CAL-AM WATER COMPANY MONTEREY DISTRICT WATER SYSTEM

SUMMARY APPRAISAL REPORT ON THE FAIR MARKET VALUE OF THE TOTAL INVESTED CAPITAL AND A 100 PERCENT INTEREST IN THE COMMON STOCK AS OF

NOVEMBER 15, 2005

March 9, 2006

Representative of Organization
Monterey Flow
449 Alvarado Street
Monterey, CA 93940

Re: Valuation of California-American Water Company Monterey District Water System

Dear Representative:

Beacon Valuation Group, LLC ("Beacon") was retained by Monterey Flow (the "Client"), to provide our opinion as to the fair market value of a 100 percent interest in the common stock of California-American Water Company Monterey District Water System ("Cal-Am" or the "Company") as of November 15, 2005 (the "Valuation Date"). This valuation engagement is being conducted solely in connection with the potential purchase of the Company.

The results of this valuation analysis indicate that the fair market value of a 100 percent interest in the equity of Cal-Am is $50,700,000, as of the Valuation Date. In addition, it is estimated that the fair market value of the **<u>Total Invested Capital</u>** of Cal-Am is **<u>$100,700,000</u>**, as of the Valuation Date. It is assumed that a hypothetical buyer willing to purchase the Company would not only pay for Cal-Am's equity, estimated at $50.7 million, but would also assume its outstanding debt, estimated at $50 million, as of the Valuation Date. *It must be noted that this value indication does not include any direct downward adjustments to value due to the potential impact of any contingent liabilities, estimated by the Client and its representatives to approximate $175 million as of the Valuation Date. Therefore, any value conclusions presented herein should be perceived as a maximum value, excluding any impact of such contingent liabilities.* Beacon was not retained to directly value the impact of any contingent liabilities ("CL"). The reference to any CL within this report (discussed in more detail separately) is provided solely for purposes of presenting all data available to Beacon as of the date of this Report. Our opinion of value as expressed in this letter can be fully understood only after reading the accompanying summary appraisal report and reviewing the sources of information relied upon, the supporting documentation and the underlying assumptions and limiting conditions.

We would like to thank you for giving us the opportunity to assist you in this endeavor. Please contact us with any questions or comments regarding the analysis and conclusions contained in this report.

Very truly yours,

BEACON VALUATION GROUP, LLC

René Hlousek

René Hlousek, ASA
President

RH/md
Enclosure

VALUATION OF CALIFORNIA-AMERICAN WATER COMPANY MONTEREY DISTRICT WATER SYSTEM

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SECTION I

VALUATION OVERVIEW

The objective of this analysis is to determine the fair market value in continued use of a 100 percent interest in the issued and outstanding common stock (the "Interest") of California-American Water Company Monterey District Water System ("Cal-Am" or the "Company"), as of November 15, 2005. Beacon Valuation Group, LLC ("Beacon") has been retained by Monterey Flow (the "Client") to perform this analysis. This report sets forth our conclusions, as well as the methods we used and factors we considered in formulating our opinion.

Valuation is not an exact science. Each valuation is grounded in its own particular facts and circumstances. A sound valuation includes not only the consideration of all relevant factors, but also common sense, informed judgment, and reasonableness in weighting the relevant factors and determining their aggregate significance. This appraisal has been completed according to these principles.

Summary Description of the Subject

Cal-Am provides public utility water service to approximately 170,000 customers in various areas in San Diego, Los Angeles, Ventura, San Mateo, Santa Cruz, Sonoma, Sacramento, Placer and Monterey counties. Cal-Am is a California corporation and a wholly owned subsidiary of American Water Works Company, Inc., which is in turn owned by RWE Aktiengesellschaft, Thames Water Acqua Holdings GmbH. Cal-Am's Monterey District provides water service to approximately 39,000 customers on the Monterey Peninsula and vicinity, encompassing the cities of Carmel-by-the-Sea, Pacific Grove, Monterey, Sand City, Del Rey Oaks and part of Seaside, much of the Carmel Valley, the Highway 68 corridor, and several other nearby unincorporated areas.

Valuation Date

The effective date of the appraisal is November 15, 2005 (the "Valuation Date"); this date was selected by the Client. Our analysis considers those facts and circumstances that were known or knowable as of the Valuation Date. Our opinion may be different if another valuation date is used. The report date is March 9, 2006.

Purpose and Use of the Appraisal

The purpose of this appraisal is to estimate the fair market value of a 100 percent controlling interest in the common stock, as a single block, of Cal-Am, as defined below.

This valuation engagement is being conducted solely in connection with the potential purchase of Cal-Am. It is intended solely for such purpose and should not be distributed or circulated, quoted from or cited in any manner that is not consistent with this purpose. As such, our findings are not to be disclosed to other parties in connection with any other matters without first obtaining the expressed written authorization of Beacon.

Beacon shall own all right, title and interest in, and the copyright on this report, but shall and hereby does grant to the Client a non-exclusive license to use such report solely for the purpose outlined herein and, in connection therewith to provide a copy of the report to users who have been disclosed to Beacon and consented to by Beacon in advance, in writing. Possession of our report, or a copy, does not carry with it the right of publication. Except as expressly permitted by our Engagement Agreement, neither this report nor any portions thereof (including without limitation any conclusions as to value, the identity of Beacon or any individuals signing or associated with the report, or the professional associations or organizations with which they are affiliated) shall be disseminated to third parties (other than to appropriate legal and financial advisors, government bodies, and approved parties pursuant to the terms of our Engagement Agreement or as otherwise consented to by Beacon). Beacon does not assume or accept any responsibility to any third parties who receive our report and, in the event that the Client provides, or discloses the results of, our report to any third party, with or without Beacon's consent, the Client shall indemnify, save, hold harmless, and defend Beacon against any and all claims whatsoever made by any such third party against Beacon. Beacon has provided four copies to be distributed to the Client.

Results of Analysis

Taking into account all that was developed through our study, it is our opinion that the fair market value, in continued use, of a 100 percent of the issued and outstanding common stock of Cal-Am, at November 15, 2005, is $50,700,000. In addition, it is estimated that the fair market value of the **Total Invested Capital** of Cal-Am is **$100,700,000**, as of the Valuation Date. It is assumed that a hypothetical buyer willing to purchase the Company would not only pay for Cal-Am's equity, estimated at $50.7 million, but would also assume its outstanding debt, estimated at $50 million, as of the Valuation Date.

It must be noted that the above value indication does not include any direct downward adjustments to value due to the potential impact of any contingent liabilities, estimated by the Client and its representatives to approximate $175 million as of the Valuation Date. Therefore, any value conclusions presented herein should be perceived as a maximum value, excluding any direct impact of such contingent liabilities. The full consideration of the aforementioned contingent liabilities ("CL") as part of the analysis, had the CL been valued separately and directly, could potentially have a significant downward impact on the Company value conclusion, as presented above. Beacon was not retained to directly value the impact of any contingent liabilities, because the key component of that analysis would most likely require the use of legal and other expertise input outside the scope of this Engagement. The reference to any CL within this report (discussed in more detail separately) is provided solely for purposes of presenting all data available to Beacon as of the date of this Report.

Standard of Value

At the Valuation Date, Cal-Am was a closely held corporation for which there was no established market for its stock. For the purposes of our opinion, we define fair market value based on the definition prescribed under Internal Revenue Service (IRS) Revenue Ruling 59-60 and Treasury Reg. 25.2512-1, as follows:

> The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

In other words, in applying the standard of fair market value, Beacon assumes that:

- the equivalent of *cash* is being paid for the subject being appraised as of the Valuation Date;
- the company (interest) being valued has been placed on the open market for a reasonable amount of time enough for all potential purchasers to be aware of its availability;
- the hypothetical buyer is prudent but without synergistic benefit;
- a seller is not forced to sell (i.e., accept an offer that represents a "distress sale") and a buyer is not compelled to buy (i.e., necessary to earn a living); and
- the business will continue as a going concern and not be liquidated.

Since there were no plans to liquidate the Company, in whole or in part, and the owner of the shares being valued could not affect a liquidation event, we determined the fair market value on a going-concern basis.

Revenue Ruling 59-60

In the report that follows, we have employed conventional valuation techniques in the analysis of those factors and considerations that are encompassed in IRS Revenue Ruling 59-60. This ruling is most commonly prescribed as a guide for the valuation of closely held businesses and their securities. Revenue Ruling 59-60 states that all relevant factors should be considered, including the following:

1. The nature of the business and the history of the enterprise from its inception;
2. The economic outlook in general and the condition and outlook of the specific industry in particular;
3. The book value of the stock and the financial condition of the business;
4. The earning capacity of the business;
5. The dividend-paying capacity;
6. Whether or not the business has goodwill or other intangible value;
7. Prior sales of the stock and the size of the block to be valued; and
8. The market price of stocks of corporations engaged in the same or a similar line of business as the subject company and whose stocks are actively traded in a free and open market, either on an exchange or over-the-counter.

Hypothetical Buyer and Seller

The buyer under fair market value is, except under rare circumstances, considered to be a "financial" and not the "strategic" buyer inherent in the investment value standard. This excludes the buyer who because of other business activities brings some "value-adding" benefits to a company, which will enhance the company being valued and the buyer's other business activities. This also excludes buyers who are already a shareholder, creditor, or a related or controlled entity that might be willing to acquire the interest at artificially high or low prices due to considerations not typical of the motivation of the arm's-length financial buyer.

In this instance the ultimate buyer may well be a strategic buyer and as such may be willing to pay an investment value, which is higher than the fair market value determined in this appraisal. The acquisition premium (the amount in excess of fair market value) being justified by the synergies and other strategic advantages the acquirer perceives will be obtained through acquiring the Company. It is all but impossible to estimate the investment value without identifying a specific strategic buyer as it is the synergies, risk aversion, cost of capital and strategic advantages of a given prospective buyer which drives the size of the acquisition premium.

The seller in the fair market value appraisal process is also hypothetical and is, therefore, imbued with knowledge of the relevant facts, i.e., the influences on value exerted by the market, the risk and value drivers specific to the Company, and the investment characteristics applicable to the subject interest's degree of control, degree of marketability, and other investment characteristics.

In a specific transaction with a specific strategic buyer, the seller may consider this fair market value to be a floor or base value with the acquisition premium derived from the synergy serving to drive the price beyond the fair market value.

Regardless of who retained Beacon, the hypothetical status of both the seller and buyer with respect to the valuation exercise places upon the appraiser the role of acting as a surrogate for both parties. The independence required by this role is essential to the determination of fair market value as defined above.

Fair Market Value vs. Investment Value

For the reasons stated above, this appraisal will proceed only with respect to fair market value. Nothing in this report should be considered an opinion of an investment value reflecting the synergies applicable to any specific prospective strategic acquirer.

Relevant Market Segment

The determination of fair market value is a mandate to estimate what the hypothetical seller and buyer could be expected to do in the marketplace, on the Valuation Date, in a sale of the subject interest. The definition of fair market value imbues upon the seller and buyer the qualities included in the definition of fair market value – knowledge of the relevant facts and the absence of compulsion. These distinctions can cause value to be different than price.

In order to estimate what could be expected to occur in the market between the parties as defined, the appraiser should think in terms of the segment of the market in which a transaction in the subject interest would most likely occur.

The sale of interests in closely held corporations are limited to the following:

(i) sale of the interest to an arm's-length, well-informed financial buyer, as defined above;
(ii) sale of the interest to one or more of the other existing shareholders – this assumes there is at least one other shareholder;
(iii) sale of the interest to the issuing corporation which would retire the shares as treasury stock – this assumes there is at least one shareholder;
(iv) sale of the subject shares in a public offering, thus ending its closely held status;
(v) sale to a strategic buyer, as defined above; or
(vi) sale of the assets in liquidation with the residual distributed to the shareholders.

In this case we are valuing a 100 percent interest for use with respect to an actual sale of the interest as a single block. This eliminates market segment (iv). Market segment (v) is eliminated in that a sale to a strategic buyer would constitute investment value when the standard of value stipulated for this appraisal is fair market value. Segment (vi) is eliminated in that the value of the Company appears to clearly be greater as a going concern and the assumption is that there is no intent or desire to liquidate. The intended use of this appraisal makes market segments (ii) and (iii) irrelevant.

The relevant market segment for this appraisal is market segment (i) — a hypothetical sale of an interest (the Company) to a financial buyer as defined above.

Valuation Considerations

In determining the fair market value of the 100 percent interest in Company's common stock (the Interest), we would typically have performed the following:

1. Analyzed the characteristics of the interest being valued, including:
    - past transactions of the stock, if any;
    - rights, obligations, and any agreements restricting transferability or otherwise affecting the value of the stock;
    - number of shares of stock under consideration relative to the total number of shares outstanding; and
    - marketability of the interest being valued.
2. Analyzed the financial condition and operating results of the Company, including:
    - balance sheets, historical and at the Valuation Date, listing assets, liabilities, and book value;
    - historical and current income and cash flow statements, particularly profits and cash flow generated and factors affecting such profits and cash flow;
    - dividends paid historically and dividend-paying capacity;

- budgets, plans, and projections of future performance, if any; and
- outlook at the Valuation Date.

