Valencia Water Company

Financial Statements as of and for the Years Ended December 31, 2016 and 2015, and Independent Auditors' Report

VALENCIA WATER COMPANY

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Valencia Water Company
Valencia, California

We have audited the accompanying financial statements of Valencia Water Company (the "Company"), which comprise the balance sheets as of December 31, 2016 and 2015, and the related statements of income, changes in stockholder's equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

March 30, 2017

VALENCIA WATER COMPANY

BALANCE SHEETS
AS OF DECEMBER 31, 2016 AND 2015
(In thousands)

	2016	2015
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 5,455	$ 8,431
Investments	8,778	2,800
Metered, unbilled, and other receivables—net of allowances for doubtful accounts of $39 in 2016 and $32 in 2015	3,078	2,612
Materials and supplies	412	417
Total current assets	17,723	14,260
UTILITY AND GENERAL PLANT ASSETS:		
Land and buildings	3,809	3,677
Wells	11,091	11,205
Pumping equipment	9,232	9,836
Transmission and distribution system	140,768	139,805
General plant	6,166	6,272
Construction in progress	3,492	2,696
Total utility and general plant assets	174,558	173,491
Accumulated depreciation and amortization	(71,537)	(68,205)
Utility and general plant assets—net	103,021	105,286
DEFERRED TAX ASSETS—State	293	
OTHER ASSETS	845	916
TOTAL	$121,882	$120,462

(Continued)

VALENCIA WATER COMPANY

BALANCE SHEETS
AS OF DECEMBER 31, 2016 AND 2015
(In thousands)

	2016	2015
LIABILITIES AND STOCKHOLDER'S EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	$ 2,304	$ 2,050
Income taxes payable (Note 5)	911	496
Advances for construction—current portion	692	696
Total current liabilities	3,907	3,242
LONG-TERM LIABILITIES:		
Secured notes payable (Note 4)	23,744	23,699
Advances for construction—less current portion	8,210	8,902
Deferred revenue	559	566
Net deferred tax liabilities (Note 5)	4,719	4,354
Deposits held for construction	3,534	2,874
Total long-term liabilities	40,766	40,395
Total liabilities	44,673	43,637
CONTRIBUTIONS IN AID OF CONSTRUCTION	50,982	52,387
COMMITMENTS AND CONTINGENCIES (Note 8)		
STOCKHOLDER'S EQUITY:		
Common stock, $100 par value—authorized, 50,000 shares; issued, 15,365 shares	1,537	1,537
Paid-in capital	6,207	6,207
Retained earnings	18,483	16,694
Total stockholder's equity	26,227	24,438
TOTAL	$121,882	$120,462

See notes to financial statements. (Concluded)

VALENCIA WATER COMPANY

STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015
(In thousands)

	2016	2015
WATER UTILITY REVENUES	$27,535	$23,006
OPERATING EXPENSES:		
Purchased water (Note 7)	7,462	6,815
Purchased power	1,823	2,115
Operations and maintenance	5,661	4,980
General and administrative	4,419	4,638
Property taxes	193	203
Depreciation and amortization	2,746	2,731
Total operating expenses	22,304	21,482
OPERATING INCOME	5,231	1,524
OTHER (EXPENSE) INCOME:		
Interest expense	(1,161)	(1,161)
Interest income	38	22
Other	7	164
Total other expense—net	(1,116)	(975)
INCOME BEFORE INCOME TAXES	4,115	549
INCOME TAXES (Note 5)	1,527	183
NET INCOME	$ 2,588	$ 366

See notes to financial statements.

VALENCIA WATER COMPANY

STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015
(In thousands)

	Common Stock	Paid-In Capital	Retained Earnings	Total Stockholder's Equity
BALANCE—January 1, 2015	$1,537	$6,207	$17,127	$24,871
Net income			366	366
Dividends—common stock (Note 6)			(799)	(799)
BALANCE—December 31, 2015	1,537	6,207	16,694	24,438
Net income			2,588	2,588
Dividends—common stock (Note 6)			(799)	(799)
BALANCE—December 31, 2016	$1,537	$6,207	$18,483	$26,227

See notes to financial statements.

