interests				(1,110,522)
Net loss attributable to Consolidated Water Co. Ltd. stockholders				\$(1,865,332)

Depreciation and amortization expenses for the three months ended September 30, 2016 for the retail, bulk and services segments were \$567,833, \$811,741 and \$451,267, respectively.

Three Months Ended September 30, 2015

	Retail	Bulk	Services	Total
Revenues	\$5,828,288	\$7,919,920	\$857,441	\$14,605,649
Cost of revenues	2,640,458	5,661,247	662,201	8,963,906
Gross profit	3,187,830	2,258,673	195,240	5,641,743
General and administrative expenses	2,728,473	357,995	401,499	3,487,967
Income (loss) from operations	\$459,357	\$1,900,678	\$(206,259)	2,153,776
Other income (expense), net				(302,603 )
Net income				1,851,173
Income attributable to non-controlling interests				75,673
Net income attributable to Consolidated Water Co. Ltd. stockholders				\$1,775,500

Depreciation and amortization expenses for the three months ended September 30, 2015 for the retail, bulk and services segments were \$583,551, \$815,994 and \$28,976, respectively.

Nine Months Ended September 30, 2016

	Retail	Bulk	Services	Total
Revenues	\$17,710,271	\$22,136,086	\$3,972,403	\$43,818,760
Cost of revenues	7,779,831	14,345,747	3,004,449	25,130,027
Gross profit	9,930,440	7,790,339	967,954	18,688,733
General and administrative expenses	8,588,529	1,302,884	4,034,026	13,925,439
Impairment loss on long-lived assets	2,000,000	-	-	2,000,000
Impairment of goodwill	-	-	1,750,000	1,750,000
Income (loss) from operations	\$(658,089 )	\$6,487,455	\$(4,816,072)	1,013,294
Other income (expense), net				45,698
Income before income taxes				1,058,992
Provision for (benefit from) income taxes				(389,860 )
Net income				1,448,852
Loss attributable to non-controlling interests				(944,790 )
Net income attributable to Consolidated Water Co. Ltd. stockholders				\$2,393,642

Depreciation and amortization expenses for the nine months ended September 30, 2016 for the retail, bulk and services segments were \$1,714,928, \$2,480,314 and \$1,213,282, respectively.

Nine Months Ended September 30, 2015

	Retail	Bulk	Services	Total
Revenues	\$18,116,111	\$24,489,509	\$1,151,810	\$43,757,430
Cost of revenues	8,065,019	16,777,236	1,159,836	26,002,091



Edgar Filing: CONSOLIDATED WATER CO LTD - Form 10-Q

Gross profit (loss)	10,051,092	7,712,273	(8,026 )	17,755,339
General and administrative expenses	8,360,765	1,187,824	1,493,918	11,042,507
Income (loss) from operations	\$1,690,327	\$6,524,449	\$(1,501,944)	6,712,832
Other income (expense), net				(493,965 )
Net income				6,218,867
Income attributable to non-controlling interests				294,006
Net income attributable to Consolidated Water Co. Ltd. stockholders				\$5,924,861

Depreciation and amortization expenses for the nine months ended September 30, 2015 for the retail, bulk and services segments were \$1,755,123, \$2,419,509 and \$73,924, respectively.

	As of September 30, 2016			
	Retail	Bulk	Services	Total
Accounts receivable, net	\$2,479,251	\$11,704,695	\$915,289	\$15,099,235
Property plant and equipment, net	\$23,844,950	\$26,775,210	\$2,122,784	\$52,742,944
Construction in progress	\$1,545,294	\$257,557	\$7,859	\$1,810,710
Intangibles, net	\$-	\$616,508	\$4,978,052	\$5,594,560
Goodwill	\$1,170,511	\$2,328,526	\$6,285,211	\$9,784,248
Land held for development	\$-	\$-	\$20,558,424	\$20,558,424
Total assets	\$55,710,082	\$68,433,012	\$39,146,429	\$163,289,523

	As of December 31, 2015			
	Retail	Bulk	Services	Total
Accounts receivable, net	\$2,261,141	\$6,231,626	\$1,036,249	\$9,529,016
Property plant and equipment, net	\$25,204,226	\$28,421,906	\$117,038	\$53,743,170
Construction in progress	\$1,860,050	\$68,560	\$-	\$1,928,610
Intangibles, net	\$-	\$666,152	\$105,659	\$771,811
Goodwill	\$1,170,511	\$2,328,526	\$-	\$3,499,037
Land held for development	\$-	\$-	\$20,558,424	\$20,558,424
Total assets	\$54,561,577	\$83,284,439	\$23,729,010	\$161,575,026

## 6. Earnings per share

Earnings per share ("EPS") are computed on a basic and diluted basis. Basic EPS is computed by dividing net income (less preferred stock dividends) available to common stockholders by the weighted average number of common shares outstanding during the period. The computation of diluted EPS assumes the issuance of common shares for all potential common shares outstanding during the reporting period and, if dilutive, the effect of stock options and unvested stock grants as computed under the treasury stock method.

The following summarizes information related to the computation of basic and diluted EPS for the three and nine months ended September 30, 2016 and 2015.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income (loss) attributable to Consolidated Water Co. Ltd. stockholders	\$ (1,865,332 )	\$ 1,775,500	\$ 2,393,642	\$ 5,924,861
Less: preferred stock dividends	(2,680 )	(2,937 )	(8,921 )	(9,118 )
Net income (loss) available to common shares in the determination of basic earnings per common share	\$ (1,868,012 )	\$ 1,772,563	\$ 2,384,721	\$ 5,915,743
Weighted average number of common shares in the determination of basic earnings per common share attributable to Consolidated Water Co. Ltd. common stockholders	14,815,248	14,749,249	14,803,216	14,734,799
Plus:				
Weighted average number of preferred shares outstanding during the period	37,719	40,194	38,516	38,510
Potential dilutive effect of unexercised options and unvested stock grants	-	12,879	98,903	14,595
	14,852,967	14,802,322	14,940,635	14,787,904

Weighted average number of shares used for determining  
diluted earnings per common share attributable to  
Consolidated Water Co. Ltd. common stockholders

## 7. Investment in OC-BVI

The Company owns 50% of the outstanding voting common shares and a 43.53% equity interest in the net income and net losses of Ocean Conversion (BVI) Ltd. (“OC-BVI”). The Company also owns certain profit sharing rights in OC-BVI that raise its effective interest in the net income of OC-BVI to approximately 45%. Pursuant to a management services agreement, OC-BVI pays the Company monthly fees for certain engineering and administrative services. OC-BVI’s primary customer is the Ministry of Communications and Works of the Government of the British Virgin Islands (the “Ministry”) to which it sells bulk water.

The Company’s equity investment in OC-BVI amounted to \$3,942,869 and \$4,548,271 as of September 30, 2016 and December 31, 2015, respectively.

Until 2009, substantially all of the water sold by OC-BVI to the Ministry was supplied by one desalination plant with a capacity of 1.7 million gallons per day located at Baughers Bay, Tortola (the “Baughers Bay plant”). As discussed later in this Note (see “*Baughers Bay litigation*”), the BVI government assumed the operating responsibilities for the Baughers Bay plant in March 2010. During 2007, OC-BVI completed the construction of a desalination plant with a capacity of 720,000 gallons per day located at Bar Bay, Tortola (the “Bar Bay plant”). OC-BVI began selling water to the Ministry from this plant in January 2009 and in March 2010, OC-BVI and the BVI government executed a seven-year contract for the Bar Bay plant (the “Bar Bay agreement”). Under the terms of the Bar Bay agreement, OC-BVI delivers up to 600,000 gallons of water per day to the BVI government from the Bar Bay plant. The Bar Bay agreement includes a seven-year extension option exercisable by the BVI government and required OC-BVI to complete a storage reservoir on a BVI government site by no later than March 4, 2011. OC-BVI has not commenced construction of this storage reservoir due to the BVI government’s failure to pay (i) the full amount of invoices for the water provided by the Bar Bay plant on a timely basis; (ii) interest income due as a result of late payment of accounts receivable balances; and (iii) the amount for the Baughers Bay plant arising from a court ruling relating to the Baughers Bay litigation (see discussion that follows).

Summarized financial information of OC-BVI is presented as follows:

	September 30, 2016	December 31, 2015
Current assets	\$5,228,414	\$4,323,792
Non-current assets	4,183,483	4,682,650
Total assets	\$9,411,897	\$9,006,442

	September 30, 2016	December 31, 2015
Current liabilities	\$359,572	\$584,116
Non-current liabilities	1,777,950	1,650,252
Total liabilities	\$2,137,522	\$2,234,368

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues	\$965,169	\$1,022,510	\$2,850,242	\$3,118,763
Cost of revenues	540,522	552,213	1,537,860	1,692,640
Gross profit	424,647	470,297	1,312,382	1,426,123
General and administrative expenses	231,750	228,472	714,483	734,270
Income from operations	192,897	241,825	597,899	691,853
Other income (expense), net	62,165	(56,700 )	(15,598 )	(153,900 )
Net income	255,062	185,125	582,301	537,953
Income attributable to non-controlling interests	22,346	16,748	48,133	52,960
Net income attributable to controlling interests	\$232,716	\$168,377	\$534,168	\$484,993

The Company recognized earnings of \$101,301 and \$73,294 for the three months ended September 30, 2016 and 2015, respectively, and \$232,523 and \$211,117 for the nine months ended September 30, 2016 and 2015, respectively, from its investment in OC-BVI. The Company recognized profit sharing income of \$38,475 and \$28,350 for the three months ended September 30, 2016 and 2015, respectively, and \$87,075 and \$76,950 for the nine months ended September 30, 2016 and 2015, respectively, from its profit sharing agreement with OC-BVI.

For the three months ended September 30, 2016 and 2015, the Company recognized revenues of \$125,930 and \$135,023, respectively, from its management services agreement with OC-BVI. For the nine months ended September

30, 2016 and 2015, the Company recognized revenues of \$390,280 and \$399,335, respectively, from its management services agreement with OC-BVI. Amounts payable by OC-BVI to the Company were \$70,746 and \$91,569 as of September 30, 2016 and December 31, 2015, respectively. The Company's recorded value of this management services agreement, which is reflected as an intangible asset on the Company's condensed consolidated balance sheets, was \$38,052 and \$105,659 as of September 30, 2016 and December 31, 2015, respectively.

*Baughers Bay Litigation*

Under the terms of a water supply agreement dated May 1990 (the "1990 Agreement") between OC-BVI and the Government of the British Islands (the "BVI government") for the Baughers Bay plant upon the expiration of its initial seven-year term in May 1999, the 1990 Agreement would automatically be extended for another seven-year term unless the BVI government provided notice, at least eight months prior to such expiration, of its decision to purchase the plant from OC-BVI at the agreed upon amount under the 1990 Agreement of approximately \$1.42 million. In correspondence between the parties from late 1998 through early 2000, the BVI government indicated that it intended to purchase the plant but would be amenable to negotiating a new water supply agreement, and that it considered the 1990 Agreement to be in force on a monthly basis until negotiations between the BVI government and OC-BVI were concluded. Occasional discussions were held between the parties after 2000 without resolution of the matter. OC-BVI continued to supply water from the plant and expended approximately \$4.7 million between 1995 and 2003 to significantly expand the production capacity of the plant beyond that contemplated in the 1990 Agreement.

In 2006, the BVI government took the position that the seven-year extension of the 1990 Agreement had been completed and that it was entitled to ownership of the Baughers Bay plant. In response, OC-BVI disputed the BVI government's contention that the original terms of the 1990 Agreement remained in effect.

During 2007, the BVI government significantly reduced its payments for the water being supplied by OC-BVI and filed a lawsuit with the Eastern Caribbean Supreme Court (the "Court") seeking ownership of the Baughers Bay plant. OC-BVI counterclaimed to the Court that it was entitled to continued possession and operation of the Baughers Bay plant until the BVI government paid OC-BVI approximately \$4.7 million, which OC-BVI believed represented the value of the Baughers Bay plant at its expanded production capacity. OC-BVI subsequently filed claims with the Court seeking payment for water sold and delivered to the BVI government through May 31, 2009 at the contract prices in effect before the BVI government asserted its purported right of ownership of the plant.

The Court ruled on this litigation in 2009 determining that (i) the BVI government was entitled to immediate ownership and possession of the Baughers Bay plant; (ii) OC-BVI was not entitled to compensation for the expenditures made to expand the production capacity of the plant; (iii) OC-BVI was entitled to full payment of water invoices issued up to December 20, 2007 which had been calculated under the terms of the original 1990 Agreement; and (iv) OC-BVI was entitled to the amount of \$10.4 million for water produced by OC-BVI from the Baughers Bay plant subsequent to December 20, 2007.

OC-BVI filed an appeal with the Eastern Caribbean Court of Appeals (the "Appellate Court") in October 2009 asking the Appellate Court to review the September 17, 2009 ruling by the Court as it related to OC-BVI's claim for compensation for expenditures made to expand the production capacity of the Baughers Bay plant. In October 2009, the BVI government also filed an appeal with the Appellate Court requesting the Appellate Court to reduce the \$10.4 million awarded by the Court to OC-BVI for water supplied subsequent to December 20, 2007 to an amount equal to the cost of producing such water.

In March 2010, OC-BVI vacated the Baughers Bay plant and the BVI government assumed direct responsibility for the plant's operations.

In June 2012, the Appellate Court 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.

OC-BVI and the BVI government engaged a mutually approved valuation expert to complete a valuation of the Baughers Bay plant at the date it was transferred to the BVI government in accordance with the Appellate Court ruling.

In June 2016, OC-BVI received the final valuation report from the valuation expert, which sets forth a value for the Baughers Bay plant of \$13.0 million as of the date OC-BVI transferred possession of the plant to the BVI government. Applying the valuation determined by the valuation expert to the formula set forth by the Appellate Court in its ruling, OC-BVI would be entitled to \$11.58 million from the BVI government for the Baughers Bay plant. The BVI government has indicated that it disagrees with the valuation methodology used by the valuation expert and the resulting valuation for the Baughers Bay plant. We cannot presently determine if the Appellate Court will uphold the Baughers Bay plant valuation or when, or to what extent, any amount for the value of the Baughers Bay plant will be paid by the BVI government to OC-BVI. Consequently, any amount due for the Baughers Bay plant valuation will not be included in OC-BVI's results of operations until such amount, if any, is paid by the BVI government.

#### *Valuation of Investment in OC-BVI*

The Company accounts for its 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.

As a quoted market price for OC-BVI's stock is not available, to test for possible impairment of its investment in OC-BVI, the Company estimates its fair value through the use of the discounted cash flow method which relies upon projections of OC-BVI's operating results, working capital and capital expenditures. The use of this method requires the Company to estimate OC-BVI's cash flows from (i) the Bar Bay agreement and (ii) the pending amount due, as required under the final ruling of the Appellate Court for the value of the Baughers Bay plant at the date it was transferred by OC-BVI to the BVI government.

The Company estimates the cash flows OC-BVI will receive from its Bar Bay plant by (i) identifying various possible future scenarios which include the execution of a new agreement for the Bar Bay plant as well as the termination of Bar Bay plant operations upon the expiration of the existing Bar Bay agreement in March 2017; (ii) estimating the cash flows associated with each possible scenario; and (iii) assigning a probability to each scenario. The Company similarly estimates the cash flows OC-BVI will receive from the BVI government for the amount due under the ruling by the Appellate Court for the value of the Baughers Bay plant at the date it was transferred to the BVI government by assigning probabilities to different valuation scenarios. The resulting probability-weighted sum represents the expected cash flows, and the Company's best estimate of future cash flows, to be derived by OC-BVI from its Bar Bay plant and the pending Appellate Court ruling.





The identification of the possible scenarios for the Bar Bay plant and the Baughers Bay plant valuation, the projections of cash flows for each scenario, and the assignment of relative probabilities to each scenario all represent significant estimates made by the Company. While the Company uses its best judgment in identifying these possible scenarios, estimating the expected cash flows for these scenarios and assigning relative probabilities to each scenario, these estimates are by their nature highly subjective and are also subject to material change by the Company's management over time based upon new information or changes in circumstances.

As of September 30, 2016, after updating its probability-weighted estimates of OC-BVI's future cash flows and its resulting estimate of the fair value of its investment in OC-BVI, the Company determined that the carrying value of its investment in OC-BVI exceeded its fair value and recorded an impairment loss of \$875,000 for the three months ended September 30, 2016. Total impairment losses recorded by the Company on its investment in OC-BVI during the nine months ended September 30, 2016 were \$925,000. The Company recorded impairment losses on its investment in OC-BVI of \$225,000 and \$810,000 for the three and nine months ended September 30, 2015, respectively.

The remaining carrying value of the Company's investment in OC-BVI of approximately \$3.9 million as of September 30, 2016 assumes that the BVI government will honor its obligations under the Bar Bay agreement and also assumes (on a probability-weighted basis) that (i) the BVI government will enter into a new agreement to purchase water from the Bar Bay plant after the current Bar Bay agreement expires in March 2017; and (ii) OC-BVI will receive the pending amount due (as estimated by the Company) as required under the Appellate Court ruling for the value of the Baughers Bay plant previously transferred by OC-BVI to the BVI government.