3. Interviewed and corresponded with Cal-Am management and appropriate legal and accounting advisors in order to augment our knowledge of the Company, including its history and management, the nature of its business, its competition and other factors affecting its business and its prospects for the future.

4. Reviewed published market data and other available public information relating to the Company and its industry, including:
   - relevant historical trends, current performance indicators, and outlook at the Valuation Date, for the economy and the utility industry, in general, and the water utility industry, in particular;
   - bases of investors' appraisal, at the Valuation Date, of publicly traded shares of companies (i.e., guideline companies) that could be used for comparative purposes; and
   - information, if any, regarding direct placements of common stock that could be used for comparative purposes.

Since Beacon did not have any access to Company management to collect and analyze certain key information, as would have been done for this valuation in accordance with the outline above, we were only able to review certain summary financial performance data for Cal-Am. Additionally, Beacon performed a review of relevant market data, as specified under item #4 from above. It must be noted that full or partial access to Company Management, and any resulting revelation and receipt of new pertinent data for purposes of this valuation, could potentially have a significant impact on this analysis and the valuation conclusions presented in this Report.

Report Presentation

The *Uniform Standards of Professional Appraisal Practice ("USPAP")*, in Standards Rule 10-2, offers two business valuation report presentation options: Appraisal Report or Restricted Use Appraisal Report. "The essential difference between these options is in the content and level of information provided. The report content and level of information requirements set forth in this Standard are minimums for both types of report."

This document constitutes an Appraisal Report. However, while this report meets the standards of an Appraisal Report, it does so in summary form, documenting our opinion of value at the Valuation Date, the methods we considered and utilized, and any conditions or limitations to our opinion.[1] As such, this summary report does not contain all of the required disclosures of a more comprehensive appraisal report. Therefore, only those individuals who have complete knowledge about the appraisal subject may be aware of all of the facts and circumstances that are not contained herein. This summary report format is also considered most appropriate given the limited Company-specific information utilized in our analysis, due to the lack of access to Cal-Am's Management.

[1] This report format is also consistent with the Institute of Business Appraisers Standard 4, pertaining to a Letter Form Written Report.

Although a summary report does not fully describe the information considered, the procedures followed, and the reasoning that supports the analyses, opinions, and conclusions, we will maintain complete and orderly workpapers documenting and providing support for our findings.

SECTION II

ECONOMIC, INDUSTRY AND COMPANY BACKGROUND

General Economic Environment

The economy more or less affects every business. If the demand for the product/service is elastic, the business will be more greatly affected by economic changes than the business whose product/service society regards as a necessity. The capacity of those who use the product/service to delay or cancel purchases determines the extent to which economic factors will influence each business enterprise.

Established appraisal theory and regulatory and legal rulings have repeatedly reaffirmed that which is intuitively logical – no business operates in a vacuum. Economic conditions, both national and local, as well as the status of the industry with which the Company is allied, must be considered in order to gain insight into the economic climate in which the business has been operating and that in which it will operate in the future.

Please see Appendix A for our complete economic analysis.

General Industry Landscape

Cal-Am conducts its operations in the general industry categorized according to the Standard Industrial Classification System as Water Supply (utilities), SIC Code Number 4941.

Cal-Am is a privately owned public utility regulated by the CPUC and operates within a service area approved by the CPUC. The laws of the State of California provide that no other investor-owned public utility may operate in the Company's service area without first obtaining from the CPUC a certificate of public convenience and necessity. Typically, a certificate is issued only after demonstrating that a utility's service in its respective area is inadequate.

California law also provides that whenever a public agency constructs facilities to extend utility service to the service area of a privately owned public utility, such an act constitutes the taking of property and is conditioned upon payment of just compensation to the private utility. Under the constitution and statutes of the State of California, municipalities, water districts and other public agencies have been authorized to engage in the ownership and operation of water systems. Such agencies are empowered to condemn properties operated by privately owned public utilities upon payment of just compensation and are further authorized to issue bonds (including revenue bonds) for the purpose of acquiring or constructing water systems.

In recent years, consolidation within the water industry has accelerated. A number of publicly traded water companies have been acquired or merged into larger domestic companies. Several acquisitions of publicly traded companies have also been completed by much larger foreign companies. Merger and acquisition transactions within the industry may be analyzed to gain insight into the value of the stock of a closely held company. Such transactions are also an indication of the attitude of potential buyers towards the industry. As will be seen in the Transaction Multiple Method subsection within Section III of this report, we searched for information on companies comparable to Cal-Am and identified five transactions.

Company Background[2]

Cal-Am provides public utility water service to approximately 170,000 customers in various areas in San Diego, Los Angeles, Ventura, San Mateo, Santa Cruz, Sonoma, Sacramento, Placer and Monterey counties. Cal-Am is a California corporation and a wholly owned subsidiary of American Water Works Company, Inc., which is in turn owned by RWE Aktiengesellschaft, Thames Water Acqua Holdings GmbH. Cal-Am's Monterey District provides water service to approximately 39,000 customers on the Monterey Peninsula and vicinity, encompassing the cities of Carmel-by-the-Sea, Pacific Grove, Monterey, Sand City, Del Rey Oaks and part of Seaside, much of the Carmel Valley, the Highway 68 corridor, and several other nearby unincorporated areas.

Cal-Am supplies about 85% of the Monterey Peninsula's water. It develops its supply from Carmel River surface water and wells in the Carmel Valley, Seaside basin, and along the Highway 68 corridor. It has been apparent for some time that during periods of drought there is not sufficient water to satisfy fully both environmental requirements and unrestrained municipal water demands, but various factors have prevented any permanent solution to date.

In 1995, the State Water Resources Control Board ("SWRCB") added a major new legal constraint to the Monterey Peninsula's physical water supply limitations. SWRCB, following hearings begun in 1992, acted on complaints alleging that Cal-Am's Carmel River water use was without valid rights and adversely impacted environmental and public trust values. In *Order WR 95-10*, it directed Cal-Am to cut its Carmel River diversions to 14,106 acre-feet annually and implement conservation measures to bring that figure down by 20% more beginning with the 1997 water year. Cal-Am met the SWRCB-mandated cutback during the first water year ending September 30, 1996 following *Order WR 95-10*. It exceeded the limit in the second year, however, and the SWRCB levied a $168,000 fine on Cal-Am for the violation. Cal-Am continues to this day to operate Monterey District under the terms of SWRCB *Order WR-95-10* as modified by *Order WR 98-04*. With the aid of Commission-authorized rate structures designed to provide very strong conservation incentives, it has been able to meet SWRCB's limits in every water year after 1997.

Cal-Am ran into difficulty again in mid-2004. Cal-Am works with Monterey Peninsula Water Management District ("MPWMD") to create quarterly water production budgets and sets monthly targets that, if met, should at the end of the water year bring production within the SWRCB annual limit. Although it had managed to stay within its cumulative water production target through April 2004 for the October 2003 through September 2004 water year, Cal-Am recognized that May deliveries were consistently exceeding the daily targets due to early, dry and hot weather conditions with no relief in sight. That pattern continued into June, making it highly likely that Carmel River production would exceed the SWRCB limit for the 2004 water year if extraordinary steps were not taken. In mid-June, Cal-Am filed *Application (A.) 04-06-020* seeking authorization to impose a special conservation rate design. In July 2004 we issued *D.04-07-035* granting Cal-Am authority to implement a modified rate design. Its efforts were successful, and Cal-Am did finish the 2004 water year within the SWRCB limit.

[2] Source: *Decision 05-03-012*, March 17, 2005; Before the Public Utilities Commission of the State of California

Although the Commission was able to act quickly during 2004, issuing *D.04-07-035* just 22 days after the application was filed, that authority has now expired and Cal-Am is concerned that there need to be measures in place to address future threats without relying on urgent Commission action. Cal-Am is proposing in its current Monterey District general rate case a rate design that will include provisions to avoid the need for urgent relief of the type that was authorized in *D.04-07-035*, but that will only address the issue from 2006 forward. To avoid another urgent request if consumption is excessive in 2005, Cal-Am seeks advance approval to implement the same rate design as in July 2004 should the need arise.

Restrictions on Sale of Subject Interest

These restrictions are not relevant to this valuation as Beacon was retained to value a 100 percent interest for purpose of sale, by all shareholders, of all shares. This means that all shareholders would agree to the transfer necessitated by the sale and amend the shareholder agreement, as and if needed, for that transaction.

Contingencies

It must be noted that as part of this analysis, Beacon did not include or incorporate any direct downward adjustments in value due to the potential impact of any contingent liabilities, estimated by the Client and its representatives to approximate $175 million as of the Valuation Date. Therefore, any value conclusions presented herein should be perceived as a maximum value, excluding any direct impact of such contingent liabilities. It is our understanding that these contingent liabilities relate to certain material and irreversible[3] damage to the Company's water dam. For purposes of this Report, it is assumed that a hypothetical buyer of the Company would have to assume any direct expenses (estimated at $175 million) and indirect costs (not known) associated with the destruction and/or replacement of such dam, representing a key physical asset of the Company, as currently operating.

The full consideration of the aforementioned contingent liabilities ("CL") as part of the analysis, if the CL were valued separately and directly, could potentially (and most likely) have a significant downward impact on the Company value conclusion, as presented within this Report. Beacon was not retained to directly value the impact of any contingent liabilities, as the key component of that analysis would most likely require the use of legal and other expertise input, which is outside the scope of this Engagement. The reference to the above CL within this report is provided solely for purposes of presenting all data available to Beacon as of the date of this Report.

Beacon has not been presented with any Company-specific or Company-unique information, other than above, that would point to any material issues pertaining to environmental contamination, litigation, labor/union, or other governmental regulations that would impact the fair market value of the Company. Beacon did take into consideration the general regulatory landscape faced by participants in Cal-Am industry that could have an impact on the Company.

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[3] For purposes of this Report, the term "irreversible" is referring to the assumption that a major repair of the dam, as opposed to its replacement, would not be a practical or viable option, at least from an economic point of view.

Financial Overview

The financial performance summary produced in this report is included solely to aid in the appraisal process and assist in determining the opinion of value. This information should not be used for accounting or tax reporting, to obtain credit, or for any other purpose. The "hypothetical buyer" is more concerned with matters such as economic depreciation, minimum officer compensation and conformity to accounting practices found among their peer companies as well as publicly traded companies. Beacon was provided with a summary of the Company's revenues and total expenses for the years 2000 through 2004.[4] See Exhibit II for summary of Cal-Am's financial performance.

The process of business appraisal commonly requires adjustment of the financial statements. Beacon has not made any adjustments due to the lack of sufficient financial data detail available to make such adjustments. The objective of valuation-related adjustments is to convert earnings and values from those established based upon historical costs and tax accounting regulations to amounts which better estimate fair market values.

There are two types of adjustments to be considered and made by the appraiser, normalizing and controlling adjustments. Normalizing adjustments adjust the income statement of a private company to show the prospective purchaser the return from normal operations of the business and reveal a "public equivalent" income stream. If such adjustments were not made, something other than a freely traded value indication of value would be developed by capitalizing the derived earnings stream.[5] Control adjustments are made when the interest is being appraised for controlling shareholders, those shareholders who have control over the cash flows of a business. Control adjustments are generally categorized as those adjustments that would change the earnings stream to run more efficiently or to achieve economies of scale due to the synergies that may exist for a strategic buyer.

These adjustments are seldom precise, but are generally made when three conditions are met:

- the amount reflected on the financial statements appears to be inconsistent with fair market values;
- when better estimates of fair market values can be made; and
- when the authority to make the change indicated by the adjustments rests within the interest being valued or some other clear circumstances apply (e.g., the change has or is expected to be put in place by the control group).

In the current case, we are valuing on a controlling interest basis; therefore, adjustments which require control would be appropriate, if data needed to make such adjustments were available.

Financial analysis commonly includes a comparison of the subject's financial and operating ratios with those of a sufficiently similar industry peer group to aid the valuation process by enhancing the evaluation of the Company's operations with respect to operational performance common to the industry. When used, the industry norms are obtained from sources such as trade associations, tax return databases, associations of credit granting officers, specific similar companies whose operating statements are filed

[4] Years 1986 through 1999 were provided, with several years of data missing. However, for purposes of this valuation, only the last five-years' of financial performance was deemed most relevant in this case.
[5] "Control Adjustments to the Income Statement", Mercer Capital, Value Matters, Volume 2004-07, October 18, 2004.

with government agencies, or other similar sources. We have analyzed the operational and financial performance of Cal-Am, along certain key financial metric parameters, and compared it to specific comparable companies.