VALENCIA WATER COMPANY

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015
(In thousands)

	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 2,588	$ 366
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,746	2,731
Deferred income taxes	72	(671)
Amortization of deferred financing costs	45	45
Amortization of deferred revenue	(18)	(18)
Changes in assets and liabilities:		
Increase in metered, unbilled, and other receivables	(466)	(137)
Decrease (increase) in materials and supplies	5	(26)
Decrease in income taxes receivable		55
Decrease (increase) in other assets	71	(10)
Increase (decrease) in accounts payable and accrued liabilities	236	(477)
Increase in income taxes payable	415	496
Increase in deferred revenue		266
Net cash provided by operating activities	5,694	2,620
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of investments	(19,708)	(15,292)
Sale of investments	13,730	12,492
Acquisition of utility and general plant assets	(2,379)	(2,982)
Net cash used in investing activities	(8,357)	(5,782)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Refunds of advances for construction	(696)	(698)
Deposits held for construction received	1,182	2,601
Dividends paid	(799)	(799)
Net cash (used in) provided by financing activities	(313)	1,104
NET (DECREASE) IN CASH AND CASH EQUIVALENTS	(2,976)	(2,058)
CASH AND CASH EQUIVALENTS—Beginning of year	8,431	10,489
CASH AND CASH EQUIVALENTS—End of year	$ 5,455	$ 8,431

VALENCIA WATER COMPANY

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015
(In thousands)

	2016	2015
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Interest paid	$ 1,109	$ 1,109
Income taxes paid	$ 1,040	$ 321
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Amortization of contributions in aid of construction and related reduction to net utility and general plant assets	$ 1,916	$ 1,896
Transfers of deposits held for construction to contributions in aid of construction	$ 511	$ 1,678
Liabilities accrued for the purchase of utility and general plant assets	$ 30	$ 12

See notes to financial statements. (Concluded)

1. ORGANIZATION AND DESCRIPTION OF THE REPORTING ENTITY

Valencia Water Company (the "Company") was incorporated on April 7, 1954, in the state of California. The Company provides potable water service to approximately 31,000 customers within an area encompassing a portion of the incorporated City of Santa Clarita and within the surrounding unincorporated communities of Castaic, Newhall, Saugus, Stevenson Ranch, and Valencia in northern Los Angeles County.

On December 21, 2012, Castaic Lake Water Agency ("Castaic") acquired all of the Company's common stock from The Newhall Land and Farming Company, a California limited partnership ("Newhall Land"), by an action of eminent domain. Certain officers of Castaic are on the Company's board of directors (the "Board of Directors"). Castaic is a public water wholesaler that provides water from the California State Water Project to the Company and other water retailers in the Santa Clarita Valley.

In addition to the water purchased by the Company from Castaic, the Company's water supply consists primarily of local ground water and a minor amount of recycled water to serve nonpotable landscape irrigation services. The mix of groundwater, purchased water, and recycled water was 58%, 40%, and 2%, respectively, in 2016 and 71%, 27%, and 2%, respectively, in 2015.

2. REGULATORY MATTERS

Prior to February 27, 2014, the Company was regulated by the California Public Utilities Commission (the "Commission"), which set rates sufficient to allow the Company to recover its reasonable cost of operations and maintenance and to provide the Company the opportunity to realize its authorized rate of return on its investment. However, on February 27, 2014, the Commission concluded that due to Castaic's acquisition of all of the Company's common stock, the Company could no longer be regulated by the Commission. As a result, the Company discontinued its application of the provisions of accounting principles generally accepted in the United States of America for accounting for regulated utilities.

As the Company is no longer subject to regulation by the Commission, rate changes by the Company are subject to the Board of Directors' approval, rather than the Commission's jurisdiction. The Board of Directors approved a 7.62% general rate increase, which took effect on May 1, 2015, followed by subsequent increases of 4.37% and 2.32% effective as of January 1, 2016, and January 1, 2017, respectively. Additionally, the Board of Directors approved a revenue adjustment surcharge effective October 1, 2016, which the Company anticipates will be in effect for approximately one year.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation—The financial statements of the Company are presented in conformity with accounting principles generally accepted in the United States of America.

Management Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses; disclosure of contingent assets or liabilities as of the date of the financial statements; and reported amounts of changes in stockholder's equity during the reporting period. Actual results could differ from those estimates. Significant accounting estimates reflected in the Company's financial statements include depreciation, accounts receivable, and unbilled revenues.