The BVI government is OC-BVI's primary customer and substantially all of OC-BVI's revenues are generated from its Bar Bay plant. As the Bar Bay agreement matures to its March 2017 expiration date and OC-BVI receives the pending amount assumed due for the value of the Baughers Bay plant, OC-BVI's expected future cash flows, and therefore its fair value computed under the discounted cash flow method, decreases. The Company will be required to record additional impairment losses to reduce the carrying value of its investment in OC-BVI to its then current fair value if OC-BVI does not obtain a new agreement for the Bar Bay plant that generates cash flows sufficient to support the Company's then carrying value of its investment in OC-BVI. If OC-BVI does not obtain a new agreement for the Bar Bay plant that generates cash flows sufficient to support OC-BVI's carrying values for its long-lived Bar Bay plant assets, OC-BVI will be required to record an impairment loss to reduce the carrying value of its long-lived Bar Bay plant assets to their then estimated fair value. The Company's equity in the net earnings or loss of OC-BVI will include 43.53% of any such impairment loss recorded by OC-BVI. Based upon the updating of its probability-weighted scenarios for the future cash flows to be derived from its Bar Bay plant, OC-BVI may be required to record impairment losses to reduce the carrying value of its Bar Bay plants assets before the expiration of the Bar Bay agreement in March 2017. As of September 30, 2016, the aggregate carrying value of OC-BVI's long-lived Bar Bay plant assets was approximately \$4.0 million. Future impairment losses on the Company's investment in OC-BVI and the Company's equity in any future losses incurred by OC-BVI could have a material adverse impact on the Company's results of operations.

In October 2016, OC-BVI submitted a proposal to the BVI government for a new 14 year contract for the Bar Bay plant with a selling price for the water that is lower than the current price and is awaiting the BVI government's response to this proposal.

#### **8. N.S.C. Agua, S.A. de C.V.**

In May 2010, the Company acquired, through its wholly-owned Netherlands subsidiary, CW-Cooperatief, a 50% interest in NSC, a development stage Mexican company. The Company has since purchased, through the conversion of a loan it made to NSC, sufficient shares to raise its ownership interest in NSC to 99.9%. NSC was formed to pursue a project (the "Project") that originally encompassed the construction, operation and minority ownership of a 100 million gallon per day seawater reverse osmosis desalination plant to be located in northern Baja California, Mexico and accompanying pipelines to deliver water to the Mexican potable water system. As discussed in paragraphs that follow, during 2015 the scope of the Project was defined by the State of Baja California (the "State") to consist of a first phase consisting of a 50 million gallons per day plant and a pipeline that connects to the Mexican potable water infrastructure and a second phase consisting of an additional 50 million gallons of production capacity.

Since its inception, NSC has engaged engineering groups with extensive regional and/or technical experience to prepare preliminary designs and cost estimates for the desalination plant and the proposed pipeline and prepare the environmental impact studies for local, state and federal regulatory agencies, and has also acquired the land, performed pilot plant and feed water source testing and evaluated financing alternatives for the Project.

Through a series of transactions completed in 2012-2014, NSC purchased 20.1 hectares of land on which the proposed Project's plant would be constructed for an aggregate price of approximately \$20.6 million.

In 2012 and 2013, NSC conducted an equipment piloting plant and water data collection program at the proposed feed water source for the Project under a Memorandum of Understanding (the "EPC MOU") with a global engineering, procurement and construction contractor for large seawater desalination plants. Under the EPC MOU, the contractor installed and operated an equipment piloting plant and collected water quality data from the proposed feed water source site in Rosarito Beach, Baja California, Mexico. The EPC MOU required that NSC negotiate exclusively with the contractor for the construction of the 100 million gallon per day seawater reverse osmosis desalination plant and further required payment by NSC to the contractor 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 the contractor. This first phase of the pilot plant testing program was completed in October 2013. NSC decided not to extend the EPC MOU beyond its February 2014 expiration date and NSC paid the contractor \$350,000 during 2014 as compensation for the operation and maintenance of the pilot plant.

In November 2012, NSC entered into a lease with an effective term of 20-years from the date of full operation of the desalination plant, with the Comisión Federal de Electricidad for approximately 5,000 square meters of land on which it plans to construct the water intake and discharge 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 may be cancelled by NSC should NSC ultimately not proceed with the Project.

In August 2014, the State enacted new legislation to regulate Public-Private Association projects which involve the type of long-term contract between a public sector authority and a private party that NSC is seeking to complete the Project. Pursuant to this new legislation, on January 4, 2015, NSC submitted an expression of interest for its project to the Secretary of Infrastructure and Urban Development of the State of Baja California (“SIDUE”). SIDUE accepted NSC’s expression of interest and requested that NSC submit a detailed proposal for the Project that complies with requirements of the new legislation. NSC submitted this detailed proposal (the “APP Proposal”) to SIDUE in late March 2015. The new legislation required that such proposal be evaluated by SIDUE and submitted to the Public-Private Association Projects State Committee (the “APP Committee”) for review and authorization. If the Project was authorized the State would be required to conduct a public tender for the Project.

In response to its unsolicited APP Proposal, in September 2015 NSC received a letter dated June 30, 2015 from the Director General of the Comisión Estatal de Agua de Baja California (“CEA”), the State agency with responsibility for the Project, stating that (i) the Project is in the public interest with high social benefits and is consistent with the objectives of the State development plan and (ii) that the Project should proceed and the required public tender should be conducted. In November 2015, the State officially commenced the tender for the Project, the scope of which the State defined as a first phase to be operational in 2019 consisting of a 50 million gallons per day plant and a pipeline that connects to the Mexican potable water infrastructure and a second phase to be operational in 2024 consisting of an additional 50 million gallons per day of production capacity. NSC submitted its tender for the Project on the April 21, 2016 tender submission deadline date set by the State.

The Company has acknowledged since the inception of the Project that, due to the amount of capital the Project requires, NSC will ultimately need an equity partner or partners for the Project. Consequently, NSC’s tender to the State for the Project was based upon the following: (i) NSC will sell or otherwise transfer the land and other Project assets to a new company (“Newco”) that would build and own the Project; (ii) NSC’s potential partners would provide the majority of the equity for the Project and thereby would own the majority interest in Newco; (iii) NSC would maintain a minority ownership position in Newco; and (iv) Newco would enter into a long-term management and technical services contract for the Project with an entity partially owned by NSC or another Company subsidiary.

On June 15, 2016, the State designated the consortium comprised of NSC, NuWater S.A.P.I. de C.V. and Degremont S.A. de C.V. (the “Consortium”) as the winner of tender process for the Project.

On August 17, 2016, NSC and NuWater incorporated Aguas de Rosarito S.A.P.I. de C.V. (“AdR”), a special project company, to execute the Project and executed a shareholders agreement for AdR agreeing among other things that (i) AdR would purchase the land and other Project assets from NSC on the date that the Project begins commercial operations; and (ii) AdR would enter into a Management and Technical Services Agreement with NSC effective on the first day that the Project begins commercial operations.

On August 22, 2016, the Public Private Partnership Agreement for public private partnership number 002/2015, contest number SIDUE-CEA-APP-2015-002 (“APP Contract”) was executed between AdR, CEA, the Government of Baja California represented by the Secretary of Planning and Finance (“SPF”), and the Public Utilities Commission of Tijuana (“CESPT”). The APP Contract requires AdR to design, construct, finance and operate a seawater desalination plant (and accompanying aqueducts) with a capacity of up to 100 million gallons per day in two phases: the first with a capacity of 50 million gallons per day and an aqueduct to the Mexican potable water system in Tijuana, Baja California; and the second phase with a capacity of 50 million gallons per day and an aqueduct to a second delivery point in Tijuana. The first phase must be operational within 36 months of commencing construction, and the second phase must be operational by the end of 2024. The APP Contract further requires AdR to operate and maintain the plant and aqueducts for a period of 37 years starting from the commencement of operation of the first phase. At the end of the operating period the plant and aqueducts will be transferred to CEA.

The total Project cost is expected to be approximately 9 billion Mexican pesos, or approximately US\$485 million (based upon the current exchange rate). Annual revenues from the Project are expected to be approximately 1.02 billion Mexican pesos, or approximately US\$55.0 million (based upon the currency exchange rate as of August 23, 2016). Water rates under the APP Contract are indexed to the Mexican national consumer price index over its term. Electrical energy costs incurred by AdR to desalinate and deliver water are treated as a pass through charge to CEA, subject to efficiency guarantees. AdR expects to raise Mexican peso denominated debt financing through a consortium led by the North American Development Bank, which also provided financial advisory services to the Company and its partners through the bidding process and contract negotiations.

The APP Contract does not become effective until AdR secures the equity and debt financing required for the first phase of the Project and the following conditions are met:

- the State has established and registered various payment trusts, guaranties and bank credit lines for specific use by the Project;
- the CEA has obtained the rights from the relevant federal authority to take and desalinate seawater and distribute it for municipal use;
- various water purchase and sale agreements between the CEA, the payment trusts and the CESPT have been executed;
- AdR has obtained all rights of ways required for the aqueduct;
- AdR has obtained permission from the relevant federal authority to discharge the residual water from the Project’s desalination plant; and
- all financing agreements necessary to provide funding for the Project have been executed.

If the Consortium is ultimately unable to proceed with the Project, the land NSC has purchased may lose its strategic importance as the site for the Project and consequently may decline in value. If the Consortium does not proceed with the Project, NSC may ultimately be unable to sell this land for an amount equal to or in excess of its current carrying value of approximately \$20.6 million and any loss on sale of the land, or impairment loss NSC may be required to record as a result of a decrease in the fair value of the land, could have a material adverse impact on the Company's results of operations.

Included in the Company's consolidated results of operations are general and administrative expenses from NSC consisting of organizational, legal, accounting, engineering, consulting and other costs relating to NSC's project development activities. Such expenses amounted to approximately \$606,000 and \$358,000 for the three months ended September 30, 2016 and 2015, respectively, and approximately \$2,248,000 and \$1,370,000 for the nine months ended September 30, 2016 and 2015, respectively. The assets and liabilities of NSC included in the Company's consolidated balance sheets amounted to approximately \$21.7 million and \$321,000, respectively, as of September 30, 2016 and approximately \$22.0 million and \$488,000 respectively, as of December 31, 2015.

#### NSC Litigation

Immediately following CW-Cooperatief's acquisition of its initial 50% ownership in NSC, the remaining 50% ownership interest in NSC was held by an unrelated company, Norte Sur Agua, S. de R.L. de C.V. ("NSA"). NSA subsequently transferred ownership of half of its shares in NSC to EWG Water LLC ("EWG") and the other half of its shares in NSC to Alejandro de la Vega (the "individual shareholder"). In February 2012, the Company paid \$300,000 to enter into an agreement (the "Option Agreement") that provided it with an option, exercisable through February 7, 2014, to purchase the shares of NSC owned by the individual shareholder, along with an immediate power of attorney to vote those shares, for \$1.0 million. Such shares constituted 25% of the ownership of NSC as of February 2012. In May 2013, NSC repaid a \$5.7 million loan payable to CW-Cooperatief by issuing additional shares of its stock. As a result of this share issuance to CW-Cooperatief, the Company acquired 99.9% of the ownership of NSC. The Option Agreement contained an anti-dilution provision that required the Company to issue new shares in NSC of an amount sufficient to maintain the individual shareholder's 25% ownership interest in NSC if (i) any new shares of NSC were issued subsequent to the execution of the Option Agreement and (ii) the Company did not exercise its share purchase option by February 7, 2014. The Company exercised its option and paid the \$1.0 million to the individual shareholder to purchase the Option Agreement shares in February 2014.

In October 2015, the Company learned that EWG had filed a lawsuit against the individual shareholder, NSC, NSA, CW-Cooperatief, Ricardo del Monte Nunez, Carlos Eduardo Ahumada Arruit, Luis de Angitia Becerra, and the Public Registry of Commerce of Tijuana, Baja California in the Civil Court located in Tecate, Baja California, Mexico.

In this lawsuit, EWG is challenging, among other things, the capital investment transactions that increased the Company's ownership interest in NSC to 99.9%. EWG requested that the court, as a preliminary matter: (a) suspend the effectiveness of the challenged transactions; (b) order public officials in Mexico to record the pendency of the lawsuit in the public records; and (c) appoint an inspector for NSA and NSC to oversee its commercial activities. The court granted, ex-parte, the preliminary relief sought by EWG, which resulted in the placement of inscriptions for the lawsuit on NSC's public records.

EWG is also seeking an order directing, among other things: (i) NSA, NSC and CW-Cooperatief to refrain from carrying out any transactions with respect to the Project; and (ii) NSA, NSC and CW-Cooperatief, and the partners thereof, to refrain from transferring any interests in NSA, NSC and CW-Cooperatief.

On April 5, 2016, NSC filed a motion for reconsideration with the Tecate, Mexico Court asking, among other things, that the Court; (i) reverse its order to record the pendency of the lawsuit in the public records, (ii) cancel the appointment of the inspector, and (iii) allow NSC to provide a counter-guarantee to suspend the effects of the Court's order regarding the challenged transactions. On April 26, 2016, the Tecate, Mexico Court issued an interlocutory judgment (i) ordering the cancellation of the inscriptions on NSC's public records and (ii) rejecting NSC's motion for cancellation of the appointment of the inspector.

On April 26, 2016, NSC filed a full answer to EWG's claims rejecting every claim made by EWG. The Court's response on this matter is pending.

On May 17, 2016, NSC filed a claim with the Third District Court in Matters of Amparo and Federal Trials in the City of Tijuana, Baja California (the "Amparo Court") challenging the Tecate, Mexico Court ex-parte order which appointed an inspector over NSC's commercial activities. On July 29, 2016, the Amparo Court found that such appointment is unconstitutional and reversed the Tecate, Mexico Court's appointment of an inspector.

On September 6, 2016, the Tecate, Mexico Court issued a decree granting the counter guaranty requested by NSC. Such counter-guaranty was fixed in the amount of 300,000 Mexican pesos and was given to the Court on October 13, 2016 at which time all remaining ex-parte restrictions on NSC related to the challenged transactions were suspended.

The Company believes that the claims made by EWG are baseless and without merit, will vigorously defend NSC and CW-Cooperatief in this litigation, and will seek dismissal of the orders entered by the court and all claims against NSC and CW-Cooperatief. Furthermore, in November 2015, NSC and CW-Cooperatief filed a complaint in the United States District Court, Southern District of New York against EWG and its managing Partner based upon the Company's conclusion that lawsuit filed by EWG in Mexico directly breaches a contract dated April 11, 2012 between NSC and CW-Cooperatief and EWG. The Company is vigorously pursuing its claims and seeking relief pursuant to this complaint. The Company incurred legal fees in connection with this litigation of approximately \$18,000 and \$357,000 for the three and nine months ended September 30, 2016.

The Company cannot presently determine the outcome of this litigation. However, such litigation could adversely impact the Company's efforts to complete the Project.

#### Mexico Tax Authority

The Mexico tax authority, the Servicio de Administracion Tributaria ("SAT"), assessed NSC for taxes relating to payments to foreign vendors on which the SAT contended should have been subject to income tax withholdings during NSC's 2011 tax year. As of December 31, 2015, the assessment and related penalties, surcharges, inflation adjustments and late fees totaled 7,367,875 Mexican pesos. Such assessments were equivalent to approximately \$428,203 as of December 31, 2015 based upon the exchange rate between the United States dollars and the Mexican peso.

NSC retained the assistance of Mexican tax advisers in this matter, as it believed the assumptions and related work performed by the SAT did not support their tax assessment. As a result, NSC elected to contest this assessment in Mexico federal tax court. NSC was required to provide an irrevocable letter of credit which amounted to 7,367,875 Mexican pesos as of December 31, 2015 as collateral in connection with this tax case. The restricted cash balance of \$428,203 included in the accompanying consolidated balance sheet as of December 31, 2015 represented the US dollar equivalent of Mexican pesos on deposit with a bank to secure payment of this irrevocable letter of credit.

In November 2014, NSC received a favorable judgment from the tax court. Based on this outcome, the SAT filed an appeal shortly thereafter to contest the judgment. On February 15, 2016, NSC received a favorable judgment from the appellate tax court and shortly thereafter obtained the release of the Mexican pesos cash balance that had been

restricted and pledged as collateral as of December 31, 2015 for the irrevocable letter of credit.

## 9. Contingencies

### Retail License

The Company sells water through its retail operations under a license issued in July 1990 by the Cayman Islands government that grants Cayman Water the exclusive right to provide potable water to customers within its licensed service area. 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, Cayman Water has the exclusive right to produce potable water and distribute it by pipeline to its licensed service area, which consists of two of the three most populated areas of Grand Cayman, the Seven Mile Beach and West Bay areas. For the three months ended September 30, 2016 and 2015, the Company generated approximately 38%, and 39%, respectively, of its consolidated revenues and 52% and 57%, respectively, of its consolidated gross profit from the retail water operations conducted pursuant to Cayman Water's exclusive license. For the nine months ended September 30, 2016 and 2015, the Company generated approximately 40% and 41%, respectively, of its consolidated revenues and 55% and 58%, respectively, of its consolidated gross profit from the retail water operations conducted pursuant to Cayman Water's exclusive license.

Under the license, Cayman Water pays a royalty to the government of 7.5% of its gross retail water sales revenues (excluding energy cost adjustments). The selling prices of water sold to its 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 (the "WAC"), on behalf of the government, reviews and confirms the calculations of the price adjustments for inflation and electricity costs. If Cayman Water wants to adjust its prices for any reason other than inflation or electricity costs, Cayman Water has to request prior approval of the Cabinet of the Cayman Islands government. Disputes regarding price adjustments would be referred to arbitration.