EXHIBIT II

California-American Water Company Monterey District

Key Income Statement Data

For the Years Ended December 31, 2000 through December 31, 2004, and Estimated For the Latest Twelve Months Ended November 15, 2005

											Estimated	
		31-Dec 2000	**% of Rev.**	**31-Dec 2001**	**% of Rev.**	**31-Dec 2002**	**% of Rev.**	**31-Dec 2003**	***% of Rev.***	**31-Dec 2004**	***% of Rev.***	**15-Nov 2005**	***% of Rev.***
Total Revenues		**21,928,756**	**100.0%**	**27,263,494**	**100.0%**	**24,893,343**	**100.0%**	**28,157,576**	**100.0%**	**27,580,561**	**100.0%**	**27,580,561**	**100.0%**
	Growth	*-2.9%*		*24%*		*-9%*		*13%*		*-2%*		*0.0%*	
Total Operating Expenses		**11,973,787**	**54.6%**	**15,617,646**	**57.3%**	**14,548,673**	**58.4%**	**16,051,626**	**57.0%**	**15,822,139**	**57.4%**	**15,720,920**	**57.0%**
EBITDA		**9,954,969**	**45.4%**	**11,645,848**	**42.7%**	**10,344,670**	**41.6%**	**12,105,950**	**43.0%**	**11,758,422**	**42.6%**	**11,859,641**	**43.0%**

Notes:

[1] It is assumed that the total operating expenses, as presented in the Krieger Report, exclude depreciation and amortization expenses and exclude any interest expense.

SECTION III

VALUATION ANALYSIS

No single method exists for determining the fair market value of the shares of a closely held company. However, there exists a generally accepted theoretical foundation to the process of valuing a business enterprise. The most critical assumption is that the value of an interest in a business to an investor is the *future benefit* that will accrue to it, with the value of the future benefit discounted back to a present value at some appropriate rate that reflects the risks inherent in the business' operations.

Valuation Approaches

In our study, we considered three generally accepted valuation approaches: (i) the Income Approach; (ii) the Market Approach; and (iii) the Asset Based Approach. Traditionally, the development of a fair market value opinion is based on the consideration of these three basic approaches to value. Value indications derived through one or more of these approaches are then analyzed in order to formulate an objective opinion as to the fair market value of the equity interest under valuation. A brief description of the three approaches follows:

> *The Income Approach* measures the value of a business based on the expected stream of monetary benefits attributable to the subject company. Generally, the present value of the income stream to be generated for the benefit of the shareholders over the business' remaining economic life is determined. This approach assumes that the income derived from the business will, to a large extent, control its value.
>
> *The Market Approach* arrives at an indication of value by comparing the company being appraised to comparable publicly traded companies or to comparable businesses which have been recently acquired in arm's-length transactions. The market data is then adjusted for any significant differences, to the extent known, between the guideline companies and the company being valued.
>
> *The Asset Based (or Cost) Approach* is a general way of determining a value indication of a business' assets and/or equity interest using one or more methods based directly on the value of the assets of the business, less liabilities.

As part of this analysis, we have applied the income and market approaches as a determinant of value. Within these approaches, we have used the Single Period Capitalization ("Capitalization") Method, the Market Multiple Method, and the Transaction Multiple Method.[6]

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[6] Within the three valuation approaches are several valuation methods. For example, within the income approach there is the multiple period discounting method, the single period capitalization method, among others. Within the market approach there is the market multiple method, the transaction multiple method, and the direct market data method, among others. Within the asset based approach, there is the adjusted book value method, among others. Within each of these methods, there are several valuation procedures. The discounted cash flow and discounted future earnings are technically procedures within the MPDM of the income approach. The capitalization of cash flow and capitalization of earnings are technically procedures within the single period capitalization method of the income approach. Any of the common multiples seen (such as price to earnings, total invested capital to EBIT, etc.) are procedures within either the market multiple method, the transaction multiple method, or the direct market data method of the market approach.

We have considered, but not used, the cost approach because this approach is usually best suited to a business with little value beyond that of its tangible assets or in which liquidation of the business is an option. Cal-Am is an operating company whose value is derived from its ability to produce future economic benefits; and since the value of the net assets, both tangible and intangible, are included in the aggregate in the income and market approaches.

Other methods considered but rejected include the following:

- The *guideline public company method* within the Market Approach rests on the assumption that the value of business ownership interests can be determined by analysis of how much is paid to acquire similar ownership interests in similar businesses. The most effective means of ascertaining how much is paid for such ownership interests is to identify similar, or guideline, companies which are actively traded on public markets and examine the prices at which their shares trade. The guideline public company method is useful to the extent that adequate and useful information is available. Market transactions in businesses, business ownership interests or securities are utilized to develop valuation measures that can be used in the valuation of the subject business. Guideline companies are companies that provide a reasonable basis for comparison to the characteristics of the subject company being valued. In our search for guideline companies, we identified and analyzed a population of companies researched in various databases according to specific search criteria and have identified none companies deemed as most comparable to Cal-Am.
- The *transaction multiple method* within the Market Approach rests on the assumption that the value of business ownership interests can be determined by analysis of how much is paid to acquire similar ownership interests in similar businesses. This method derives indications of value based on the prices at which entire companies or operating units of companies have been sold, or the prices at which significant interests in companies changed hands. There must be a reasonable basis for selecting certain transactions or investments as a comparison to the subject company. Factors that would influence this decision include: (1) similar quantitative and qualitative data; (2) sufficient known and verifiable information on the given investments or companies; and (3) the basis of the transactions, whether they were "arm's-length" or distressed sales.[7] In our search for guideline companies, we identified and analyzed a population of companies researched in various databases according to specific search criteria and have identified five transactions involving target companies comparable to Cal-Am
- The direct market data ("DMD") method is a market based valuation method whereby all transactions for which market data is available are considered as a statistical ensemble that defines the market for businesses of the same general type (e.g. SIC category) as the target business. The database from which the market data is obtained is the product of a leading association of appraisers, The Institute of Business Appraisers, Inc. ("IBA"). Beacon did not find any transactions involving comparable target companies.

[7] American Society of Appraisers, Business Valuation Standards, BVS-V, p.11.

- *Book value* is the difference between the total assets and total liabilities of a business as they appear on the balance sheet. Since a company's book value does not consider the fair market value of its assets and liabilities, or of any intangible assets, it is not an accurate reflection of the business' fair market value at the Valuation Date. In this case, the Company's value does not heavily depend on its tangible assets. Rather, value is added by the services provided with the use of these assets. Therefore, Cal-Am's book value (book value of equity), was not considered an accurate indicator of the Company's fair market value.
- *Liquidation value* is the value of the Company's assets (less liabilities) valued as if they were to be sold in an orderly, piecemeal manner. Given the fact that the business is a going concern, this method has been rejected as an indication of Cal-Am's fair market value.
- *Dividend paying capacity*, although specifically mentioned in IRS Revenue Ruling 59-60 as a method in valuing a closely held business, is rarely used by business appraisers. Many investors consider a company's dividend paying policies when making their decision to purchase a company. This policy is considered because dividend payments are a good indicator that investors will receive a return on their investment. In addition, Revenue Ruling 59-60 states, "Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders." Finally, the capacity to pay dividends is essentially considered in our income approach analysis. Therefore, this method, in the strict sense, has not been directly used as an indication of Cal-Am's fair market value.
- Rules of thumb are often referred to as homemade recipes for a guess. No one ever seems able to identify the specific transactions from which rules of thumb were determined, and they seldom change with economic or industry conditions. They "may provide insight on the value of a business, business ownership interest or security. However, value indications derived from the use of rules of thumb should not be given substantial weight unless supported by other valuation methods and it can be established that knowledgeable buyers and sellers place substantial reliance on them."[8] As rules of thumb, they do not provide the basis for an appraisal or a business valuation and should therefore only be used as a reasonableness check of the indicated values determined by other methods. As such, they are considered reasonableness checks to help corroborate the values estimated using other approaches.
- *Multiple period discounting*, which involves forecasting future cash flow over some defined forecast period, was rejected as the status and outlook for the Company was one where growth and margins were at a relatively steady state. Also, Beacon did not have access to any projections for the Company. In the alternative, we will use the single period capitalization method, which seeks to derive a "normalized" single-period cash flow for the company being valued which a buyer would believe could be expected in the *next* period, and which is then assumed to be indicative of all future periods.

[8] American Society of Appraisers, Business Valuation Standards, BVS-V, p. 12.

- *Prior transactions* can usually provide an indication of value when they are at arm's-length. Based on information provided by the client, the Company's current parent company paid $186 million for, what is now known as, Cal-Am. Due to the time elapsed since the year of the transaction, and the number of developments that may have affected the value of Cal-Am since the date of the transaction, this price is not deemed relevant for purposes of this valuation.

As mentioned above, the valuation methods utilized to implement the Income and Market Approaches were the Capitalization Method, the Market Multiple Method, and the Transaction Multiple Method.

Income Approach: Single Period Capitalization Method

The single period capitalization ("capitalization") method is based upon the premise that the value of a company can be determined by assessing the future cash flows, earnings, or dividends that will be derived from the ongoing operations of the business. In the present case, cash flows are being capitalized to determine value. The assessment of such future cash flows requires that the risks associated with the Company's operations be analyzed and that such risks be reflected in calculating the present value of those future returns. In essence, the capitalization method attempts to measure what a buyer would be willing to pay currently for the future cash generating potential of an entity. The capitalization method is what is known as a single-period discounting technique. Essentially, rather than try to forecast future cash flow over some defined forecast period, this method seeks to derive a "normalized" or "typical" (i.e., free of unusual, non-recurring financial events) single-period (i.e., annual period) cash flow for the Company which a buyer would expect to be generated in the *next* period. This single period is then assumed to be indicative of all future periods, with provisions for expected future nominal growth (i.e., including inflationary growth) being made through an adjustment to the discount rate. The growth rate of the cash flow stream is assumed to be constant over time and is assumed to be small relative to the discount rate. The adjustment to the discount rate to provide for future growth converts the discount rate to a "capitalization" rate.

In summary, the capitalization method for valuing a company estimates the future cash flows that a business is expected to generate by assuming that a company's cash flow will grow constantly over time. Therefore, the method capitalizes an expected single-period cash flow at a risk-adjusted cost of capital less a growth factor in order to arrive at a net present value for the Company. This method is based on the following formula:

$$v = cf/(k - g)$$

where,

v = estimated value
cf = cash flows
$k - g$ = capitalization rate
k = discount rate
g = growth rate

Selection of Income Stream to be Capitalized

The cash flow to be capitalized results from a sustainable level of earnings and, coupled with anticipated growth, reflects the future expectations of the business. In this case we selected unlevered, which is the net free cash flows on an after-tax, pre-debt basis, which is consistent with the discount rate that is developed in the following section. Debt-free net cash flow is defined as follows:

	Earnings before interest and taxes ("EBIT")
Plus (Less):	Applicable (if any) adjustments to arrive at adjusted EBIT
Less:	Taxes on adjusted EBIT at the Company's effective tax rate
Plus:	Non-cash charges (i.e., depreciation and amortization)
Less (Plus):	Increase (Decrease) in Gross Property, Plant and Equipment
Less (Plus):	Increase (Decrease) in Non-cash Working Capital
Equals:	Net Free Cash Flow

In determining the net cash flow for the normalized period, we analyzed Company financial summary data for the fiscal years ended 2000 through 2004, as well as estimated financial performance for the 12-months period ended November 15, 2005, as estimated by Beacon, based on historical Company trends. See Exhibit II for estimated financial results for the 12-month period ending November 15, 2005 (the Valuation Date).

Normalized Earnings

Beacon has analyzed the historical operating results, which form the basis for the capitalization of net earnings analysis and has determined that they generally provide a reasonable base for expected future performance in light of the Company' track record in achieving the revenues and earnings, and the supporting relevant industry factors gathered in our research of the water utility industry affecting Cal-Am. Specifically, the assumptions used in the capitalization analysis (Exhibit III-1) are discussed in the bullets noted below.

It should be noted that regarding our calculation of a normalized level of net operating income, we chose to apply a weighted average to the five years of financial results under consideration, placing more weight on recent years' performance, in light of the moderately volatile growth experienced by the Company.

- Historical (Unadjusted) Pre-tax Earnings – These figures are sourced directly from the Company's unadjusted income statement, per Exhibit II.
- Normalized Net Operating Income for capitalization is calculated based on a weighted average for fiscal years 2000 through 2004. We have determined that the use of a simple average of the five years would not be reasonable in light of the inconsistency of the revenues and earning levels over this five-year reporting period. We have placed more weight on recent years, due to the increased relevance to the state of economy and the Company, including the regulatory environment, existing as of the Valuation Date.

- It is estimated that depreciation expense would be similar, as a percentage of revenues, to companies comparable to Cal-Am in terms of operations
- Based on input from the Client, it is our understanding that the Company has $50 million in debt, bearing an interest rate of 6 percent. As such, we have estimated that the annual interest expense related to this debt level would approximate $3 million ($50 million x 6%). There is no provision for other income items for the Company on a normalized basis.
- The tax rate of 40 percent applied to income is estimated based on general blended federal and state corporate income tax rates. As a result, EBIT is adjusted for corporate level taxes at a rate of 40 percent.
- The Capitalization Methodology seeks to derive a "normalized" or "typical" single-period cash flow for the Company, which a buyer would believe could be expected in the next period. This normalized net earnings is determined by multiplying the calculated base net earnings of $5,730,656 times the sustainable long-term growth rate of 5 percent. This single period is then assumed to be indicative of all future periods, with provisions for expected future growth being made through an adjustment to the discount rate.
- The net earnings streams for the normalized year are then discounted at a risk-adjusted discount rate, discussed in the next section.
- It is assumed that net earnings are received at mid-year on average. Therefore, the capitalization result must be adjusted by a future value factor of 0.5 (1/2 year).

