California Water Service Group
2001 Annual Report
Rising to the challenge

In 2001, the water industry faced significant challenges. By keeping focused on the fundamentals—and excelling in the key operational areas that set us apart from the competition—we are turning challenges into opportunities.

And turning challenge into opportunity.

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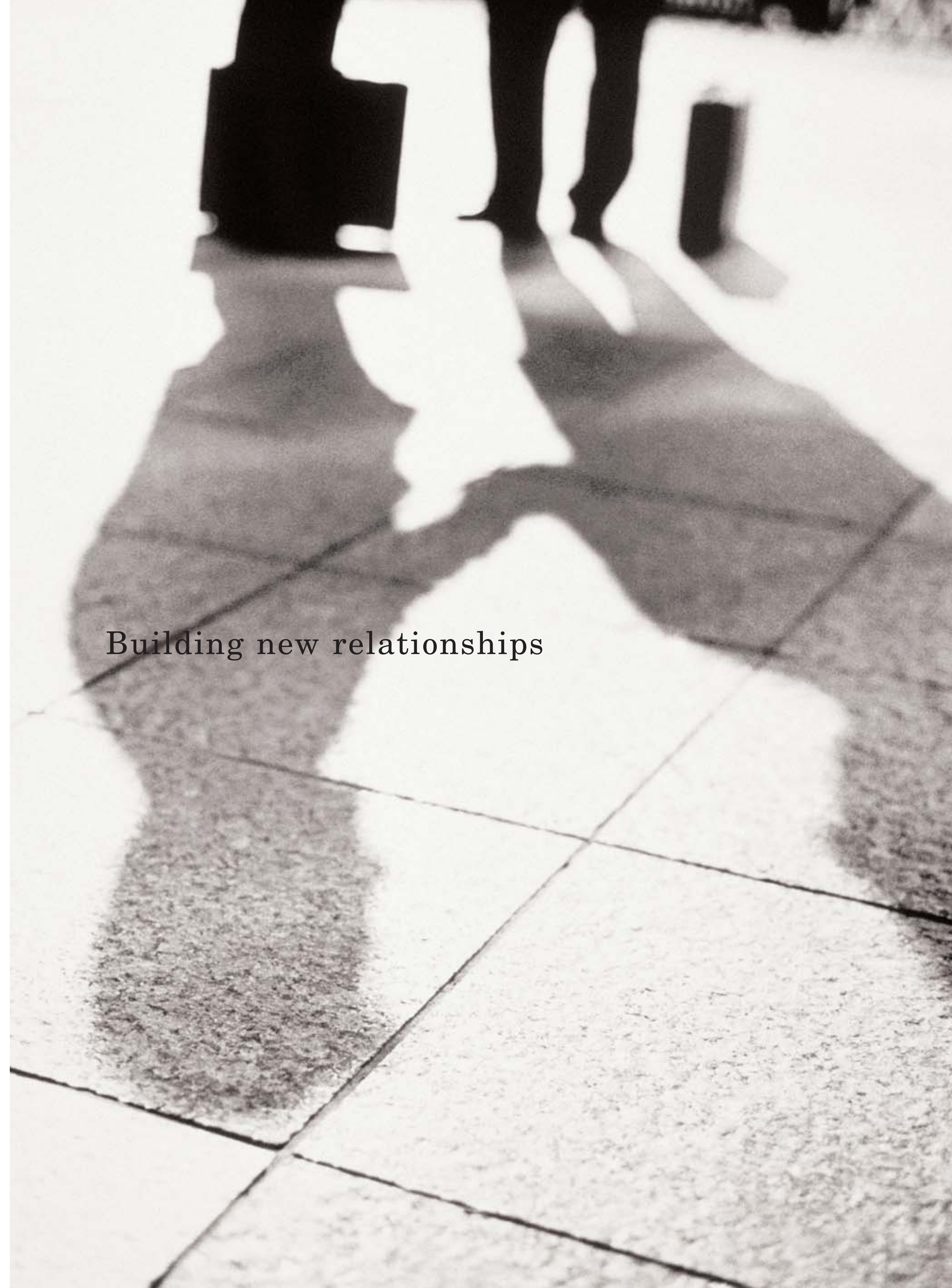


Maintaining financial strength

Expanding our first-class infrastructure

Rising to the Challenge 2001 brought with it a number of challenges, and we responded to them by focusing on those things that are most important in our business—building new relationships, maintaining financial strength, expanding our first-class infrastructure, and providing excellent service. In short, we responded by doing what we do best: we excelled in the fundamentals of our business while executing our carefully crafted, deliberate strategy for meeting challenges and turning them into opportunities.

Building New Relationships Washington Water Service Company made great strides in 2001, growing its regulated customer base by 10%. In California, we were awarded a utility billing contract in Stockton and the opportunity to negotiate a 15-year water system operating agreement with the City of Commerce, which we currently operate under a short-term agreement. 2001 also saw us renew an old partnership, as we entered into a contract to provide water quality testing services to San Jose Water Company.

Maintaining Financial Strength A tough regulatory climate, significantly higher electricity costs, and lower water usage due to cooler weather made maintaining our financial strength a challenge in 2001, but it was a challenge we tackled with determination. A company-wide cost con-

trol program helped curb expenses, while Continuous Improvement Process (CIP) teams made up of employees throughout the company worked on projects that increased efficiency. For example, one team realized company-wide savings by changing the way we handle customers' returned mail; another team conducted energy use audits and developed a plan to reduce electricity costs; and yet another increased revenue by revising the process for metering new construction projects. These efforts, combined with numerous applications we filed for rate relief with the California Public Utilities Commission, should reduce expenses and increase revenues in 2002.

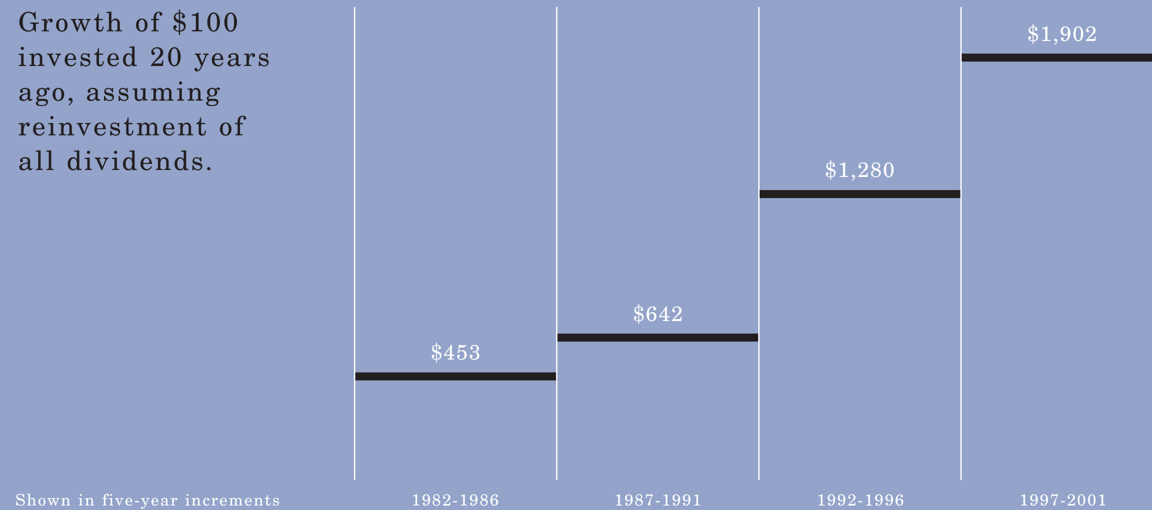
Expanding Our First-Class Infrastructure A water utility that maintains a first-class infrastructure is like a property owner who invests time, effort, and resources into upgrading his or her home to increase the property's value and reduce the costs associated with unexpected repairs. We are diligent about maintaining and upgrading our infrastructure. That means our invested capital grows each year along with the value of our water systems and we spend less money on unanticipated repairs. In 2001, we completed more than 500 capital projects, including a new treatment plant in our Kern River Valley District, a new water storage tank in our East Los Angeles District, and a new well in our King City District. We also broke ground on a large treatment plant in Bakersfield and expanded our infrastructure to serve 6,100 new customers. To ensure that we can continue to provide our customers with a reliable water supply that meets increasingly strict water quality standards, we will invest more in our infrastructure in 2002 than ever before.

Providing Excellent Service Ask anyone at our company what we do, whether it is a member of the water quality team working in front of a microscope, a water service professional replacing a broken pipeline, or a customer service representative answering the telephone, and he or she will tell you that we are in the business of providing excellent service. That is why we have an employee team dedicated to measuring our ability to satisfy our customers. Recently, this team conducted a series of surveys to measure our ability to meet customers' needs the first time they called us. Why? Because our research indicated that customers want "quick and easy" telephone service, and that satisfaction levels drop 50% every time a customer is not satisfied on the first contact. The most recent survey indicated that 95% of our customers were satisfied on the first call.

Financial Highlights

Year Ended December 31	2001	2000	1999	1998	1997
Book value	$ 12.95	$ 13.13	$ 12.89	$ 12.49	$ 12.15
Market price	25.75	27.00	30.31	31.31	29.53
Earnings per share	.97	1.31	1.44	1.31	1.71
Dividends per share	1.115	1.10	1.085	1.07	1.055
Revenue (in thousands)	246,820	244,806	234,937	214,926	225,165
Net income (in thousands)	14,965	19,963	21,971	19,860	25,757

Growth of $100 invested 20 years ago, assuming reinvestment of all dividends.



Shown in five-year increments

To Our Stockholders

Our world changed in 2001. Freedom-loving people everywhere suffered a great loss on September 11 when terrorists attacked the United States of America. As individuals, we mourned; we took pride in the courage and compassion that characterized our country's response; and we gained from the experience a renewed sense of what is important in life. As a company, we faced a need to increase security and safeguard our water supplies. We also faced challenges unrelated to the attacks, such as higher electricity costs, a tough regulatory climate, and cool, wet weather. We responded to all of these challenges by focusing on the fundamentals of our business while executing an aggressive strategy for improving our financial results in years to come.

Our two biggest challenges in 2001 were lower water usage due to cool, wet weather, and decisions by the California Public Utilities Commission (CPUC) to delay our requests for rate relief. Although we can have no influence over the weather, we are continuing our efforts to grow our business and diversify our operations to lessen its impact on our earnings. The regulatory climate had an even greater impact on our business in 2001, and we brought significant resources to bear in executing a multifaceted strategy to help ensure that we receive fair regulatory treatment in the future. For example, we are a leader in the water industry's efforts to improve communications with the CPUC and influence key decisions. Even more importantly, we have taken an aggressive approach to rate cases, filing for increases for an unprecedented 15 districts in California in 2001. We hope to receive decisions on these rate cases in the third quarter of 2002.

One of the most significant developments at the CPUC in 2001 was a decision to reconsider the way water industry offset expenses are processed. For more than two decades, water utilities have been able to include increases in certain unpredictable and uncontrollable expenses in rates, including electric cost increases, without having to wait to request recovery in general rate case applications, which can only be filed every three years. The CPUC has delayed our requests to recover a large portion of our higher electricity costs until it decides upon the matter of offset expenses. Our electricity costs rose $6 million in 2001, and our unsuccessful efforts to recover all of that cost increase had a significant negative impact on our earnings. We are participating actively in the CPUC proceeding on this issue, both as a company and as an industry, in an effort to protect the interests of both stockholders and customers.

We expect our efforts and the efforts of the water industry to yield positive results in future years, but 2001 financial results were clearly impacted by weather and regulatory treatment. Our operating revenues for 2001 were $247 million, compared to $245 million in 2000. Net income was $15 million, compared to $20 million in 2000, and earnings were $0.97 per share, compared to $1.31 per share in 2000.

We remain committed to doing all we can to provide our stockholders a fair rate of return, and we will be relentless in pursuing every opportunity to increase stockholder value. Evidence of this commitment is born out by our track record. We have paid a dividend every year for the past 57 years; in 2001, it increased to $1.115 per share. The graph on page 8 reflects the long-term value of an investment in our company, showing that $100 invested in 1981 would be worth $1,902 today, assuming reinvestment of all dividends.

Our growth strategy will be key in ensuring future success. In 2001, we continued to pursue growth opportunities that add to shareholders' long-term value. As for regulated business, we purchased the assets of seven small systems in Washington, growing customer base by 10%. We added 5,000 metered connections in California, including infrastructure needed to serve 120 new subdivisions. And in New Mexico, we continued to pursue new growth opportunities while the New Mexico Public Regulation Commission considered our request to purchase the Rio Grande Utility Corporation. We expect to receive a decision on the Rio Grande purchase in the second quarter of 2002.

On the non-regulated side, we signed five water system operation agreements in Washington and were selected to negotiate a 15-year lease agreement with the City of Commerce, California, whose 1,085-connection water system we are currently operating under a short-term agreement. We were also proud to be selected to provide utility billing services in the City of Stockton, California and water quality testing services to San Jose Water Company.

In the coming year, we will continue to work diligently to ensure fair regulatory treatment, while we maintain our company-wide focus on operating efficiently and providing excellent service. We will also seek to expand the non-regulated side of the business by pursuing non-regulated service contracts, maximizing the value of our excess real estate, and leasing portions of our properties to partners like cellular telephone service providers.