The license was scheduled to expire in July 2010 but has been extended several times by the Cayman Islands government in order to provide the parties with additional time to negotiate the terms of a new license agreement. The most recent extension of the license expired on June 30, 2016. The Company continues to provide water subsequent to June 30, 2016 under a further extension of the license that the Company believes will be forthcoming.



The Cayman Islands government could ultimately offer a third party a license to service some or all of Cayman Water's present service area. However, as set forth in the existing license, *"the Governor hereby agrees that upon the expiry of the term of this Licence or any extension thereof, he will not grant a licence or franchise to any other person or company for the processing, distribution, sale and supply of water within the Licence Area without having first offered such a licence or franchise to the Company on terms no less favourable than the terms offered to such other person or company."*

In February 2011, the Water (Production and Supply) Law, 2011 and the Water Authority (Amendment) Law, 2011 (the "New Laws") were published and enacted. Under the New Laws, the WAC will issue any new license, and such new license could include a rate of return on invested capital model, as discussed in the following paragraph.

Following the enactment of the New Laws, the Company was advised in correspondence from the Cayman Islands government and the WAC that: (i) the WAC, and not the Cayman Islands government, is the principal negotiator in these license negotiations; and (ii) the WAC has determined that a rate of return on invested capital model ("RCAM") for the retail license is in the best interest of the public and Cayman Water'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. The Company responded to the Cayman Islands government that it disagreed with the government's position on these two matters and negotiations for a new license temporarily ceased.

In July 2012, in an effort to resolve several issues relating to its retail license renewal negotiations, the Company filed an Application for Leave to Apply for Judicial Review (the "Application") with the Grand Court of the Cayman Islands (the "Court"), seeking declarations that: (i) certain provisions of the New Laws appear to be incompatible and a determination as to how those provisions should be interpreted; (ii) the WAC's roles as the principal license negotiator, statutory regulator and the Company's competitor put the WAC in a position of hopeless conflict; and (iii) the WAC's decision to replace the rate structure under the Company's current exclusive license with RCAM was predetermined and unreasonable. In October 2012 the Company was notified that the Court agreed to consider the issues raised in the Application.

The hearing for this judicial review was held on April 1, 2014. Prior to the commencement of the hearing, the parties agreed that the Court should solely be concerned with the interpretation of the statutory provisions. As part of this agreement, the WAC agreed to consider the Company's submissions on the RCAM model and/or alternative models of pricing. In June 2014, the Court determined that: (i) the renewal of the license does not require a public bidding process; and (ii) the WAC is the proper entity to negotiate with the Company for the renewal of the license.

The Company's submissions on the RCAM model and/or alternative models of pricing were made to the WAC on June 9, 2014. The Company received a letter from the WAC dated September 11, 2014, which fully rejected the Company's submissions and stated that they intended to provide the Company with a draft RCAM license in due course.

On November 21, 2014, the Company wrote to the Minister of Works offering to recommence license negotiations on the basis of the RCAM model subject to the following conditions: (i) the Government would undertake to amend the current water legislation to provide for an independent regulator and a fair and balanced regulatory regime more consistent with that provided under the electrical utility regulatory regime, (ii) the Government and the Company would mutually appoint an independent referee and chairman of the negotiations, (iii) the Company's new license would provide exclusivity for the production and provision of all piped water, both potable and non-potable, within its Cayman Islands license area, (iv) the Government would allow the Company to submit its counter proposal to the WAC's June 2010 RCAM license draft, and (v) the principle of subsidization of residential customer rates by commercial customer rates would continue under a new license. On March 23 2015, the Company received a letter from the Minister of Works with the following responses to the Company's November 21, 2014 letter: (1) while the Cayman government plans to create a new public utilities commission, the provision of the new retail license will not depend upon the formation of such a commission; (2) any consideration regarding inclusion of the exclusive right to sell non-potable water within the area covered by the retail license will not take place until after the draft license has proceeded through the review process of the negotiations; (3) rather than allow the Company to submit its counter proposal to the WAC's June 2010 RCAM license draft, the WAC will draft the license with the understanding that the Company will be allowed to propose amendments thereto; (4) the principle of subsidization of residential customer rates by commercial customer rates would continue under the new license; and (5) a request that the Company consider eliminating its monthly minimum volume charge in the new license.

The Company recommenced license negotiations with the WAC during the third quarter of 2015 based upon a draft RCAM license provided by the WAC. Such license negotiations remain on-going. The Company is presently unable to determine when such negotiations will be completed or the final outcome of such negotiations.

In October 2016, the Government of the Cayman Islands passed legislation which created a new utilities regulation and competition office ("URCO"). This legislation will become law when it is assented to by the Governor of the Cayman Islands and published in the official Cayman Islands Gazette. URCO is an independent and accountable regulatory body with a view of protecting the rights of consumers, encouraging affordable utility services, and promoting competition. URCO has the ability to supervise, monitor and regulate multiple utility undertakings and markets. Water utilities are not presently included in the scope of URCO's regulatory functions and remain under the regulatory control of the WAC. The Company has been advised by government officials that it is government's intention to include water utilities under the ambit of URCO through additional legislation in 2017. The Company has been further advised that if and when this additional legislation is enacted, the WAC will no longer regulate water utilities since this function will be taken over by URCO. The Company is presently unable to determine (i) when such additional legislation will be enacted and consequently if or when URCO will become its new regulator in the Cayman Islands; or (ii) the impact of URCO on its retail license negotiations.

The resolution of these license negotiations could result in a material reduction of the operating income and cash flows the Company has historically generated from its retail license and could require the Company to record an impairment loss to reduce the carrying value of its goodwill. Such impairment loss could have a material adverse impact on the Company's results of operations.

The Company is presently unable to determine what impact the resolution of these matters will have on its financial condition, results of operations or cash flows.

#### CW-Bali

Through its subsidiary CW-Bali, the Company has built and presently operates a seawater reverse osmosis plant with a productive capacity of approximately 790,000 gallons per day located in Nusa Dua, one of the primary tourist areas of Bali, Indonesia. Since its inception, the sales volumes for this plant have not been sufficient to cover its operating costs. CW-Bali's operating losses were approximately (\$2.1 million) and (\$80,000) for the three months ended September 30, 2016, and 2015, respectively. CW-Bali's operating losses were approximately (\$2.4 million) and (\$383,000) for the nine months ended September 30, 2016, and 2015, respectively. CW-Bali's operating losses for the three and nine months ended September 30, 2016 include an impairment loss (as discussed later in this note) of \$2.0 million to reduce the carrying value of its long-lived assets to their estimated fair value.

In 2015, the Indonesian government passed Regulation 122 which provides a mechanism for governmental regulatory oversight over the utilization of Indonesia's water resources. Under this new regulation, the approval or cooperation of the local government water utility is required for any water supply contracts executed by non-governmental providers after the effective date of the regulation. Consequently CW-Bali will be required to enter into a cooperation agreement with Bali's local government water utility, PDAM, or otherwise obtain PDAM's approval, to supply any new customers. Since commencing operations, CW-Bali has held discussions with PDAM and other governmental entities for possible water sale arrangements, and CW-Bali is presently pursuing a formal cooperation agreement with PDAM for the sale of water to the resorts in its target market that are not presently served by PDAM.

As an Indonesian company that is majority-owned by foreigners, CW-Bali is required to obtain and maintain an "in-principle" (i.e. – short term, temporary) license to operate until such time as it is able to demonstrate that it has invested sufficient capital and made sufficient progress under its business plan to receive a non-temporary business license. The term of CW-Bali's initial in-principle license ended in October 2016. CW-Bali is applying for a new in-principle license. However, the Indonesian government could decide not to grant CW-Bali a new in-principle license, in which case the Company would be required to cease CW-Bali's operations and dispose of its investment in this subsidiary.

In late 2015, the Company decided to seek a strategic partner for CW-Bali to (i) purchase a major portion of its equity ownership in CW-Bali; (ii) lead CW-Bali's sales and marketing efforts; (iii) liaise with PDAM; and (iv) assist with CW-Bali's on-going funding requirements.

During the three months ended September 30, 2016, the Company reassessed the prospects for CW-Bali in light of its results to date, current circumstances and uncertainties impacting the business, and expected future funding requirements and tested its long-lived assets for possible impairment. To test for impairment, the Company estimated the future undiscounted cash flows CW-Bali will receive from its plant by (i) identifying various possible future scenarios for the business; (ii) estimating the undiscounted future cash flows associated with each possible scenario; and (iii) assigning a probability to each scenario. The resulting probability-weighted sum represents the Company's best estimate of the future undiscounted cash flows to be derived by CW-Bali from its long-lived desalination plant assets. The carrying value of CW-Bali's long-lived assets exceeded the Company's probability-weighted estimate of CW-Bali's future undiscounted cash flows which indicated impairment of these assets, and the Company recorded an impairment loss of \$2.0 million during the three months ended September 30, 2016 to reduce the carrying value of its long-lived CW-Bali assets to their estimated fair value.

If CW-Bali is not able to obtain a strategic partner, sell water to PDAM or to other new customers through a cooperation agreement, or otherwise significantly increase the revenues generated by its Nusa Dua plant in the future, the Company may cease CW-Bali's operations. The Company will also be required to cease CW-Bali's operations if CW-Bali does not obtain a new in-principle license. If the Company ceases CW-Bali's operations, it may be required to record further impairment losses to reduce the carrying value of its investment in CW-Bali to its fair value for the period in which the Company formally commits to exit the Bali market. Such impairment losses could have a material adverse impact on the Company's results of operations. Any sale of a portion of the Company's investment in CW-Bali may be for an amount less than its carrying amount, resulting in a loss on the sale that could have a material adverse impact on the Company's results of operations. The carrying value of the Company's investment in CW-Bali as of September 30, 2016 totaled \$2.1 million, consisting of net assets of approximately \$1.51 million and a cumulative foreign currency translation adjustment reflected in stockholders' equity of \$549,555.

The Company anticipated at the time CW-Bali commenced operations that CW-Bali's revenues, expenditures, and other cash flows would be conducted primarily in the local currency, the Indonesian rupiah (IDR). The Company expected that financial support it and its other subsidiaries provided to CW-Bali would not extend beyond CW-Bali's start-up phase, and that thereafter CW-Bali would generate positive net cash flows from its operations and thus remain relatively self-contained and integrated within the economic environment of Bali, Indonesia. As a result, since inception of its operations through September 30, 2016, the functional currency of CW-Bali was the IDR.

However, since its inception CW-Bali has been dependent upon on-going financial support from the Company in U.S dollars (US\$) to continue its operations. The Company expects such funding to continue until such time, if ever, that CW-Bali generates sufficient revenues to support its operations, or is able to obtain a strategic partner to assist with its on-going funding requirements, or ceases operations. Consequently, effective as of October 1, 2016, the Company changed the functional currency of CW-Bali to US\$.

During the periods for which IDR was CW-Bali's functional currency, the Company recorded foreign currency gains and losses arising from CW-Bali's transactions conducted in currencies other than the IDR. Such foreign currency gains and losses included amounts associated with (i) transactions denominated in currencies other than the IDR and (ii) the re-measurement of monetary assets and liabilities denominated in currencies other than the IDR as of the balance sheet date. CW-Bali's monetary assets and liabilities denominated in currencies other than the IDR consist of US\$-denominated bank accounts and US\$-denominated loans provided to CW-Bali by the Company. Such foreign currency transaction gains (losses) were included in income and amounted to approximately \$28,000 and (\$309,000) for the three months ended September 30, 2016 and 2015, respectively and approximately \$202,000 and (\$542,000) for the nine months ended September 30, 2016 and 2015, respectively. After the re-measurement process of monetary assets and liabilities was completed, the assets and liabilities of CW-Bali were translated into US\$ using exchange rates in effect at the end of each period. Revenues and expenses for CW-Bali were translated using rates that approximated those in effect during the period. The effect of these foreign currency translations was recognized in the cumulative translation adjustment included in the Company's stockholders' equity, which amounted to (\$549,555) and (\$533,565) as of September 30, 2016 and December 31, 2015, respectively.

This change in functional currency will be applied on a prospective basis, and therefore, the cumulative translation adjustment of (\$549,555) as of September 30, 2016 will remain unchanged until such time that the CW-Bali is no longer dependent on US\$ funding to support its operations, the Company sells all or a portion of its equity interest in CW-Bali, or the Company discontinues CW-Bali's operations. Translated amounts for non-monetary assets as of September 30, 2016 will become the new accounting basis for those assets effective October 1, 2016. Monetary assets denominated in foreign currencies, including the IDR, will be re-measured to US\$ at the current exchange rate as of the balance sheet date going forward. The Company anticipates that the likely effect of this change in functional currency will result in future foreign currency gains and losses that pertain to (i) transactions denominated in IDR and (ii) foreign currency re-measurements associated with monetary assets and liabilities denominated in IDR. As of September 30, 2016, such balances include IDR-denominated cash, accounts receivable, and accounts payable, which amounted to approximately \$20,000, \$37,000, and \$35,000, respectively, based upon the exchange rate between the IDR and US\$ as of that date. Based on this change in functional currency, the US\$-denominated loans to CW-Bali from its parent and affiliates will not be subject to further re-measurement adjustments.

#### 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 Belize courts could hear the matter. 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. The Company is presently unable to determine what impact the Order and the Second Order will have on its financial condition, results of operations or cash flows.

#### Windsor Plant Water Supply Agreement

CW-Bahamas provides 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. Pursuant to a water supply agreement, CW-Bahamas was required to provide the WSC with at least 16.8 million gallons per week of potable water from the Windsor plant. This water supply agreement was scheduled to expire when CW-Bahamas delivered the total amount of water required under the agreement in July 2013, but has been extended on a month-to-month basis. At the conclusion of the agreement, the WSC has the option to (i) extend the agreement for an additional five years at a rate to be negotiated; (ii) exercise a right of first refusal to purchase any materials, equipment and facilities and CW-Bahamas intends to remove from the site at a purchase price to be negotiated with CW-Bahamas; or (iii) require CW-Bahamas to remove all materials, equipment and facilities from the site.

At the request of the government of The Bahamas, CW-Bahamas continues to operate and maintain the Windsor plant on a month-to-month basis to provide the government of The Bahamas with additional time to decide whether or not it will extend CW-Bahamas’ water supply agreement for the Windsor plant on a long-term basis. CW-Bahamas generated revenues from the operation of this plant of approximately \$1.3 million and \$1.5 million during the three months ended September 30, 2016 and 2015, respectively, and \$4.0 million and \$4.5 million during the nine months ended September 30, 2016 and 2015, respectively.

## 10. Impact of recent accounting standards

### Adoption of New Accounting Standards:

In February 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2015-02, *Consolidation (Topic 810) - Amendments to the Consolidation Analysis*. The amendments in this update require management to reevaluate whether certain legal entities should be consolidated. Specifically, the amendments (1) modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (“VIEs”) or voting interest entities, (2) eliminate the presumption that a general partner should consolidate a limited partnership, (3) affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships, and (4) provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. The amendments in this update are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of ASU 2015-02 did not have a material impact on the Company’s consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, *Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. ASU 2015-03 provides authoritative guidance related to the presentation of debt issuance costs on the balance sheet, requiring companies to present debt issuance costs as a direct deduction from the carrying value of debt. The amendments in this update are effective for public business entities in fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The new guidance must be applied retrospectively to each prior period presented. The adoption of ASU 2015-03 did not have a material impact on the Company’s consolidated financial statements.

In August 2015, the FASB issued ASU 2015-15, *Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements*, which clarifies the treatment of debt issuance costs from line-of-credit arrangements after adoption of ASU 2015-03. The SEC Staff announced they would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The amendment requires retrospective application and represents a change in accounting principle. The amendment becomes effective in fiscal years beginning after December 15, 2015. The adoption of ASU 2015-15 did not have a material impact on the Company’s consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, *Business Combinations: Simplifying the Accounting for Measurement-Period Adjustments*, which requires an acquirer to recognize adjustments identified during the measurement period in the reporting period in which the adjustment amounts are determined. The adjustment must

include the cumulative effect of the adjustment as if the accounting had been completed on the acquisition date. The update should be applied prospectively and becomes effective January 1, 2016. Early application is permitted. The adoption of ASU 2015-16 did not have a material impact on the Company's consolidated financial statements.

**Effect of newly issued but not yet effective accounting standards:**

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 requires revenue recognition to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 prescribes a five step framework in accounting for revenues from contracts within its scope, including (a) identification of the contract, (b) identification of the performance obligations under the contract, (c) determination of the transaction price, (d) allocation of the transaction price to the identified performance obligations and (e) recognition of revenues as the identified performance obligations are satisfied. ASU 2014-09 also prescribes additional disclosures and financial statement presentations. ASU 2014-09 may be adopted retrospectively or under a modified retrospective method where the cumulative effect is recognized at the date of initial application. This amendment was originally effective January 1, 2017. In August 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, which defers the effective date by one year to January 1, 2018. Early application is permitted but not before January 1, 2017.

In March 2016, the FASB issued ASU 2016-08, *Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, that amends the principal versus agent guidance in ASU 2014-09. ASU 2016-08 clarifies that the analysis must focus on whether the entity has control of the goods or services before they are transferred to the customer. ASU 2016-08 also provides additional guidance about how to apply the control principle when services are provided and when goods or services are combined with other goods or services.