Discount Rate

The rate of return used to capitalize (or discount) projected future income to a value today must be a reasonable proxy for the return necessary in the market place to attract the capital of the “willing buyer” inherent in the fair market value standard. At its most elemental conceptual level, the rate of return demanded by the investor is the expression of the risk or uncertainty he perceives in the investment. The return acceptable to individual investors varies from investor to investor depending on their perception of risk. Under the fair market value standard, rates are developed assuming that the hypothetical buyer and seller are well informed and prudent, and the investment for the buyer is void of synergy. Under this standard of value the buyer is defined as a financial buyer.

The fundamental premise underlying the selection of a discount or capitalization rate is that the rate of return required by an investor in the subject firm is the sum of the rate required by investors in risk-free securities, plus theoretically derived risk premia. The risk premium is indicative of the incremental rate of return demanded by investors in investments similar in risk to the subject. Hence:

Discount Rate = Risk Free Rate + Risk Premia, and

Capitalization Rate = Discount Rate – Long Term Growth Rate

When using the income approach to value, the estimated future income stream generated by the ongoing operation of the business is discounted at an appropriate risk rate to express an opinion on the present value of the future benefits of ownership. In considering the time factor to be used when discounting, we assume that annual cash flows are to be received throughout the year, so that on average, cash flows would be received mid-year. The discount factor, which is used to determine the present value of the future cash streams, reflects both the business and financial risk of an investment in the Company.

The appropriate rate at which to discount a company's debt-free future cash flows is the weighted average cost of equity and debt capital ("WACC"). The WACC incorporates the returns demanded by both shareholders and debt holders and because pre-debt cash flows are discounted (i.e., cash flows on which both shareholders and debt holders have claims). Therefore, the costs of equity and debt must be considered in proportion to their relative capital contribution. This is performed by weighting the costs of the two components in the calculation of the cost of capital.

Cost of Equity Capital.

The ke reflects the rate of return that an equity investor in the Company would require to compensate for the risks of investing in the Company. We assume an investor would take the following factors into account in assessing risk at the Valuation Date: (i) the available yields on risk-free securities, (ii) the historical premiums over such yields which publicly traded equity securities have offered, (iii) the Company's size relative to publicly traded firms, and (iv) the Company's perceived volatility (i.e., risk) relative to the overall stock market.

The ke represents the expected after-tax return to an investor in a company to compensate him/her for both the business and the financial risk inherent in his investment in a business. The ke of a private company can be estimated using several different methods. For the purpose of this valuation, we used the "build-up method" which can be expressed by the formula:

$$ke = Rf + Rp + Rps + Rpcs$$

where ke is the cost of equity capital; Rf is the risk-free rate of return; Rp is the equity risk premium; Rps is the small company premium; and Rpcs is the company-specific risk premium, or alpha:

- The risk-free rate of return (Rf) is the yield that one can obtain from an investment considered to be risk-free, such as a government security. At the Valuation Date, the Rf, based on 20-year Treasury Bond rate, was 4.83 percent.
- The equity risk premium (Rp) is the additional return that an investor would require for investing in a general portfolio of equity securities, over and above the yield of a risk-free security, such as a government bond. The Rp, as determined by Ibbotson[9] data through December 31, 2004, was 6.1 percent.

[9] Stocks, Bonds, Bills, and Inflation 2005 Yearbook, Ibbotson Associates, Inc. While the premium stated in this analysis is 7.17 percent between 1926 and 2004, a study by Roger Ibbotson and Peng Chen, "Long-Run Stock Returns: Participating in the Real Economy" forecasts the Rp through a supply side model. The supply side Rp, as presented on page 96 of the 2005 Yearbook, is 6.14 percent for the 79 year period. *Financial Analysts Journal* (January/February 2003), pp. 88-98, finds that "these estimates are about 1.25 percentage points lower than the historical estimates." See also, *Shannon Pratt's Business Valuation Update*, November 2003. In addition, the premium for a shorter period of time is lower than 7.2 percent (e.g., the premium over the last 30 years is 6.9% and 6.0% over the last 15 years, but due to the fact that these are shorter timeframes, these returns tend to be more volatile from year-to-year).

- The small company stock risk premium (Rps) represents the additional return, over and above the equity risk premium, that an investor would require for investing in the equity of a company with a total market valuation that is the average of the smallest 10 percent of companies traded on the New York Stock Exchange (i.e., with market capitalization of under $97 million). The Rps, as determined by Ibbotson[10] data through December 31, 2004, was 4.5 percent.

A company-specific risk premium (Rpcs) was then added to the ke as calculated using the build-up method. The company-specific risk premium represents the additional return, over and above the equity and small company risk premiums, which an investor would require for investing in the equity of Cal-Am. Giving consideration to all factors on a general basis, we believe that a prudent investor would find an investment in Cal-Am to be considerably more risky than an investment in a "typical public company," and would require an additional premium in order to compensate for the additional risk associated with the external and internal risks facing the Company. We have factored this additional risk component into our calculation of the discount rate by adding a factor of 600 basis points, or 6 percent, to the ke.

It should be noted that this risk factor is subjective (determined using the judgment of the appraiser) in that there is no objective source of data to properly reflect or to quantify this premium. It is based on the appraiser's informed judgment, determined by a qualitative and quantitative analysis of the Company. Therefore, a review of the Company's strengths and weaknesses must be performed in order to determine an appropriate company-specific risk level. The risk factors used in the determination of this risk premium are as follows:

The weaknesses of the Company, which have an upward impact on Cal-Am's company-specific risk premium are as follows:

- Cal-Am is very small as compared to the companies used to derive this build-up rate, and the small company risk premium added does not fully compensate for the market risk of investing in the Company given its size
- the Company is subject to heavy local, regional government, and other regulation;
- the Company is heavily indebted and therefore has very limited to no capacity to take on any additional debt and leverage if needed
- the Company's processes may soon be outmoded due to changes in sources of water and changes in the most efficient method of tapping into new resources of water
- Cal-Am is lacking the financial resources that may be required to invest in capital expenditures needed to adapt to changes in water resources or methods of tapping into these resources

Based on the aggregate of the above risk components, we estimate that Cal-Am's ke is 21.4 percent (rounded) at the Valuation Date, which is calculated as follows:

$$ke = Rf + Rp + Rps + Rpcs$$

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[10] *Ibid.*

$$21.4\% = 4.8\% + 6.1\% + 4.5\% + 6\%$$

Cost of Debt Capital.

The cost of debt capital ("kd") represents the after-tax interest cost to a company from borrowing long-term funds. Based on information provided by the Client, Cal-Am's borrowing rate is 6 percent. The cost of debt capital can be expressed by the formula:

$$kd = i * (1 - t)$$

$$3.6\% = 6\% * (1 - 40\%)$$

where kd is the cost of debt capital; i is the borrowing rate; and t is the corporate income tax rate.

Weighted Average Cost of Capital.

The WACC is the blended cost of equity and debt capital applicable to a company.

Cal-Am's existing capitalization represents the financial structure chosen by its current owners. From our analysis, we determined that the Company's current capital structure is comprised of 60 percent debt and 40 percent equity.

We performed the procedures described above and estimated that Cal-Am's WACC was 11 percent (rounded) at the Valuation Date, calculated as follows:

$$WACC = (\%\ Equity * ke) + (\%\ Debt * kd)$$

$$11\% = (40\% * 21.4\%) + (60\% * 3.6\%)$$

The discount rate is then applied to the net free cash flows in determining the capitalized value of the future cash flows for the Company.

Conversion to Net Income

The above discount rate is one that is applicable to net free cash flow. In the present analysis, we are capitalizing a net earnings income stream. As such, the above-derived net free cash flow discount rate must be converted to a net earnings discount rate. There have been no definitive studies of public company data on this conversion factor. However, many experienced practitioners feel that this difference most typically ranges from 3 percent to 6 percent, but can be lower or higher[11]. That is a net cash flow discount rate can be converted to a net income discount rate by adding a 3 to 6 percent

[11] Z. Christopher Mercer, "Adjusting Capitalization Rates for the Differences Between Net Income and Net Free Cash Flow", *Business Valuation Review*, December 1992.

increment, or conversion factor. For this particular valuation, given the minimal relative level of capital expenditures needed in the operations of the business (for its current state) and the lack of heavy reliance on working capital growth for the type of revenue growth that is being forecasted, we have anticipated a conversion factor below this typical range, or 1 percent, to convert the net cash flow discount rate derived above to a net income discount rate. This 1 percent conversion factor was included in our derivation of the Company specific risk and the resulting cost of equity. As such, the discount rate applicable to net income is 11 percent.

Capitalization Rate

Consistent with the previous discussion of the capitalization method, the WACC, or discount rate, is reduced by a constant growth factor to determine a capitalization rate. In general, capitalization rates are determined by the market, depend on what type of income is being capitalized, vary with time, are sensitive to inflationary expectations, and have a very long time-horizon expected growth rate. In determining a growth factor, we considered the following: (1) since the investment horizon is undefined but presumed to be very long, the rate of growth assumed must be one that could reasonably be expected to be sustained indefinitely; (2) over a prolonged period of time, it is difficult to sustain growth that exceeds the rate of inflation plus per capita gross national product (i.e., growth in the economy as a whole); (3) the growth patterns of the industry in which the Company operates (per the Industry Analysis section); (4) all businesses are subject to life cycles, and the growth rate assumed in any given valuation must take into consideration the existing state of "maturity" of the subject company; and (5) the Company's historical growth patterns.

Specifically with regard to Cal-Am, we factored in the following considerations when determining the Company's long-term growth rate of 5 percent: (i) the economic outlook, presented in the Economic Background section, reports a restated annualized growth rate of approximately 3.5 to 4 percent in the real GDP; and (ii) the growth in Cal-Am's revenues has realized a 5-year average revenue growth rate of 4.8 percent.

Based on the aforementioned factors, we have selected a long-term sustainable growth rate of 5 percent. Therefore, the capitalization rate is estimated at the discount rate of 11 percent minus the 5 percent growth rate, or 6 percent. The capitalization rate is then applied to the normalized cash flows in determining the Total Invested Capital (total equity and debt) of the Company under the capitalization method.

The fair market value of Cal-Am's equity is determined by then reducing the unadjusted total invested capital of the Company by the level debt of $50 million. In the case of Cal-Am, there were no adjustments applicable to the unadjusted equity value of the Company. Thus, the indicated fair market value of Cal-Am's equity, as of November 15, 2005, based on the capitalization method is $50,630,000. This analysis is presented in Exhibit III-1.

EXHIBIT III-1

California-American Water Company Monterey District

Capitalization of Net Earnings Analysis

	Normalized	2004	2003	2002	2001	2000
Calculation of Earnings:						
Operating Revenues		27,580,561	28,157,576	24,893,343	27,263,494	21,928,756
Less: Total Operating Expenses		15,822,139	16,051,626	14,548,673	15,617,646	11,973,787
Plus (Less): Normalization Adjustments		0	0	0	0	0
Equals: Adjusted Net Operating Income	**11,433,106**	11,758,422	12,105,950	10,344,670	11,645,848	9,954,969
Plus (Less): Other Income (Expense)	0	0	0	0	0	0
Less: Depreciation Expense	2,336,827	2,482,250	2,534,182	2,240,401	2,453,714	1,973,588
Less: Interest Expense	3,000,000	3,000,000	3,000,000	3,000,000	3,000,000	3,000,000
Equals: Adjusted Pretax Income	6,096,279	6,276,172	6,571,768	5,104,269	6,192,134	4,981,381
Add back: Interest Expense	3,000,000	3,000,000	3,000,000	3,000,000	3,000,000	3,000,000
Adjusted Earnings Before Interest and Taxes (EBIT)	9,096,279	9,276,172	9,571,768	8,104,269	9,192,134	7,981,381
Less: Provision for Income Taxes	3,638,512	3,710,469	3,828,707	3,241,708	3,676,853	3,192,552
Equals: Debt-free Net Income	5,457,767	5,565,703	5,743,061	4,862,561	5,515,280	4,788,829

Earnings for Capitalization	5,730,656
Capitalization Rate based on WACC	6.00%
Future Value Adj for Mid-Year Convention	1.0536
Total Invested Capital ("TIC")	100,627,007
Less: Debt	50,000,000
Unadjusted Estimated Value of Equity	50,627,007
Less: Net Discount	0
Plus: Excess Cash Balance	0
Fair Market Value of Equity (rounded)	**$50,630,000**

Calculation of weighted average:

		2004	2003	2002	2001	2000
Net Operating Income		11,758,422	12,105,950	10,344,670	11,645,848	9,954,969
Weighting of historic period		5	4	3	2	1
		58,792,110	48,423,800	31,034,010	23,291,696	9,954,969
Weighted Average Net Operating Income	11,433,106					

Market Approach: Market Multiple Method

The market multiple method utilizes market transactions in businesses (i.e., guideline companies), business ownership interests or securities to develop valuation measures that can be used in the valuation of the subject business. This method is useful to the extent that adequate and useful information is available. Guideline companies are companies that provide a reasonable basis for comparison to the characteristics of the subject company being valued. The guideline companies should, ideally, operate within the same industry as the subject company. The lack of sufficient transactions in companies in the same industry may require the use of companies with similar investment and/or operating characteristics, such as markets, product growth, cycles and/or other similar factors. Once these guideline companies have been identified, this method then consists of developing ratios of value or market "multiples" based on (i) the traded market value of each selected public company and (ii) operating performance and financial condition indicators such as earnings (at various levels), cash flow, and/or revenues. The indicated fair market value of the Company's equity is determined by then reducing the indication of total invested capital by the amount of debt. This analysis is presented in Exhibit III-2 at the end of this section.