Our stockholders will earn on a growing capital investment, as we plan to invest more in our infrastructure in 2002 than ever before. Much of the capital investment planned for 2002 is needed to enable us to meet increasingly strict water quality standards, including the funds invested in the construction of a $49 million water treatment plant begun in Bakersfield in 2001 and expected to be completed in 2003. A notable development in the water quality arena in 2001 was the adoption of a new federal standard of 10 parts per billion for arsenic, which will require significant capital investments by all water providers in the coming years.

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Peter C. Nelson
President and CEO

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Robert W. Foy
Chairman of the Board

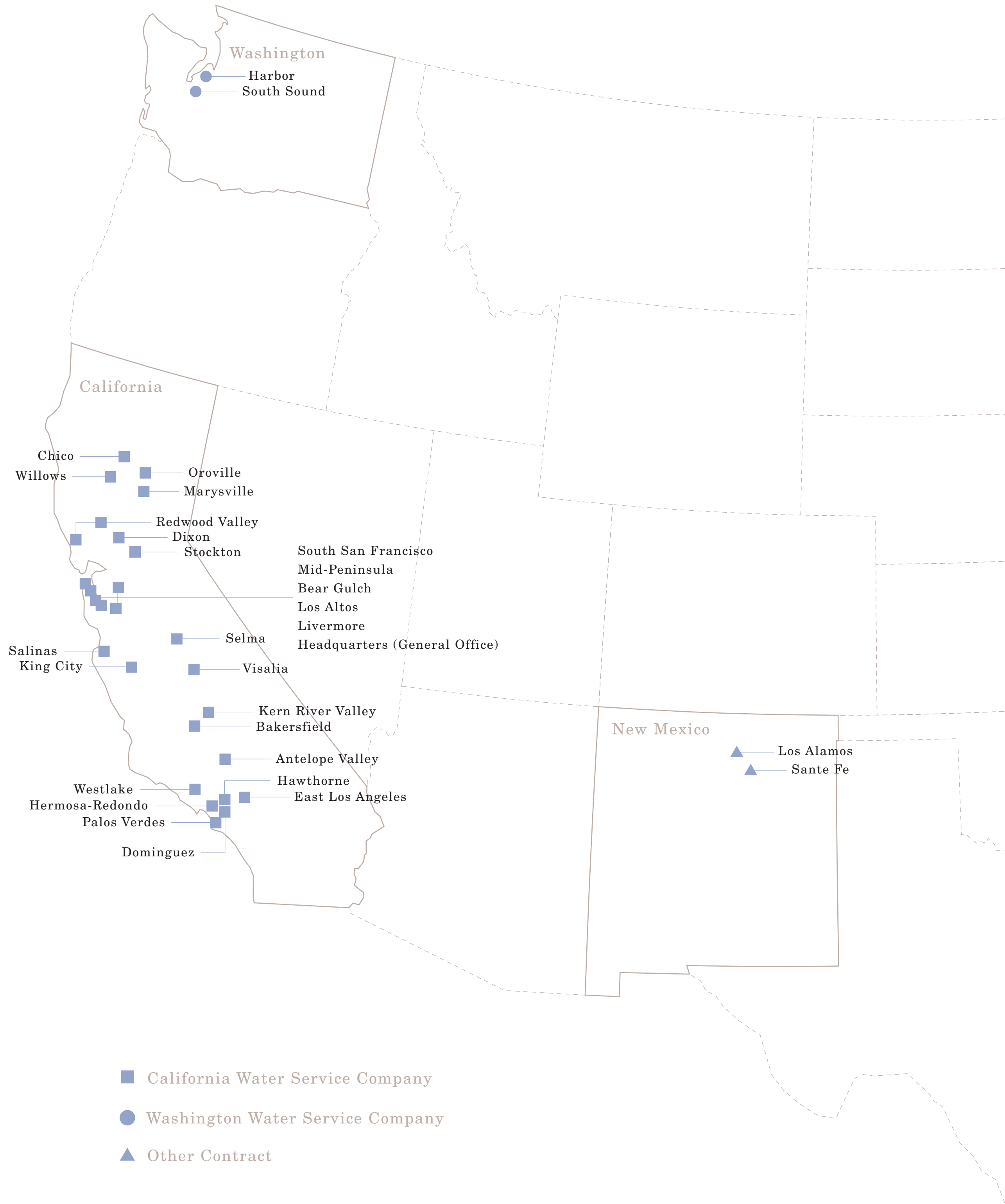
Whatever else we do, our future success depends on our ability to provide excellent customer service. And we have the right people to get the job done—people like Denise Diaz, a customer service representative who recently had the water turned on in 15 minutes for a neighboring family that came to her door one night; people like Nadia Watson, a collector who contacted local agencies to assist an elderly customer in need, and even made the customer a sandwich before she left; people like Al Welte, a pump operator who changed a customer's flat tire one fall day so she could get her kids to school on time. We are fortunate to have such a caring and talented group of people on our team—people who cared so much about the victims of September 11 that they volunteered to forgo our annual Employee Celebration Day and instead send a significant employee contribution to help those in need...people who work hard every day, both individually and on teams, to ensure that we provide excellent service to our customers.

There is no doubt about it, 2001 was a year fraught with challenges. But by focusing on excelling at the things we do best, we are turning those challenges into opportunities. We believe that our proven ability to grow profitably, maintain our financial strength, make wise investments in our infrastructure, and provide excellent customer service positions us well for future success. We thank you for your investment in California Water Service Group and look forward to a bright and rewarding future.

Sincerely,

Robert W. Foy
Chairman of the Board

Peter C. Nelson
President and Chief Executive Officer



Customers

California

District Name	*Including*	*Regulated*	*Non-regulated*
Antelope Valley	Fremont Valley, Lake Hughes, Lancaster & Leona Valley; Painted Turtle, Prayer Mountain and other operating agreements	1,300	400
Bakersfield	O&M contracts for the City of Bakersfield, Spicer City & Lost Hills	58,400	27,000
Bear Gulch	Atherton, Woodside, Portola Valley, portions of Menlo Park & City of Menlo Park service contract	17,600	4,200
Chico†	Hamilton City	23,800	–
Dixon		2,800	–
Dominguez	Carson and portions of Compton, Harbor City, Long Beach, Los Angeles & Torrance	33,100	–
East Los Angeles	O&M contracts for cities of Commerce & Montebello	26,400	2,700
Hawthorne	15-year lease — full-service water operations	–	6,100
Hermosa-Redondo†	A portion of Torrance; meter reading for Manhattan Beach	25,700	13,400
Kern River Valley	Bodfish, Kernville, Lakeland, Mtn. Shadows, Onyx, Squirrel Valley, South Lake & Wofford Heights; numerous operating contracts	4,100	500
King City†		2,200	–
Livermore	O&M contracts for Castlewood Country Club & Crane Ridge MWC	17,000	200
Los Altos	Portions of Cupertino, Los Altos Hills, Mtn. View & Sunnyvale	18,400	–
Marysville†		3,800	–
Mid-Peninsula	San Mateo & San Carlos	35,800	–
Oroville		3,500	–
Palos Verdes	Palos Verdes Estates, Rancho Palos Verdes, Rolling Hills Estates & Rolling Hills	23,600	–
Redwood Valley	Lucerne, Duncans Mills, Guerneville, Dillon Beach and a portion of Santa Rosa	1,900	–
Salinas	O&M contracts for Foothill Estates & Spreckels Water Co.	27,000	300
Selma		5,300	–
South San Francisco	Colma & Broadmoor	16,300	–
Stockton		42,000	–
Visalia†		31,300	–
Westlake	A portion of Thousand Oaks	7,000	–
Willows†		2,300	–
	SUBTOTAL	430,600	54,800

New Mexico

District Name	Including	Regulated	Non-regulated
Los Alamos	Meter-reading contract	–	22,000
Santa Fe	Meter-reading contract	–	27,000
	SUBTOTAL	–	49,000

Washington

District Name	Including	Regulated	Non-regulated
Harbor	Numerous O&M contracts	10,800	1,100
South Sound	Numerous O&M contracts	2,900	1,200
	SUBTOTAL	13,700	2,300
	TOTAL	444,300	106,100

MWC = Mutual Water Company | O&M = Operations and Maintenance | † = Billing Contract

Ten-Year Financial Review

Dollars in thousands, except common share data	*2001*	*2000*	*1999*	*1998*	*1997*	*1996*	*1995*	*1994*	*1993*	*1992*
Summary of Operations										
Operating revenue										
Residential	$173,823	$171,234	$163,681	$150,491	$158,210	$148,313	$132,859	$127,228	$122,585	$111,353
Business	44,944	44,211	41,246	38,854	40,520	37,605	35,873	33,712	31,360	29,208
Industrial	9,907	11,014	12,695	10,150	10,376	9,748	9,952	9,080	8,415	7,905
Public authorities	11,860	11,609	10,898	9,654	11,173	10,509	9,585	9,397	8,535	7,899
Other	6,286	6,738	6,417	5,777	4,886	4,083	4,833	3,767	4,985	7,104
Total operating revenue	246,820	244,806	234,937	214,926	225,165	210,258	193,102	183,184	175,880	163,469
Operating expenses	221,669	211,610	201,890	183,245	188,020	177,356	164,958	155,012	145,517	137,401
Interest expense, other income and expenses, net	10,186	13,233	11,076	11,821	11,388	11,502	11,176	11,537	12,785	11,794
Net income	$ 14,965	$ 19,963	$ 21,971	$ 19,860	$ 25,757	$ 21,400	$ 16,968	$ 16,635	$ 17,578	$ 14,274
*Common Share Data**										
Earnings per share - diluted	$ 0.97	$ 1.31	$ 1.44	$ 1.31	$ 1.71	$ 1.42	$ 1.13	$ 1.17	$ 1.26	$ 1.02
Dividend declared	1.115	1.100	1.085	1.070	1.055	1.040	1.020	0.990	0.960	0.930
Dividend payout ratio	115%	84%	75%	82%	62%	73%	90%	85%	76%	91%
Book value	$ 12.95	$ 13.13	$ 12.89	$ 12.49	$ 12.15	$ 11.47	$ 10.97	$ 10.72	$ 10.03	$ 9.65
Market price at year-end	25.75	27.00	30.31	31.31	29.53	21.00	16.38	16.00	20.00	16.50
Common shares outstanding at year-end (in thousands)	15,182	15,146	15,094	15,015	15,015	15,015	14,934	14,890	13,773	13,773
Return on average common stockholders' equity	7.6%	10.1%	11.5%	10.8%	14.5%	12.8%	10.6%	11.1%	12.6%	10.7%
Long-term debt interest coverage	2.87	3.58	3.79	3.64	4.37	3.81	3.41	3.49	3.34	3.21
Balance Sheet Data										
Net utility plant	$624,342	$582,782	$564,390	$538,741	$515,917	$495,985	$471,994	$455,769	$437,065	$419,194
Utility plant expenditures	62,049	37,161	48,519	41,061	37,511	40,310	31,031	32,435	31,097	37,698
Total assets	710,214	666,605	645,507	613,143	594,444	569,745	553,027	516,507	497,717	451,754
Long-term debt including current portion	207,981	189,979	171,613	152,674	153,271	151,725	154,416	138,628	138,863	130,971
Capitalization ratios:										
Common stockholders' equity	48.8%	51.1%	53.0%	54.6%	53.8%	52.7%	50.9%	52.9%	49.3%	49.7%
Preferred stock	0.9%	0.9%	0.9%	1.0%	1.0%	1.1%	1.1%	1.2%	1.2%	1.3%
Long-term debt	50.3%	48.0%	46.1%	44.4%	45.2%	46.2%	48.0%	45.9%	49.5%	49.0%
Other Data										
Water production (million gallons)										
Wells and surface supply	65,283	65,408	65,144	57,482	63,736	60,964	54,818	53,274	48,598	55,641
Purchased	61,343	62,237	58,618	54,661	59,646	56,769	57,560	59,850	59,103	49,303
Total water production	126,626	127,645	123,762	112,143	123,382	117,733	112,378	113,124	107,701	104,944
Metered customers	371,281	366,242	361,235	354,832	350,139	345,307	335,238	332,146	326,564	322,457
Flat-rate customers	79,146	78,104	77,892	77,568	77,878	77,991	78,330	79,159	81,416	82,617
Customers at year-end, including Hawthorne	450,427	444,346	439,127	432,400	428,017	423,298	413,568	411,305	407,980	405,074
New customers added	6,081	5,219	6,727	4,383	4,719	9,730	2,263	3,325	2,906	3,769
Average revenue per customer	$ 552	$ 554	$ 539	$ 500	$ 529	$ 502	$ 468	$ 447	$ 433	$ 404
Utility plant per customer at year-end	2,020	1,916	1,851	1,768	1,694	1,632	1,580	1,520	1,459	1,400
Employees at year-end	783	797	790	759	752	740	738	729	717	706

**Common share data is restated to reflect the effective two-for-one stock split on December 31, 1997*

Management's Discussion and Analysis of Results of Operations and Financial Condition

California Water Service Group (Company) is a holding company with four operating subsidiaries: California Water Service Company (Cal Water), CWS Utility Services (Utility Services), New Mexico Water Service Company (New Mexico Water) and Washington Water Service Company (Washington Water). Cal Water and Washington Water are regulated public utilities. Their assets and operating revenues currently comprise the majority of the Company's assets and revenues. New Mexico Water was formed in 2000 to provide regulated water services. Utility Services provides non-regulated water operations and related services to other private companies and municipalities. The following discussion and analysis provides information regarding the Company, its assets, operations and financial condition.