In April 2016, the FASB issued ASU 2016-10, *Identifying Performance Obligations and Licensing*, that amends the revenue guidance in ASU 2014-09 on identifying performance obligations and accounting for licenses of intellectual property. ASU 2016-10 changed the FASB's previous proposals on renewals of right-to-use licenses and contractual restrictions. The effective date of the standard for the Company will coincide with ASU 2014-09 during the first quarter 2018.

In May 2016, the FASB issued ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting*. ASU 2016-11 rescinds several SEC Staff Announcements that are codified in Topic 605, including, among other items, guidance relating to accounting for shipping and handling fees and freight services.



In May 2016, the FASB issued ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, which clarifies implementation guidance around collectability, sales taxes collected from customers, noncash considerations, contract modifications at transition, and completed contracts at transition.

The effective dates of ASU 2016-08, ASU 2016-10, ASU 2016-11 and ASU 2016-12 are the same as ASU 2015-14 discussed above. The Company is currently evaluating the effect the adoption of these standards will have on the Company's consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*. ASU 2015-11 applies to all inventory that is measured using first-in, first-out or average cost. The guidance requires an entity to measure inventory at the lower of cost or net realizable value. ASU 2015-11 is effective prospectively for fiscal years, and for interim periods within those years, beginning after December 15, 2016. Early application is permitted. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740), Balance Sheet Classification of Deferred Taxes*. ASU 2015-17 requires net deferred tax assets and liabilities be classified as noncurrent in a classified balance sheet and eliminates the classification between current and noncurrent amounts ASU No. 2015-17 is effective for financial statements issued for annual periods beginning after December 15, 2016 and interim periods within those annual periods. Early adoption is permitted. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which provides guidance for the recognition, measurement, presentation and disclosure of financial assets and financial liabilities. ASU 2016-01 is effective for fiscal years, and for interim periods within those years, beginning after December 15, 2017 and, for most provisions, is effective using the cumulative-effect transition approach. Early application is permitted for certain provisions. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which provides guidance for accounting for leases. The new guidance requires companies to recognize the assets and liabilities for the rights and obligations created by leased assets. The accounting guidance for lessors will remain relatively largely unchanged. ASU 2016-02 is effective for annual and interim periods beginning after December 15, 2018. Early adoption is permitted. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-07, *Investments- Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*, which eliminates the requirement to apply the equity method of accounting retrospectively when a reporting entity obtains significant influence over a previously held investment. ASU 2016-07 will be effective for the Company's fiscal year beginning January 1, 2017 and subsequent interim periods. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*, which simplifies several aspects related to the accounting for share-based payment transactions, including the accounting for income taxes, statutory tax withholding requirements and classification on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments*, which clarifies how certain cash receipts and payments are presented in the statement of cash flows. ASU 2016-15 is effective for annual periods beginning after December 15, 2017 and early adoption is permitted. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

## **11. Subsequent events**

The Company's management evaluated subsequent events through the time of the filing of this report on Form 10-Q. Other than as disclosed in these condensed consolidated financial statements, the Company's management is not aware of any significant events that occurred subsequent to the balance sheet date but prior to the filing of this report that would have a material impact on its consolidated financial statements.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Cautionary Note Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, 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,” “anticipate,” “expect,” “intend,” 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 serve;
- the economies of the U.S. and other countries in which we conduct business;
- our relationships with the governments we serve;
- regulatory matters, including resolution of the negotiations for the renewal of our retail license on Grand Cayman;
- our ability to successfully enter new markets, including Mexico and Asia; and
- other factors, including those “Risk Factors” set forth under Part II, Item 1A in this Quarterly Report and in our 2015 Annual Report on Form 10-K.

The forward-looking statements in this Quarterly Report speak as of its date. We expressly disclaim any obligation or undertaking to update or revise any forward-looking statement contained in this Quarterly 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.

References herein to “we,” “our,” “ours” and “us” refer to Consolidated Water Co. Ltd. and its subsidiaries.

### **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 because:

- 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 the valuation of our (i) equity investment in our affiliate, OC-BVI; (ii) goodwill and intangible assets; and (iii) long-lived assets.

#### *Valuation of 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.

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 the use of the discounted cash flow method which relies upon projections of OC-BVI’s operating results, working capital and capital expenditures. The use of this method requires us to estimate OC-BVI’s cash flows from (i) its water supply agreement with the BVI government for its Bar Bay plant (the “Bar Bay agreement”); and (ii) the pending amount awarded by the Eastern Caribbean Court of Appeals for the value of the Baughers Bay plant previously transferred by OC-BVI to the BVI government (see further discussion of the Baughers Bay litigation at Item 1. - Notes to the Condensed Consolidated Financial Statements - Note 7).

We estimate the cash flows OC-BVI will receive from its Bar Bay plant by (i) identifying various possible future scenarios which include the execution of a new agreement for the Bar Bay plant as well as the termination of Bar Bay plant operations upon the expiration of the existing Bar Bay agreement in March 2017; (ii) estimating the cash flows associated with each possible scenario; and (iii) assigning a probability to each scenario. We similarly estimate the cash flows OC-BVI will receive from the BVI government for the amount due under the ruling by the Eastern Caribbean Court of Appeals for the value of the Baughers Bay plant at the date it was transferred to the BVI government by assigning probabilities to different valuation scenarios. The resulting probability-weighted sum represents the expected cash flows, and our best estimate of future cash flows, to be derived by OC-BVI from its Bar Bay plant and the pending court award.

The identification of the possible scenarios for the Bar Bay plant and the Baughers Bay plant valuation, the projections of cash flows for each scenario, and the assignment of relative probabilities to each scenario all represent significant estimates made by us. While we use our best judgment in identifying these possible scenarios, estimating the expected cash flows for these scenarios and assigning relative probabilities to each scenario, these estimates are by their nature highly subjective and are also subject to material change by our management over time based upon new information or changes in circumstances.

As of September 30, 2016, after updating our probability-weighted estimates of OC-BVI's future cash flows and our resulting estimate of the fair value of our investment in OC-BVI, we determined that the carrying value of our investment in OC-BVI exceeded its fair value and recorded an impairment loss of \$875,000 for the three months ended September 30, 2016. We recorded total investment losses on our investment in OC-BVI of \$925,000 for the nine months ended September 30, 2016. We recorded impairment losses of \$225,000 and \$810,000 for the three and nine months ended September 30, 2015, respectively.

The remaining carrying value of our investment in OC-BVI of approximately \$3.9 million as of September 30, 2016 assumes that the BVI government will honor its obligations under the Bar Bay agreement and also assumes (on a probability-weighted basis) that (i) the BVI government will enter into a new agreement to purchase water from the Bar Bay plant after the current Bar Bay agreement expires in March 2017; and (ii) OC-BVI will receive the pending amount (based upon our estimate) awarded by the Eastern Caribbean Court of Appeals for the value of the Baughers Bay plant transferred by OC-BVI to the BVI government.

The BVI government is OC-BVI's primary customer and substantially all of OC-BVI's revenues are generated from its Bar Bay plant. As the Bar Bay agreement matures to its March 4, 2017 expiration date and OC-BVI receives the pending court award amount assumed due for the value of the Baughers Bay plant, OC-BVI's expected future cash flows, and therefore its fair value computed under the discounted cash flow method, decreases. We will be required to record additional impairment losses to reduce the carrying value of our investment in OC-BVI to its then current fair value if OC-BVI does not obtain a new agreement for the Bar Bay plant that generates cash flows sufficient to support the Company's then carrying value of its investment in OC-BVI. If OC-BVI does not obtain a new agreement for the Bar Bay plant that generates cash flows sufficient to support OC-BVI's carrying values for its long-lived Bar Bay plant

assets OC-BVI will be required to record an impairment loss to reduce the carrying value of its long-lived Bar Bay plant assets to their then estimated fair value. Our equity in the net earnings or loss of OC-BVI will include 43.53% of any such impairment loss recorded by OC-BVI. Based upon the updating of its probability-weighted scenarios for the future cash flows to be derived from its Bar Bay plant, OC-BVI may be required to record impairment losses to reduce the carrying value of its Bar Bay plant assets before the expiration of the Bar Bay agreement in March 2017. As of September 30, 2016, the aggregate carrying value of OC-BVI's long-lived Bar Bay plant assets was approximately \$4.0 million. Future impairment losses for our investment in OC-BVI and our equity in any future losses incurred by OC-BVI could have a material adverse impact on our results of operations.

In October 2016, OC-BVI submitted a proposal to the BVI government for a new 14 year contract for the Bar Bay plant with a selling price for the water that is lower than the current price and is awaiting the BVI government's response to this proposal.

#### *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 ended December 31, 2015 and 2014, 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, and the mergers and acquisitions 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 our retail unit we (i) identified 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 the years ended December 31, 2015 and 2014 through reference to the quoted market prices for our Company and guideline companies and the market multiples implied by guideline merger and acquisition transactions.

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. The respective weightings we applied to each method as of December 31, 2015 were consistent with those used as of December 31, 2014 and were as follows:

Method	Retail		Bulk	
Discounted cash flow	50	%	50	%
Subject company stock price	30	%	30	%
Guideline public company	10	%	10	%
Mergers and acquisitions	10	%	10	%
	100	%	100	%

The fair values we estimated for our retail and bulk units exceeded their carrying amounts by 72% and 20%, respectively, as of December 31, 2015. The fair values we estimated for our retail and bulk units exceeded their carrying amounts by 36% and 29%, respectively, as of December 31, 2014.

We also performed an analysis reconciling the conclusions of value for our reporting units to our market capitalization at October 1, 2015. This reconciliation resulted in an implied control premium for our Company of 5%.

On February 11, 2016, we acquired 51% ownership interest in Aerex. In connection with this acquisition we recorded goodwill of \$8,035,211. Aerex's actual results of operations for the period subsequent to our acquisition of the company on February 11, 2016 fell significantly short of the projected results for this period that were included in the overall cash flow projections we utilized to determine the purchase price for Aerex and the fair values of its assets and liabilities. Based upon currently available information, we believe Aerex's results of operations for the remainder of 2016, as well as for fiscal 2017, will also fall short of our purchase price cash flow projections for Aerex. As a result of these actual and projected shortfalls in Aerex's results of operations, we tested Aerex's goodwill for possible impairment as of September 30, 2016 by estimating its fair value using the discounted cash flow method. As a result of this impairment testing, we determined that the carrying value of our Aerex goodwill exceeded its fair value, and recorded an impairment loss for the three months ended September 30, 2016 of \$1,750,000 to reduce the carrying value of this goodwill.

#### *Long-lived assets*

We review the carrying amounts of our long-lived assets 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, we recognize an impairment loss only if its carrying amount is not recoverable through its undiscounted cash flows and measure the impairment loss based on the difference between the carrying amount and fair value.

Through our subsidiary, CW-Bali, we have built and presently operate a seawater reverse osmosis plant with a productive capacity of approximately 790,000 gallons per day located in Nusa Dua, one of the primary tourist areas of Bali, Indonesia. Since its inception, we have recorded operating losses for CW-Bali as the sales volumes for its plant have not been sufficient to cover its operating costs.

During the three months ended September 30, 2016, we determined, based upon probability-weighted scenarios for CW-Bali's future undiscounted cash flows, that the carrying value of CW-Bali's long-lived assets were not recoverable and recorded an impairment loss of \$2.0 million to reduce the carrying value of these assets to their fair value. See further discussion of this subsidiary at Item 2. - "Material Commitments, Expenditures and Contingencies - CW-Bali."



## RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and accompanying notes included under Part I, Item 1 of this Quarterly Report and our consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for our fiscal year ended December 31, 2015 (“2015 Form 10-K”) and the information set forth under Item 7 “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of our 2015 Form 10-K.

### Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015

#### Consolidated Results

The net loss attributable to Consolidated Water Co. Ltd. stockholders for 2016 was (\$1,865,332) or (\$0.13) per share on a fully-diluted basis, as compared to net income of \$1,775,500, or \$0.12 per share on a fully-diluted basis, for 2015.

Total revenues for 2016 decreased to \$14,385,353 from \$14,605,649 in 2015 due to lower revenues for our retail and bulk services segments that were not offset by an increase in service segment revenues. Gross profit for 2016 was \$5,919,323 or 41% of total revenues, as compared to \$5,641,743 or 39% of total revenues, for 2015. Gross profit increased in 2016 from 2015 for our bulk and services segments but decreased for our retail segment. For further discussion of revenues and gross profit for 2016, see the “Results by Segment” analysis that follows.

General and administrative (“G&A”) expenses on a consolidated basis were \$4,528,679 and \$3,487,967 for 2016 and 2015, respectively. The increase in consolidated G&A expenses from 2015 to 2016 is primarily attributable to the addition of approximately \$649,000 in expenses for Aerex Industries, Inc. (“Aerex”) as a result of our acquisition of a 51% ownership interest in this company on February 11, 2016, and an increase of approximately \$249,000 in the project development expenses incurred by our Mexican subsidiary, NSC.

We recorded an impairment loss of \$2 million in 2016 to reduce the carrying value of CW-Bali’s long-lived assets to their estimated fair value. See further discussion of this impairment loss at Item 2. - “Material Commitments, Expenditures and Contingencies - CW-Bali.”

We recorded an impairment loss of \$1,750,000 in 2016 to reduce the carrying value of the goodwill associated with the Aerex acquisition. See further discussion of this impairment loss at the discussion of the results of the services segment that follows.

Other income (expense), net was (\$762,696) for 2016 as compared to (\$302,603) for 2015. The fluctuation in this net component of our results of operations reflects (i) an impairment loss recorded for our equity investment in OC-BVI in 2016 of (\$875,000) as compared to an impairment loss of (\$225,000) for this investment in 2015; (ii) an unrealized loss of (\$275,000) recorded in 2016 resulting from the revaluation of the net put/call option value recorded in connection with the Aerex acquisition; and (iii) foreign currency gains relating to CW-Bali of approximately \$28,000 in 2016, as compared to foreign currency losses relating to CW-Bali of approximately (\$309,000) in 2015.

## Results by Segment

### *Retail Segment:*

The retail segment generated a loss from operations of (\$1,828,903) in 2016 as compared to income from operations of \$459,357 in 2015. The loss from operations for 2016 is attributable to a \$2.0 million impairment loss recorded on the long-lived assets of CW-Bali.

Revenues generated by our retail water operations were \$5,447,200 in 2016 as compared to \$5,828,288 in 2015. The decrease in retail revenues in 2016 is attributable to (i) lower energy costs, which reduced the energy component of the rates we charge to our Cayman Water customers by \$276,663 from 2015; (ii) a reduction in Cayman Water base rates in the first quarter of 2016 of 4.4% from 2015; and (iii) a decrease in the sales for CW-Bali of approximately \$95,000. The volume of water sold by our Cayman Water retail operations increased by 2% from 2015 to 2016.

Retail segment gross profit was \$2,982,359 (55% of retail revenues) and \$3,187,830 (55% of retail revenues) for 2016 and 2015, respectively.

Consistent with prior periods, we record all non-direct G&A expenses in our retail segment and do not allocate any of these non-direct expenses to our other two business segments. Retail G&A expenses for 2016 and 2015 remained relatively consistent at \$2,811,262 and \$2,728,473 for 2016 and 2015, respectively.

CW-Bali owns and operates a seawater reverse osmosis plant with a productive capacity of approximately 790,000 gallons per day located in Nusa Dua, one of the primary tourist areas of Bali, Indonesia. The revenues we generated from this plant amounted to \$24,349 and \$119,661 for 2016 and 2015, respectively. CW-Bali's operating loss was approximately (\$2,134,000) for 2016 as we recorded an impairment loss of (\$2.0 million) during the period to reduce the carrying value of CW-Bali's long-lived assets to their estimated fair value. CW-Bali's operating loss was approximately (\$80,000) for 2015. See further discussion of this subsidiary at Item 2. - "Material Commitments, Expenditures and Contingencies-CW-Bali."

*Bulk Segment:*

The bulk segment contributed \$2,082,570 and \$1,900,678 to our income from operations for 2016 and 2015, respectively.

Bulk segment revenues were \$7,429,732 and \$7,919,920 for 2016 and 2015, respectively. The decrease in bulk revenues from 2015 to 2016 is attributable to our Bahamas and Cayman operations, which generated approximately \$246,000 and \$296,000 less in revenues, respectively, in 2016 than in 2015 due to a significant decrease in the prices of diesel fuel and electricity from 2015 to 2016, which reduced the energy component of our bulk water rates.

Gross profit for our bulk segment was \$2,507,570 and \$2,258,673 for 2016 and 2015, respectively. Gross profit as a percentage of bulk revenues was approximately 34% and 29% for 2016 and 2015, respectively. Gross profit as a percentage of revenues increased in 2016 as compared to 2015 due to (i) the reduced energy prices, as energy expense for our bulk operations was approximately \$486,000 less in 2016 than in 2015; and (ii) plant maintenance expenses that were lower in 2016 than in 2015.

Bulk segment G&A expenses remained relatively consistent at \$425,000 and \$357,995 for 2016 and 2015, respectively.

*Services Segment:*

The comparability of the services segment's results from 2015 to 2016 is significantly impacted by the inclusion of Aerex's results of operations subsequent to our acquisition of a 51% ownership interest in this company in February 2016.

The services segment incurred losses from operations of (\$2,613,023) and (\$206,259) for 2016 and 2015, respectively.

Services segment revenues were \$1,508,421 and \$857,441 for 2016 and 2015, respectively. Services revenues increased in 2016 due to the addition of \$1,382,492 of revenues generated by Aerex in 2016. Revenues generated by the services segment in 2015 consisted primarily of approximately \$722,000 recognized on the refurbishment of the WAC's North Sound plant.