Market Approach: Transaction Multiple Method

The transaction multiple method rests on the assumption that the value of business ownership interests can be determined by analysis of how much is paid to acquire similar ownership interests in similar businesses. This method derives indications of value based on the prices at which entire companies or operating units of companies have been sold, or the prices at which significant interests in companies changed hands. Multiples are developed based on (i) the actual price paid for the company that has been acquired and (ii) operating performance and financial condition indicators such as earnings (at various levels), cash flow, and/or revenues. The indicated fair market value of the Company's equity is determined by then reducing the indication of total invested capital by the amount of debt. This analysis is presented in Exhibit III-3 at the end of this section of the report.

Non-operating Assets

A non-operating asset is defined as any asset that can be both identified and separated from a business without any impairment in its operating results or to the financial position necessary to operate the business. Examples of non-operating assets include: cash or other liquid investments, land or buildings which have no present or future use in the business, cash value of life insurance, partnership investments, loans to officers and shareholders, and excess working capital invested in accounts receivable, inventory, or reduced levels of accounts payable.[12] Because Beacon had very limited access to data for the Company, no adjustments for non-operating assets were made in this case.

Discount for Lack of Marketability

When valuing a non-controlling interest in a company, two separate discounts are typically applicable to the pro rata value of the stock. Discounts may be taken for the lack of control and related disadvantages

[12] Patton, Kenneth W. "Treatment of Non-Operating Assets – With a Focus on Excess Working Capital." Business Appraisal Practice. Winter 2000-2001, p. 41.

that are associated with owning a non-controlling interest (i.e., a discount for lack of control or "DLOC"), and for that interest's lack of marketability. Discounts for lack of marketability ("DLOM") are meant to account for the lack of liquidity (or marketability) of stock that is not traded on public exchanges. The relationship between the DLOM (also referred to as an illiquidity discount or a marketability discount) and the DLOC lies in the fact that, even after discounting a non-controlling interest for its lack of control, it is still significantly more difficult to sell a non-controlling interest, than to sell a controlling interest, in a closely held business. Within the income approach to value, a DLOC is only applicable when adjustments have been made to the cash flows being discounted or capitalized. Since we have made no such adjustments in this analysis, only a DLOM is applicable to the valuation of the Interest being valued.

Because of their various disadvantages, non-controlling interests in closely-held companies are usually much less liquid or marketable than controlling interests; certainly they are less marketable than the total company. Furthermore, a relatively small interest is usually less marketable than an interest large enough to have some influence on company policies.

Given Cal-Am's ownership by a publicly-traded company and the fact that we are valuing a 100 percent controlling interest, coupled with the application of the relevant methods used in this analysis, no adjustments were made for lack of marketability.

Discount For Lack of Control

A discount for lack of control ("DLOC") is applied to the equity value in order to determine the value of a non-controlling interest (*aka*, minority interest) for the transaction multiple method, as the basis of this method is one of control. The concept of a non-controlling interest deals with the relationship between the interest being valued and the total enterprise. The primary factor influencing the value of the non-controlling interest in relation to the value of the total business is how much control, or lack thereof, the non-controlling interest has over that entity. While there is no set formula for determining the exact percentage of DLOC, it can be determined as the corollary of the control premium.

A control premium represents the portion of a price paid for a majority interest in a company that is over and above the per share price. This is because in a control position owners are able to exercise their rights to change and shape the company. These rights include electing directors, appointing the management team, acquiring and liquidating corporate assets, setting business policy, declaring dividends, determining compensation and selling or acquiring treasury stock. These are all actions that minority shareholders cannot effect, making their interest worth less relative to those of a controlling shareholder. The discount for lack of control is derived from control premium data by subtracting one divided by one plus the control premium from one. Mathematically, that is 1-(1/(1+cp)), where cp represents the control premium.

As with the DLOM, with respect to the quantification of the DLOC, it is necessary to review all available and pertinent empirical studies, tax court cases, and applicable revenue rulings to conclude on a reasonable measure of this discount. We have studied the following information in determining an appropriate DLOC: (i) Empirical Evidence as provided by the *Mergerstat/Shannon Pratt's Control Premium Study*™ for transactions involving a control premium, (ii) Empirical Evidence as provided by closed-end mutual funds, and (iii) Tax Court Rulings on Discounts for Lack of Control. Due to the summary nature of this report, the details behind each of these sources are available only in our workpapers.

Given the fact that we are valuing a 100 percent controlling interest, coupled with the application of the relevant methods used in this analysis, no adjustments were made for lack of control.

Checks to Value

Checks to Value are performed once indications to value are determined based on the various approaches to valuation. As mentioned earlier, we have considered the transaction multiple method within the market approach as a check to value. This method rests on the assumption that the value of business ownership interests can be determined by analysis of how much is paid to acquire similar ownership interests in similar businesses. This method derives indications of value based on the prices at which entire companies or operating units of companies have been sold, or the prices at which significant interests in companies changed hands. Multiples are developed based on (i) the actual price paid for the company that has been acquired and (ii) operating performance and financial condition indicators such as earnings (at various levels), cash flow and/or revenues.

Based on a value of Cal-Am's total invested capital (not equity), which includes equity *and* debt (or $106,300,000)[13], our conclusion of value translates into a revenue multiple of 3.65 on the estimated LTM revenues. This result is within the range of the five transactions sampled in the Transaction Method.

Balancing out the results of the above transaction multiple analysis, we deem our conclusion of value as reasonable.

Conclusion of Value

The following table summarizes the results of the valuation methodologies we used and reflects how the allocations for the weighted values are brought together. As there is no precise formula for determining the percentage weight to apply to the various indications of value, the relevant facts and circumstances will dictate the respective weighting assigned to each. The weights applied to the values indicated by each method are not intended to turn the final valuation into a mathematical formula, but to assist the reader in grasping the appraiser's confidence in each method for the reason discussed in the section to which the table is a part.

WEIGHTING OF VALUATION METHODOLOGIES – Table III-1

Valuation Method	Indication of Value	Weight	Value Factor
Income Approach	$50,630,000	40%	$20,252,000
Market Multiple	$47,890,000	20%	$9,578,000
Transaction Multiple	$52,270,000	40%	$20,908,000

13 As a check to value, we have calculated the total invested capital of the Company, which includes both debt and equity, as opposed to determining solely the equity value of the Company. This exercise was performed for the purpose of drawing a comparison of the acquisition multiples researched to a comparable multiple of Cal-Am's value to revenues (the financial barometer obtained in our research). The acquisition multiples obtained were based on values that included both the equity and debt components. The $106,300,000 referenced above is the sum of the line item "Indicated Value of Equity" in Exhibit III-1, or $50,630,000, plus the operating interest-bearing debt, or $50,000,000.

Taking into account all that was developed through our study, it is our opinion that the fair market value, in continued use, of a 100 percent of the issued and outstanding common stock (equity) of Cal-Am, at November 15, 2005, is **$50,700,000**.

It must be noted that the above value indication does not include any direct downward adjustments to value due to the potential impact of any contingent liabilities, estimated by the Client and its representatives to approximate $175 million as of the Valuation Date. Therefore, any value conclusions presented herein should be perceived as a maximum value, excluding any direct impact of such contingent liabilities. The full consideration of the aforementioned contingent liabilities as part of the analysis, had the CL been valued separately and directly, could potentially have a significant downward impact on the Company value conclusion, as presented above. Beacon was not retained to directly value the impact of any contingent liabilities, because the key component of that analysis would most likely require the use of legal and other expertise input outside the scope of this Engagement. The reference to any CL within this report is provided solely for purposes of presenting all data available to Beacon as of the date of this Report.

Although we believe the information and assumptions used in our analysis constitute a reasonable basis for the preparation of this report and our conclusion of value, the ultimate determination of the amount at which an equity interest may change hands would rest with the parties to such a transfer based on their own individual evaluation of factors involved. Furthermore, our analysis contemplates facts and conditions existing as of the Valuation Date. Events and conditions subsequent to that date may have a material effect upon the value of the Company.

Our determination of fair market value is not a finding of fact. It is a finding of opinion based on the facts known to us as of the Valuation Date. It is supported by our research, review and analysis of the documentation and information provided to us and by our informed and unbiased opinion. Failure of our opinion to be accepted by any person or entity (government or otherwise) shall not constitute a breach of any of our duties under this agreement, give rise to any claim or cause of action by the Client or any third parties, nor relieve the Client of any duties hereunder.

EXHIBIT III-2
California-American Water Company Monterey District
Market Multiple Data
Income Statement Summary and Comparison
Utility Industry (SIC 4941)

Company Name	Ticker	Revenue ($000's)	Depreciation Expense ($000's)	Interest Expense ($000's)	Pretax Income ($000's)	Net Income ($000's)	EBIT ($000's)	EBITDA ($000's)	Common Size EBIT	Common Size EBITDA	Common Size N.I.
Southwest Water Company	SWWC	147,026	9,195	5,612	7,098	4,534	12,710	21,905	8.6%	14.9%	3.1%
SJW Corp.	SJW	166,911	18,481	9,247	31,430	19,786	40,677	59,158	24.4%	35.4%	11.9%
California Water Service Group	CWT	315,567	26,114	17,840	26,026	8,942	43,866	69,980	13.9%	22.2%	2.8%
American States Water Company	AWR	228,005	20,824	17,850	32,006	18,541	49,856	70,680	21.9%	31.0%	8.1%
Aqua America, Inc.	WTR	442,039	58,864	46,375	132,131	80,007	178,506	237,370	40.4%	53.7%	18.1%
Middlesex Water Company	MSEX	70,991	6,388	5,469	12,260	8,446	17,729	24,117	25.0%	34.0%	11.9%
Pennichuck Corporation	PNNW	23,025	3,084	1,952	2,959	1,820	4,911	7,995	21.3%	34.7%	7.9%
The York Water Company	YORW	22,504	1,815	3,197	8,352	5,301	11,549	13,364	51.3%	59.4%	23.6%
BIW Limited	BIW	9,866	879	574	758	511	1,332	2,211	13.5%	22.4%	5.2%
	Median	*147,026*									
	1st Quartile	*23,025*									

	EBIT	EBITDA	N.I.
Min	8.6%	14.9%	2.8%
Max	51.3%	59.4%	23.6%
Median	21.9%	34.0%	8.1%
Mean	24.5%	34.2%	10.3%
1st Quartile	13.9%	22.4%	5.2%
3rd Quartile	25.0%	35.4%	11.9%
Cal-Am	**NA**	**43.0%**	**NA**

Company Name	Ticker	11/15/2005 Stock Price [1]	Shares Outstanding (000's)	Total Interest-Bearing Debt ($000's)	Total Invested Capital (TIC)	TIC/ EBIT	TIC/ EBITDA	Price/ Earnings	TIC/ Revenues
Southwest Water Company	SWWC	$13.61	21,530	127,739	420,762	33.1	19.2	64.6	2.9
SJW Corp.	SJW	$50.17	9,140	208,855	667,409	16.4	11.3	23.2	4.0
California Water Service Group	CWT	$35.91	18,390	274,821	935,206	21.3	13.4	73.9	3.0
American States Water Company	AWR	$30.69	16,790	228,902	744,187	14.9	10.5	27.8	3.3
Aqua America, Inc.	WTR	$33.56	128,670	784,461	5,102,626	28.6	21.5	54.0	11.5
Middlesex Water Company	MSEX	$19.51	11,520	115,281	340,036	19.2	14.1	26.6	4.8
Pennichuck Corporation	PNNW	$19.47	4,190	16,946	98,525	20.1	12.3	44.8	4.3
The York Water Company	YORW	$24.40	6,920	35,871	204,719	17.7	15.3	31.9	9.1
BIW Limited	BIW	$18.43	1,660	9,000	39,594	29.7	17.9	59.9	4.0
					Min	14.9	10.5	23.2	2.9
					Max	33.1	21.5	73.9	11.5
					Median	20.1	14.1	44.8	4.0
					Mean	22.3	15.1	45.2	5.2
					1st Quartile	17.7	12.3	27.8	3.3
					3rd Quartile	28.6	17.9	59.9	4.8
					Selection	16.0	11.0	25.0	3.0

Notes:
This data has been sourced from EDGAR reflecting financial statement data from the most recent 10-K. It has not been verified or adjusted in any way by Beacon.