FORWARD-LOOKING STATEMENTS

This annual report, including the Letter to Stockholders and Management's Discussion and Analysis, contains forward-looking statements within the meaning established by the Private Securities Litigation Reform Act of 1995 (Act). The forward-looking statements are intended to qualify under provisions of the federal securities laws for "safe harbor" treatment established by the Act. Forward-looking statements are based on currently available information, expectations, estimates, assumptions and projections, and management's judgment about the Company, the water utility industry and general economic conditions. Such words as expects, intends, plans, believes, estimates, anticipates, projects or variations of such words or similar expressions are intended to identify forward-looking statements. The forward-looking statements are not guarantees of future performance. Actual results may vary materially from what is contained in a forward-looking statement. Factors which may cause a result different than expected or anticipated include: governmental and regulatory commissions' decisions, changes in regulatory commissions' policies or procedures, the timeliness of regulatory commissions' actions concerning rate relief, new legislation, electric power interruptions, increases in suppliers' prices and the availability of supplies including water and power, changes in environmental compliance requirements, acquisitions, the ability to successfully implement business plans, changes in customer water use patterns and the impact of weather on operating results, especially as it impacts water sales. The Company assumes no obligation to provide public updates of forward-looking statements.

BUSINESS

Cal Water is a public utility supplying water service to 436,700 customers in 75 California communities through 25 separate water systems or districts. Cal Water's 24 regulated systems, which are subject to regulation by the California Public Utilities Commission (CPUC) serve 430,600 customers. An additional 6,100 customers receive service through a long-term lease of the City of Hawthorne's water system, which is not subject to CPUC regulation.

Washington Water's utility operations are regulated by the Washington Utilities and Transportation Commission (WUTC). Washington Water provides domestic water service to 13,700 customers in the Tacoma and Olympia areas. An additional 2,300 customers are served under operating agreements with private owners.

In November 2000, New Mexico Water signed an agreement to acquire the water and wastewater assets of Rio Grande Utility Corporation. Rio Grande has annual revenue of $1.2 million and serves 2,300 water and 1,600 wastewater customers south of Albuquerque. The acquisition is contingent on approval by the state's Public Regulation Commission, which is now expected in the second quarter of 2002.

Utility Services derives non-regulated income from contracts with other private companies and municipalities to operate water systems and provide meter reading and billing services for customers. It also leases communication antenna sites, operates recycled water systems, provides meter reading and customer services, and periodically sells surplus real estate. The Company expects the meter reading service it provides in Santa Fe, New Mexico to be assumed by the City of Santa Fe during the first quarter of 2002.

Rates and operations for regulated customers are subject to the jurisdiction of the respective state's regulatory commission. The commissions require that water rates for each regulated district be independently determined. Rates for the City of Hawthorne system are established in accordance with an operating agreement and are subject to ratification by the City Council. Fees for other operating agreements are based on contracts negotiated among the parties.

CRITICAL ACCOUNTING POLICIES

The Company maintains its accounting records in accordance with generally accepted accounting principles and as directed by the Commissions. This section addresses two areas that the Company believes are most important among its accounting policies.

Revenue Recognition. Revenue from metered customers includes billings to customers based on monthly meter readings plus an estimate of water used since the customer's last meter reading and the end of the accounting period. The unbilled revenue amount is recorded as a current asset on the balance sheet under the caption "Unbilled Revenue." At December 31, 2001, the unbilled amount was $7.3 million and at December 31, 2000 the amount was $8.0 million. The amount recorded as unbilled revenue varies depending on water usage, the number of days between meter reads for each billing cycle, and the number of days between each cycle's meter reading and the end of the accounting cycle.

Flat rate customers are billed in advance at the beginning of the service period. The revenue is prorated so that the portion of revenue applicable to the current accounting period is included in that period's revenue. The portion related to a subsequent accounting period is recorded as unearned revenue on the balance sheet and recognized as revenue in the subsequent accounting period. At December 31, 2001 and 2000, the unearned revenue liability was $1.7 million and $1.5 million, respectively.

Expense Balancing Accounts. The Company does not record expense balancing accounts in revenue until the CPUC has authorized a change in customer rates and the customer has been billed. Expense balancing accounts include the amount of suppliers' rate increases charged to the Company for purchased water, purchased power and pump tax expenses that are not included in customer water rates. The cost increases are referred to as "Offsetable Expenses" because under certain circumstances they are recoverable from customers in future rate increases designed to offset the higher costs.

The Company tracks the cost increases in expense balancing accounts as allowed by the CPUC. At December 31, 2001, the amount included in these accounts was $6.5 million and relates primarily to higher electric costs incurred by the Company during 2001 that have not been billed to customers. At December 31, 2000, the amount in the expense balancing accounts was $0.6 million. For the years 1996 through 2000, the average year-end balance was $1.2 million. To the extent the Company meets the criteria set forth by the CPUC in its interim balancing account recovery procedures, the Company expects to collect the balancing account amounts in future customer billings. The CPUC's procedures are discussed in detail under the "Rates and Regulation" section of this report. The Company is uncertain if it will meet the CPUC's criteria or what portion of the balancing accounts will be recoverable in offset rate increases. Therefore, the Company's accounting policy is not to record the balancing account amounts until they are included in customer billings.

RESULTS OF OPERATIONS

Earnings and Dividends. Net Income in 2001 was $14,965,000 compared to $19,963,000 in 2000 and $21,971,000 in 1999. Diluted earnings per common share were $0.97 in 2001, $1.31 in 2000 and $1.44 in 1999. The weighted average number of common shares outstanding was 15,285,000 in 2001, 15,173,000 in 2000 and 15,142,000 in 1999. As explained below, the decline in 2001 net income resulted from three primary factors: lower water sales to existing customers due to weather conditions, significantly higher purchased power costs and delays in regulatory rate relief.

At its January 2001 meeting, the Board of Directors increased the common stock dividend for the 34th consecutive year. 2001 also marked the 57th consecutive year that a dividend had been paid on the Company's common stock. The annual dividend paid in 2001 was $1.115, a 1.4% increase over the $1.10 paid in 2000, which is an increase of 1.4% over the $1.085 paid in 1999. The dividend increases were based on projections that the higher dividend could be sustained while still providing the Company with adequate financial resources and flexibility. Earnings not paid as dividends are reinvested in the business for the benefit of stockholders. The dividend payout ratio was 115% in 2001, 84% in 2000 and 75% in 1999, an average of 91% during the three-year period.

Operating Revenue. Operating revenue, including revenue from the City of Hawthorne lease, was $246.8 million, 0.8% more than the $244.8 million recorded in 2000. Revenue in 1999 was $234.9 million. The source of changes in operating revenue were:

Dollars in millions	*2001*	*2000*	*1999*
Customer water usage	$ (5.7)	$ 4.8	$ 14.0
Rate increases	5.4	3.0	3.2
Usage by new customers	2.3	2.1	2.8
Net change	$ 2.0	$ 9.9	$ 20.0
Average revenue per customer (in dollars)	$ 552	$ 554	$ 539
Average metered customer usage (Ccf)	363	371	349
New customers added	6,100	5,200	6,700

During 2001, revenue from usage by existing customers declined $5.7 million. A cool, wet spring, mild summer and early fall rains throughout the Company's service territories resulted in a weather pattern that caused water usage by existing customers to decline by 2%. Rainfall was near normal in the northern part of California, but well above normal in the south. The unusually heavy rains in southern California reduced water sales, a trend that continued all year because of the year's weather pattern. Washington Water experienced dry conditions during the winter and spring months; however, summer rains reduced water sales in the normally high usage summer months.

Rate increases in 2001 added $5.4 million in new revenue, offsetting the decline in revenue from usage by existing customers. The Company received CPUC decisions in 2001 for General Rate Case (GRC) increases in three districts providing $1.3 million in new revenue. Step rate increases of $2.6 million that had been authorized in prior GRCs and $0.8 million in offset increases to recover higher power costs in four districts were also granted. New water rates for the City of Hawthorne water system added $0.5 million to revenue, and a GRC decision for Washington Water added $0.2 million.

During 2000, the first quarter was wetter than in the prior year, causing a reduction in customer usage. Second and third quarter weather was normal; however, rains in the early part of the fourth quarter negatively affected usage and consequently reduced revenue.

Effective in August 2000, offset rate increases to recover increases in water production expenses became effective in four Cal Water districts. The rates generated $1.6 million in additional 2000 revenue. Step rate increases that were effective at the start of the year and new water rates in the City of Hawthorne system accounted for the remainder of the new revenue from rate increases.

The December 31, 2001 customer count, including the Hawthorne customers, was 450,400, an increase of 1.4% from the 444,300 customers at the end of 2000, which was an increase of 1.1% from the 439,100 customers at the end of 1999. The growth in customers was due to normal growth within existing service areas and several small system acquisitions.

Operating and Interest Expenses. Total operating expenses were $221.7 million in 2001, $211.6 million in 2000, and $201.9 million in 1999.

Wells provided 50.6% of water requirements in 2001 and purchased water provided 48.9%, with 0.5% obtained from surface supplies. For 2000, the corresponding percentages were 50.7%, 48.7% and 0.6%, and in 1999 the percentages were 52.4%, 47.2% and 0.4%.

As a group, water production costs, which are purchased water, purchased power and pump taxes, comprise the largest segment of total operating costs. Together, water production costs accounted for 45% of total operating costs in 2001, 2000 and 1999. Rates charged for purchased water and pump taxes are set by various public agencies; the electric rates charged by power companies are authorized by the CPUC. As such, these rates are beyond the Company's control. The table below provides comparative information regarding water production costs during the past three years:

Dollars in millions	*2001*	*2000*	*1999*
Purchased water	$ 73.2	$73.8	$69.4
Purchased power	21.1	15.1	14.4
Pump taxes	5.9	6.3	6.9
Total water production costs	$100.2	$95.2	$90.7
Change from prior year	5%	5%	15%
Water production (billion gallons)	127	128	124
Change from prior year	(1)%	3%	10%

Water production expenses vary with wholesale suppliers' prices, the quantity of water produced to supply customer water usage, and the sources of supply. In 2001 and 2000, seven wholesale water suppliers increased rates from 2% to 7%. In December 2001, wholesale suppliers in the Los Angeles area refunded $1.4 million for over collecting on water purchases in prior periods. The refunds were recorded as a reduction of purchased water costs. For 2002, wholesale rate increases are expected in seven districts ranging from 1% to 11%. One supplier plans to reduce rates 9%.

Purchased power is required to operate wells and pumps. Its cost increased $6.0 million in 2001 and $0.7 million in 2000. Through much of 2001, the Company paid substantially higher energy costs that were not recovered in customer rates. The CPUC's authorizations allowing the Company to recover a portion of the higher power costs were not effective until September and November, well after the high usage summer months. The purchased power cost increase in 2000 was due mainly to a 3% increase in water production.

Prior to 2001, the Company had not been subjected to significant electric power cost increases. However, as has been widely publicized, California energy costs rose significantly in 2001. In January, the CPUC approved an energy surcharge that increased the Company's cost of purchased electric power by 10%. A second, more significant 38% increase in electric power costs became effective in May, bringing the total increase to 48%. When the CPUC proposed electric cost increases, the Company believed the higher costs were recoverable from consumers on a pass-through basis under established CPUC procedures. However, as explained in the Rates and Regulation section of this report, the CPUC revised its rules regarding recovery of the higher costs, resulting in delays in recovering the higher costs. No new power rate increases are proposed at this time.

Employee payroll and benefits charged to operations and maintenance were $47.8 million for 2001, $44.5 million for 2000 and $43.0 in 1999. The increases in payroll and related benefits are attributable to general wage increases effective at the start of each year and additional hours worked. At year-end 2001, 2000 and 1999, there were 783, 797 and 790 employees, respectively.

During 2000, a curtailment of the Dominguez pension plan was recorded resulting in a non-taxable gain of $1.2 million that was offset against operating expenses. The curtailment occurred because the Dominguez pension plan was frozen at the merger date and its participants became participants in the Company pension plan. Previous amounts expensed by Dominguez but not funded to the plan comprise the curtailment amount. This amount is included in the $44.5 million reported for payroll and benefits charged to operations and maintenance expense.

Income tax expense was $9.7 million in 2001, $11.6 million in 2000 and $13.5 million in 1999. The changes in taxes are generally due to variations in taxable income. There is no state income tax in Washington.

Interest on long-term debt increased $1.3 million over 2000. The issuance of $20 million of Series D senior notes in September 2001 and $20 million of Series C senior notes in October 2000, net of sinking fund payments on first mortgage bonds, resulted in a larger principal amount of long-term debt outstanding and thus increased interest expense. In 2000, long-term interest cost was unchanged from 1999. The added interest expense due to the Series C senior note issue was offset by lower interest due to sinking fund payments on first mortgage bonds. Capitalized interest was $0.9 million on construction projects in 2001 and $0.7 million in 2000. A larger amount is expected to be capitalized during 2002 because of the increase in the capital project expenditures. Interest coverage of long-term debt before income taxes was 2.9 times in 2001, 3.6 times in 2000 and 3.8 times in 1999. The reduction in interest coverage for 2001 resulted from lower earnings and the new senior note issues outstanding.