Revenue Recognition—Water utility revenues include amounts billed monthly to customers and unbilled revenue of $2,223,000 and $1,764,000 for the years ended December 31, 2016 and 2015, respectively, based on estimated usage from the last meter-reading date to December 31 at current rates. Water utility revenues are recognized as water is delivered to the customer.

Cash and Cash Equivalents—Included in cash and cash equivalents are short-term investments that have original maturity dates of three months or less. The carrying amounts of these short-term investments approximate fair value due to their short-term nature. The Company has its cash and cash equivalents on deposit with banks, which are insured by the Federal Deposit Insurance Corporation up to $250,000 per financial institution. At various times during the years ended December 31, 2016 and 2015, the Company maintained balances in excess of insured amounts.

Investments—Included in investments are certificates of deposit with banks, which are insured by the Federal Deposit Insurance Corporation up to $250,000 per financial institution, and investments in commercial paper with original maturity dates ranging from 3 months to one year.

Utility and General Plant Assets—The cost of additions, renewals, and betterments to utility and general plant assets is capitalized in the appropriate plant accounts. Costs include labor, material, and other direct and certain indirect charges. The cost of utility and general plant assets retired or otherwise disposed of, including removal costs, is charged to accumulated depreciation. Depreciation is recorded primarily on a straight-line basis over the assets' useful lives (40 years for buildings, 30 years for wells, 20 years for pumping equipment, 20 to 40 years for transmission and distribution system, and 7 to 20 years for general plant) and was equivalent to approximately 3% of depreciable utility and general plant assets for the years ended December 31, 2016 and 2015.

Expenditures that materially increase the lives of utility and general plant assets are capitalized, while costs of maintenance and repairs are charged to expense as incurred.

The Company reviews its investments in long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If, after review, an asset is determined to be impaired, an impairment loss in the amount by which the carrying amount of the asset exceeds its fair value is recorded. There were no impairment losses recorded during the years ended December 31, 2016 and 2015.

Other Assets—Other assets include prepaid expenses related primarily to property and liability insurance policies.

Advances for Construction—Advances for construction represent cash received from developers by the Company for extensions of the Company's distribution system. Advance contracts are generally refundable to the depositor at a rate of 2.5% each year over a

40-year period and do not bear interest. The Company expects to repay approximately $692,000 in advances in each year from 2017 through 2021, with the remaining $5,442,000 in advances due in years thereafter.

Contributions in Aid of Construction—Contributions in aid of construction are nonrefundable contributions received by the Company in cash, services, or property, primarily from developers for the purpose of constructing utility plant assets. Depreciation applicable to such utility plant assets is charged directly to the contributions in aid of construction account rather than to depreciation expense in the statements of income. The charges continue until the cost applicable to such utility plant assets has been fully depreciated or the asset is retired. Although the contribution remains on the Company's financial statements until the asset is fully depreciated, the Company has no future obligations to these developers for the contribution other than general maintenance of the utility plant assets. Accordingly, contributions in aid of construction have not been classified as a liability or as equity in the accompanying financial statements.

As certain contributions in aid of construction received by the Company in cash are taxable, the Company collects an additional amount above the cost of the related utility plant (an income tax gross-up component). This additional amount received by the Company is recorded as deferred revenue on the balance sheets and recognized as revenue over the estimated useful life of the related utility plant.

Deposits Held for Construction—Deposits held for construction represent cash received by the Company for extensions of the Company's distribution system. Deposits are based on the estimated cost to construct the extension of the Company's distribution system. When construction of these assets is complete, they become part of the Company's distribution system and are accounted for as advances for construction or contributions in aid of construction, depending on the terms of the agreement.

Income Taxes—The Company uses the asset and liability method of accounting for income taxes. This method requires the recognition of tax consequences of temporary differences between tax bases and financial reporting bases of assets and liabilities.

Recent Accounting Pronouncements

In March 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2015-03, *Simplifying the Presentation of Debt Issuance Costs*. This update changes the presentation of debt issuance costs in the financial statements. Under this ASU, an entity presents such costs in the balance sheet as a direct deduction from the recognized debt liability rather than as an asset. Amortization of the costs is reported as interest expense. In accordance with the ASU, the Company retrospectively adopted this ASU as of January 1, 2016, and there was an immaterial impact to the financial statements and related disclosures (see Note 4).