Indications of Value:	**Revenue**	**EBIT**	**EBITDA**	**Net Income**
Company Fundamentals	27,580,561	NA	11,859,641	NA
Selected Multiple	3.0	16.0	11.0	25.0
Size Adjustment	10%	10%	10%	10%
Adjusted Multiple	2.7	14.4	9.9	22.5
	74,467,515	NA	117,410,448	NA
Less: Interest-Bearing Debt	50,000,000	50,000,000	50,000,000	
Unadjusted Indicated Value of Equity	24,467,515	NA	67,410,448	NA
Selected Weight	60%	0%	40%	0%
	14,680,509	NA	26,964,179	NA
Unadjusted Indicated Value of Equity	41,644,688			
Estimated Discount/Premium	-15%			
Plus: Excess Assets	0			
Indicated Value of Equity	$47,890,000			

EXHIBIT III-3
California-American Water Company Monterey District
Acquisition Multiple Data
Income Statement and Multiple Summary and Comparison
Water Utility Industry (SIC 4941)

Date	Acquiring Company	Target Company	Total Acquisition Cost (TIC)	Debt Assumed	Market Value of Equity (MVE)	EBIT	EBITDA	Total Revenue	Net Income	Common Size EBIT	Common Size EBITDA	Common Size Net Income
Jan-00	Kelda Group plc	Aquarion Cmpany	596,000,000	141,000,000	455,000,000	34,054,000	48,586,000	115,669,000	19,959,000	29.4%	42.0%	17.3%
Mar-99	Philadelphia Suburban Corporation	Consumers Water Company	460,000,000	190,000,000	270,000,000	40,466,000	52,458,000	98,469,000	16,251,000	41.1%	53.3%	16.5%
May-00	California Water Service Group	Dominguez Service Corporation	68,433,000	12,369,000	56,064,000	4,264,000	5,708,000	28,497,000	2,242,000	15.0%	20.0%	7.9%
Nov-00	Thames Water plc	E'town Corporation	690,100,000	-	690,100,000	37,907,000	51,261,000	138,306,000	20,592,000	27.4%	37.1%	14.9%
Feb-96	No Data	Water Business of PGE Energy, Inc.	413,500,000	141,100,000	272,400,000	21,489,000	29,347,000	66,306,000	8,746,000	32.4%	44.3%	13.2%
							Median:	*98,469,000*				
							1st Quartile:	*66,306,000*				

Date	Acquiring Company	Target Company	TIC/ EBIT	TIC/ EBITDA	TIC/ Revenue	MVE/ Net Income
Jan-00	Kelda Group plc	Aquarion Cmpany	17.5	12.3	5.2	22.8
Mar-99	Philadelphia Suburban Corporation	Consumers Water Company	11.4	8.8	4.7	16.6
May-00	California Water Service Group	Dominguez Service Corporation	16.1	12.0	2.4	25.0
Nov-00	Thames Water plc	E'town Corporation	18.2	13.5	5.0	33.5
Feb-96	No Data	Water Business of PGE Energy, Inc.	19.2	14.1	6.2	31.1
		Min	11.4	8.8	2.4	16.6
		Max	19.2	14.1	6.2	33.5
		Median	17.5	12.3	5.0	25.0
		Mean	16.5	12.1	4.7	25.8
		1st Quartile	16.1	12.0	4.7	22.8
		3rd Quartile	18.2	13.5	5.2	31.1
		Selection	14.0	10.0	4.0	20.0

	EBIT	EBITDA	Net Income
Min	15.0%	20.0%	7.9%
Max	41.1%	53.3%	17.3%
Median	29.4%	42.0%	14.9%
Mean	29.1%	39.3%	13.9%
1st Quartile	27.4%	37.1%	13.2%
3rd Quartile	32.4%	44.3%	16.5%
CalAm Water Company	**NA**	**43.0%**	**NA**

Notes:
This data has been sourced from Pratt's Stats and has in no way been verified by Beacon.
NA: Data not available
Transactions involving target companies with revenues most comparable to CalAm were deemed as the top selections for valuation purposes.
1st quartile selected as CalAm exhibited greater financial risk metrics than the group examined.

Indications of Value:	**EBIT**	**EBITDA**	**Revenue**	**Net Income**
Company Fundamentals (As of 11/15/2005)	NA	11,859,641	27,580,561	NA
Selected Multiple	14.0	10.0	4.0	20.0
Size Adjustment	10.0%	10.0%	10.0%	10.0%
Adjusted Multiple	12.6	9.0	3.6	18.0
	NA	106,736,771	99,290,020	NA
Less: Interest-Bearing Debt	50,000,000	50,000,000	50,000,000	
Unadjusted Indicated Value of Equity	NA	56,736,771	49,290,020	NA
Selected Weight	0%	40%	60%	0%
	NA	22,694,708	29,574,012	NA
Unadjusted Indicated Value of Equity	52,268,720			
Estimated Discount/Premium	0%			
Plus: Excess Assets	0			
Indicated Value of Equity	**$52,270,000**			

SECTION IV

SUPPORTING DOCUMENTATION

This Summary Appraisal Report is the result of substantial financial calculations and analysis. We have maintained orderly and comprehensive workpapers that provide further support for the value presented herein and, if requested by you, we will discuss extending our engagement in order to prepare additional schedules, more detailed written analysis, or other materials demonstrating how we arrived at this value.

Sources of Information Relied Upon

During the course of our investigation, we relied upon the following materials and personnel:

- Conversations with Mr. Nader Agha
- Subsequent follow-up phone conversations and e-mails with Mr. Burke Pease and Ron Weitzman of Monterey Flow prior to the date of this report
- Historical summary financial performance for Cal-Am for FYE 2000 through FYE 2004, as presented in an independent third-party appraisal report prepared by Krieger & Stewart, Inc., dated August 2, 2005.
- SEC filings
- Economic data, as specified
- Industry statistics, studies and forecasts, as specified
- Market data, as specified
- Research with respect to the selection of and analysis of the operations of other companies in the same or similar industry
- Guide to Business Valuations, Practitioners Publishing Company, March 2002
- Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses, 2nd edition, Gary R. Trugman, 2002
- Valuing a Business – The Analysis and Appraisal of Closely Held Companies, 4th edition, Shannon P. Pratt, Robert F. Reilly, Robert P. Schweihs, 2000
- Cost of Capital – Estimation and Applications, Shannon P. Pratt, 2002
- The Market Approach to Valuing Businesses, Shannon P. Pratt, 2001
- Quantifying Marketability Discounts, Z. Christopher Mercer, 2001
- *Business Valuation Review*, American Society of Appraisers, various issues
- *Business Appraisal Practice*, The Institute of Business Appraisers, various issues
- *Shannon Pratt's Business Valuation Update*, Business Valuation Resources, LLC, various issues
- Uniform Standards of Professional Appraisal Practice, The Appraisal Foundation
- Business Valuation Standards, American Society of Appraisers
- Business Appraisal Standards, The Institute of Business Appraisers, Inc.
- Cost of Capital Quarterly, 2004, Ibbotson Associates, Inc.

- Stocks, Bonds, Bills, and Inflation 2005 Yearbook, Ibbotson Associates, Inc.
- Integrainfo.com
- 1stresearch.com
- Databases: xls, Pratt's Stats, Done Deals, BIZCOMPS, IBA Market Data
- Other sources as specified herein

SECTION V

TERMS OF VALUATION ANALYSIS

Assumptions and Limiting Conditions

This appraisal report has been made with the following assumptions and limiting conditions, many of which may have a significant influence on the valuation conclusion, including without limitation, the following:

1. We have relied solely and fully, without independent verification, on all data and information (including any statements or representations, whether written or oral) provided to us or made by the Client, or the Client's other representatives or agents. We have assumed, with the Client's permission, all such data and information is true, correct, complete and accurate in all respects and reflects the Company's status and prospects at the Valuation Date from both an operating and a financial point of view. However, there is no guarantee that all relevant information has been disclosed to us. Beacon may have also relied on information from third parties or from publicly available data and sources that we have not audited or verified but which we have deemed true, correct and complete. Beacon had no access to Company management for financial or other information that would have otherwise been considered and utilized as part of this analysis.
2. Our valuation has assumed the Company will continue to operate as it is presently configured, as a going concern and in the ordinary course, without material adjustments to its capital structure, product lines, services offered, and the like, and is based on past and existing results of operations. Any incorrectness of this assumption could have a material effect upon the value of the Company's equity and therefore on the value of the Interest. Beacon shall not be liable to the Client or Company or to any other person in the event such assumption ultimately proves to have been incorrect.
3. Our report contains an opinion of the fair market value of the equity based on Company, industry and general market conditions known to us at the Valuation Date. Events and conditions subsequent to that date may have a material effect upon the value of the Company. Beacon shall not be held responsible for changes in market conditions and shall not be obligated to revise its report to reflect events or conditions that occur subsequent to the Valuation Date, unless separate arrangements are made.
4. Our services cannot be relied on to disclose any errors, irregularities, or illegal acts, including fraud or defalcations, which may exist. The scope of our valuation excludes forensic accounting, and more than a reasonable inquiry into the quality of management. We have assumed, for example, that there is no underreporting of income or other misrepresentations of the financial condition of the Company. We have also assumed that all required licenses, certificates of occupancy, consents or legislative or administrative authority from any Federal, state or local government, private entity or organization have been or can be obtained or renewed for any use on which the opinion contained in our valuation report is based. No investigation of title to the business or its assets has been made. Ownership claims to the business and its assets are assumed to be valid. We assume no hidden or unexpected conditions to the subject assets, properties or business interests, except as stated in our report.

Except as otherwise stated in our report, we assume full compliance with all applicable Federal, state and local laws and regulations and that there are no Federal or state laws or regulations that would alter the valuation process. Any significant errors or omissions in the information provided to us could have a material effect on the analysis and/or the resulting conclusions.

5. Beacon is not a law firm and none of its employees or consultants are licensed to practice law in any jurisdiction. Issues we consider and documents we review in the course of our valuation that may have legal ramifications are considered from a layperson's perspective using the reasoning expressed or implied within the report. Accordingly, our report does not constitute a legal opinion nor may it be relied upon by any party as such. Should legal ramifications of our report be material to any users of our report, proper legal counsel should be obtained by such persons or entities. Beacon was not retained to investigate the claims or value the financial impact related to any existing contingent liabilities of the Company, as of the Valuation Date.

6. We have relied in our analysis on, among other things, summary financial information as presented in an independent third-party report. We have neither audited nor reviewed any of the historic, current or forecasted financial information furnished to us in accordance with the rules of the AICPA and other like professional organizations. In rendering our opinion we have assumed such financial data are true, correct and complete and fairly and accurately reflect the financial position of the Company as of the dates therein referenced. Beacon expresses no opinion or any other form of assurance on and will take no steps to determine if the Company's financial statements or accounting generally departs from Generally Accepted Accounting Principles ("GAAP") or tax reporting requirements or the existence, in connection therewith, of any fraud, misrepresentation, errors or irregularities.

7. The Client acknowledges that some of our assumptions inevitably will turn out to be incorrect, and unanticipated events and circumstances may occur affecting the accuracy of our valuation. No projections can anticipate economic, socioeconomic, or political factors or acts of God that may impact on the expected growth of the Company. Therefore, the actual performance of the Company in the areas that are estimated, forecasted or projected, will vary from the estimates, forecasts, and projections we use in formulating our opinion, and such variation may be material. While developed in good faith and as a non-advocate, Beacon does not express any opinion or form of assurance on the likelihood of the Company achieving such estimates, forecasts or projections or on the reasonableness of the assumptions we use in conducting our valuation.

8. We express no opinion as to the tax consequences of our valuation. We express no opinion as to: (i) the tax consequences of any transaction that may take into account or use our valuation result, (ii) the tax consequences of any net value received or to be received as a result of such a transaction, or (iii) the possible impact on the fair market value resulting from any need to effect a transaction to pay taxes. The Client is urged to contact its own tax advisor(s) with respect to such impacts or consequences.

9. Our report gives no consideration to any contingent assets or liabilities other than those specified, if any, within this report.

10. Neither Beacon nor any individual signing or associated with our report shall be required by reason of such signing or association to give testimony or appear in court or other legal proceedings, unless all conditions to such testimony or appearances contained in this Agreement have been satisfied.
11. Neither our opinion of value nor our report constitutes advice for any specific action.
12. We have not considered the effect on fair market value of any restructuring, recapitalization, outside financing, merger, acquisition or other sale of the Company or any public offering of the Company's stock. If material changes, other than those specified in this report, occur in the ownership of the Company or if the Company contemplates becoming a party to any outside financing, sale transaction or public offering, the impact upon value could be significant and some of the assumptions inherent in our valuation could be invalid.
13. Beacon expressly prohibits the Company from using this summary appraisal report as an expert report. In the event of litigation, Beacon will need to complete a more comprehensive report. This summary appraisal report does not contain all of the required disclosures of a comprehensive appraisal report. Therefore, only those individuals who have complete knowledge about the appraisal subject may be aware of all of the facts and circumstances that are not contained herein.

Statement of Qualifications and Disinterestedness

This report was prepared under the direction of René Hlousek, ASA, president of Beacon. The American Society of Appraisers has a mandatory recertification program for all of its Senior members. Mr. Hlousek is in compliance with the requirements of the above program.