Short-term bank borrowings to meet operating and interim construction funding needs increased other interest expense in 2001 by $0.1 million. The amount borrowed during the year was larger because of reduced cash flow from operations and an increase in capital project expenditures, but lower short-term rates reduced interest cost on the outstanding balances. There was $22.0 million in short-term borrowings at the end of 2001 and $14.6 million at the end of 2000.

Other Income and Expenses. Other income is derived from management contracts whereby the Company operates private and municipally owned water systems, agreements for operation of two recycled water systems, contracts for meter reading and billing services to various cities, leases of communication antenna sites, surplus property sales, other non-utility sources and interest on short-term investments. Other income, net of expenses, was $5.8 million in 2001, $1.4 million in 2000 and $3.1 million in 1999. During 2001, $3.9 million in pre-tax profits were realized from surplus properties sold as part of the Real Estate Program that is described in more detail in the "Liquidity and Capital Resources" section of this report. There were no property sales in 2000 and $1.3 million in 1999.

RATES AND REGULATION

After analyzing 17 Cal Water districts that were eligible for general rate filings in 2001, and based on current earnings levels, projected expense increases, including higher electric power costs, and expected capital expenditures, applications were filed in July 2001 for 15 districts covering about 65% of Cal Water customers. The applications request an 11.5% return on equity including 75 basis points to reflect the increased risk associated with the CPUC's changes in recovery of water production expense increases. An application to increase customer rates to cover higher General Office expenses is also being processed by the CPUC. Combined the applications request $19 million in additional annual revenue. A decision from the CPUC on the General Office application is expected in the second quarter of 2002, and a decision on the district GRC applications is expected in 2002's third quarter. There can be no assurance that the increases will be granted as requested. The CPUC has lengthened the time required to process the 2001 series of GRC applications. The schedule had required approximately 10 months, but for this series, it is expected to exceed one year. The regulatory delays are detrimental to the Company because rate relief to cover increased costs are not issued on a timely basis, and revenue is effectively lost.

In October 2001, the CPUC adopted a resolution implementing its staff's interim recommendation concerning practices and policies that enable water utilities to recover increases in purchased water, purchased power and pump taxes. These expenses are referred to as "offsetable expenses." The CPUC also directed its staff to open a proceeding to evaluate offsetable expense recovery practices and policies, and recommend permanent revisions. Historically, offset rate increases have enabled water utilities to recover increases in offsetable expenses that were not anticipated when customer rates were established and are beyond the utility's control. Future Company requests to recover offsetable expenses will be processed only if a district has filed a GRC application within its three-year rate case cycle and the district is not earning more than its authorized rate of return on a forward-looking, pro-forma basis. Neither of these requirements applied to offset rate increases prior to adoption of the resolution. The Company can continue to track offsetable expenses in regulatory memorandum accounts for potential recovery subject to the CPUC's future determination of appropriate practices and policies.

During 2001, the rates charged to the Company by electric power suppliers increased almost 50%. In May 2001, immediately after the CPUC authorized substantial electric rate increases for the state's two largest power companies, the Company requested authorization to recover $5.9 million in higher power costs for 23 of its 24 regulated California districts. Late in 2001, the Company was authorized rate increases in four districts totaling $2.7 million in additional annual revenue. The Company's requests to recover power cost increases in the other districts will be processed in accordance with the interim policies adopted by the CPUC. Although the Company is hopeful that it will be authorized to recover the additional offsetable expenses, it is unable to predict the timing or amount of such recoveries.

During 2002, the Company expects to file GRCs for six of its California operating districts. Those filings will be made in July 2002 with a decision expected from the CPUC about mid-year in 2003. A GRC was filed for Washington Water in February 2002 with a decision expected in April 2002.

WATER SUPPLY

The Company's source of supply varies among its operating districts. Certain districts obtain all of their supply from wells, some districts purchase all of the supply from wholesale suppliers and other districts obtain the supply from a combination of well and purchased sources. A small portion of the supply is from surface sources and processed through three Company-owned treatment plants. On average, slightly more than half of the water produced is provided from wells and surface supply with the remainder purchased from wholesale suppliers.

California's normal weather pattern yields little precipitation between mid-spring and mid-fall. The Washington service areas receive precipitation in all seasons with the heaviest amounts during the winter. Water usage is highest during the warm and dry summers and declines in the cool winter months. Rain and snow during the winter months replenish underground water basins and fill reservoirs providing the water supply for subsequent delivery to customers. To date, snow and rainfall accumulation during the 2001-2002 water year has been above average. Precipitation in the prior five years has been near normal levels. Water storage in California's reservoirs at the end of 2001 was at historic average. The Company believes that its supply from underground aquifers and purchased sources will be adequate to meet customer demand during 2002. The Company also develops long-term water supply plans for each of its districts to help assure an adequate water source under various operating and supply conditions.

ENVIRONMENTAL MATTERS

The Company is subject to regulations of the United States Environmental Protection Agency (EPA), state health service departments and various local health departments concerning water quality matters. It is also subject to the jurisdiction of various state and local regulatory agencies relating to environmental matters, including handling and disposal of hazardous materials. The Company strives for complete compliance with all requirements set forth by the various agencies.

The Safe Drinking Water Act (SDWA) was amended in 1996 to provide a new process for the EPA to select and regulate waterborne contaminants. The EPA can now regulate only contaminants that are known or likely to occur at levels expected to pose a risk to public health when regulation would provide a meaningful opportunity to reduce a health risk. New drinking water regulations will be based primarily on risk assessment and measurement of cost/benefit considerations for minimizing overall health risk. The amended SDWA allows EPA to require monitoring of up to 30 contaminants in any five-year cycle. Also, every five years the EPA must select at least five listed contaminants and determine if they should be regulated.

The Company has an established water supply monitoring program to test for contaminants in accordance with SDWA requirements. Water pumped from underground sources is treated as necessary or required by regulations. The Company owns and operates three surface water treatment plants. The cost of existing treatment is being recovered in customer rates as authorized by the regulatory authorities. Water purchased from wholesale suppliers is treated before delivery to the Company's systems.

Enforcement of the EPA standards is the responsibility of individual states. The states can impose more stringent regulation than mandated by EPA. In addition to the EPA's requirements, various regulatory agencies could require increased monitoring and possibly require additional treatment of water supplies.

During 2001, EPA released a new, lower Maximum Contaminant Level (MCL) of 10 parts per billion for arsenic, a naturally-occurring element, that is sometimes present in groundwater. Compliance with the new standard is required by January 2006. Of the Company's almost 900 wells, 75 will require treatment to comply with the new MCL. The Company estimates the compliance cost at $125 million in capital expenditures over the next five years and $10 million in additional annual operating costs. The State of California could establish a lower arsenic MCL standard. If the state were to set the standard at five parts per billion, the estimated capital expenditures necessary for compliance would be $250 million. At this time, the Company is unable to predict if the state will adopt the EPA standard or require a lower MCL. The Company is participating in testing alternate arsenic treatment technologies in order to meet the standard in the most cost efficient manner.

It is anticipated that EPA will issue other regulations that will require further monitoring and possible treatment for specific contaminants. Depending on the action levels contained in the regulations, the cost of compliance with the new regulations could be significant in certain Company districts. The Company intends to request recovery for capital investments and additional treatment costs needed to remain in compliance with established health standards through the ratemaking process.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity. The Company's liquidity is provided by bank lines of credit and internally generated funds. The Company has a $60 million bank line of credit that expires on April 30, 2003. The Company expects the bank lines of credit will be renewed upon expiration. It replaced a previous $50 million credit line. Of the $60 million total, $10 million is designated for the parent and $50 million is available to Cal Water. The $10 million portion may be drawn on for use by the Company, including funding of its subsidiaries' operations. Cal Water's $50 million portion can be used solely for purposes of the regulated utility.

The Company has committed $7.6 million of the $10 million credit line to a contractor for construction of a customer/operation center where the Company will consolidate its South Bay Los Angeles operations, including the former Dominguez Water Company operations. At December 31, 2001, $6.3 million had been drawn to acquire land and construct the facility. The amount drawn on the credit line is an obligation of the contractor, but guaranteed by the Company. The new facility is pledged to the Company as security for the guarantee. The Company occupied the new facility in January 2002 on a month-to-month rent basis. The transac-

tion is structured so that the Company will exchange on a tax-free basis surplus real property to the contractor for the new facility. The exchange is expected to occur after mid-year 2002 at which time the contractor will repay the construction loan and the Company's commitment will be extinguished.

Washington Water has a line of credit totaling $0.1 million from a bank to meet its operating and capital equipment purchase requirements. At December 31, 2001, nothing was outstanding under the commitment. Generally, short-term borrowings under the commitment are converted annually to long-term borrowings with repayment terms tied to system and equipment acquisitions.

The water business is seasonal. Revenue is lower in the cool, wet winter months when less water is used compared to the warm, dry summer months when water use is higher and more revenue is generated. During the winter period, the need for short-term borrowings under the bank lines of credit increases. The increase in cash flow during the summer allows short-term borrowings to be paid down. Short-term borrowings that remain outstanding more than one year have generally been converted to long-term debt. In years when more than normal precipitation falls in the Company's service areas or temperatures are lower than normal, especially in the summer months, customer water usage can be lower than normal. The reduction in water usage reduces cash flow from operations and increases the need for short-term bank borrowings. Regulatory lag, the delay in receiving authorization to increase customer rates to cover capital expenditures and higher operating costs, can also result in the need for increased short-term bank borrowings. The Company believes that long-term financing is available to it through debt and equity markets.

Standard & Poor's and Moody's have maintained their ratings of Cal Water's first mortgage bonds at AA- and Aa3, respectively. These are the highest ratings for senior debt in the water industry. The Company's bank line of credit agreement contains a provision that if the Company's Standard & Poor's or Moody's senior debt ratings fall below investment grade, the credit line may be terminated by the banks. The senior note covenants include cross default provisions that would be triggered if the bank line of credit provisions are not met. The Company believes the credit rating agencies will maintain investment grade ratings for the Company's first mortgage bonds.

Long-term financing, which includes common stock, first mortgage bonds, senior notes and other debt securities, has been used to replace short-term borrowings and fund construction. Developer contributions in aid of construction which are not refundable and refundable advances for construction are sources of funds for various contractor funded construction projects. Internally generated funds come from retention of earnings not paid out as dividends, depreciation and deferred income taxes. Additional information regarding the bank borrowings and long-term debt is presented in Notes 7 and 8 to the financial statements.

In both 2001 and 2000, long-term financing was provided by issuance of $20 million, 30-year senior notes for a total of $40 million. The Series D, 7.13% senior notes were issued in September 2001, and in October 2000, the Series C, 8.15% notes were issued. The senior notes do not require sinking fund payments.

Cash flow during 2001 was lower than expected because of reduced water usage by existing customers, regulatory lag in receiving rate relief and increased operating costs, especially for purchased power. As a result, funds required to pay 2001 dividends exceeded net income by $2.1 million, resulting in a reduction of stockholders' equity. The reduced cash flow also required the Company to borrow additional funds under the bank line of credit agreement. In 2000 and 1999, $3.6 million and $6.6 million of net income had been reinvested in the business after payment of dividends.

The Company has a Dividend Reinvestment and Stock Purchase Plan (Plan). Under the Plan, stockholders may reinvest dividends to purchase additional Company common stock. The Plan also allows existing stockholders and other interested investors to purchase Company common stock through the transfer agent. The Plan provides that shares required for the Plan may be purchased on the open market or be newly issued shares. Therefore, the Plan presents the Company with an alternative means of developing additional equity if new shares were issued. During 2001 and 2000, shares were purchased on the open market. At this time, the Company intends to continue purchasing shares required for the Plan on the open market. However, if new shares were issued to satisfy future Plan requirements, the impact on earnings per share could be dilutive because of the additional shares outstanding. Also, stockholders may experience dilution of their ownership percentage.

Contractual Obligations. The Company's contractual obligations as of December 31, 2001 are summarized in the table below. Long-term debt payments include annual sinking fund payments on first mortgage bonds, maturities of first mortgage bonds and annual payments on other long-term obligations. Advances for construction represent annual contract refunds to developers for the cost of water systems paid for by the developers. The contracts are non-interest bearing with refunds generally on a straight-line basis over a 40-year period. Operating leases are generally rents for office space. The total amount presented for operating leases is for a 20-year period.

Contractual Obligations (In thousands)	*Total*	*Less Than 1 Year*	*2-3 Years*	*4-5 Years*	*After 5 Years*
Long-term debt	$207,981	$5,381	$7,783	$ 5,184	$189,633
Advances for construction	106,657	4,475	9,630	10,621	81,931
Operating leases	21,000	750	1,610	1,778	16,862

The Company has water supply contracts with wholesale suppliers in 16 of its operating districts. For each contract, the cost of water is established by the wholesale supplier and is generally beyond the Company's control. In the past two years, wholesaler price increases have averaged 2.5%. The amount paid annually to the wholesale suppliers is charged to purchased water expense on the Company's statement of income. Three contracts noted below require minimum payments. The other contracts do not require minimum annual payments. The amount paid under the contracts, except for the contract with Stockton East Water District (SEWD), varies with the volume of water purchased from the wholesalers. The contract with SEWD requires an annual payment of $3,198,000. The amount paid under this contract is fixed annually and does not vary with the quantity of water delivered by the district. Because of the fixed price arrangement, the Company operates to receive as much water as possible from SEWD in order to minimize the cost of operating wells to supplement SEWD deliveries. Two contracts require the Company to purchase minimum quantities of water at the contractors' current wholesale rate for purchased water. Under both contracts, the Company operates so that purchases exceed the contractual minimum amount. The Company plans to continue to purchase at least the minimum water requirement under both contracts in the future.