Gross profit for our services segment was \$429,394 and \$195,240 for 2016 and 2015, respectively. The increase in the service segment's gross profit from 2015 to 2016 reflects the incremental gross profit generated by Aerex.

G&A expenses for the services segment were \$1,292,417 and \$401,499 for 2016 and 2015, respectively. The increase in G&A expenses for 2016 as compared to 2015 reflects the incremental G&A expenses of Aerex and an increase of approximately \$249,000 in the project development expenses incurred by our Mexican subsidiary, NSC. Total G&A expenses for Aerex for 2016 were approximately \$649,000, and include \$360,000 in amortization expense for the intangible assets arising from our acquisition of Aerex.

Aerex's actual results of operations for the period subsequent to our acquisition of the company on February 11, 2016 fell significantly short of the projected results for this period that were included in the overall cash flow projections we utilized to determine the purchase price for Aerex and the fair values of its assets and liabilities. Based upon currently available information, we believe Aerex's results of operations for the remainder of 2016, as well as for fiscal 2017, will also fall short of our purchase price cash flow projections for Aerex. As a result of these actual and projected shortfalls in Aerex's results of operations, we tested Aerex's goodwill for possible impairment as of September 30, 2016. As a result of this impairment testing, we determined that the carrying value of our Aerex goodwill exceeded its fair value, and recorded an impairment loss for the three months ended September 30, 2016 of \$1,750,000 to reduce the carrying value of this goodwill.

### **Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015**

#### **Consolidated Results**

Net income attributable to Consolidated Water Co. Ltd. stockholders for 2016 was \$2,393,642 (\$0.16 per share on a fully-diluted basis), as compared to \$5,924,861 (\$0.40 per share on a fully-diluted basis) for 2015.

Total revenues for 2016 and 2015 were \$43,818,760 and \$43,757,430, respectively. Higher revenues for our services segment in 2016 served to offset decreases in retail and bulk segment revenues. Gross profit for 2016 was \$18,688,733 or 43% of total revenues, as compared to \$17,755,339 or 41% of total revenues, for 2015. Gross profit for the service and bulk segments increased from 2015 to 2016 while the retail segment gross profit declined. For further discussion of revenues and gross profit for 2016, see the "Results by Segment" analysis that follows.

G&A expenses on a consolidated basis were \$13,925,439 and \$11,042,507 for 2016 and 2015, respectively. The increase in consolidated G&A expenses from 2015 to 2016 is primarily attributable to the addition of approximately \$1,671,000 in expenses for Aerex after our acquisition of a 51% ownership interest in this company in February 2016.

and an increase of approximately \$879,000 in the project development expenses incurred by our Mexican subsidiary, NSC.

We recorded an impairment loss of \$2 million in 2016 to reduce the carrying value of CW-Bali's long-lived assets to their estimated fair value. See further discussion of this impairment loss at Item 2. - "Material Commitments, Expenditures and Contingencies - CW-Bali."

We recorded an impairment loss of \$1,750,000 in 2016 to reduce the carrying value of the goodwill associated with the Aerex acquisition. See further discussion of this impairment loss at the discussion of the results of the services segment that follows.

Other income (expense), net for 2016 was \$45,698 as compared to (\$493,965) for 2015. The fluctuation in this net component of our results of operations reflects (i) an impairment loss recorded for our equity investment in OC-BVI in 2016 of (\$925,000) as compared to an impairment loss of (\$810,000) for this investment in 2015; (ii) an unrealized loss of (\$275,000) recorded in 2016 resulting from the revaluation of the net put/call option value recorded in connection with the Aerex acquisition; and (iii) foreign currency gains relating to CW-Bali of approximately \$202,000 in 2016, as compared to foreign currency losses relating to CW-Bali of approximately (\$542,000) in 2015.

## Results by Segment

### *Retail Segment:*

The retail segment generated a loss from operations of (\$658,089) in 2016 as compared to income from operations of \$1,690,327 in 2015. The loss from operations for 2016 is attributable to a \$2.0 million impairment loss recorded during the three months ended September 30, 2016 on the long-lived assets of CW-Bali.

Revenues generated by our retail water operations were \$17,710,271 in 2016 as compared to \$18,116,111 in 2015. The decrease in retail revenues in 2016 is attributable to (i) lower energy costs, which reduced the energy component of the rates we charge to our Cayman Water customers by \$685,992 from 2015; (ii) a reduction in Cayman Water base rates in the first quarter of 2016 of 4.4% from 2015; and (iii) a decrease in the sales for CW-Bali of approximately \$216,000. The volume of water sold by our Cayman Water retail operations increased by 8% from 2015 to 2016.

Retail segment gross profit was \$9,930,440 (56% of retail revenues) and \$10,051,092 (55% of retail revenues) for 2016 and 2015, respectively.

Consistent with prior periods, we record all non-direct G&A expenses in our retail segment and do not allocate any of these non-direct expenses to our other two business segments. Retail G&A expenses for the nine months ended September 30, 2016 and 2015 were \$8,588,529 and \$8,360,765, respectively. G&A expenses increased from 2015 to 2016 primarily due to an increase of \$166,000 in employee costs due to base salary increases.

CW-Bali owns and operates a seawater reverse osmosis plant with a productive capacity of approximately 790,000 gallons per day located in Nusa Dua, one of the primary tourist areas of Bali, Indonesia. The revenues we generated from this plant amounted to \$70,760 and \$286,802 for 2016 and 2015, respectively. CW-Bali's operating loss was approximately (\$2,438,000) for 2016 as we recorded an impairment loss of \$2.0 million during the three months ended September 30, 2016 to reduce the carrying value of CW-Bali's long-lived assets to their estimated fair value. CW-Bali's operating loss was approximately (\$383,000) for 2015. See further discussion of this subsidiary at Item 2. - "Material Commitments, Expenditures and Contingencies - CW-Bali."

### *Bulk Segment:*

The bulk segment contributed \$6,487,455 and \$6,524,449 to our income from operations for 2016 and 2015, respectively.

Bulk segment revenues were \$22,136,086 and \$24,489,509 for 2016 and 2015, respectively. The decrease in bulk revenues from 2015 to 2016 is attributable to our Bahamas and Cayman operations, which generated approximately \$1,749,000 and \$730,000 less in revenues, respectively, in 2016 than in 2015 due to a significant decrease in the prices of diesel fuel and electricity from 2015 to 2016, which reduced the energy component of our bulk water rates.

Gross profit for our bulk segment was \$7,790,339 and \$7,712,273 for 2016 and 2015, respectively. Gross profit as a percentage of bulk revenues was approximately 35% and 31% for 2016 and 2015, respectively. Gross profit as a percentage of revenues increased in 2016 as compared to 2015 due to the reduced energy prices, as energy expense for our bulk operations was approximately \$2,188,000 less in 2016 than in 2015.

Bulk segment G&A expenses remained relatively consistent at \$1,302,884 and \$1,187,824 for 2016 and 2015, respectively.

#### *Services Segment:*

The comparability of the services segment's results from 2015 to 2016 is significantly impacted by the inclusion of Aerex's results of operations subsequent to our acquisition of a 51% ownership interest in this company in February 2016.

The services segment incurred losses from operations of (\$4,816,072) and (\$1,501,944) for 2016 and 2015, respectively.

Services segment revenues were \$3,972,403 and \$1,151,810 for 2016 and 2015, respectively. Services revenues increased in 2016 due to the addition of approximately \$3.3 million of revenues generated by Aerex in 2016. Revenues generated by the services segment in 2015 consisted primarily of approximately \$752,000 recognized on the refurbishment of the WAC's North Sound plant.

Gross profit for our services segment was \$967,954 and (\$8,026) for 2016 and 2015, respectively. The increase in the service segment's gross profit from 2015 to 2016 reflects the incremental gross profit generated by Aerex.



G&A expenses for the services segment were \$4,034,026 and \$1,493,918 for 2016 and 2015, respectively. The increase in G&A expenses for 2016 as compared to 2015 reflects the incremental G&A expenses of Aerex and an increase of approximately \$879,000 in the project development expenses incurred by our Mexican subsidiary, NSC. Total G&A expenses for Aerex for 2016 were approximately \$1,671,000, and include \$960,000 in amortization expense for the intangible assets arising from our acquisition of Aerex.

Aerex's actual results of operations for the period subsequent to our acquisition of the company on February 11, 2016 fell significantly short of the projected results for this period that were included in the overall cash flow projections we utilized to determine the purchase price for Aerex and the fair values of its assets and liabilities. Based upon currently available information, we believe Aerex's results of operations for the remainder of 2016, as well as for fiscal 2017, will also fall short of our purchase price cash flow projections for Aerex. As a result of these actual and projected shortfalls in Aerex's results of operations, we tested Aerex's goodwill for possible impairment as of September 30, 2016. As a result of this impairment testing, we determined that the carrying value of our Aerex goodwill exceeded its fair value, and recorded an impairment loss for the three months ended September 30, 2016 of \$1,750,000 to reduce the carrying value of this goodwill.

## **FINANCIAL CONDITION**

The increases in the amounts reported in our consolidated balance sheets for intangible assets, goodwill, deferred tax liability and non-controlling interests from December 31, 2015 to September 30, 2016 result from the acquisition of Aerex in February 2016.

Accounts receivable increased by approximately \$5.6 million from December 31, 2015 to September 30, 2016 primarily due an increase in the accounts receivables for CW-Bahamas of approximately \$5.7 million. We believe, based upon prior payment history, that CW-Bahamas' accounts receivable balances will be collected in full.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Liquidity Position**

Our projected liquidity requirements for the remainder of 2016 include capital expenditures for our existing operations of approximately \$1.3 million. Our liquidity requirements for the rest of 2016 may also include quarterly dividends, if such dividends are declared by our Board. Our dividend payments amounted to approximately \$4.4 million for the year ended December 31, 2015 and approximately \$3.3 million for the nine months ended September 30, 2016.

In May 2014, we obtained financing (the proceeds of which were used to fund NSC's land purchases in May 2014) in the form of a demand loan payable with an initial principal balance of \$10 million. The outstanding balance on this demand loan payable was approximately \$7.0 million as of December 31, 2015. Payments on this loan were due quarterly under a five year amortization schedule with the remaining principal balance due on May 14, 2016. This loan bore interest at LIBOR plus 1.5%. We repaid this loan with available cash balances in May 2016.

Immediately following our acquisition of 51% of the ownership interest in Aerex, we and the former sole shareholder of Aerex loaned Aerex \$510,000 and \$490,000, respectively, in the form of notes payable which mature on June 30, 2017 and bear interest at 1% per annum.

As of September 30, 2016, we had cash and cash equivalents of approximately \$37.1 million and working capital of approximately \$52.1 million. We are not presently aware of anything that would lead us to believe that we will not

have sufficient liquidity to meet our needs.

Transfers from our bank accounts in The Bahamas and Belize to our bank accounts in other countries require the approval of the Central Banks of the Bahamas and Belize, respectively. As of September 30, 2016, the equivalent United States dollar cash balances for our bank account deposits in the Bahamas and Belize were approximately \$6.6 million and \$5.3 million, respectively.

### **Discussion of Cash Flows for the Nine Months Ended September 30, 2016**

Our cash and cash equivalents decreased to \$37.1 million as of September 30, 2016 from \$44.8 million as of December 31, 2015.

#### *Cash Flows from Operating Activities*

Our operating activities provided cash of approximately \$4.5 million. This net cash provided reflects net income generated for the nine months of approximately \$1.4 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 and changes in working capital components included depreciation and amortization of approximately \$5.4 million, a net increase in accounts receivable of approximately \$5.8 million, and non-cash impairment losses aggregating approximately \$4.7 million.

#### *Cash Flows from Investing Activities*

Net cash used in our investing activities was approximately \$2.4 million. In February 2016, we acquired a 51% ownership interest in Aerex through a stock purchase agreement for an aggregate purchase price of approximately \$7.7 million in cash. We purchased property plant and equipment and expended funds on construction in progress in the normal course of business in the aggregate of amount of approximately \$2.6 million. We received approximately \$5.6 million upon the maturity of a certificate of deposit. We collected approximately \$1.4 million in principal repayments on our loans receivable from the WAC. As a result of a favorable ruling by a Mexico appellate court in February 2016, we also obtained the release of approximately \$399,000 in cash that had been restricted and pledged as collateral for a letter of credit at December 31, 2015.

#### *Cash Flows from Financing Activities*

Our financing activities used approximately \$9.9 million in net cash as we paid dividends of approximately \$3.5 million and repaid a \$7.0 million demand note payable. We also obtained a \$490,000 working capital loan from Aerex's prior sole stockholder that matures on June 30, 2017.

## Material Commitments, Expenditures and Contingencies

### *Retail License*

We sell water through our retail operations under a license issued in July 1990 by the Cayman Islands government that grants Cayman Water the exclusive right to provide potable water to customers within its licensed service area. 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 two of the three most populated areas of Grand Cayman, the Seven Mile Beach and West Bay areas. For the three months ended September 30, 2016 and 2015, we generated approximately 38%, and 39%, respectively, of our consolidated revenues and 52% and 57%, respectively, of our consolidated gross profit from the retail water operations conducted pursuant to Cayman Water's exclusive license. For the nine months ended September 30, 2016 and 2015, we generated approximately 40% and 41%, respectively, of our consolidated revenues and 55% and 58%, respectively, of our consolidated gross profit from the retail water operations conducted pursuant to Cayman Water's exclusive license.

Under our license, we pay a royalty to the government of 7.5% of our gross retail water sales revenues (excluding energy cost 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 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 would be referred to arbitration.

The license was scheduled to expire in July 2010 but has been extended several times by the Cayman Islands government in order to provide the parties with additional time to negotiate the terms of a new license agreement. The most recent extension of the license expired June 30, 2016. We continue to provide water subsequent to June 30, 2016 under a further extension of the license that we believe will be forthcoming.

The Cayman Islands government could ultimately offer a third party a license to service some or all of Cayman Water's present service area. However, as set forth in the existing license, *"the Governor hereby agrees that upon the expiry of the term of this Licence or any extension thereof, he will not grant a licence or franchise to any other person or company for the processing, distribution, sale and supply of water within the Licence Area without having first offered such a licence or franchise to the Company on terms no less favourable than the terms offered to such other person or company."*

In February 2011, the Water (Production and Supply) Law, 2011 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 will issue any new license, and such new license could include a rate of return on invested capital model, as discussed in the following paragraph.

We have been advised in correspondence from the Cayman Islands government and the WAC that: (i) the WAC, and not the Cayman Islands government, is the principal negotiator in these license negotiations; and (ii) the WAC has determined that a rate of return on invested capital model (“RCAM”) for the retail license is in the best interest of the public and our 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. We have advised the Cayman Islands government that we disagree with its position on these two issues.

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”), seeking declarations that: (i) certain provisions of the New Laws appear to be incompatible and a determination as to how those provisions should be interpreted; (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. In October 2012, we were notified that the Court agreed to consider the issues raised in the Application.

The hearing for this judicial review was held on April 1, 2014. Prior to the commencement of the hearing, the parties agreed that the Court should solely be concerned with the interpretation of the statutory provisions. As part of this agreement, the WAC agreed to consider our submissions on the RCAM model and/or alternative models of pricing. In June 2014, the Court determined that: (i) the renewal of the 1990 License does not require a public bidding process; and (ii) the WAC is the proper entity to negotiate with us for the renewal of the 1990 License.

Our submissions on the RCAM model and/or alternative models of pricing were made to the WAC on June 9, 2014. We received a letter from the WAC dated September 11, 2014, which fully rejected our submissions and stated that the WAC intended to provide us with a draft RCAM license in due course.

On November 21, 2014, we wrote to the Minister of Works offering to recommence license negotiations on the basis of the RCAM model subject to the following conditions: (i) the Government would undertake to amend the current water legislation to provide for an independent regulator and a fair and balanced regulatory regime more consistent with that provided under the electrical utility regulatory regime, (ii) the Government and we would mutually appoint an independent referee and chairman of the negotiations, (iii) our new license would provide exclusivity for the production and provision of all piped water, both potable and non-potable, within our Cayman Islands license area, (iv) the Government would allow us to submit our counter proposal to the WAC's June 2010 RCAM license draft, and (v) the principle of subsidization of residential customer rates by commercial customer rates would continue under a new license. On March 23 2015, we received a letter from the Minister of Works with the following responses to our November 21, 2014 letter: (1) that while the Cayman government plans to create a public utilities commission, the provision of a new license will not depend upon the formation of such a commission; (2) any consideration regarding inclusion of the exclusive right to sell non-potable water within the area covered by the retail license will not take place until after the draft license has proceeded through the review process of the negotiations; (3) rather than allow us to submit a counter proposal to the WAC's June 2010 RCAM license draft, the WAC will draft the license with the understanding that we will be allowed to propose amendments thereto; (4) the principle of subsidization of residential customer rates by commercial customer rates would continue under the new license; and (5) a request that we consider eliminating our monthly minimum volume charge in the new license.

We recommenced license negotiations with the WAC during the third quarter of 2015. However, we are presently unable to determine when such negotiations will be completed or the final outcome of such negotiations.