This report is in compliance with *USPAP*, developed and amended by the Appraisal Standards Board of the Appraisal Foundation. Our certification of value is attached. Neither Beacon nor its owner or any associated professional staff have any present, prospective, direct or indirect interests in Cal-Am or the interest whose value we have determined, or any other interest which might prevent us from performing an unbiased valuation.

California-American Water Company Monterey District Water System

Appraiser's Certification

I certify that, to the best of my knowledge and belief:

- The statements of fact contained in this report are true and correct.
- The reported analyses, opinions and conclusions are limited only by the reported assumptions and limiting conditions, and are my personal, impartial, and unbiased professional analyses, opinions, and conclusions.
- I have no present or prospective interest in the business or intangible asset that is the subject of this report, and I have no personal interest with respect to the parties involved.
- I have no bias with respect to the business or intangible asset that is the subject of this report or to the parties involved with this assignment.
- My engagement in this assignment was not contingent upon developing or reporting predetermined results.
- My compensation for completing this assignment is not contingent upon the development or reporting of a predetermined value or direction in value that favors the cause of the client, the amount of the value opinion, the attainment of a stipulated result, or the occurrence of a subsequent event directly related to the intended use of this appraisal.
- My analyses, opinions and conclusions were developed, and this report has been prepared, in conformity with the *Uniform Standards of Professional Appraisal Practice* as promulgated by the Appraisal Foundation, the *Principles of Appraisal Practice*, *Code of Ethics,* and *Business Valuation Standards* as promulgated by the American Society of Appraisers, and the *Business Appraisal Standards* and *Code of Ethics* of The Institute of Business Appraisers, Inc.
- No one has provided significant business appraisal assistance to the person signing this certification.

____

René Hlousek, ASA
President
Beacon Valuation Group, LLC

Accredited Senior Appraiser, Business Valuation
(The American Society of Appraisers) and

Member
(The Institute of Business Appraisers, Inc.)

SECTION VI

STATEMENT OF QUALIFICATIONS

Beacon Valuation Group, LLC

Beacon is a leading provider of valuation advisory services, located in San Francisco. Beacon's business and intangible asset valuation practice performs strategic and financial advisory services for clients nationwide throughout every phase of the economic cycle. Our business appraisals are independent, unbiased determinations of value that are based on objective, well-documented information and analysis. Appraisals form the foundation of transactions and business, estate, financial, and succession plans.

Beacon performs Business Valuations for a variety of purposes, including tax restructuring, regulatory reporting, estate and gift tax planning, transfer of a business or equity interest, strategic planning, liquidation, and litigation. Beacon values a wide array of intangible assets and intellectual property, including patents, technology, trade secrets, trade names and trademarks, corporate brands, in-process R&D, customer lists, software, licensing agreements, contractual agreements such as non-competes, and goodwill. Beacon performs the above valuations for strategic, financial reporting, litigation, and/or tax purposes, including purchase price allocations (SFAS 141), goodwill impairment testing (SFAS 142), charitable donations, and for IP holding companies. Beacon also performs valuations for licensing purposes and other transfers of intellectual property, including transfer pricing studies in accordance with IRS Section 482.

Beacon offers a powerful combination of independence, certified expertise, and real-world experience, personal service, professionalism, sources and technology. We are small enough to provide the personal attention you expect, but deep enough to possess the broad range of service expertise you may need.

René Hlousek, ASA

René is the President and founder of Beacon Valuation Group, LLC, headquartered in San Francisco, California. His core experience includes conducting an extensive array of business valuation engagements, having determined and opined to the value of more than 200 major business entities and over 1,000 distinct intangible assets in connection with mergers and acquisitions, financial reporting, reorganization, liquidation, domestic and international taxes, strategic corporate planning, and litigation. In addition to valuing closely-held companies, René specializes in intangible asset and intellectual property valuation, with significant experience in executing engagements for financial reporting purposes in accordance with SFAS 141 and SFAS 142, as well as tax compliance and planning. A representative sample of intangible assets valued includes existing technology, IPR&D, patents, customer lists, strategic relationships, trademarks, brand names, contracts, non-competes, trade secrets, and goodwill.

Prior to forming Beacon, René has served both domestic and international clients while employed at American Appraisal Associates and the Big Five accounting firm of Arthur Andersen, as well as an independent consultant, having aided corporations of all sizes, stages of development, and financial health. During his valuation tenure, René has written several articles, and been a guest speaker at various industry conferences and major professional venues held nationwide as well as internationally, on the subject of intangible asset and intellectual property valuation. René is an active officer on the Board of Directors of the San Francisco Bay Area Chapter of the American Society of Appraisers, the nation's oldest and largest interdisciplinary appraisal organization, where he also recently served as President during 2004-2005. In addition, René currently serves on the Valuation and Taxation Committee of the Licensing Executives Society.

PROFESSIONAL AFFILIATIONS

- President; American Society of Appraisers, San Francisco Bay Area Chapter, 2004-2005; Board of Directors, 2002 – present
- Accredited Senior Appraiser, Business Valuation Discipline; Designation awarded by the American Society of Appraisers
- Managing Editor; San Francisco Bay Area Chapter ASA Newsletter, 2004-2005; Winner of national Best Newsletter Award
- Institute of Business Appraisers
- Business Valuation Roundtable of San Francisco
- Association for Corporate Growth
- Licensing Executives Society; Member of Valuation and Taxation Committee
- World Affairs Council of Northern California
- Commonwealth Club: Business & Leadership Forum; International Relations Forum

ACADEMIC CREDENTIALS

- B.S.B.A., Finance; University of Southern California, *magna cum laude*
- School of Sciences and Humanities; Prague, Czechoslovakia
- Fluent in Czech and Slovak; Conversant in Russian

SPEAKING ENGAGEMENTS

- "Maximizing Enterprise Value of Distressed Intellectual Property," Strategic Research Institute – Annual Intellectual Property Financing and Securitization Summit, New York, September 2005.
- "Financing and Valuation of Intellectual Property: Secured Financing Options and Opportunities," Strategic Research Institute – Global Asset Based Lending Summit, London, May 2005.
- "Reinvigorated Approach to Valuing Technology-based Intangibles," The Institute of Business Appraisers – 2005 Annual Business Valuation Conference, Orlando FL, May 2005.
- "Rounding-Up the Valuation Drivers of a Distressed Company's Intangibles," Strategic Research Institute - Distressed Debt Investing Forum, Las Vegas, November 2004.
- "Intangible Asset Valuation Primer," American Society of Appraisers: San Francisco Chapter Meeting, San Francisco CA, February 2004.
- "Valuing to Buy or Sell a Business," Boston College Small Business Development Center, Boston (Chestnut Hill) MA, November 2003.
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SECTION VII

APPENDICES

General Economic Environment

Advance third quarter 2005 data from the Bureau of Economic Analysis indicate that real (inflation adjusted) gross domestic product (GDP) – defined as the output of goods and services produced by labor and property located in the U.S. – grew by an estimated 3.8 percent. It should be noted that advance figures are based on preliminary and incomplete data that is subject to further revision (upward or downward). Major contributors to third quarter growth were personal consumption expenditures, equipment and software, federal government spending, and residential fixed investment. Real GDP expanded by 4.2 percent in 2004, compared to 2.7 percent in 2003, and 1.6 percent in 2002.[14] Between 3.0 percent and 3.5 percent is generally considered trend growth for the U.S. economy.[15]

The National Association for Business Economics (NABE), a professional forecasting group that has been measuring and reporting on the U.S. economy since 1965, slightly raised its September forecast for growth in 2005 to 3.5 percent, up from 3.4 percent predicted in May. The outlook for growth in 2006 remains unchanged at 3.4 percent.[16]

Projections from Wachovia Securities are comparable to the NABE for the current year, however, they are more pessimistic about the subsequent year. The Wachovia forecast envisions 3.5 percent growth in 2005 with only 2.7 growth in 2006 followed by more trend line growth of 3.4 percent in each of the first two quarters of 2007. Classifying the current business cycle as "one of the most confounding in recent memory," Wachovia analysts believe that both consumers and businesses have been *behaving* as if the economy is healthier than monthly and quarterly indicators would suggest. While there may be underlying strength in the economy that is not being captured by economic data, near-term and intermediate risks ahead (this year and next) include decreased consumer spending due to a foreseen slowdown in real disposable income growth, rising interest rates, higher energy prices, and slightly higher inflation. Any retrenchment from consumers will likely cause a reduction in business investment spending as corporate profits are already under pressure from rising energy prices.[17]

Higher prices for crude oil are expected to reduce GDP growth by an estimated 0.6 percent this year and 0.7 percent next year (as compared to a scenario in which the price of crude oil remained near its 2004 average of $41 per barrel). Although core inflation (after removing the volatile food and energy items) will presumably hold steady at around 2.3 percent, it is edging near the top of the Federal Reserve's comfort range. Anticipated increases in labor costs may also fuel inflation. The Fed will probably raise the federal funds target rate to 4 percent this year, then to 4.5 percent by the end of 2006 in order to keep inflation in check. Although interest rates are rising moderately, forecasters with the NABE believe the housing market will hold up well.[18]

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[14] U.S. Department of Commerce, *BEA News: Gross Domestic Product: 3rd Quarter 2005 (Advance)*, October 28, 2005.
[15] *The Economist.*
[16] *NABE Outlook*, National Association for Business Economics, September 26, 2005.
[17] *Monthly Economic Outlook*, Wachovia Securities, July 18, 2005 and October 14, 2005.
[18] *NABE Outlook*, National Association for Business Economics, September 26, 2005.

One of the worst hurricane seasons in recent U.S. history culminated during the third quarter, however, it resulted in only minor revisions to overall economic growth forecasts. The NABE panel anticipates a drop of just 0.4 percent related GDP growth in the third quarter followed by a 0.2 percent decrease in the fourth quarter. Most economists consider the effect on the national economy both modest and short-lived.[19]

Consumer Spending

Personal consumption expenditures comprise two-thirds of the gross domestic product, so it is an important economic indicator. It has been the economy's main growth engine and is expected to continue at a healthy pace throughout 2005. NABE projects 3.5 percent growth in 2005 followed by a 3.0 percent increase in 2006, which is comparable to 3.9 percent annual growth in 2004.[20] Wachovia analysts expect consumer spending to slow more than that, however, as they predict 3.4 percent growth in 2005 followed by 2.2 percent in 2006. The more moderate consumer spending forecast from Wachovia for next year is based on an anticipated slowdown in real personal income growth (leaving less disposable income), higher gasoline prices and natural gas prices, and rising interest rates.[21]

Lynn Franco, director of The Conference Board's Consumer Research Center, reports that shocks like the hurricanes that struck the Gulf Coast usually have a short-term impact on consumer confidence. The Conference Board's Consumer Confidence Index, which is based on a survey of 5,000 U.S. households, suffered its biggest drop in 15 years during September. Future gasoline prices, home heating fuel costs this winter, and holiday spending are all open questions.[22]

Economists and market analysts have been issuing warnings that consumers might pull back in their spending (and thereby trigger a retrenchment in business spending) ever since the price of crude oil reached $40 per barrel and then again when it hit $50 per barrel. Because consumers have kept spending, economists can only speculate what effect, if any, consistent crude oil prices of $60 per barrel (or more) will have on continued economic growth.[23]

The second major factor influencing consumer spending relates to moderately rising short-term interest rates and the corresponding impact on homeowner refinancing-fueled spending. Although the Fed continues to raise the target for the federal funds rate, long-term interest and mortgage rates have actually dropped, an unprecedented occurrence.[24]

A housing slowdown, or tapering off, by the end of this year or next is the general consensus. S. Lawrence Yun, senior economist for the National Association of Realtors sees signs of an approaching slowdown as their August affordability index for new home prices reached its lowest level since September 1991 – a precursor to the 1991-92 recession. Optimists point out, however, that low unemployment and healthy economic growth are fundamentals that are still in place.[25]

[19] *NABE Outlook*, National Association for Business Economics, September 26, 2005.
[20] *NABE Outlook*, National Association for Business Economics, September 26, 2005.
[21] *Monthly Economic Outlook*, Wachovia Securities, October 14, 2005.
[22] "Consumer Confidence Sinks in September," *Business Week*, September 27, 2005.
[23] "Stock Market Quarterly Review: Abreast of the Market," *Wall Street Journal*, October 3, 2005.
[24] "Greenspan Says Speculation Adds to Home-Price Surge," *Bloomberg.com*, September 26, 2005.
[25] "Housing: Less Bang Than Whimper," *Business Week*, October 5, 2005.