Capital Requirements. Capital requirements consist primarily of new construction expenditures for expanding and replacing the Company's utility plant facilities and the acquisition of new water properties. They also include refunds of advances for construction and retirement of first mortgage bonds.

Utility plant expenditures in 2001 totaled $62.0 million compared to $37.2 million in 2000 and $48.6 million in 1999. The 2001 construction program included $53.4 million of Company-funded projects and $8.6 million of projects funded by funds received from developers for non-refundable contributions in aid of construction and refundable advances for construction. The Company's 2001 projects were funded by internally generated funds, borrowings under bank credit lines, and issuance of the $20 million Series D senior notes. The 2000 expenditures included $33.5 million provided by Company funds and $3.6 million received from developers. The Company's 2000 projects were funded by internally generated funds, short-term bank borrowings, and issuance of the $20 million Series C senior notes.

The 2002 Company-funded construction budget was authorized at $76.8 million. It includes $32.0 million for the fourth year of a five-year program to construct a water treatment plant to accommodate growth and meet water quality standards in the Bakersfield district. Over the five-year period, the plant and related pumping and pipeline facilities are estimated to cost $49.0 million. Also in the 2002 budget is $12.0 million for new and replacement water mains and $5.0 million for new wells and storage facilities. The budget will be funded by funds from operations, bank borrowings and long-term debt and equity financing. New subdivision construction will be financed by developers' contributions and advances for construction.

Company-funded construction budgets over the next five years are projected to be about $350 million. Included in the estimated amount is $125 million for compliance with arsenic water quality regulations, completion of the Bakersfield treatment plant and expansion and replacement of water plant infrastructure. An application was filed in January 2002 requesting authorization from the CPUC for $250 million of debt and equity financing through 2005.

Capital Structure. Common stockholders' equity was reduced in 2001 by the $2.1 million that dividends paid exceeded net income. In 2000 and 1999, common stockholders' equity increased by annual retained earnings of $3.6 million and $6.6 million. New equity was issued in 2001 to acquire a water system. The long-term debt portion of the capital structure increased in 2001 and 2000 due to the issuance of Series C and Series D, $20 million senior notes. It was reduced by first mortgage bond sinking fund payments.

The Company's total capitalization at December 31, 2001, was $402.7 million and at the end of 2000 was $389.4 million. Capital ratios were:

	2001	*2000*
Common equity	48.8%	51.1%
Preferred stock	0.9%	0.9%
Long-term debt	50.3%	48.0%

The return on average common equity was 7.6% in 2001 compared to 10.1% in 2000. The decline in 2001 was caused by the lower net income.

Other Acquisitions. On January 25, 2001, the CPUC approved the Company's acquisition of the Nish water systems in Visalia. The four systems serve 1,100 customers and had annual revenue of $1.2 million. The Company issued 36,180 shares of its common stock valued at $0.9 million and assumed debt of $0.3 million to complete the transaction, which was accounted for as a pooling of interests. The effect of pooling was deemed not to be material; therefore, prior year financial statements have not been restated and pro-forma disclosures were not considered significant. The net equity of Nish was recorded as an adjustment to retained earnings as of January 1, 2001.

In 2001, Washington Water purchased the assets of seven water companies that serve 681 customers and generate about $0.3 million in annual revenue. The combined purchase price was $0.7 million.

In 2000, Washington Water purchased the assets of two water companies that together serve almost 800 customers and produce annual revenue of about $0.3 million. Washington Water also purchased the assets of Robischon Engineers, Inc. in April 2000. This acquisition added in-house engineering capabilities to the Washington operation, enabling Washington Water to provide water system design services to other water providers.

The Company agreed to acquire the Rio Grande Utility Corporation that serves 2,300 water and 1,600 wastewater customers near Albuquerque in November 2000. The acquisition, which will be made for $2.3 million in cash and assumed debt of $3.1 million, is pending approval of the New Mexico Public Regulation Commission. Approval is expected in the second quarter 2002.

Real Estate Program. The Company's subsidiaries own more than 900 real estate parcels. Certain parcels are not necessary for or used in water utility operations. Most surplus properties have a low cost basis. A program has been developed to realize the value of certain surplus properties through sale or lease of those properties. The program will be ongoing for a period of several years. During the next four years, the Company estimates that gross property transactions totaling over $10 million could be completed. In 2001, $3.9 million in pretax sales were completed. No transactions were completed during 2000. During 2002, the Company expects to complete sales in excess of $3 million.

Stockholder Rights Plan. As explained in Note 6 to the Consolidated Financial Statements, in January 1998, the Board of Directors adopted a Stockholder Rights Plan (Plan). In connection with the Plan, a dividend distribution of one right for each common share to purchase preferred stock under certain circumstances was also authorized. The Plan is designed to protect stockholders and maximize stockholder value in the event of an unsolicited takeover proposal by encouraging a prospective acquirer to negotiate with the Board.

FINANCIAL RISK MANAGEMENT

The Company does not participate in hedge arrangements, such as forward contracts, swap agreements, options or other contractual agreements relative to the impact of market fluctuations on its assets, liabilities, production or contractual commitments. The Company operates only in the United States, and therefore, is not subject to foreign currency exchange rate risks.

Interest Rate Risk. The Company does have exposure to market risk that includes changes in interest rates. Interest rate risk exists because the Company's financing includes the use of long-term debt obligations with maturity dates up to 30 years from the date of issue and during the outstanding period interest rates are subject to fluctuation. The Company's long-term obligations are first mortgage bonds and senior note obligations that are generally placed with insurance companies. Washington Water's long-term obligations are for periods of up to 10 years and are placed with two banks. During 2001, the Company issued a single series of $20 million, 30-year senior notes at 7.13%. To expand access to capital debt markets, the Company may investigate the use of private and public markets for future debt issues. It may also consider financing on a parent company basis, rather than on a subsidiary-by-subsidiary basis.

The Company's short-term financing is provided by bank lines of credit that are discussed under the "Liquidity and Capital Resources" section of this report. Short-term borrowings that are not repaid from operating cash or funded by retained earnings are generally converted to long-term debt issues. The Company plans to continue the financing of its construction program in this manner. Financing of acquisitions has been done using Company common stock or through the debt financing vehicles available to the subsidiary companies.

Value Risk. Because the Company operates primarily in a regulated industry, its value risk is somewhat lessened; however, regulated parameters also can be recognized as limitations to operations and earnings, and the ability to respond to certain business condition changes. Also, changes in regulatory practices can impact the Company's operations as was experienced during 2001 when the CPUC adopted a new policy for recovery of offsetable expenses. Non-regulated operations are subject to risk of contract constraints and performance by the Company in achieving its objectives. Value risk management is accomplished using various financial models that consider changing business parameters. It is also supplemented by considering various risk control processes that may be available as circumstances warrant.

Equity Risk. The Company does not have equity investments; therefore, it does not have equity risks.

NEW ACCOUNTING STANDARDS

In July 2001, the Financial Accounting Standards Board issued Statement No. 141, "Business Combinations," and Statement No. 142, "Goodwill and Other Intangible Assets." Statement No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 as well as for all purchase method business combinations completed after June 30, 2001. Statement No. 141 also specifies conditions that intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill. Statement No. 142 specifies that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually in accordance with the provisions of Statement No. 142. The statement also requires that intangible assets with determinable useful lives be amortized over their useful lives to their estimated residual values and reviewed for impairment. Statement No. 142 is effective for the Company on January 1, 2002. Its adoption is not expected to have a material impact on the Company's financial position or results of operations.

In June 2001, Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" of long-lived assets was issued. The statement is effective for fiscal years beginning after June 15, 2002. The Company has not yet completed a full review of the impact that adopting the statement will have on its financial position or results of operations, and therefore is unable to state the impact that adopting the statement will have on its financial position or results of operations.

In August 2001, Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," was issued. The statement sets forth requirements for measuring impairment of a long-lived asset that is defined as the condition that exists when the carrying amount of a long-lived asset exceeds its fair value. The statement also establishes criteria in which an impairment loss must be recognized. The Company has not yet completed a full assessment of the impact of adopting this statement, and therefore is uncertain as to the impact that adopting the statement will have on its financial position or results of operations. The statement is effective for the Company on January 1, 2002.

Consolidated Balance Sheet

In thousands, except per share data

December 31, 2001 and 2000	*2001*	*2000*
ASSETS		
Utility plant:		
Land	$ 10,709	$ 10,641
Depreciable plant and equipment	859,846	797,403
Construction work in progress	26,826	31,400
Intangible assets	12,277	11,837
Total utility plant	909,658	851,281
Less accumulated depreciation and amortization	285,316	268,499
Net utility plant	624,342	582,782
Current assets:		
Cash and cash equivalents	953	3,241
Receivables:		
Customers	14,572	15,163
Other	8,228	5,450
Unbilled revenue	7,291	7,964
Materials and supplies at average cost	2,147	2,718
Taxes and other prepaid expenses	7,224	5,483
Total current assets	40,415	40,019
Other assets:		
Regulatory assets	38,893	38,133
Unamortized debt premium and expense	3,800	3,817
Other	2,764	1,854
Total other assets	45,457	43,804
	$710,214	$666,605

	2001	*2000*
CAPITALIZATION AND LIABILITIES		
Capitalization:		
Common stock, $.01 par value; 25,000 shares authorized, 15,182 and 15,146 shares outstanding in 2001 and 2000, respectively	$ 152	$ 151
Additional paid-in capital	49,984	49,984
Retained earnings	147,299	149,185
Accumulated other comprehensive loss	(816)	(486)
Total common stockholders' equity	196,619	198,834
Preferred stock without mandatory redemption provision, $25 par value, 380 shares authorized, 139 shares outstanding	3,475	3,475
Long-term debt, less current maturities	202,600	187,098
Total capitalization	402,694	389,407
Current liabilities:		
Current maturities of long-term debt	5,381	2,881
Short-term borrowings	22,000	14,598
Accounts payable	24,032	26,493
Accrued taxes	3,813	3,976
Accrued interest	2,535	2,579
Other accrued liabilities	21,228	13,209
Total current liabilities	78,989	63,736
Unamortized investment tax credits	2,882	2,989
Deferred income taxes	28,816	25,620
Regulatory and other liabilities	20,680	20,316
Advances for construction	106,657	105,562
Contributions in aid of construction	69,496	58,975
Commitments		
	$710,214	$666,605

See accompanying notes to consolidated financial statements.

Consolidated Statement of Income

In thousands, except per share data

For the years ended December 31, 2001, 2000 and 1999	*2001*	*2000*	*1999*
Operating revenue	$246,820	$244,806	$234,937
Operating expenses:			
Operations:			
Purchased water	73,174	73,768	69,351
Purchased power	21,130	15,136	14,355
Pump taxes	5,910	6,275	6,856
Administrative and general	36,521	32,974	32,266
Other	34,109	32,308	28,963
Maintenance	12,131	11,592	10,200
Depreciation and amortization	19,226	18,368	17,246
Income taxes	9,728	11,571	13,515
Property and other taxes	9,740	9,618	9,138
Total operating expenses	221,669	211,610	201,890
Net operating income	25,151	33,196	33,047
Other income and expenses, net	5,843	1,413	3,089
Income before interest expense	30,994	34,609	36,136
Interest expense:			
Long-term debt interest	14,187	12,901	13,084
Other interest	1,842	1,745	1,081
Total interest expense	16,029	14,646	14,165
Net income	$ 14,965	$ 19,963	$ 21,971
Earnings per share:			
Basic	$ 0.98	$ 1.31	$ 1.45
Diluted	$ 0.97	$ 1.31	$ 1.44
Weighted average number of common shares outstanding:			
Basic	15,182	15,126	15,090
Diluted	15,285	15,173	15,142

See accompanying notes to consolidated financial statements.

Consolidated Statement of Common Stockholders' Equity and Comprehensive Income

In thousands

For the years ended December 31, 2001, 2000 and 1999	*Common Stock*	*Additional Paid-in Capital*	*Retained Earnings*	*Accumulated Other Comprehensive Income (Loss)*	*Total Stockholders' Equity*	*Total Comprehensive Income*
Balance at December 31, 1998	$150	$48,372	$139,054	$ —	$187,576	$ —
Issuance of common stock	1	968	—	—	969	—
Net income	—	—	21,971	—	21,971	21,971
Dividends paid:						
Preferred stock	—	—	153	—	153	—
Common stock	—	—	15,262	—	15,262	—
Total dividends paid	—	—	15,415	—	15,415	—
Other comprehensive loss	—	—	—	(517)	(517)	(517)
Balance at December 31, 1999	151	49,340	145,610	(517)	194,584	21,454
Issuance of common stock	—	644	—	—	644	—
Net income	—	—	19,963	—	19,963	19,963
Dividends paid:						
Preferred stock	—	—	152	—	152	—
Common stock	—	—	16,236	—	16,236	—
Total dividends paid	—	—	16,388	—	16,388	—
Other comprehensive income	—	—	—	31	31	31
Balance at December 31, 2000	151	49,984	149,185	(486)	198,834	19,994
Acquisition	1	—	220	—	221	—
Net income	—	—	14,965	—	14,965	14,965
Dividends paid:						
Preferred stock	—	—	153	—	153	—
Common stock	—	—	16,918	—	16,918	—
Total dividends paid	—	—	17,071	—	17,071	—
Other comprehensive loss	—	—	—	(330)	(330)	(330)
Balance at December 31, 2001	$152	$49,984	$147,299	$(816)	$196,619	$14,635

See accompanying notes to consolidated financial statements.