In October 2016, the Government of the Cayman Islands passed legislation which created a new utilities regulation and competition office ("URCO"). This legislation will become law when it is assented to by the Governor of the Cayman Islands and published in the official Cayman Islands Gazette. URCO is an independent and accountable regulatory body with a view of protecting the rights of consumers, encouraging affordable utility services, and promoting competition. URCO has the ability to supervise, monitor and regulate multiple utility undertakings and markets. Water utilities are not presently included in the scope of URCO's regulatory functions and remain under the regulatory control of the WAC. We have been advised by government officials that it is government's intention to include water utilities under the ambit of URCO through additional legislation in 2017. We have been further advised that if and when this additional legislation is enacted, the WAC will no longer regulate water utilities since this function will be taken over by URCO. We are presently unable to determine (i) when such additional legislation will be enacted and consequently if or when URCO will become its new regulator in the Cayman Islands; or (ii) the impact of URCO on our retail license negotiations.

The resolution of these license negotiations could result in a material reduction of the operating income and cash flows we have historically generated from our retail license and could require us to record an impairment loss to reduce the carrying value of our goodwill. Such impairment loss could have a material adverse impact on our results of operations.

*N.S.C. Agua, S.A. de C.V.*

In May 2010, we acquired, through our wholly-owned Netherlands subsidiary, Consolidated Water Cooperatief, U.A., (“CW-Cooperatief”) a 50% interest in N.S.C. Agua, S.A. de C.V. (“NSC”), a development stage Mexican company. We have since purchased, through the conversion of a loan we made to NSC, sufficient shares to raise our ownership interest in NSC to 99.9%. NSC was formed to pursue a project (the “Project”) encompassing the construction, operation and minority ownership of a 100 million gallon per day seawater reverse osmosis desalination plant to be located in northern Baja California, Mexico and accompanying pipelines to deliver water to the Mexican potable water system. As discussed in the paragraphs that follow, during 2015 the scope of the Project was defined by the State of Baja California (the “State”) to consist of a first phase consisting of a 50 million gallons per day plant and a pipeline that connects to the Mexican potable water infrastructure and a second phase consisting of an additional 50 million gallons of production capacity.

Since its inception, NSC has engaged engineering groups with extensive regional and/or technical experience to prepare preliminary designs and cost estimates for the desalination plant and the proposed pipeline and prepare the environmental impact studies for local, state and federal regulatory agencies, and has also acquired the land, performed pilot plant and feed water source testing and evaluated financing alternatives for the Project.

Through a series of transactions completed in 2012-2014, NSC purchased 20.1 hectares of land on which the proposed Project’s plant would be constructed for an aggregate price of approximately \$20.6 million.

In 2012 and 2013, NSC conducted an equipment piloting plant and water data collection program at the proposed feed water source for the Project under a Memorandum of Understanding (the “EPC MOU”) with a global engineering, procurement and construction contractor for large seawater desalination plants. Under the EPC MOU, the contractor installed and operated an equipment piloting plant and collected water quality data from the proposed feed water source site in Rosarito Beach, Baja California, Mexico. The EPC MOU required that NSC negotiate exclusively with the contractor for the construction of the 100 million gallon per day seawater reverse osmosis desalination plant and further required payment by NSC to the contractor 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 the contractor. This first phase of the pilot plant testing program was completed in October 2013. NSC decided not to extend the EPC MOU beyond its February 2014 expiration date and NSC paid the contractor \$350,000 during 2014 as compensation for the operation and maintenance of the pilot plant.



In 2012, NSC entered into a lease with an effective term of 20 years from the date of full operation of the desalination plant with the Comisión Federal de Electricidad for approximately 5,000 square meters of land on which it plans to construct the water intake and discharge 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 may be cancelled by NSC should NSC ultimately not proceed with the Project.

In August 2014, the State enacted new legislation to regulate Public-Private Association projects which involve the type of long-term contract between a public sector authority and a private party that NSC is seeking to complete the Project. Pursuant to this new legislation, on January 4, 2015, NSC submitted an expression of interest for its project to the Secretary of Infrastructure and Urban Development of the State of Baja California ("SIDUE"). SIDUE accepted NSC's expression of interest and requested that NSC submit a detailed proposal for the Project that complies with requirements of the new legislation. NSC submitted this detailed proposal (the "APP Proposal") to SIDUE in late March 2015. The new legislation required that such proposal be evaluated by SIDUE and submitted to the Public-Private Association Projects State Committee (the "APP Committee") for review and authorization. If the Project was authorized the State would be required to conduct a public tender for the Project.

In response to its APP Proposal, in September 2015 NSC received a letter dated June 30, 2015 from the Director General of the Comisión Estatal de Agua de Baja California ("CEA"), the State agency with responsibility for the Project, stating that (i) the Project is in the public interest with high social benefits and is consistent with the objectives of the State development plan and (ii) that the Project and accompanying required public tender process should be conducted. In November 2015, the State officially commenced the tender for the Project, the scope of which the State has defined as a first phase to be operational in 2019 consisting of a 50 million gallons per day plant and a pipeline that connects to the Mexican potable water infrastructure and a second phase to be operational in 2024 consisting of an additional 50 million gallons per day of production capacity. NSC submitted its tender for the Project on the April 21, 2016 tender submission deadline date set by the State.

We have acknowledged since the inception of the Project that, due to the amount of capital the Project requires, NSC will ultimately need an equity partner or partners for the Project. Consequently, NSC's tender to the State for the Project was based upon the following: (i) NSC will sell or otherwise transfer the land and other Project assets to a new company ("Newco") that would build and own the Project; (ii) NSC's potential partners would provide the majority of the equity for the Project and thereby would own the majority interest in Newco; (iii) NSC would maintain a minority ownership position in Newco; and (iv) Newco would enter into a long-term management and technical services contract for the Project with an entity partially owned by NSC or another Company subsidiary.

On June 15, 2016, the State designated the consortium comprised of NSC, NuWater S.A.P.I. de C.V. and Degremont S.A. de C.V. (the "Consortium") as the winner of tender process for the Project.

On August 17, 2016, NSC and NuWater incorporated a special purpose project company named Aguas de Rosarito S.A.P.I. de C.V. (“AdR”) to execute the Project and executed a shareholders agreement for AdR agreeing among other things that (i) AdR would purchase the Land and other Project assets from NSC on the date that the Project begins commercial operation; and (ii) AdR would enter into a Management and Technical Services Agreement with NSC effective on the first day that the Project begins commercial operation.

On August 22, 2016, the Public Private Partnership Agreement for public private partnership number 002/2015, contest number SIDUE-CEA-APP-2015-002 (“APP Contract”) was executed between AdR, CEA, the Government of Baja California represented by the Secretary of Planning and Finance (“SPF”), and the Public Utilities Commission of Tijuana (“CESPT”). The APP Contract requires AdR to design, construct, finance and operate a seawater desalination plant (and accompanying aqueducts) with a capacity of up to 100 million gallons per day in two phases: the first with a capacity of 50 million gallons per day and an aqueduct to the Mexican potable water system in Tijuana, Baja California; and the second phase with a capacity of 50 million gallons per day and an aqueduct to a second delivery point in Tijuana. The first phase must be operational within 36 months of commencing construction, and the second phase must be operational by the end of 2024. The APP Contract further requires AdR to operate and maintain the plant and aqueducts for a period of 37 years starting from the commencement of operation of the first phase. At the end of the operating period the plant and aqueducts will be transferred to CEA.

The total Project cost is expected to be approximately 9 billion Mexican pesos, or approximately US\$485 million (based upon the current exchange rate). Annual revenues from the Project are expected to be approximately 1.02 billion Mexican pesos, or approximately US\$55.0 million (based upon the currency exchange rate as of August 23, 2016). Water rates under the APP Contract are indexed to the Mexican national consumer price index over its term. Electrical energy costs incurred by AdR to desalinate and deliver water are treated as a pass through charge to CEA, subject to efficiency guarantees. AdR expects to raise Mexican peso denominated debt financing through a consortium led by the North American Development Bank, which also provided financial advisory services to us and our partners through the bidding process and contract negotiations.

The APP Contract does not become effective until AdR secures the equity and debt financing required for the first phase of the Project and the following conditions are met:

- the State has established and registered various payment trusts, guaranties and bank credit lines for specific use by the Project;
- the CEA has obtained the rights from the relevant federal authority to take and desalinate seawater and distribute it for municipal use;
- various water purchase and sale agreements between the CEA, the payment trusts and the CESPT have been executed;
- AdR has obtained all rights of ways required for the aqueduct;
- AdR has obtained permission from the relevant federal authority to discharge the residual water from the Project's desalination plant; and
- all financing agreements necessary to provide funding for the Project have been executed.

If the Consortium is ultimately unable to proceed with the Project, the land NSC has purchased may lose its strategic importance as the site for the Project and consequently may decline in value. If the Consortium does not proceed with the Project, NSC may ultimately be unable to sell this land for an amount equal to or in excess of its current carrying value of approximately \$20.6 million, and any loss on sale of the land, or impairment loss NSC may be required to record as a result of a decrease in the fair value of the land could have a material adverse impact on our results of operations.

Included in our results of operations are general and administrative expenses from NSC, consisting of organizational, legal, accounting, engineering, consulting and other costs relating to NSC's project development activities. Such expenses amounted to approximately \$606,000 and \$358,000 for the three months ended September 30, 2016 and 2015, respectively, and approximately \$2,248,000 and \$1,370,000 for the nine months ended September 30, 2016 and 2015, respectively. The assets and liabilities of NSC included in the Company's consolidated balance sheets amounted to approximately \$21.7 million and \$321,000, respectively, as of September 30, 2016 and approximately \$22.0 million and \$488,000 respectively, as of December 31, 2015.

We expect to incur additional project development costs on behalf of NSC and AdR during the remainder of 2016 and during 2017.

#### NSC Litigation

Immediately following CW-Cooperatief's acquisition of its initial 50% ownership in NSC, the remaining 50% ownership interest in NSC was held by an unrelated company, Norte Sur Agua, S. de R.L. de C.V. ("NSA"). NSA subsequently transferred ownership of half of its shares in NSC to EWG Water LLC ("EWG") and the other half of its shares in NSC to Alejandro de la Vega (the "individual shareholder"). In February 2012, we paid \$300,000 to enter into an agreement (the "Option Agreement") that provided us with an option, exercisable through February 7, 2014, to purchase the shares of NSC owned by the individual shareholder, along with an immediate power of attorney to vote those shares, for \$1.0 million. Such shares constituted 25% of the ownership of NSC as of February 2012. In May 2013, NSC repaid a \$5.7 million loan payable to CW-Cooperatief by issuing additional shares of its stock. As a result of this share issuance to CW-Cooperatief, we acquired 99.9% of the ownership of NSC. The Option Agreement contained an anti-dilution provision that required us to issue new shares in NSC of an amount sufficient to maintain the individual shareholder's 25% ownership interest in NSC if (i) any new shares of NSC were issued subsequent to the execution of the Option Agreement and (ii) we did not exercise our share purchase option by February 7, 2014. We exercised our option and paid the \$1.0 million to the individual shareholder to purchase the Option Agreement shares in February 2014.

In October 2015, we learned that EWG has filed a lawsuit against the individual shareholder, NSC, NSA, CW-Cooperatief, Ricardo del Monte Nunez, Carlos Eduardo Ahumada Arruit, Luis de Angitia Becerra, and the Public Registry of Commerce of Tijuana, Baja California in the Civil Court located in Tecate, Baja California, Mexico.

In this lawsuit, EWG is challenging, among other things, the capital investment transactions that increased our ownership interest in NSC to 99.9%. EWG requested that the court, as a preliminary matter: (a) suspend of the effectiveness of the challenged transactions; (b) order of public officials in Mexico to record the pendency of the lawsuit in the public records; and (c) appoint an inspector for NSA and NSC to oversee its commercial activities. The court granted, ex-parte, the preliminary relief sought by EWG, which resulted in the placement of inscriptions for the lawsuit on NSC's public records.

EWG also is seeking an order directing, among other things: (i) NSA, NSC and CW-Cooperatief to refrain from carrying out any transactions with respect to the Project; and (ii) NSA, NSC and CW-Cooperatief, and the partners thereof, to refrain from transferring any interests in NSA, NSC and CW-Cooperatief.

On April 5, 2016, NSC filed a motion for reconsideration with the Tecate, Mexico Court asking, among other things, that the Court; (i) reverse its order to record the pendency of the lawsuit in the public records; (ii) cancel the appointment of the inspector; and (iii) allow NSC to provide a counter-guarantee to suspend the effects of the Court's order regarding the challenged transactions. On April 26, 2016, the Tecate, Mexico Court issued an interlocutory judgment (i) ordering the cancellation of the inscriptions on NSC's public records and (ii) rejecting NSC's motion for cancellation of the appointment of the inspector.

On April 26, 2016, NSC filed a full answer to EWG's claims, rejecting every claim made by EWG. The Court's response on this matter is pending.

On May 17, 2016, NSC filed a claim with the Third District Court in Matters of Amparo and Federal Trials in the City of Tijuana, Baja California (the "Amparo Court") challenging the Tecate, Mexico Court ex-parte order which appointed an inspector over NSC's commercial activities. On July 29, 2016, the Amparo Court found that such appointment is unconstitutional and reversed the Tecate, Mexico Court's appointment of an inspector.

On September 6, 2016, the Tecate, Mexico Court issued a decree granting the counter guaranty requested by NSC. Such counter-guaranty was fixed in the amount of 300,000 Mexican pesos and was given to the Court on October 13, 2016 at which time all remaining ex-parte restrictions on NSC related to the challenged transactions were suspended.

We believe that the claims made by EWG are baseless and without merit, will vigorously defend NSC and CW-Cooperatief in this litigation, and will seek dismissal of the orders entered by the court and all claims against NSC and CW-Cooperatief. We cannot presently determine the outcome of this litigation. However, such litigation could adversely impact our efforts to complete the Project. The Company incurred legal fees in connection with this litigation of approximately \$18,000 and \$357,000 for the three and nine months ended September 30, 2016.

#### *CW-Bali*

Through our subsidiary CW-Bali, we have built and presently operate a seawater reverse osmosis plant with a productive capacity of approximately 790,000 gallons per day located in Nusa Dua, one of the primary tourist areas of

Bali, Indonesia. We built this plant based upon our belief that future water shortages in this area of Bali would eventually enable us to sell all of this plant's production. However, since its inception, our sales volumes for this plant have not been sufficient to cover its operating costs.

In 2015, the Indonesian government passed Regulation 122 which provides a mechanism for governmental regulatory oversight over the utilization of Indonesia's water resources. Under this new regulation, the approval or cooperation of the local government water utility is required for any water supply contracts executed by non-governmental providers after the effective date of the regulation. Consequently CW-Bali will be required to enter into a cooperation agreement with Bali's local government water utility, PDAM, or otherwise obtain PDAM's approval, to supply any new customers. Since commencing operations in CW-Bali, we have held discussions with PDAM and other governmental entities for possible water sale arrangements, and we are presently pursuing a formal cooperation agreement with PDAM for the sale of water to the resorts in CW-Bali's target market that are not presently served by PDAM.

As an Indonesian company that is majority-owned by foreigners, CW-Bali is required to obtain and maintain an "in-principle" (i.e. – short term, temporary) license to operate until such time as it is able to demonstrate that it has invested sufficient capital and made sufficient progress under its business plan to receive a non-temporary business license. The term of CW-Bali's initial in-principle license ended in October 2016. We are applying for a new in-principle license and expect to obtain this license. However, the Indonesian government could decide not to grant CW-Bali a new in-principle license, in which case we would be required to cease operations and dispose of our investment in CW-Bali.

CW-Bali's target resort customers in Nusa Dua (as do many other parties in Bali) obtain their fresh water from wells on their properties that access the island's underground fresh water aquifer. The continued use of such wells threatens to permanently damage the aquifer making it vulnerable to intrusion by seawater, sewage and pollution. The Bali government has sought to discourage and/or eliminate the use of such wells by threatening to impose substantial taxes on the value of water drawn from them. Our decision to build a speculative plant in Bali was based upon (i) PDAM's inability to provide water to the various newer and planned resorts in Nusa Dua, resorts that required large quantities of fresh water; (ii) these resorts' apparent interest in securing a new water supply given their eventual reduced access to fresh water wells due to governmental taxation, other regulatory actions or eventual contamination of the aquifer; and (iii) desalination as the only viable new means of supplying large amounts of fresh water to Nusa Dua in a reasonable time frame. We believed the resorts would utilize CW-Bali as a much higher quality, drought-proof, environmentally safe water supply and reduce or eliminate their dependence on wells and/or trucked water. However, no taxes have yet been assessed or governmental regulatory actions yet taken to discourage or end the use of fresh water wells. Economic conditions in Bali have declined significantly since CW-Bali commenced operations and, to date, the resorts in Nusa Dua have not elected to replace or supplement their much less expensive well water with CW-Bali's alternative supply. CW-Bali's sales have been inadequate to cover its costs and we have incurred operating losses for this subsidiary since its inception.

In late 2015, we decided to seek a strategic partner for CW-Bali to (i) purchase a major portion of its equity ownership in CW-Bali; (ii) lead CW-Bali's sales and marketing efforts; (iii) liaise with PDAM; and (iv) assist with CW-Bali's on-going funding requirements. While we have held discussions and exchanged information with potential partners, we have not yet received an offer for an investment in, a purchase of, or a joint venture for CW-Bali on terms we consider acceptable.