The consumer spending fallout from slackening housing market activity would be felt most keenly by those who have relied on low interest rates and housing price appreciation when refinancing. Federal Reserve Chairman Alan Greenspan voiced his concerns regarding speculative home buying and unconventional mortgages in a speech to the American Bankers Association in September. He suggested the banking industry exhibit more scrutiny in relation to unconventional mortgages that let buyers who barely qualify purchase homes at inflated prices. Greenspan also claims that speculative buying may be contributing to record-breaking home prices. Both borrowers and lenders would suffer losses if the housing market were to bust and prices tumble. He estimates that a fourth to a third of home equity cashed out by households is used to finance consumer spending.[26]

Going forward, Freddie Mac predicts cashouts will decline from $139.2 billion last year to $95.9 billion in 2005 and $61.2 billion in 2006. Rising demand from baby boomers and immigrants are expected to absorb some of the anticipated housing market slack, however, a shortfall could leave the economy vulnerable.[27]

Consumer confidence and consumer sentiment indexes have moved up and down from month to month, however, consumers have kept spending.[28]

Labor Market

Although hurricane Katrina struck the Gulf Coast on August 29th, it is not fully reflected in September employment figures. Over the 12-month period prior to September, employment increased by an average of 194,000 per month, and the unemployment rate trended down from 5.4 percent to 4.9 percent.[29]

Employment gains have remained somewhat sluggish throughout the recovery from the 2001 recession. Job growth of 1.6 percent is expected in both this year and next. That compares to below-par employment gains of 1.3 percent in 2004. Unemployment should drop from a rate of 5.5 percent in 2004 to 5.1 percent in 2005 and 5.0 percent in 2006. When recently asked why employment has not increased more during the current economic expansion, NABE panelists answered with the same set of factors specified over a year ago, namely productivity gains, increased technology, and cautious CEOs.[30]

Added to that are claims by some analysts that companies headquartered in the U.S. are emphasizing overseas production of goods sold in America, leaving hiring and capital spending in the U.S. out of the loop.[31] Another theory put forth by Wachovia economists involves the employment of undocumented workers. They believe that employment data may not be capturing the economic contribution of this sizable population, many of whom operate as independent contractors or set up businesses for themselves.[32]

[26] "Greenspan Says Speculation Adds to Home-Price Surge," *Bloomberg.com*, September 26, 2005.
[27] "After The Housing Boom," *Business Week*, April 11, 2005.
[28] "U.S. Consumer Confidence Slips In Sept...," *Boston Globe*, October 1, 2003.
[29] U.S. Department of Labor, *BLS News: Statement of Deputy Commissioner*, October 7, 2005.
[30] *NABE Outlook*, National Association for Business Economics, May 23, 2005 and September 26, 2005.
[31] "Ahead of the Tape," *Wall Street Journal*, April 28, 2005.
[32] *Monthly Economic Outlook*, Wachovia Securities, July 18, 2005.

Inflation

The consumer price index (CPI), which is a measure of the average change in the price of goods and services over time, increased by seasonally adjusted annual rate of 9.4 percent in the third quarter, up considerably from 4.3 percent in the first quarter and 1.9 percent in the second quarter. The year-to-date annual rate is at 5.1 percent, compared to an annual increase of 3.3 percent in 2004. Petroleum-based costs increased by 122.1 percent during the third quarter of 2005. So far this year, energy costs have risen 42.5 percent after increasing 16.6 percent last year, the highest peak in the last five years.[33]

Core inflation, the measure of CPI exclusive of the more volatile food and energy items, remained between approximately 2 percent and 2.7 percent from 1998 to 2002 before dropping to its lowest point, 1.1 percent in 2003. Core inflation advanced by only 1.4 percent in the third quarter and stands at 2.0 percent for the nine months ended September 2005.[34] According to economists with Wachovia Securities, core inflation and employment are two of the Federal Reserve's main "guideposts."[35]

Spiking energy prices have prompted fears that inflation may be poised to accelerate and a handful of analysts have sounded alarms. However, Wachovia chief economist John Silvia and senior economist Mark Vitner believe that inflation will creep higher, but will not surge. They point out that while the consumer price index (CPI) is rising, it is doing so from very low levels.[36]

The economic panelists who participate in the biannual *Livingston Survey* expect the consumer price index to rise in the near-term, but hold relatively steady in the long run, averaging 2.5 percent a year over the next ten years, a projection that has remained unchanged since December 2001.[37]

Interest Rates

After lowering rates 13 times between January 2001 and June 2003, the Federal Reserve finally started to raise its target for the federal funds rate (the overnight rate banks charge each other) in June 2004 and continued to raise rates by a quarter percent in each subsequent meeting of the Federal Open Market Committee to bring the rate to 3.75 percent in September 2005.[38]

It was during the March meeting that the Fed acknowledged that pressures on inflation had accelerated in recent months. Although energy prices continue to climb, the Fed stated in September that long-term inflation remains in check. Notwithstanding the short-term disruption from hurricanes, economic expansion appears on track. Monetary policy is still considered "accommodative" and will be removed (by raising rates further) at a measured pace, according to the Fed.[39] There is widespread anticipation that monetary policy will continue to tighten over the next six months, however some analysts believe the Fed may go too far with rate increases and provoke a negative event. They maintain that past Fed rate increases have continued until some kind of blowup occurred – the 1994 bond market crash, the Russian debt default, or the collapse of hedge fund Long Term Capital Management (both in 1998). There is some

[33] U.S. Department of Labor, *BLS News: Consumer Price Index: September 2005*, October 14, 2005.
[34] U.S. Department of Labor, *BLS News: Consumer Price Index: September 2005*, October 14, 2005.
[35] *Monthly Economic Outlook*, Wachovia Securities, April 8, 2004.
[36] *Monthly Economic Outlook*, Wachovia Securities, April 11, 2005.
[37] *Livingston Survey: December 2004*, Federal Reserve Bank of Philadelphia, June 8, 2005.
[38] Federal Reserve Board, Press releases. Available: www.federalreserve.gov.
[39] Federal Reserve Board, Press releases. Available: www.federalreserve.gov.

conjecture that if the Fed continues to raise rates well into 2006, it could lead to a recession or blowup in the housing market.[40]

Changes to the federal funds target rate typically have a direct effect on all other interest rates, from Treasury bonds to mortgage rates.[41] Lower interest rates encourage borrowing and result in additional consumer spending and investment, higher imports, overall elevated economic activity, and possibly faster inflation. Higher interest rates achieve just the opposite.[42]

Financial Markets

The conclusion of 2004 brought another year of gains for the stock market and analysts expect that 2005 will make it three years in a row. Although that is generally accepted, it is by no means a sure thing. Any sudden uptick in inflation and interest rates, or faltering corporate profits could send stocks into retreat.

The Dow Jones Industrial Average managed a gain of 2.9 percent in the third quarter, but it remains down by 2.0 percent for the year. The Standard & Poor's 500 stock index finished the quarter up 3.0 percent, pushing it into the plus column with a 1.4 percent gain for the year. Uncertainty surrounding the strength of the economy, whether oil prices will continue to mount, rising short-term interest rates, and the effect of hurricane damage on corporate profits have restricted stock gains.[43]

A slowing economy would adversely affect corporate profits (the main driver of stock prices). In addition, if monetary policy is perceived as too tight, bringing with it higher interest rates that could hurt consumer spending, business investment will likely retrench. Curtailed consumer spending and higher interest rates would translate into bad news for corporate profits.[44]

October can provide a turning point for stocks (for better or worse) and market analysts will be watching consumer spending trends for evidence of either a tailwind or headwind as the end of the year approaches. While most expect small to moderate gains, some analysts are concerned that the Fed will go too far in tightening monetary policy, causing either a recession or housing market bust.[45]

When the stock market is volatile, it becomes difficult for businesses to agree on a value for their companies. A "roller-coaster" market will often induce companies to focus on their own businesses rather than participate in mergers and acquisitions.[46]

After being quelled in 2000, a victim of recession, corporate scandals, and a sluggish stock market, merger and acquisition activity picked up significant steam in the fourth quarter of 2004. The comeback was fueled by an expanding economy, strong corporate profits, higher stock prices, and readily available cash for deals. Other factors include stricter governance standards that have forced some poorly performing

[40] "Stock Market Quarterly Review: Abreast of the Market," *Wall Street Journal*, October 3, 2005.
[41] "Fed Maintains Low Rate," *United Press International*, March 16, 2004.
[42] *The Economist Guide To Economic Indicators*, Wiley & Sons, Inc., Pg. 171.
[43] "Stock Market Quarterly Review: Abreast of the Market," *Wall Street Journal*, October 3, 2005.
[44] "Stock Market Quarterly Review: Swing And A Miss...," *Wall Street Journal*, April 1, 2005.
[45] "Stock Market Quarterly Review: Abreast of the Market," *Wall Street Journal*, October 3, 2005.
[46] "Year-End Review Of Markets & Finance 2001; Volatile US Markets," *Wall Street Journal*, January 2, 2002.

CEOs and boards to entertain unwanted takeover bids, as well as a repeat of the trend of the 1990s when deals spawned more deals resulting in the consolidation of entire industries.[47]

Total domestic (U.S.) mergers and acquisitions volume grew to $198 billion for the third quarter, up by 30 percent from the same period last year, according to data from Thomson Financial. Most of the U.S. deals were concentrated around private equity transactions. Worldwide deal volume reached $598 billion, a 48 percent increase from a year ago, but down by 11 percent from the second quarter. Although this year's activity is considered robust, it is not expected to surpass the record-breaking volume of the technology boom when global deals topped $700 billion in the second and third quarters of 2000. A conservative pace in the future may prove to be a signal for prolonged strength, as opposed to the recklessness that marked the latter stages of previous cycles. The deal market has taken recent unanticipated events such as hurricane Katrina and the July London terror bombings in stride. Significant threats to the market would be in the form of a sudden decrease in consumer spending or the tightening of corporate lending terms. Absent of those shocks, Steven Baronoff, Merrill Lynch's global head of mergers and acquisitions, believes that 2006 will outpace this year and may even extend the current run into 2007.[48]

Forecast

All eyes will be watching consumer spending over the next few months for possible signs that higher gasoline prices, increased heating oil costs this winter, and rising interest rates are putting a dent in the largest growth driver in the U.S. economy. A significant slowdown would likely hurt corporate profits (causing stock market prices to drop) and reduce business spending.

Because corporate profits are already under pressure due to higher energy costs, a few analysts are holding out the possibility that a retrenchment in consumer spending would raise the risk of a consumer-led recession sometime next year. David R. Kotok, chairman and chief investment officer at Cumberland Advisors in Vineland, NJ, estimates that energy costs comprised approximately 4.5 percent of consumers' disposable personal income last year. He suggests that figure rose to 5.5 percent in the second quarter of this year and now stands at about 6 to 6.5 percent. According to Kotok, the last time such a dramatic shift took place was in the early 1970s.[49] Although the economy continues to grow, there are those who worry that it is being propped up by deficit spending by the government and the current availability of cheap money.[50]

Consensus economic forecasters with the NABE, however, anticipate tempered, but still solid economic expansion through 2005 and 2006. Panelists expect the federal funds rate to reach 4.0 percent by the end of 2005 and rise to 4.5 percent in 2006. The effect of hurricane Katrina on the overall U.S. economy is presumed moderate and short-lived. Consumer spending is projected at a slightly lower growth rate going forward. NABE has forecast 3.5 percent growth in 2005 followed by 3.0 percent in 2006. Although interest rates are expected to rise, housing starts have been projected upward to 2 million units for this

[47] "Shake, Rattle, And Merger," *Business Week*, January 10, 2005.
[48] "Stock Market Quarterly Review: Merger Mania Heats Up in Europe," *Wall Street Journal*, October 3, 2005.
[49] "Storm-proof and Rolling?," *The Washington Post*, October 2, 2005.
[50] "Signs of a Pumped Up Economy," *Washington Post*, March 27, 2005.

year and 1.9 million units next year. That compares favorably to the actual rate of 1.9 million units in 2004.[51]

The two tables below include a range of short-term and long-term growth rates from various forecasting groups as well as a detailed outlook for the U.S. economy.

Exhibit 1. Real Gross Domestic Product Forecast

Annual Averages *(Median Forecast Reported)*	**2005**	**2006**	**10 - Year**
National Association for Business Economics (NABE)	3.5	3.4	
Livingston Survey (Philadelphia Fed)	3.5	3.3	3.2
Wachovia Securities	3.5	2.7	

Sources: National Association for Business Economics: panel of 43 professional forecasters (September 26, 2005). Livingston Survey: panel of 39 forecasters surveyed by the Philadelphia Federal Reserve (June 8, 2005). Wachovia Securities: John Silvia – chief economist, Mark Vitner – senior economist (October 14, 2005).

Exhibit 2. Detailed U.S. Outlook

Annual Averages *(Median Forecast Reported)*	**2004 Actual**	**2005 Forecast**	**2006 Forecast**
Real GDP %	4.2	3.5	3.4
Personal consumption %	3.9	3.5	3.0
Nonresidential fixed investment %	9.4	8.6	8.0
Residential investment %	10.3	6.1	-0.3
Change in business inventories (billions $)	52.0	29.0	43.2
Corporate profits (after tax) %	11.8	14.6	7.0
Unemployment (civilian) %	5.5	5.1	5.0
Industrial production %	4.1	3.2	3.6
Capacity utilization rate, manufacturing	76.2	78.3	79.4
Housing starts (millions of units)	1.9	2.0	1.9
Consumer price index (CPI) %	2.7	3.2	2.6
Federal funds (effective) rate %	1.35	3.20	4.30
10-year treasury note yield %	4.27	4.28	4.90

Source: *NABE Outlook*, September 26, 2005.

[51] *NABE Outlook*, National Association for Business Economics, September 26, 2005.