Consolidated Statement of Cash Flows

In thousands

For the years ended December 31, 2001, 2000, 1999	*2001*	*2000*	*1999*
Operating activities:			
Net income	$14,965	$19,963	$21,971
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	19,226	18,368	17,246
Deferred income taxes, investment tax credits, and regulatory assets and liabilities, net	2,919	(3,203)	1,360
Changes in operating assets and liabilities			
Receivables	(2,186)	(1,503)	(2,324)
Unbilled revenue	673	235	(1,187)
Accounts payable	(2,461)	(255)	7,623
Other current assets and liabilities	6,642	1,093	(649)
Other changes, net	(1,191)	(71)	3,334
Net adjustments	23,622	14,664	25,403
Net cash provided by operating activities	38,587	34,627	47,374
Investing activities:			
Utility plant expenditures			
Company funded	(53,379)	(33,540)	(35,535)
Developer advances and contributions in aid of construction	(8,670)	(3,621)	(12,984)
Other investments	—	—	(80)
Net cash used in investing activities	(62,049)	(37,161)	(48,599)
Financing activities:			
Net short-term borrowings	7,402	599	(8,951)
Issuance of common stock	—	644	46
Issuance of long-term debt	20,524	20,326	20,062
Advances for construction	6,498	3,846	7,480
Refunds of advances for construction	(4,166)	(3,870)	(4,056)
Contributions in aid of construction	10,868	1,883	4,814
Retirement of long-term debt	(2,881)	(2,920)	(2,318)
Dividends paid	(17,071)	(16,388)	(15,415)
Net cash provided by financing activities	21,174	4,120	1,662
Change in cash and cash equivalents	(2,288)	1,586	437
Cash and cash equivalents at beginning of year	3,241	1,655	1,218
Cash and cash equivalents at end of year	$ 953	$ 3,241	$ 1,655
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest (net of amounts capitalized)	$14,378	$14,785	$13,796
Income taxes	6,238	11,775	11,499
Non-cash financing activity - common stock issued in acquisitions	899	—	922

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

December 31, 2001, 2000, and 1999

NOTE 1. ORGANIZATION AND OPERATIONS

California Water Service Group (Company) is a holding company incorporated in Delaware that through its wholly owned subsidiaries provides water utility and other related services in California, Washington and New Mexico. California Water Service Company (Cal Water) and Washington Water Service Company (Washington Water) provide regulated utility services under the rules and regulations of their respective regulatory commissions (jointly referred to as Commissions). CWS Utility Services provides non-regulated water utility and utility-related services in all three states. New Mexico Water Service Company was formed in 2000 to provide regulated utility services.

The Company operates primarily in one business segment, providing water and related utility services.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. The financial statements give retroactive effect to acquisitions, accounted for as pooling of interests. Accordingly, the Company's consolidated financial statements and footnotes have been restated to include Dominguez Services Corporation and subsidiaries (Dominguez), which was merged into the Company on May 25, 2000, as if the merger had been completed as of the beginning of the earliest period presented. Intercompany transactions and balances have been eliminated.

The accounting records of the Company are maintained in accordance with the uniform system of accounts prescribed by the Commissions. Certain prior years' amounts have been reclassified, where necessary, to conform to the current presentation.

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

Revenue Revenue consists of monthly cycle customer billings for regulated water service at rates authorized by the Commissions and billings to certain non-regulated customers. Revenue from metered accounts includes unbilled amounts based on the estimated usage from the latest meter reading to the end of the accounting period. Flat-rate accounts, which are billed at the beginning of the service period, are included in revenue on a pro rata basis for the portion applicable to the current accounting period. The unearned portion is deferred into the following accounting period.

Expense balancing accounts are used to track suppliers' rate increases for purchased water, purchased power and pump taxes that are not included in customer water rates. The cost increases are referred to as "Offsetable Expenses" because under certain circumstances they are recoverable from customers in future rate increases designed to offset the higher costs. The Company does not record the balancing accounts until the CPUC has authorized a change in customer rates and the customer has been billed.

Utility Plant Utility plant is carried at original cost when first constructed or purchased, except for certain minor units of property recorded at estimated fair values at dates of acquisition. Cost of depreciable plant retired is eliminated from utility plant accounts and such costs are charged against accumulated depreciation. Maintenance of utility plant is charged primarily to operation expenses. Interest is capitalized on plant expenditures during the construction period and amounted to $858,000 in 2001, $703,000 in 2000 and $324,000 in 1999.

Intangible assets acquired as part of water systems purchased are stated at amounts as prescribed by the Commissions. All other intangibles have been recorded at cost. Included in intangible assets is $6,500,000 paid to the City of Hawthorne to lease the city's water system and associated water rights. The lease payment is being amortized on a straight-line basis over the 15-year life of the lease. The Company continually evaluates the recoverability of utility plant by assessing whether the amortization of the balance over the remaining life can be recovered through the expected and undiscounted future cash flows.

Depreciation Depreciation of utility plant for financial statement purposes is computed on the straight-line remaining life method at rates based on the estimated useful lives of the assets, ranging from 5 to 65 years. The provision for depreciation expressed as a percentage of the aggregate depreciable asset balances was 2.4% in 2001 and 2000, and 2.5% in 1999. For income tax purposes, as applicable, the Company computes depreciation using the accelerated methods allowed by the respective taxing authorities. Plant additions since June 1996 are depreciated on a straight-line basis for tax purposes in accordance with tax regulations.

Cash Equivalents Cash equivalents include highly liquid investments, primarily U.S. Treasury and U.S. Government agency interest-bearing securities, stated at cost with original maturities of three months or less.

Restricted Cash Restricted cash represents proceeds collected through a surcharge on certain customers' bills plus interest earned on the proceeds. The restricted cash is to service California Safe Drinking Water Bond obligations and is classified in other prepaid expenses. At December 31, 2001 and 2000, the amounts restricted were $887,000 and $755,000, respectively.

Regulatory Assets The Company records regulatory assets for future revenues expected to be realized as the tax effects of certain temporary differences previously passed through to customers reverse. The temporary differences relate primarily to the difference between book and income tax depreciation on utility plant that was placed in service before the regulatory Commissions adopted normalization for ratemaking purposes. The regulatory assets are net of revenue related to deferred income taxes that were provided at prior tax rates and the amount that would be provided at current tax rates. The differences will reverse over the remaining book lives of the related assets.

Long-term Debt Premium, Discount and Expense The discount and issuance expense on long-term debt is amortized over the original lives of the related debt issues. Premiums paid on the early redemption of certain debt issues and unamortized original issue discount and expense of such issues are amortized over the life of new debt issued in conjunction with the early redemption.

Accumulated Other Comprehensive Loss The Company has an unfunded Supplemental Executive Retirement Plan. The unfunded accumulated benefit obligation of the plan exceeds the accrued benefit cost. This amount exceeds the unrecognized prior service cost; therefore accumulated other comprehensive loss has been recorded (net of income tax) as a separate component of Stockholders' Equity.

Advances for Construction Advances for construction consist of payments received from developers for installation of water production and distribution facilities to serve new developments. Advances are excluded from rate base for rate setting purposes. Annual refunds are made to developers without interest over a 20-year or 40-year period. Refund amounts under the 20-year contracts are based on annual revenues from the extensions. Unrefunded balances at the end of the contract period are credited to Contributions in Aid of Construction and are no longer refundable. Refunds on contracts entered into since 1982 are made in equal annual amounts over 40 years. At December 31, 2001, the amounts refundable under the 20-year contracts were $4,320,000 and under 40-year contracts were $102,337,000. Estimated refunds for 2002 for all water main extension contracts are $4,475,000.

Contributions in Aid of Construction Contributions in aid of construction represent payments received from developers, primarily for fire protection purposes, which are not subject to refunds. Facilities funded by contributions are included in utility plant, but excluded from rate base. Depreciation related to contributions is charged to contributions in aid of construction.

Income Taxes The Company accounts for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Measurement of the deferred tax assets and liabilities is at enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

It is anticipated that future rate action by the Commissions will reflect revenue requirements for the tax effects of temporary differences recognized, which have previously been flowed through to customers. The Commissions have granted the Company customer rate increases to reflect the normalization of the tax benefits of the federal accelerated methods and available Investment Tax Credits (ITC) for all assets placed in service after 1980. ITC are deferred and amortized over the lives of the related properties for book purposes.

Advances for construction and contributions in aid of construction received from developers subsequent to 1986 were taxable for federal income tax purposes and subsequent to 1991 were subject to California income tax. In 1996 the federal tax law, and in 1997 the California tax law, changed and only deposits for new services were taxable. In late 2000, federal regulations were further modified to exclude fire services from tax.

Earnings Per Share Basic earnings per share (EPS) is calculated by dividing income available to common stockholders by the weighted average shares outstanding during the year. Diluted EPS is calculated by dividing income available to common stockholders by the weighted average shares outstanding and potentially dilutive shares.

Stock-based Compensation The Company adopted Statement on Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation." The Company elected to adopt the provision of the statement that allows the continuing practice of not recognizing compensation expense related to the granting of employee stock options to the extent that the option price of the underlying stock was equal to or greater than the market price on the date of the option grant.

Business Combinations In July 2001, the Financial Accounting Standards Board issued Statement No. 141, "Business Combinations." Statement No. 141 requires that the purchase method of accounting be used for all business combinations after June 30, 2001. Statement No. 141 also specifies conditions that intangible assets acquired in a purchase method of business combinations must meet to be recognized and reported apart from goodwill. The Company adopted Statement No. 141 immediately. The Company is not involved in a business combination initiated prior to July 1, 2001 that would be accounted for using the pooling-of-interest method.

NOTE 3. MERGER WITH DOMINGUEZ SERVICES CORPORATION

The Merger between the Company and Dominguez was completed on May 25, 2000. On the merger date, each outstanding Dominguez common share was exchanged for 1.38 shares of Company common stock. The Company issued 2,210,254 new common shares in exchange for the 1,601,679 outstanding Dominguez shares. Dominguez provided water service to about 40,000 customers in 21 California communities. The former Dominguez operations became districts within Cal Water.

The Merger was accounted for as a pooling of interests. There were no intercompany transactions as a result of the Merger. Certain reclassifications were made to the historic financial statements of the companies to conform presentation.

For the periods indicated below, the Company and Dominguez reported the following items:

Unaudited – In thousands	*6 Months Ended 6-30-00*	*Year Ended 12-31-99*
Revenue:		
Company	$ 98,428	$206,440
Dominguez	14,232	28,497
	$112,660	$234,937
Net income:		
Company	$ 6,139	$ 19,919
Dominguez	1,147	2,052
	$ 7,286	$ 21,971

No adjustments were made to the Dominguez net assets in applying the accounting practices of the Company. Dominguez previously reported common stock of $1,542,000 that was reclassified by the Company to "Paid-in-Capital" in accordance with the Company's financial statement presentation. The Company and Dominguez each had December 31 year-ends; therefore no adjustment was required to retained earnings due to a change in fiscal year-ends.

NOTE 4. OTHER ACQUISITIONS

In 2001, the Company acquired four companies operating in the Company's Visalia district. The companies serve 1,100 customers. The acquisitions were completed in February 2001, in exchange for 36,180 shares of Company common stock worth $899,000 and assumed debt of $218,000. The acquisitions were accounted for under the pooling of interests method; however, due to the results from operations not being material to the Company's consolidated results from operations, prior periods were not restated. The net equity acquired was recorded as an increase to retained earnings at the beginning of the year. In addition, the Company purchased the assets of seven Washington water systems for cash of $701,000. The acquired companies serve approximately 700 customers and produce annual revenue of about $270,000. The acquisitions were accounted for under purchase accounting.

During 2000, the Company purchased the assets of Mirrormount Water Services and Lacamas Farmsteads Water Company for $639,000 in cash and assumed debt. Together the companies serve almost 800 customers and produce annual revenue of about $250,000. To provide in-house engineering, Washington Water also purchased the assets of Robischon Engineers, Inc. in April 2000 for $70,000 in cash. The acquisitions were accounted for under purchase accounting.

During 1999, the Company acquired all of the outstanding stock of Harbor Water Company and South Sound Utility Company, which form the operations of Washington Water, serving 14,900 regulated and non-regulated customers. The acquisitions were accounted for under the pooling of interests method in exchange for 316,472 shares of Company stock and assumption of long-term debt of $2,959,000. The results of operations previously reported by the separate entities are included in the accompanying consolidated financial statements. Two other water company asset acquisitions were completed in 1999. The acquired companies served 288 customers. The acquisitions were accounted for under purchase accounting.

During 1998, the Company agreed to purchase the assets of Lucerne Water Company, Rancho del Paradiso Water Company and Armstrong Valley Water Company. These investor-owned systems serve 1,624 accounts. The acquisitions were completed effective January 1, 1999, in exchange for the equivalent of 75,164 shares of Company common stock. The acquisitions were accounted for under purchase accounting. The purchases were completed on a non-cash basis in which the Company issued common stock valued at $922,000 and assumed debt obligations of $1,108,000.