While we continue to believe that desalination technology will play a major part in addressing the long term water supply needs of CW-Bali's target market in Nusa Dua and Bali in general, the time frame for the widespread market adoption of such technology will likely be significantly longer than we anticipated when we decided to commence business in Bali. Consequently, during the three months ended September 30, 2016, we reassessed the prospects for CW-Bali in light of (i) its results to date; (ii) current circumstances and the uncertainties impacting the business; and (iii) its on-going funding requirements and our willingness to continue to provide such funding, and tested CW-Bali's long-lived assets for possible impairment. To test for impairment, we estimated the future undiscounted cash flows CW-Bali will receive from its plant by (i) identifying various possible future scenarios for the business; (ii) estimating the undiscounted future cash flows associated with each possible scenario; and (iii) assigning a probability to each scenario. The resulting probability-weighted sum represents our best estimate of the future undiscounted cash flows to be derived by CW-Bali from its long-lived desalination plant assets. The carrying value of our Bali long-lived assets exceeded our probability-weighted estimate of CW-Bali's future undiscounted cash flows which indicated impairment of these assets, and we recorded an impairment loss of \$2.0 million during the three months ended September 30, 2016 to reduce the carrying value of our long-lived CW-Bali assets to their estimated fair value.

If we are not able to obtain a strategic partner for CW-Bali, sell water to PDAM or to other new customers through a cooperation agreement, or otherwise significantly increase the revenues generated by our Nusa Dua plant in the future, we may cease CW-Bali's operations. We will also be required to cease CW-Bali's operations if we do not obtain a new

in-principle license. If we cease operations at CW-Bali, we may be required to record further impairment losses to reduce the carrying value of our investment in CW-Bali to its fair value for the period in which we formally commit to exit the Bali market. Such impairment losses could be material to our results of operations. Any sale of a portion of our investment in CW-Bali may be for an amount less than our carrying amount, resulting in a loss on the sale that could be material to our results of operations. The carrying value of our investment in CW-Bali as of September 30, 2016 totaled \$2.1 million, consisting of net assets of \$1.51 million and a cumulative foreign currency translation adjustment reflected in our stockholders' equity of \$549,555.

We anticipated at the time CW-Bali commenced operations that CW-Bali's revenues, expenditures, and other cash flows would be conducted primarily in the local currency, the Indonesian rupiah (IDR). We expected that financial support we provided to CW-Bali would not extend beyond CW-Bali's start-up phase, and that thereafter CW-Bali would generate positive net cash flows from its operations and thus remain relatively self-contained and integrated within the economic environment of Bali, Indonesia. As a result, since inception of its operations through September 30, 2016, the functional currency of CW-Bali was the IDR.



However, since its inception CW-Bali has been dependent upon on-going financial support in U.S dollars (US\$) to continue its operations. We expect such funding to continue until such time, if ever, that CW-Bali generates sufficient revenues to support its operations, or is able to obtain a strategic partner to assist with its on-going funding requirements, or ceases operations. Consequently, effective as of October 1, 2016, we changed the functional currency of CW-Bali to US\$.

During the periods for which IDR was CW-Bali's functional currency, we recorded foreign currency gains and losses arising from CW-Bali's transactions conducted in currencies other than the IDR. Such foreign currency gains and losses included amounts associated with (i) transactions denominated in currencies other than the IDR and (ii) the re-measurement of monetary assets and liabilities denominated in currencies other than the IDR as of the balance sheet date. CW-Bali's monetary assets and liabilities denominated in currencies other than the IDR consist of US\$-denominated bank accounts and US\$-denominated we loans provided to CW-Bali. Such foreign currency transaction gains (losses) were included in income and amounted to approximately \$28,000 and (\$309,000) for the three months ended September 30, 2016 and 2015, respectively and approximately \$202,000 and (\$542,000) for the nine months ended September 30, 2016 and 2015, respectively. After the re-measurement process of monetary assets and liabilities was completed, the assets and liabilities of CW-Bali were translated into US\$ using exchange rates in effect at the end of each period. Revenues and expenses for CW-Bali were translated using rates that approximated those in effect during the period. The effect of these foreign currency translations was recognized in the cumulative translation adjustment included in our stockholders' equity, which amounted to (\$549,555) and (\$533,365) as of September 30, 2016 and December 31, 2015, respectively.

This change in functional currency will be applied on a prospective basis, and therefore, the cumulative translation adjustment of (\$549,555) as of September 30, 2016 will remain unchanged until such time that the CW-Bali is no longer dependent on US\$ funding to support its operations, we sell all or a portion of our equity interest in CW-Bali, or we discontinue CW-Bali's operations. Translated amounts for non-monetary assets as of September 30, 2016 will become the new accounting basis for those assets effective October 1, 2016. Monetary assets denominated in foreign currencies, including the IDR, will be re-measured to US\$ at the current exchange rate as of the balance sheet date going forward. We anticipate that the likely effect of this change in functional currency will result in future foreign currency gains and losses that pertain to (i) transactions denominated in IDR and (ii) foreign currency re-measurements associated with monetary assets and liabilities denominated in IDR. As of September 30, 2016, such balances include IDR-denominated cash, accounts receivable, and accounts payable, which amounted to approximately \$20,000, \$37,000, and \$35,000, respectively, based upon the exchange rate between the IDR and US\$ as of that date. Based on this change in functional currency, our US\$-denominated loans to CW-Bali will not be subject to further re-measurement adjustments.

#### *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 Belize courts could hear the matter. 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 financial condition, results of operations or cash flows.

#### *Windsor Plant Water Supply Agreement*

Our subsidiary CW-Bahamas provides bulk water to the WSC, which distributes the water through its own pipeline system to residential, commercial and tourist properties on the Island of New Providence. Pursuant to a water supply agreement, we are required to provide the WSC with at least 16.8 million gallons per week of potable water from the Windsor plant, and the WSC had contracted to purchase at least that amount on a take-or-pay basis. This water supply agreement was scheduled to expire when we delivered the total amount of water required under the agreement in July 2013, but has been extended on a month-to-month basis. At the conclusion of the agreement, the WSC has the option to (i) extend the agreement for an additional five years at a rate to be negotiated; (ii) exercise a right of first refusal to purchase any materials, equipment and facilities that CW-Bahamas intends to remove from the Windsor plant site, and negotiate a purchase price with CW-Bahamas; or (iii) require CW-Bahamas to remove all materials, equipment and facilities from the site.

At the request of the government of The Bahamas, we continue to operate and maintain the Windsor plant on a month-to-month basis to provide the government of The Bahamas with additional time to decide whether or not it will extend CW-Bahamas’ water supply agreement for the Windsor plant on a long-term basis. CW-Bahamas generated revenues from the operation of this plant of approximately \$1.3 million and \$1.5 million during the three months ended September 30, 2016 and 2015, respectively, and \$4.0 million and \$4.5 million during the nine months ended September 30, 2016 and 2015, respectively.

### **Adoption of New Accounting Standards:**

In February 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2015-02, *Consolidation (Topic 810) - Amendments to the Consolidation Analysis*. The amendments in this update require management to reevaluate whether certain legal entities should be consolidated. Specifically, the amendments (1) modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (“VIEs”) or voting interest entities, (2) eliminate the presumption that a general partner should consolidate a limited partnership, (3) affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships, and (4) provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. The amendments in this update are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of ASU 2015-02 did not have a material impact on the Company’s consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, *Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. ASU 2015-03 provides authoritative guidance related to the presentation of debt issuance costs on the balance sheet, requiring companies to present debt issuance costs as a direct deduction from the carrying value of debt. The amendments in this update are effective for public business entities in fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The new guidance must be applied retrospectively to each prior period presented. The adoption of ASU 2015-03 did not have a material impact on the Company’s consolidated financial statements.

In August 2015, the FASB issued ASU 2015-15, *Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements*, which clarifies the treatment of debt issuance costs from line-of-credit arrangements after adoption of ASU 2015-03. The SEC Staff announced they would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The amendment requires retrospective application and represents a change in accounting principle. The amendment becomes effective in fiscal years beginning after December 15, 2015. The adoption of ASU 2015-15 did not have a material impact on the Company’s consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, *Business Combinations: Simplifying the Accounting for Measurement-Period Adjustments*, which requires an acquirer to recognize adjustments identified during the measurement period in the reporting period in which the adjustment amounts are determined. The adjustment must include the cumulative effect of the adjustment as if the accounting had been completed on the acquisition date. The update should be applied prospectively and becomes effective January 1, 2016. Early application is permitted. The adoption of ASU 2015-16 did not have a material impact on the Company’s consolidated financial statements.

**Effect of newly issued but not yet effective accounting standards:**

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 requires revenue recognition to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 prescribes a five step framework in accounting for revenues from contracts within its scope, including (a) identification of the contract, (b) identification of the performance obligations under the contract, (c) determination of the transaction price, (d) allocation of the transaction price to the identified performance obligations and (e) recognition of revenues as the identified performance obligations are satisfied. ASU 2014-09 also prescribes additional disclosures and financial statement presentations. ASU 2014-09 may be adopted retrospectively or under a modified retrospective method where the cumulative effect is recognized at the date of initial application. This amendment was originally effective January 1, 2017. In August 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, which defers the effective date by one year to January 1, 2018. Early application is permitted but not before January 1, 2017.

In March 2016, the FASB issued ASU 2016-08, *Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, that amends the principal versus agent guidance in ASU 2014-09. ASU 2016-08 clarifies that the analysis must focus on whether the entity has control of the goods or services before they are transferred to the customer. ASU 2016-08 also provides additional guidance about how to apply the control principle when services are provided and when goods or services are combined with other goods or services.

In April 2016, the FASB issued ASU 2016-10, *Identifying Performance Obligations and Licensing*, that amends the revenue guidance in ASU 2014-09 on identifying performance obligations and accounting for licenses of intellectual property. ASU 2016-10 changed the FASB's previous proposals on renewals of right-to-use licenses and contractual restrictions.

In May 2016, the FASB issued ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting*. ASU 2016-11 rescinds several SEC Staff Announcements that are codified in Topic 605, including, among other items, guidance relating to accounting for shipping and handling fees and freight services.

In May 2016, the FASB issued ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, which clarifies implementation guidance around collectability, sales taxes collected from customers, noncash considerations, contract modifications at transition, and completed contracts at transition.

The effective dates of ASU 2016-08, ASU 2016-10, ASU 2016-11 and ASU 2016-12 are the same as ASU 2015-14 discussed above. The Company is currently evaluating the effect the adoption of these standards will have on the Company's consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*. ASU 2015-11 applies to all inventory that is measured using first-in, first-out or average cost. The guidance requires an entity to measure inventory at the lower of cost or net realizable value. ASU 2015-11 is effective prospectively for fiscal years, and for interim periods within those years, beginning after December 15, 2016. Early application is permitted. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740), Balance Sheet Classification of Deferred Taxes*. ASU 2015-17 requires net deferred tax assets and liabilities be classified as noncurrent in a classified balance sheet and eliminates the classification between current and noncurrent amounts ASU No. 2015-17 is effective for financial statements issued for annual periods beginning after December 15, 2016 and interim periods within those annual periods. Early adoption is permitted. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which provides guidance for the recognition, measurement, presentation and disclosure of financial assets and financial liabilities. ASU 2016-01 is effective for fiscal years, and for interim periods within those years, beginning after December 15, 2017 and, for most provisions, is effective using the cumulative-effect transition approach. Early application is permitted for certain provisions. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which provides guidance for accounting for leases. The new guidance requires companies to recognize the assets and liabilities for the rights and obligations created by leased assets. The accounting guidance for lessors will remain relatively largely unchanged. ASU 2016-02 is effective for annual and interim periods beginning after December 15, 2018. Early adoption is permitted. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-07, *Investments- Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*, which eliminates the requirement to apply the equity method of accounting retrospectively when a reporting entity obtains significant influence over a previously held investment. ASU 2016-07 will be effective for the Company's fiscal year beginning January 1, 2017 and subsequent interim periods. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*, which simplifies several aspects related to the accounting for share-based payment transactions, including the accounting for income taxes, statutory tax withholding requirements and classification on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments*, which clarifies how certain cash receipts and payments are presented in the statement of cash flows. ASU 2016-15 is effective for annual periods beginning after December 15, 2017 and early adoption is permitted. The Company is currently evaluating the effect the adoption of this amendment will have on the Company's consolidated financial statements.

## **Dividends**

- On January 31, 2016, we paid a dividend of \$0.075 to shareholders of record on January 1, 2016.
- On April 30, 2016, we paid a dividend of \$0.075 to shareholders of record on April 1, 2016.
- On July 31, 2016, we paid a dividend of \$0.075 to shareholders of record on July 1, 2016.
- On August 16, 2016, our Board declared a dividend of \$0.075 payable on October 31, 2016 to shareholders of record on October 3, 2016.

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.

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

This program is available to our common 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 The Bahamas, Belize 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 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no material changes in our exposure to market risk from December 31, 2015 to the end of the period covered by this report.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

Our management has evaluated, with the participation of its principal executive officer and principal financial and accounting officer, the effectiveness of its disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, our principal executive officer and principal financial and accounting officer have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

#### **Changes in Internal Controls**

We are in the process of integrating Aerex into our structure for disclosure controls and procedures.

Except as described above, there have been no changes in the Company's internal control over financial reporting identified in connection with the evaluation of such internal control that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

#### *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 Belize courts could hear the matter. 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 financial condition, results of operations or cash flows.

#### *N.S.C. Agua, S.A. de C.V.*

In May 2010, we acquired, through our wholly-owned Netherlands subsidiary, Consolidated Water Cooperatief, U.A., (“CW-Cooperatief”) a 50% interest in N.S.C. Agua, S.A. de C.V. (“NSC”), a development stage Mexican company. We have since purchased, through the conversion of a loan we made to NSC, sufficient shares to raise our ownership interest in NSC to 99.9%. NSC was formed to pursue a project encompassing the construction, operation and minority ownership 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 (the “Project”).

Immediately following CW-Cooperatief's acquisition of its initial 50% ownership in NSC, the remaining 50% ownership interest in NSC was held by an unrelated company, Norte Sur Agua, S. de R.L. de C.V. ("NSA"). NSA subsequently transferred ownership of half of its shares in NSC to EWG Water LLC ("EWG") and the other half of its shares in NSC to Alejandro de la Vega (the "individual shareholder"). In February 2012, we paid \$300,000 to enter into an agreement (the "Option Agreement") that provided us with an option, exercisable through February 7, 2014, to purchase the shares of NSC owned by the individual shareholder, along with an immediate power of attorney to vote those shares, for \$1.0 million. Such shares constituted 25% of the ownership of NSC as of February 2012. In May 2013, NSC repaid a \$5.7 million loan payable to CW-Cooperatief by issuing additional shares of its stock. As a result of this share issuance to CW-Cooperatief, we acquired 99.9% of the ownership of NSC. The Option Agreement contained an anti-dilution provision that required us to issue new shares in NSC of an amount sufficient to maintain the individual shareholder's 25% ownership interest in NSC if (i) any new shares of NSC were issued subsequent to the execution of the Option Agreement and (ii) we did not exercise our share purchase option by February 7, 2014. We exercised our option and paid the \$1.0 million to the individual shareholder to purchase the Option Agreement shares in February 2014.

In October 2015, we learned that EWG filed a lawsuit against the individual shareholder, NSC, NSA, CW-Cooperatief, Ricardo del Monte Nunez, Carlos Eduardo Ahumada Arruit, Luis de Angitia Becerra, and the Public Registry of Commerce of Tijuana, Baja California in the Civil Court located in Tecate, Baja California, Mexico.

In this lawsuit, EWG is challenging, among other things, the capital investment transactions that increased our ownership interest in NSC to 99.9%. EWG requested that the court, as a preliminary matter: (a) suspend the effectiveness of the challenged transactions; (b) order public officials in Mexico to record the pendency of the lawsuit in the public records; and (c) appoint an inspector for NSA and NSC to oversee its commercial activities. The Court granted, ex-parte, the preliminary relief sought by EWG, which resulted in the placement of inscriptions for the lawsuit on NSC's public records.

EWG is also seeking an order directing, among other things: (i) NSA, NSC and CW-Cooperatief to refrain from carrying out any transactions with respect to the Project; and (ii) NSA, NSC and CW-Cooperatief, and the partners thereof, to refrain from transferring any interests in NSA, NSC and CW-Cooperatief. The Court has not yet ruled on these requests.

On April 5, 2016, NSC filed a motion for reconsideration with the Tecate, Mexico Court asking, among other things, that the Court; (i) reverse its order to record the pendency of the lawsuit in the public records, (ii) cancel the appointment of the inspector, and (iii) allow NSC to provide a counter-guarantee to suspend the effects of the Court's order regarding the challenged transactions. On April 26, 2016, the Tecate, Mexico Court issued an interlocutory judgment (i) ordering the cancellation of the inscriptions on NSC's public records and (ii) rejecting NSC's motion for cancellation of the appointment of the inspector.

On April 26, 2016, NSC filed a full answer to EWG's claims, rejecting every claim made by EWG. The Court's response on this matter is pending.

On May 17, 2016, the Company filed a claim with the Third District Court in Matters of Amparo and Federal Trials in the City of Tijuana, Baja California (the "Amparo Court") challenging the Tecate, Mexico Court ex-parte order which appointed an inspector over NSC's commercial activities. On July 29, 2016, the Amparo Court found that such appointment is unconstitutional and reversed the Tecate, Mexico Court's appointment of an inspector.

On September 6, 2016, the Tecate, Mexico Court issued a decree granting the counter guaranty requested by NSC. Such counter-guaranty was fixed in the amount of MXP 300,000.00 Mexican pesos and was given to the Court on October 13, 2016 at which time all remaining ex-parte restrictions on NSC related to the challenged transactions were suspended.