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU No. 2014-09 supersedes most existing revenue recognition guidance, including industry-specific revenue recognition guidance. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers*, which deferred the effective date of ASU No. 2014-09 by one year to annual reporting periods beginning after December 15, 2018 for private entities. Further, the application of ASU No. 2014-09 permits the use of either the full retrospective or cumulative effect transition approach. Early adoption is permitted for fiscal years beginning after December 15, 2016. The Company will adopt ASU No. 2014-09 on January 1, 2019. The Company has not yet selected a transition method nor has it determined the impact the adoption of ASU No. 2014-09 will have on its financial statements, if any.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. This ASU requires that lessees recognize assets and liabilities for leases with lease terms greater than twelve months in the balance sheet and also requires improved disclosures to help users of financial statements better understand the amount, timing and uncertainty of cash flows arising from leases. This update is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted. The Company is in the process of assessing the impact that the adoption of this ASU will have on its financial statements.

4. SECURED NOTES PAYABLE

On June 1, 2010, the Company entered into a $12,000,000 senior secured note with Modern Woodmen of America ("Modern Woodmen"). On September 15, 2010, the Company entered into an additional $12,000,000 senior secured note with Modern Woodmen (collectively, the "Senior Secured Notes"). The Senior Secured Notes are secured by all of the Company's assets. Interest is payable semiannually on April 15 and October 15 at a fixed rate of 4.62% per annum. The Senior Secured Notes contain various financial covenants with which the Company was in compliance as of December 31, 2016 and 2015. There are no principal payments due until the Senior Secured Notes mature on September 15, 2022. Debt issuance costs of $555,000 have been capitalized and are amortized over the life of the loan. The balance of the note has been reduced by the unamortized balance of the debt financing costs of $256,000 and $301,000 as of December 31, 2016 and 2015, respectively.

5. INCOME TAXES

The provision for income taxes for the years ended December 31, 2016 and 2015, is as follows (in thousands):

	2016	**2015**
Current:		
Federal	$1,073	$ 636
State	382	218
Total current	1,455	854
Deferred:		
Federal	89	(498)
State	(17)	(173)
Total deferred	72	(671)
Total provision for income taxes	$1,527	$ 183

For the year ended December 31, 2016, the tax provision represents an effective tax rate of approximately 37.1%, compared to 33.3% in 2015. The increased effective tax rate is the result of higher pretax book income in the current year, which reduces the impact of a small number of permanent tax benefits.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities as of December 31, 2016 and 2015, are as follows (in thousands):

	2016	**2015**
Deferred tax assets:		
Advances for construction	$ 1,052	$ 1,169
Contributions in aid of construction liability	21,841	22,443
Settlement proceeds	534	536
Other	441	297
Total deferred tax assets	23,868	24,445
Deferred tax liabilities:		
Excess tax depreciation	(11,540)	(11,418)
Contributions in aid of construction fixed assets	(16,637)	(17,264)
Investment tax credit	(117)	(117)
Total deferred tax liabilities	(28,294)	(28,799)
Net deferred tax liabilities	$ (4,426)	$ (4,354)

No valuation allowance was provided against the deferred tax assets as of December 31, 2016 and 2015. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Based on this assessment, management has concluded that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the deferred tax assets.

As of December 31, 2016 and 2015, the Company did not have unrecognized tax benefits that, if recognized, would affect the annual effective tax rate. The Company recognizes interest accrued related to unrecognized tax benefits as income tax expense. During the years ended December 31, 2016 and 2015, the Company recognized no interest expense related to income taxes.

The Company is subject to taxation in the United States and California jurisdictions. As of December 31, 2016, the Company is no longer subject to US federal examinations by tax authorities for years before 2013. As of December 31, 2016, the Company is no longer subject to California examinations by tax authorities for years before 2012.

6. STOCKHOLDER'S EQUITY

The Board of Directors authorized, and the Company declared and paid dividends on its common stock of $799,000 during each of the years ended December 31, 2016 and December 31, 2015.