New Mexico Water has agreed to acquire the Rio Grande Utility Corporation, which serves 2,300 water and 1,600 wastewater customers, for $2.3 million in cash and assumed debt of $3.1 million. The acquisition is expected to be completed in the second quarter of 2002 after approval of the state's regulatory authority is received.

NOTE 5. PREFERRED STOCK

As of December 31, 2001 and 2000, 380,000 shares of preferred stock were authorized. Dividends on outstanding shares are payable quarterly at a fixed rate before any dividends can be paid on common stock. Preferred shares are entitled to sixteen votes, each with the right to cumulative votes at any election of directors.

The outstanding 139,000 shares of $25 par value cumulative, 4.4% Series C preferred shares are not convertible to common stock. A premium of $243,250 would be due upon voluntary liquidation of Series C. There is no premium in the event of an involuntary liquidation.

NOTE 6. COMMON STOCKHOLDERS' EQUITY

The Company is authorized to issue 25,000,000 shares of $.01 par value common stock. As of December 31, 2001 and 2000, 15,182,046 and 15,145,866 shares of common stock were issued and outstanding, respectively. All shares of common stock are eligible to participate in the Company's dividend reinvestment plan. Approximately 10% of the outstanding shares participate in the plan.

Stockholder Rights Plan The Company's Stockholder Rights Plan (Plan) is designed to provide stockholders protection and to maximize stockholder value by encouraging a prospective acquirer to negotiate with the Board. The Plan was adopted in 1998 and authorized a dividend distribution of one right (Right) to purchase 1/100th share of Series D Preferred Stock for each outstanding share of Common Stock in certain circumstances. The Rights are for a ten-year period that expires in February 2008.

Each Right represents a right to purchase 1/100th share of Series D Preferred Stock at the price of $120, subject to adjustment (the Purchase Price). Each share of Series D Preferred Stock is entitled to receive a dividend equal to 100 times any dividend paid on common stock and 100 votes per share in any stockholder election. The Rights become exercisable upon occurrence of a Distribution Date. A Distribution Date event occurs if (a) any person accumulates 15% of the then outstanding Common Stock, (b) any person presents a tender offer which causes the person's ownership level to exceed 15% and the Board determines the tender offer not to be fair to the Company's stockholders, or (c) the Board determines that a stockholder maintaining a 10% interest in the Common Stock could have an adverse impact on the Company or could attempt to pressure the Company to repurchase the holder's shares at a premium.

Until the occurrence of a Distribution Date, each Right trades with the Common Stock and is not separately transferable. When a Distribution Date occurs: (a) the Company would distribute separate Rights Certificates to Common Stockholders and the Rights would subsequently trade separate from the Common Stock; and (b) each holder of a Right, other than the acquiring person (whose Rights would thereafter be void), would have the right to receive upon exercise at its then current Purchase Price that number of shares of Common Stock having a market value of two times the Purchase Price of the Right. If the Company merges into the acquiring person or enters into any transaction that unfairly favors the acquiring person or disfavors the Company's other stockholders, the Right becomes a right to purchase Common Stock of the acquiring person having a market value of two times the Purchase Price.

The Board may determine that in certain circumstances a proposal that would cause a Distribution Date is in the Company stockholders' best interest. Therefore, the Board may, at its option, redeem the Rights at a redemption price of $.001 per Right.

NOTE 7. SHORT-TERM BORROWINGS

As of December 31, 2001, the Company maintained a bank line of credit providing unsecured borrowings of up to $10,000,000 at the prime lending rate or lower rates as quoted by the bank. Approximately $7,562,000 of the line is committed to a contractor for construction of an office complex for combined Los Angeles South Bay operations. When completed, the office complex will be exchanged with the contractor for surplus Company-owned land on a tax-free basis. Cal Water maintained a bank line of credit for an additional $50,000,000 on the same terms as the Company. The line of credit agreements, which expire in April 2003 and which the Company expects to renew, do not require minimum or specific compensating balances. Washington Water has a $0.1 million bank line of credit with nothing outstanding at December 31, 2001.

The following table represents borrowings under the bank lines of credit:

Dollars in thousands	*2001*	*2000*	*1999*
Maximum short-term borrowings	$36,800	$26,750	$25,500
Average amount outstanding	24,453	16,810	9,093
Weighted average interest rate	5.29%	7.77%	6.52%
Interest rate at December 31	3.16%	7.88%	7.11%

NOTE 8. LONG-TERM DEBT

As of December 31, 2001 and 2000, long-term debt outstanding was:

In thousands	*Series*	*Interest Rate*	*Maturity Date*	*2001*	*2000*
First Mortgage Bonds:	J	8.86%	2023	$ 4,000	$ 4,000
	K	6.94%	2012	5,000	5,000
	P	7.875%	2002	2,565	2,580
	S	8.50%	2003	2,580	2,595
	BB	9.48%	2008	11,520	13,230
	CC	9.86%	2020	18,500	18,600
	DD	8.63%	2022	19,100	19,200
	EE	7.90%	2023	19,200	19,300
	FF	6.95%	2023	19,200	19,300
	GG	6.98%	2023	19,200	19,300
				120,865	123,105
Senior Notes:	A	7.28%	2025	20,000	20,000
	B	6.77%	2028	20,000	20,000
	C	8.15%	2030	20,000	20,000
	D	7.13%	2031	20,000	—
California Department of Water Resources loans		3.0% to 8.1%	2011-32	2,886	3,176
Other long-term debt				4,230	3,698
Total long-term debt				207,981	189,979
Less current maturities				5,381	2,881
Long-term debt excluding current maturities				$202,600	$187,098

The first mortgage bonds are obligations of Cal Water. All bonds are held by institutional investors and secured by substantially all of Cal Water's utility plant. The unsecured senior notes are also obligations of Cal Water. They are held by institutional investors and require interest-only payments until maturity. The Department of Water Resources (DWR) loans were financed under the California Safe Drinking Water Bond Act. Repayment of principal and interest on the DWR loans is through a surcharge on customer bills. Other long-term debt is primarily equipment and system acquisition financing arrangements with financial institutions. Aggregate maturities and sinking fund requirements for each of the succeeding five years (2002 through 2006) are $5,381,000, $5,204,000, $2,579,000 $2,579,000, and $2,605,000.

NOTE 9. INCOME TAXES

Income tax expense consists of the following:

In thousands		*Federal*	*State*	*Total*
2001	Current	$ 6,472	$2,136	$ 8,608
	Deferred	1,456	(336)	1,120
	Total	$ 7,928	$1,800	$ 9,728
2000	Current	$ 7,961	$2,519	$10,480
	Deferred	1,554	(463)	1,091
	Total	$ 9,515	$2,056	$11,571
1999	Current	$ 8,291	$2,560	$10,851
	Deferred	2,769	(105)	2,664
	Total	$11,060	$2,455	$13,515

Income tax expense computed by applying the current federal 35% tax rate to pretax book income differs from the amount shown in the Consolidated Statement of Income. The difference is reconciled in the table below:

In thousands	*2001*	*2000*	*1999*
Computed "expected" tax expense	$8,643	$11,037	$12,420
Increase (reduction) in taxes due to:			
State income taxes net of federal tax benefit	1,170	1,336	1,624
Investment tax credits	(156)	(155)	(184)
Other	71	(647)	(345)
Total income tax	$9,728	$11,571	$13,515

The components of deferred income tax expense were:

In thousands	*2001*	*2000*	*1999*
Depreciation	$2,337	$2,031	$2,974
Developer advances and contributions	(783)	(814)	(749)
Bond redemption premiums	(42)	(61)	(62)
Investment tax credits	(94)	(61)	(94)
Other	(298)	(4)	595
Total deferred income tax expense	$1,120	$1,091	$2,664

The tax effects of differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2001 and 2000 are presented in the following table:

In thousands	*2001*	*2000*
Deferred tax assets:		
Developer deposits for extension agreements and contributions in aid of construction	$41,531	$40,458
Federal benefit of state tax deductions	5,744	5,648
Book plant cost reduction for future deferred ITC amortization	1,703	1,765
Insurance loss provisions	537	632
Pension plan	938	736
Other	868	4,860
Total deferred tax assets	51,321	54,099
Deferred tax liabilities:		
Utility plant, principally due to depreciation differences	79,348	78,894
Premium on early retirement of bonds	789	825
Total deferred tax liabilities	80,137	79,719
Net deferred tax liabilities	$28,816	$25,620

A valuation allowance was not required during 2001 and 2000. Based on historic taxable income and future taxable income projections over the period in which the deferred assets are deductible, management believes it is more likely than not that the Company will realize the benefits of the deductible differences.

NOTE 10. EMPLOYEE BENEFIT PLANS

Pension Plan The Company provides a qualified defined benefit, non-contributory pension plan for substantially all employees. The cost of the plan was charged to expense and utility plant. The Company makes annual contributions to fund the amounts accrued for pension cost. Plan assets are invested in mutual funds, bonds and short-term investment accounts. The data below includes the unfunded, non-qualified, supplemental executive retirement plan.

Benefits earned by Dominguez employees under the Dominguez pension plan were frozen as of the merger date and future pension benefits to those employees will be provided under the Company pension plan. The Dominguez plan was fully funded and additional contributions to the plan could not be funded, although plan annual expense was recorded. At the merger date, the Dominguez plan was curtailed. As a result of the curtailment, accrued pension liability of $1,218,000 that had been expensed by Dominguez in prior years was reversed by the Company in 2000. The amount was offset against other operations expense.

Savings Plan The Company sponsors a 401(k) qualified, defined contribution savings plan that allowed participants to contribute up to 18% of pre-tax compensation in 2001 and 2000, and 15% in 1999. The Company matches fifty cents for each dollar contributed by the employee up to a maximum Company match of 4%. Company contributions were $1,425,000, $1,298,000, and $1,126,000, for the years 2001, 2000 and 1999.

Other Postretirement Plans The Company provides substantially all active employees with medical, dental and vision benefits through a self-insured plan. Employees retiring at or after age 58 with 10 or more years of service are offered, along with their spouses and dependents, continued participation in the plan by payment of a premium. Retired employees are also provided with a $5,000 life insurance benefit. Plan assets are invested in mutual funds, short-term money market instruments and commercial paper.

The Company records the costs of postretirement benefits during the employees' years of active service. The Commissions have issued decisions that authorize rate recovery of tax deductible funding of postretirement benefits and permit recording of a regulatory asset for the portion of costs that will be recoverable in future rates.

The following table reconciles the funded status of the plans with the accrued pension liability and the net postretirement benefit liability as of December 31, 2001 and 2000:

	Pension Benefits		*Other Benefits*	
In thousands	*2001*	*2000*	*2001*	*2000*
Change in benefit obligation:				
Beginning of year	$59,098	$ 55,692	$ 12,052	$10,195
Service cost	2,786	2,846	625	544
Interest cost	4,333	4,079	858	790
Assumption change	1,326	825	1,943	394
Plan amendment	11	1,215	—	—
Experience (gain) or loss	2,289	(34)	15	558
Curtailment gain	—	(1,347)	—	—
Benefits paid	(9,484)	(4,178)	(785)	(429)
End of year	$60,359	$ 59,098	$ 14,708	$12,052
Change in plan assets:				
Fair value of plan assets at beginning of year	$63,648	$ 61,008	$ 2,067	$ 1,561
Actual return on plan assets	1,356	3,140	237	228
Employer contributions	1,820	3,678	781	707
Retiree contributions	—	—	415	370
Benefits paid	(9,484)	(4,178)	(1,201)	(799)
Fair value of plan assets at end of year	$57,340	$ 63,648	$ 2,299	$ 2,067
Funded status	$ (3,019)	$ 4,550	$(12,408)	$ (9,985)
Unrecognized actuarial (gain) or loss	(6,191)	(13,534)	3,339	1,422
Unrecognized prior service cost	4,525	5,279	817	888
Unrecognized transition obligation	—	—	3,321	3,597
Unrecognized net initial asset	—	228	(276)	(276)
Net amount recognized	$ (4,685)	$ (3,477)	$ (5,207)	$ (4,354)

Amounts recognized on the balance sheet consist of:

	Pension Benefits		*Other Benefits*	
In thousands	*2001*	*2000*	*2001*	*2000*
Accrued benefit costs	$(4,685)	$(3,477)	$(5,207)	$(4,354)
Additional minimum liability	(1,396)	(1,363)	—	—
Intangible asset	580	877	—	—
Accumulated other comprehensive loss	816	486	—	—
Net amount recognized	$(4,685)	$(3,477)	$(5,207)	$(4,354)

	Pension Benefits		*Other Benefits*	
	2001	*2000*	*2001*	*2000*
Weighted average assumptions as of December 31:				
Discount rate	7.00%	7.25%	7.00%	7.25%
Long-term rate of return on plan assets	8.00%	8.00%	8.00%	8.00%
Rate of compensation increases	4.25%	4.50%	—	—

Net periodic benefit costs for the pension and other postretirement plans for the years ending December 31, 2001, 2000 and 1999 included the following components:

	Pension Benefits			Other Benefits		
In thousands	*2001*	*2000*	*1999*	*2001*	*2000*	*1999*
Service cost	$2,786	$2,846	$2,899	$ 625	$ 544	$ 498
Interest cost	4,333	4,079	3,894	858	790	689
Expected return on plan assets	(4,946)	(4,498)	(4,450)	(212)	(152)	(144)
Net amortization and deferral	855	486	871	363	357	401
Net periodic benefit cost	$3,028	$2,913	$3,214	$1,634	$1,539	$1,444

Postretirement benefit expense recorded in 2001, 2000, and 1999 was $885,000, $781,000, and $1,064,000, respectively. $4,186,000, which is recoverable through future customer rates, is recorded as a regulatory asset. The Company intends to make annual contributions to the plan up to the amount deductible for tax purposes.