We believe that the claims made by EWG are baseless and without merit, and we will vigorously defend NSC and CW-Cooperatief in this litigation, and will seek dismissal of the orders entered by the court and all claims against NSC and CW-Cooperatief. Furthermore, on November 19, 2015, NSC and CW-Cooperatief filed a complaint in the United States District Court, Southern District of New York against EWG and its Managing Partner, based upon our conclusion that lawsuit filed by EWG in Mexico directly breaches a contract dated April 11, 2012 between NSC and CW-Cooperatief, and EWG. We are vigorously pursuing our claims and seeking relief pursuant to this complaint. We incurred legal fees in connection with this litigation of approximately \$18,000 and \$357,000 for the three and nine months ended September 30, 2016.

We cannot presently determine the outcome of this litigation. However, such litigation could adversely impact our efforts to complete the Project.

## **ITEM 1A. RISK FACTORS**

*Our business faces significant risks. These risks include those disclosed in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 as supplemented by the additional risk factors included below. If any of the events or circumstances described in the referenced risks actually occurs, our business, financial condition or results of operations could be materially adversely affected and such events or circumstances could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. These risks should be read in conjunction with the other information set forth in this Quarterly Report as well as in our Annual Report on Form 10-K for the year ended December 31, 2015 and in our other periodic reports on Form 10-Q and Form 8-K.*

**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 in July 1990 by the Cayman Islands government that grants our subsidiary, Cayman Water, the exclusive right to provide water to retail customers within our licensed service area. 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 two of the three most populated areas of Grand Cayman, the Seven Mile Beach and West Bay areas. For the three months ended September 30, 2016 and 2015, the Company generated approximately 38%, and 39%, respectively, of its consolidated revenues and 52% and 57%, respectively, of its consolidated gross profit from the retail water operations conducted pursuant to Cayman Water's exclusive license. For the nine months ended September 30, 2016 and 2015, the Company generated approximately 40% and 41%, respectively, of its consolidated revenues and 55% and 58%, respectively, of its consolidated gross profit from the retail water operations conducted pursuant to Cayman Water's exclusive license.

Under our license, we pay a royalty to the government of 7.5% of our gross retail water sales revenues (excluding energy cost 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 (the "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 would be referred to arbitration.

This license was set to expire on July 10, 2010; however, the Cayman Islands government and we 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 expired June 30, 2016. We continue to provide water subsequent to June 30, 2016 under a further extension of the license that we believe will be forthcoming. The Cayman Islands government could ultimately offer a third party a license to service some or all of our present service area. However, as set forth in the existing license, *"the Governor hereby agrees that upon the expiry of the term of this Licence or any extension thereof, he will not grant a licence or franchise to any other person or company for the processing, distribution, sale and supply of water within the Licence Area without having first offered such a licence or franchise to the Company on terms no less favourable than the terms offered to such other person or company."*

In February 2011, the Water (Production and Supply) Law, 2011 and the Water Authority (Amendment) Law, 2011 (the “New Laws”) were published and enacted. Under the New Laws, the WAC will issue any new license, and such new license could include a rate of return on invested capital model, as discussed in the following paragraph.

Following the enactment of the New Laws, we were advised in correspondence from the Cayman Islands government and the WAC that: (i) the WAC, and not the Cayman Islands government, is the principal negotiator in our license negotiations; and (ii) the WAC had determined that a rate of return on invested capital model (“RCAM”) for the retail license is in the best interest of the public and our 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. We responded to the Cayman Islands government that we disagreed with its position on these two matters and negotiations for a new license temporarily ceased.

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 New Laws 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. In October 2012, we were notified that the Court agreed to consider the issues outlined in the Application.

The hearing for this judicial review was held on April 1, 2014. Prior to the commencement of the hearing, the parties agreed that the Court should solely be concerned with the interpretation of the statutory provisions. As part of this agreement, the WAC agreed to consider our submissions on the RCAM model and/or alternative models of pricing. In June 2014, the Court determined that: (i) the renewal of the license does not require a public bidding process; and (ii) the WAC is the proper entity to negotiate with us for the renewal of the license.

Our submissions on the RCAM model and/or alternative models of pricing were made to the WAC on June 9, 2014. We received a letter from the WAC dated September 11, 2014, which fully rejected our submissions and stated that the WAC intended to provide us with a draft RCAM license in due course.

On November 21, 2014, we wrote to the Minister of Works offering to recommence license negotiations on the basis of the RCAM model subject to the following conditions: (i) the Government would undertake to amend the current water legislation to provide for an independent regulator and a fair and balanced regulatory regime more consistent with that provided under the electrical utility regulatory regime, (ii) the Government and we would mutually appoint an independent referee and chairman of the negotiations, (iii) our new license would provide exclusivity for the production and provision of all piped water, both potable and non-potable, within our Cayman Islands license area, (iv) the Government would allow us to submit our counter proposal to the WAC’s June 2010 RCAM license draft, and

(v) the principle of subsidization of residential customer rates by commercial customer rates would continue under a new license. On March 23 2015, we received a letter from the Minister of Works with the following responses to our November 21, 2014 letter: (1) that while the Cayman government plans to create a public utilities commission, the provision of a new license will not depend upon the formation of such a commission; (2) any consideration regarding inclusion of the exclusive right to sell non-potable water within the area covered by the retail license will not take place until after the draft license has proceeded through the review process of the negotiations; (3) rather than allow us to submit a counter proposal to the WAC's June 2010 RCAM license draft, the WAC will draft the license with the understanding that we will be allowed to propose amendments thereto; (4) the principle of subsidization of residential customer rates by commercial customer rates would continue under the new license; and (5) a request that we consider eliminating our monthly minimum volume charge in the new license.

We recommenced license negotiations with the WAC during the third quarter of 2015 based upon a draft RCAM license provided by the WAC. Such license negotiations remain on-going. We are presently unable to determine when such negotiations will be completed or the final outcome of such negotiations.

In October 2016, the Government of the Cayman Islands passed legislation which created a new utilities regulation and competition office ("URCO"). This legislation will become law when it is assented to by the Governor of the Cayman Islands and published in the official Cayman Islands Gazette. URCO is an independent and accountable regulatory body with a view of protecting the rights of consumers, encouraging affordable utility services, and promoting competition. URCO has the ability to supervise, monitor and regulate multiple utility undertakings and markets. Water utilities are not presently included in the scope of URCO's regulatory functions and remain under the regulatory control of the WAC. We have been advised by government officials that it is government's intention to include water utilities under the ambit of URCO through additional legislation in 2017. We have been further advised that if and when this additional legislation is enacted, the WAC will no longer regulate water utilities since this function will be taken over by URCO. We are presently unable to determine (i) when such additional legislation will be enacted and consequently if or when URCO will become its new regulator in the Cayman Islands; or (ii) the impact of URCO on our retail license negotiations.

The resolution of these license negotiations could result in a material reduction of the operating income and cash flows we have historically generated from our retail license and could require us to record an impairment loss to reduce the carrying value of our goodwill. Such impairment loss could have a material adverse impact on our results of operations.

**We have purchased \$20.7 million in land and equipment and incurred development expenses totaling approximately \$19.0 million for a possible project in Mexico. We expect to expend significant additional funds in 2016 to continue to pursue this project. However, we may not be successful in completing this project.**

We own a 99.9% interest in N.S.C. Agua, S.A. de C.V. (“NSC”), a development stage Mexico company formed to pursue a project encompassing the construction, operation and minority ownership 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 (the “Project”). As of September 30, 2016, our consolidated balance sheet includes purchases for the Project of approximately \$20.6 million in land and \$98,000 in equipment. The project development activities we have conducted, which include conducting an equipment piloting plant and water data collection program at the proposed feed water source, completing various engineering studies and obtaining various governmental permits, have resulted in additional developmental expenses totaling \$19.0 million from 2010 through September 30, 2016.

In August 2014, the State of Baja California (the “State”) enacted new legislation to regulate Public-Private Association projects which involve the type of long-term contract between a public sector authority and a private party that NSC is seeking to complete the Project. Pursuant to this new legislation, in January 2015, NSC submitted an expression of interest for its project to the Secretary of Infrastructure and Urban Development of the State of Baja California (“SIDUE”). SIDUE accepted NSC’s expression of interest and requested that NSC submit a detailed proposal for the Project that complied with requirements of the new legislation. NSC submitted this detailed proposal (the “APP Proposal”) to SIDUE in late March 2015. The new legislation required that such proposal be evaluated by SIDUE and submitted to the Public-Private Association Projects State Committee (the “APP Committee”) for review and authorization. If the Project was authorized the State would be required to conduct a public tender for the Project.

In response to our APP Proposal, in September 2015 NSC received a letter dated June 30, 2015 from the Director General of the Comisión Estatal de Agua de Baja California (“CEA”), the State agency with responsibility for the Project that stated (i) the Project is in the public interest with high social benefits and is consistent with the objectives of the State development plan and (ii) that the Project and accompanying required public tender process should be conducted. In November 2015, the State officially commenced the tender for the Project, the scope of which the State defined as a first phase to be operational in 2019 consisting of a 50 million gallons per day plant and a pipeline that connects to the Mexican potable water infrastructure and a second phase to be operational in 2024 consisting of an additional 50 million gallons per day of production capacity. NSC submitted its tender for the Project on the April 21, 2016 tender submission deadline date set by the State.



We have acknowledged since the inception of the Project that, due to the amount of capital the Project requires, NSC will ultimately need an equity partner or partners for the Project. Consequently, NSC's tender to the State for the Project was based upon the following: (i) NSC will sell or otherwise transfer the land and other Project assets to a new company ("Newco") that would build and own the Project; (ii) NSC's potential partners would provide the majority of the equity for the Project and thereby would own the majority interest in Newco; (iii) NSC would maintain a minority ownership position in Newco; and (iv) Newco would enter into a long-term management and technical services contract for the Project with an entity partially owned by NSC or another Company subsidiary.

On June 15, 2016, the State designated the consortium comprised of NSC, NuWater S.A.P.I. de C.V. and Degremont S.A. de C.V. (the "Consortium") as the winner of tender process for the Project.

On August 17, 2016, NSC and NuWater incorporated a special purpose project company named Aguas de Rosarito S.A.P.I. de C.V. ("AdR") to execute the Project and executed a shareholders agreement agreeing among other things that; (i) AdR would purchase the Land and other Project assets from NSC on the date that the Project begins commercial operation; and (ii) AdR would enter into a Management and Technical Services Agreement with NSC effective on the first day that the Project begins commercial operation.

On August 22, 2016, the Public Private Partnership Agreement for public private partnership number 002/2015, contest number SIDUE-CEA-APP-2015-002 ("APP Contract") was executed between AdR, the State Water Commission of Baja California ("CEA"), the Government of Baja California represented by the Secretary of Planning and Finance ("SPF"), and the Public Utilities Commission of Tijuana ("CESPT"). The APP Contract requires AdR to design, construct, finance and operate a seawater desalination plant (and accompanying aqueducts) with a capacity of up to 100 million gallons per day in two phases: the first with a capacity of 50 million gallons per day and an aqueduct to the Mexican potable water system in Tijuana, Baja California; and the second phase with a capacity of 50 million gallons per day and an aqueduct to a second delivery point in Tijuana. The first phase must be operational within 36 months of commencing construction, and the second phase must be operational by the end of 2024. The APP Contract further requires AdR to operate and maintain the plant and aqueducts for a period of 37 years starting from the commencement of operation of the first phase. At the end of the operating period the plant and aqueducts will be transferred to CEA.

The total Project cost is expected to be approximately 9 billion Mexican pesos, or approximately US\$485 million (based upon the current exchange rate). Annual revenues from the Project are expected to be approximately 1.02 billion Mexican pesos, or approximately US\$55.0 million (based upon the currency exchange rate as of August 23, 2016). Water rates under the APP Contract are indexed to the Mexican national consumer price index over its term. Electrical energy costs incurred by AdR to desalinate and deliver water are treated as a pass through charge to CEA, subject to efficiency guarantees. AdR expects to raise Mexican peso denominated debt financing through a consortium led by the North American Development Bank, which also provided financial advisory services to us and our partners through the bidding process and contract negotiations.



The APP Contract does not become effective until AdR secures the equity and debt financing required for the first phase of the Project and the following conditions are met:

- the State has established and registered various payment trusts, guaranties and bank credit lines for specific use by the Project;
- the CEA has obtained the rights from the relevant federal authority to take and desalinate seawater and distribute it for municipal use;
- various water purchase and sale agreements between the CEA, the payment trusts and the CESPT have been executed;
- AdR has obtained all rights of ways required for the aqueduct;
- AdR has obtained permission from the relevant federal authority to discharge the residual water from the Project's desalination plant; and
- all financing agreements necessary to provide funding for the Project have been executed.

If the Consortium is ultimately unable to proceed with the Project, the land NSC has purchased may lose its strategic importance as the site for the Project and consequently may decline in value. If the Consortium does not proceed with the Project, NSC may ultimately be unable to sell this land for an amount equal to or in excess of its current carrying value of approximately \$20.6 million, and any loss on sale of the land, or impairment loss we may be required to record as a result of a decrease in the fair value of the land could have a material adverse impact on our results of operations.

EWG Water LLC ("EWG"), a minority shareholder in NSC, has filed a lawsuit against NSC, CW-Cooperatief, the Public Registry of Commerce of Tijuana, Baja California, and other parties in the Civil Court located in Tecate, Baja California, Mexico.

In this lawsuit, EWG is challenging, among other things, the capital investment transactions that increased our ownership interest in NSC to 99.9%. EWG requested that the court, as a preliminary matter: (a) suspend the effectiveness of the challenged transactions; (b) order public officials in Mexico to record the pendency of the lawsuit in the public records; and (c) appoint an inspector for NSC to oversee its commercial activities. The court granted, ex-parte, the preliminary relief sought by EWG, which resulted in the placement of inscriptions for the lawsuit on NSC's public records.

EWG is also seeking an order directing, among other things: (i) NSA, NSC and CW-Cooperatief to refrain from carrying out any transactions with respect to the Project; and (ii) NSA, NSC and CW-Cooperatief, and the partners thereof, to refrain from transferring any interests in NSA, NSC and CW-Cooperatief.

This litigation could adversely impact our efforts to complete the Project.

**If we are unable to significantly increase the amount of water we presently sell from our plant in Bali, Indonesia, we may be required to cease its operations and may be required to record further impairment losses on our investment in our Bali subsidiary.**

Through our subsidiary, CW-Bali, we have built and presently operate a seawater reverse osmosis plant with a productive capacity of approximately 790,000 gallons per day located in Nusa Dua, one of the primary tourist areas of Bali, Indonesia. Since its inception, the sales volumes for this plant have not been sufficient to cover its operating costs. CW-Bali's operating loss was approximately (\$2.4 million) for the nine months ended September 30, 2016, which includes an impairment loss recorded during the three months ended September 30, 2016 to reduce the carrying value of CW-Bali's long-lived assets to their estimated fair value.

If we are not able to obtain a strategic partner for CW-Bali, sell water to new customers, or otherwise significantly increase the revenues generated by our Nusa Dua plant in the future, we may cease CW-Bali's operations. We will also be required to cease CW-Bali's operations if we do not obtain a new in-principle license for CW-Bali. If we cease operations at CW-Bali, we may be required to record further impairment losses to reduce the carrying value of our investment in CW-Bali to its fair value for the period in which we formally commit to exit the Bali market. Such impairment losses could have a material adverse impact on our results of operations. Any sale of a portion of our investment in CW-Bali may be for an amount less than our carrying amount, resulting in a loss on the sale that could have a material adverse impact on our results of operations. The carrying value of our investment in CW-Bali as of September 30, 2016 totaled \$2.1 million, consisting of net assets of \$1.51 million and a cumulative translation adjustment reflected in our stockholders' equity of \$549,555.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In July 2016, we issued 1,258 shares of preferred stock to 13 employees for cash at a price of \$8.72 per share. The issuance of the preferred stock to the employees was exempt from registration under Regulation S promulgated under the Securities Act of 1933, as amended (the “Securities Act”), because the shares were issued outside of the United States to non-US persons (as defined in Regulation S). Three of the employees are US persons and the issuance of such shares to them was exempt under Section 4(a)(2) of the Securities Act. The US persons are knowledgeable, sophisticated and experienced in making investment decisions of this kind and received adequate information about us or had adequate access, including through the employee’s business relationship with us, to information about us.

These preferred shares were issued under the Company’s Employee Share Incentive Plan and convert to common stock on a share for share basis on the fourth anniversary of each grant date.

## ITEM 6. EXHIBITS

### Exhibit

#### Number Exhibit Description

31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.1	Section 1350 Certification of Chief Executive Officer
32.2	Section 1350 Certification of Chief Financial Officer
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Schema
101.CAL	XBRL Taxonomy Calculation Linkbase
101.DEF	XBRL Taxonomy Definition Linkbase
101.LAB	XBRL Taxonomy Label Linkbase
101.PRE	XBRL Taxonomy Presentation Linkbase



## **SIGNATURES**

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

### **CONSOLIDATED WATER CO. LTD.**

By: /s/ Frederick W. McTaggart  
Frederick W. McTaggart  
Chief Executive Officer  
(Principal Executive Officer)

By: /s/ David W. Sasnett  
David W. Sasnett  
Executive Vice President & Chief Financial Officer  
(Principal Financial and Accounting Officer)

Date: November 9, 2016