7. RELATED-PARTY TRANSACTIONS

As mentioned above, the Company purchases water from Castaic, which also provides the Company with water quality testing services, and the associated expense is included within operations and maintenance expenses. In addition, Castaic provides human resources services to the Company, and the associated expense for these services is included within general and administrative expenses. The amounts for these related-party transactions are listed below (in thousands):

	2016
Purchased water	$7,179
Water quality testing	41
Human resources services expense	36

	2015
Water utility revenues	$ 53
Purchased water	6,815
Water quality testing	43
Human resources services expense	36

The Company has the following related-party amounts recorded on the balance sheets (in thousands):

	2016
Accounts receivable	$ 2
Accounts payable	563

	2015
Accounts receivable	$ 8
Accounts payable	625

8. COMMITMENTS AND CONTINGENCIES

Commitments—The Company leases vehicles under operating leases expiring in 2017 through 2020. Rent expenses under these leases were $177,000 and $167,000 for the years ended December 31, 2016 and 2015, respectively, and are included within operations and maintenance expenses. Future minimum payments due under these leases as of December 31, 2016, are as follows (in thousands):

Years Ending December 31	
2017	$183
2018	105
2019	72
2020	24

Litigation—The Company is involved in litigation and various claims, including those arising from its ordinary conduct of business. Management is of the opinion that the ultimate liability from this litigation and/or various claims will not materially affect the Company's financial statements. The Company believes it has adequate insurance to protect itself against any future material property and casualty losses.

On January 4, 2013, Santa Clarita Organization for Planning and the Environment (SCOPE) and Friends of the River filed a complaint (C.13-01-005, the "SCOPE CPUC Complaint") before the Commission alleging that the Company and Castaic violated provisions of the Public Utilities Code in connection with Castaic's December 21, 2012, acquisition of all of the Company's common stock by an action in eminent domain, which was effectuated under the authority of the Los Angeles County Superior Court (the "Transaction"). On February 27, 2014, the Commission adopted a final decision on the subject of the Commission's jurisdiction to regulate the Transaction and the Company. The decision found that as a result of the Transaction, the Company was no longer a "private corporation" subject to the Commission's jurisdiction. Accordingly, the decision (1) dismissed the Company's applications for changes in its rates and its cost of capital, (2) dismissed the SCOPE CPUC Complaint, (3) closed the Commission's investigation, and (4) canceled the Company's certificate of public convenience and necessity. Going forward, the Commission will neither set nor enforce the Company's rates and rules of operation. On March 7, 2014, Newhall Land filed an application for rehearing of the decision by the Commission, asserting that the Commission's determination that it lacks jurisdiction over the Company was legally erroneous and that the Commission had failed to follow required procedures in resolving the case. If rehearing is denied or produces an unsatisfactory result, Newhall Land may seek judicial review by petition for writ of review in the California Courts of Appeal or the California Supreme Court. On December 5, 2014, with the Commission not having acted on its application for rehearing, Newhall Land filed a request to hold its application in abeyance pending a final judgment in the related civil case, described more fully below. On March 20, 2017, Newhall Land requested leave to withdraw its application for rehearing. The Company is not presently in a position to predict whether the effects of the Commission's decision will be sustained or whether it will have a material financial impact.

In addition to the SCOPE CPUC Complaint, on February 8, 2013, SCOPE filed an action in Los Angeles County Superior Court alleging various violations of the Code of Civil Procedure (including a claim of illegal expenditure by Castaic), the California Environmental Quality Act (CEQA, Public Resources Code § 21000 et seq.), and the Government Code (including a claim for conflict of interest) and in connection with the aforementioned Transaction (Case No. BS141673, the "SCOPE Superior Court Case").

On March 10, 2015, the Los Angeles County Superior Court issued a written ruling denying all of SCOPE's claims in the SCOPE Superior Court Case. On or about May 21, 2015, SCOPE filed a Notice of Appeal indicating that SCOPE will appeal the Los Angeles County Superior Court's denial of its claims in the SCOPE Superior Court Case. After briefing and oral argument on July 20, 2016, the California Court of Appeal issued a published opinion affirming the denial of all of SCOPE's claims. On September 6, 2016, SCOPE filed a petition for review with the California Supreme Court. The California Supreme Court denied review, and remittitur issued from the California Court of Appeal on December 12, 2016. This case is now complete, except for the Company's recovery of certain nominal costs from SCOPE, and was settled in favor of the Company.

9. SUBSEQUENT EVENTS

The Company has evaluated subsequent events through March 30, 2017, the date the financial statements were available to be issued.

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