For 2001 measurement purposes, the Company assumed an 8% annual rate of increase in the per capita cost of covered benefits with the rate decreasing 1% per year to a long-term annual rate of 5% per year after three years. The health care cost trend rate assumption has a significant effect on the amounts reported. A one-percentage point change in assumed health care cost trends is estimated to have the following effect:

In thousands	*Increase*	*Decrease*
Effect on total service and interest costs	$ 278	$ (220)
Effect on accumulated postretirement benefit obligation	2,350	(1,904)

NOTE 11. STOCK-BASED COMPENSATION PLANS

At the Company's 2000 annual meeting, stockholders approved a Long-Term Incentive Plan that allows granting of nonqualified stock options, performance shares and dividend units. Under the plan, a total of 1,500,000 common shares are authorized for option grants. Options are granted at an exercise price that is not less than the per share common stock market price on the date of grant. The options vest at a 25% rate on their anniversary date over their first four years and are exercisable over a ten-year period. At December 31, 2001, 11,875 options were vested.

Certain key Dominguez executives participated in the Dominguez 1997 Stock Incentive Plan that was terminated at the time Dominguez merged with the Company. The plan provided that in the event of a merger of Dominguez into another entity, granted but unexercised stock options issued became exercisable. Prior to the Merger, all outstanding Dominguez options were exercised and converted into Dominguez shares, and subsequently converted to 52,357 shares of Company common stock.

Under SFAS No. 123, "Accounting for Stock-Based Compensation," the Company elected to apply the provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees." Accordingly, no compensation cost has been recognized in the consolidated financial statements for stock options that have been granted. If the Company had elected to adopt the optional recognition provisions of SFAS No. 123 for its stock option plans, basic and diluted earnings per share would be unchanged from the amounts reported, except for 2000 diluted earnings per share which was reported as $1.31, but on a pro forma basis would be $1.30. Net income for the years ended December 31, 2001, 2000 and 1999 would be as presented in the following table:

In thousands	*2001*	*2000*	*1999*
As reported	$14,965	$19,963	$21,971
Pro forma	14,898	19,939	21,937

The fair value of stock options used to compute pro forma net income and earnings per share disclosures is the estimated fair value at grant date using the Black-Scholes option-pricing model with the following assumptions:

	2001	*2000*	*1999*
Expected dividend	4.3%	4.3%	4.3%
Expected volatility	30.4%	22.0%	22.6%
Risk-free interest rate	4.6%	4.9%	6.2%
Expected holding period in years	5.0	5.0	10.0

The following table summarizes the activity for the stock option plans:

	Shares	*Weighted Average Exercise Price*	*Weighted Average Remaining Contractual Life*	*Options Exercisable*	*Weighted Average Fair Value*
Outstanding at December 31, 1998	56,221	$23.38	—	8,901	—
Exercised	(3,864)	22.54			
Outstanding at December 31, 1999	52,357	23.45	—	19,092	—
Granted	53,500	23.06			$3.74
Exercised	(52,357)	23.45			
Outstanding at December 31, 2000	53,500	23.06	9.5	—	—
Granted	58,000	25.94			5.65
Cancelled	(12,000)	24.50			
Outstanding at December 31, 2001	99,500	24.57	8.8	11,875	—

NOTE 12. FAIR VALUE OF FINANCIAL INSTRUMENTS

For those financial instruments for which it is practicable to estimate a fair value, the following methods and assumptions were used. For cash equivalents, the carrying amount approximates fair value because of the short-term maturity of the instruments. The fair value of the Company's long-term debt including current installments is estimated at $214,046,000 as of December 31, 2001, and $199,890,000 as of December 31, 2000, using a discounted cash flow analysis, based on the current rates available to the Company for debt of similar maturities. The fair value of advances for construction contracts is estimated at $32,000,000 as of December 31, 2001 and $27,000,000 as of December 31, 2000, based on data provided by brokers.

NOTE 13. COMMITMENTS

The Company leases office facilities in many of its operating districts. The total paid and charged to operations for such leases was $720,000 in 2001, $760,000 in 2000, and $663,000 in 1999. Payments under the lease commitments over the succeeding five years 2002 through 2006 are estimated to be $750,000, $780,000, $830,000, $867,000 and $911,000. Over the 20-year period through 2022, payments under lease commitments, assuming renewal of existing or replacement leases, is estimated to be $21,000,000.

The Company has long-term contracts with two wholesale water suppliers that require the Company to purchase minimum annual water quantities. Purchases are priced at the suppliers' then current wholesale water rate. The Company operates to purchase sufficient water to equal or exceed the minimum quantities under both contracts. The total paid under the contracts was $6,208,000 in 2001, $5,400,000 in 2000 and $4,766,000 in 1999. The estimated payments under the contracts for the five years 2002 through 2006 are estimated to be $7,000,000, $7,280,000, $7,571,000, $7,874,000 and $8,190,000.

The water supply contract with Stockton East Water District (SEWD) requires a fixed, annual payment and does not vary with the quantity of water delivered by the district. Because of the fixed price arrangement, the Company operates to receive as much water as possible from SEWD in order to minimize the cost of operating wells to supplement SEWD deliveries. The total paid under the contract was $3,496,000 in 2001, $3,269,000 in 2000 and $3,086,000 in 1999. Pricing under the contract varies annually. For 2002, the estimated payment is $3,198,000.

The Company has committed $7.6 million of its $10 million bank credit line to a contractor for construction of a new operation facility. At December 31, 2001, $6.3 million had been drawn to acquire land and construct the facility. The amount drawn on the credit line is an obligation of the contractor, but guaranteed by the Company. The new facility is pledged to the Company as security for the guarantee. The Company occupied the new facility in January 2002 on a month-to-month rent basis. The Company expects to exchange surplus real property for the new facility on a tax-free basis after mid-year 2002 at which time the contractor will repay the construction loan and the Company's commitment would be extinguished.

NOTE 14. QUARTERLY FINANCIAL DATA (UNAUDITED)

The Company's common stock is traded on the New York Stock Exchange under the symbol "CWT." Quarterly dividends have been paid on common stock for 228 consecutive quarters and the quarterly rate has been increased each year since 1968.

2001 – in thousands except per share amounts	*First*	*Second*	*Third*	*Fourth*
Operating revenue	$47,008	$66,958	$76,310	$56,544
Net operating income	3,792	8,050	9,517	3,792
Net income	221	5,764	5,920	3,060
Diluted earnings per share	.01	.37	.39	.20
Common stock market price range:				
High	28.60	27.70	27.00	27.50
Low	23.38	24.10	23.77	24.00
Dividends paid	.27875	.27875	.27875	.27875

2000 – in thousands except per share amounts	*First*	*Second*	*Third*	*Fourth*
Operating revenue	$46,694	$65,966	$76,580	$55,566
Net operating income	4,902	8,977	12,782	6,535
Net income	1,533	5,753	9,205	3,472
Diluted earnings per share	.10	.38	.60	.23
Common stock market price range:				
High	31.38	26.75	26.88	27.81
Low	22.25	21.50	22.50	24.88
Dividends paid	.275	.275	.275	.275

Independent Auditors' Report

THE BOARD OF DIRECTORS
CALIFORNIA WATER SERVICE GROUP:

We have audited the accompanying consolidated balance sheet of California Water Service Group and subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of income, common stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

The consolidated financial statements of California Water Service Group for the year ended December 31, 1999, have been restated to reflect the pooling-of-interests transaction with Dominguez Services Corporation and subsidiaries as described in Note 3 to the consolidated financial statements. We did not audit the consolidated financial statements of Dominguez Services Corporation and subsidiaries, which financial statements reflect total revenue constituting 12.1 percent of the related consolidated total as of December 31, 1999. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Dominguez Services Corporation and subsidiaries for the year ended December 31, 1999, is based solely on the report of the other auditors.

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

In our opinion, based on our audits and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of California Water Service Group and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Mountain View, California
January 30, 2002

Corporate Information

STOCK TRANSFER, DIVIDEND DISBURSING AND REINVESTMENT AGENT

Fleet National Bank
c/o EquiServe L.P.
P.O. Box 43010
Providence, RI 02940-3010
(800) 736-3001

TO TRANSFER STOCK

A change of ownership of shares (such as when stock is sold or gifted or when owners are deleted from or added to stock certificates) requires a transfer of stock. To transfer stock, the owner must complete the assignment on the back of the certificate and sign it exactly as his or her name appears on the front. This signature must be guaranteed by an eligible guarantor institution (banks, stock brokers, savings and loan associations and credit unions with membership in approved signature medallion programs) pursuant to SEC Rule 17Ad-15. A notary's acknowledgement is not acceptable. This certificate should then be sent to EquiServe, L.P. Stockholder Services, by registered or certified mail with complete transfer instructions.

BOND REGISTRAR

US Bank Trust, N.A.
One California Street
San Francisco, CA 94111-5402
(415) 273-4580

EXECUTIVE OFFICE

California Water Service Group
1720 North First Street
San Jose, CA 95112-4598
(408) 367-8200

ANNUAL MEETING

The Annual Meeting of Stockholders will be held on Wednesday, April 24, 2002, at 10 a.m. at the Company's Executive Office, located at 1720 North First Street in San Jose, California. Details of the business to be transacted during the meeting will be contained in the proxy material, which will be mailed to stockholders on or about March 25, 2002.

DIVIDEND DATES FOR 2002

Quarter	*Declaration*	*Record Date*	*Payment Date*
First	January 30	February 8	February 22
Second	April 24	May 6	May 20
Third	July 24	August 5	August 19
Fourth	October 23	November 4	November 18

ANNUAL REPORT FOR 2001 ON FORM 10-K

A copy of the Company's report for 2001 filed with the Securities and Exchange Commission on Form 10-K will be available in April 2002 and can be obtained by any stockholder at no charge upon written request to the address below.

STOCKHOLDER INFORMATION

California Water Service Group
Attn: Stockholder Relations
1720 North First Street
San Jose, CA 95112-4598
(408) 367-8200 or (800) 750-8200
http://www.calwater.com

Officers

CALIFORNIA WATER SERVICE COMPANY

Robert W. Foy [1, 2, 3]
Chairman of the Board

Peter C. Nelson [1, 2, 3]
President and Chief Executive Officer

Paul G. Ekstrom [4]
Vice President, Customer Service and Corporate Secretary

Gerald F. Feeney [1, 2, 3]
Vice President, Chief Financial Officer and Treasurer

Francis S. Ferraro [5]
Vice President, Regulatory Matters and Corporate Development

Robert R. Guzzetta [2]
Vice President, Engineering and Water Quality

Christine L. McFarlane
Vice President, Human Resources

Raymond H. Taylor
Vice President, Operations

Dan L. Stockton
Vice President, Chief Information Officer

Calvin L. Breed [1]
Controller, Assistant Secretary and Assistant Treasurer

WASHINGTON WATER SERVICE COMPANY

Michael P. Ireland
President

1 *Holds the same position with California Water Service Group*
2 *Holds the same position with CWS Utility Services*
3 *Also an officer of Washington Water Service Company and New Mexico Water Service Company*
4 *Also Corporate Secretary of California Water Service Group, CWS Utility Services, Washington Water Service Company and New Mexico Water Service Company*
5 *Holds the same position with New Mexico Water Service Company*

Board of Directors

Peter C. Nelson *
President and Chief Executive Officer

Robert W. Foy *
Chairman of the Board

C.H. Stump #
Former Chairman of the Board and CEO of California Water Service Company

Linda R. Meier †‡
Member, National Advisory Board, Haas Public Service Center; Member of the Board of Directors, Greater Bay Bancorp

Langdon W. Owen †
President, Don Owen & Associates; Member of the Board of Directors, Metropolitan Water District of Southern California

George A. Vera †
Vice President and Chief Financial Officer, the David & Lucile Packard Foundation

Edward D. Harris, Jr., M.D. ‡*
George DeForest Barnett Professor of Medicine, Stanford University Medical Center

Richard P. Magnuson †‡
Private Venture Capital Investor

Douglas M. Brown ‡
President and CEO of Tuition Plan Consortium; Chairman of Talbot Financial Services

† Member of the Audit Committee
‡ Member of the Compensation Committee
* Member of the Executive Committee
# Director Emeritus

California Water Service Group (Company) provides high-quality water utility services to 1.5 million people through its four subsidiaries: California Water Service Company (Cal Water), Washington Water Service Company (Washington Water), New Mexico Water Service Company (New Mexico Water) and CWS Utility Services. Regulated by state utility commissions, Cal Water and Washington Water provide water utility services to customers in 96 communities throughout California and Washington. New Mexico Water is nearing completion of its acquisition of a regulated water utility in that state. CWS Utility Services conducts the Company's non-regulated business, which includes providing billing and meter reading services, as well as full-system water operations, for cities and companies in California, Washington and New Mexico.

DESIGN: Douglas Joseph Partners, Los Angeles

California Water Service Group

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