

CALIFORNIA WATER SERVICE GROUP

Form 10-Q

November 09, 2009

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from _____ to _____

**Commission file number 1-13883
CALIFORNIA WATER SERVICE GROUP**

(Exact name of registrant as specified in its charter)

Delaware

77-0448994

(State or other jurisdiction of incorporation or organization)

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

1720 North First Street, San Jose, CA.

95112

(Address of principal executive offices)

(Zip Code)

408-367-8200

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act)

Yes No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. Common shares outstanding as of November 2, 2009 20,744,952

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PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

The condensed consolidated financial statements presented in this filing on Form 10-Q have been prepared by management and are unaudited.

**CALIFORNIA WATER SERVICE GROUP
CONDENSED CONSOLIDATED BALANCE SHEETS**

Unaudited

(In thousands, except per share data)

	September 30, 2009	December 31, 2008
ASSETS		
Utility plant:		
Utility plant	\$ 1,676,287	\$ 1,583,079
Less accumulated depreciation and amortization	(501,704)	(470,712)
Net utility plant	1,174,583	1,112,367
Current assets:		
Cash and cash equivalents	47,581	13,869
Receivables:		
Customers	31,722	22,786
Regulatory balancing accounts	15,592	4,629
Other	10,752	7,442
Unbilled revenue	21,352	13,112
Materials and supplies at weighted average cost	5,457	5,070
Taxes, prepaid expenses and other assets	7,922	12,890
Total current assets	140,378	79,798
Other assets:		
Regulatory assets	201,442	198,293
Goodwill	2,615	3,906
Other assets	30,456	23,743
Total other assets	234,513	225,942
	\$ 1,549,474	\$ 1,418,107
CAPITALIZATION AND LIABILITIES		
Capitalization:		
Common stock, \$.01 par value	\$ 207	\$ 207
Additional paid-in capital	214,715	213,922
Retained earnings	204,570	188,820
Total common stockholders' equity	419,492	402,949
Long-term debt, less current maturities	373,541	287,498

Total capitalization	793,033	690,447
Current liabilities:		
Current maturities of long-term debt	12,424	2,818
Short-term borrowings	12,000	40,000
Accounts payable:		
Trade and other	46,894	39,187
Regulatory balancing accounts	7,486	2,585
Accrued interest	9,096	3,295
Accrued expenses and other liabilities	42,938	35,311
Total current liabilities	130,838	123,196
Unamortized investment tax credits	2,392	2,392
Deferred income taxes, net	83,512	72,344
Pension and postretirement benefits other than pensions	152,467	152,685
Regulatory and other liabilities	83,357	83,312
Advances for construction	182,763	176,163
Contributions in aid of construction	121,112	117,568
Commitments and contingencies		
	\$ 1,549,474	\$ 1,418,107

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

Table of Contents**CALIFORNIA WATER SERVICE GROUP
CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

Unaudited

(In thousands, except per share data)

For the three months ended	September 30, 2009	September 30, 2008
Operating revenue	\$ 139,167	\$ 131,702
Operating expenses:		
Operations:		
Water production costs	48,898	46,455
Administrative and general	19,084	14,995
Other operations	14,639	12,935
Maintenance	4,405	3,824
Depreciation and amortization	10,259	9,281
Income taxes	13,417	13,510
Property and other taxes	4,371	3,940
Total operating expenses	115,073	104,940
Net operating income	24,094	26,762
Other income and expenses:		
Non-regulated revenue	5,194	3,805
Non-regulated expenses, net	(3,464)	(4,501)
Income taxes (expense) benefit on other income and expenses	(702)	288
Net other income and expenses	1,028	(408)
Interest expense:		
Interest expense	6,480	5,233
Less: capitalized interest	(950)	(1,065)
Net interest expense	5,530	4,168
Net income	\$ 19,592	\$ 22,186
Earnings per share		
Basic	\$ 0.94	\$ 1.06
Diluted	\$ 0.94	\$ 1.06

Weighted average shares outstanding			
Basic	20,745		20,717
Diluted	20,767		20,740
Dividends declared per share of common stock	\$	0.2950	\$ 0.2925

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

Unaudited

(In thousands, except per share data)

For the nine months ended	September 30, 2009	September 30, 2008
Operating revenue	\$ 342,447	\$ 310,204
Operating expenses:		
Operations:		
Water production costs	119,468	112,162
Administrative and general	57,331	42,248
Other operations	41,425	37,766
Maintenance	13,352	12,884
Depreciation and amortization	30,739	27,779
Income taxes	21,438	20,127
Property and other taxes	12,371	11,163
Total operating expenses	296,124	264,129
Net operating income	46,323	46,075
Other income and expenses:		
Non-regulated revenue	11,173	9,452
Non-regulated expenses, net	(6,826)	(9,715)
Gain on sale of non-utility property	675	7
Income taxes (expense) benefit on other income and expenses	(2,032)	118
Net other income and expense	2,990	(138)
Interest expense:		
Interest expense	17,480	15,405
Less: capitalized interest	(2,270)	(1,955)
Net interest expense	15,210	13,450
Net income	\$ 34,103	\$ 32,487
Earnings per share		
Basic	\$ 1.64	\$ 1.55

Diluted	\$	1.64	\$	1.55
Weighted average shares outstanding				
Basic		20,740		20,707
Diluted		20,765		20,731
Dividends declared per share of common stock				
	\$	0.8850	\$	0.8775

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

Table of Contents**CALIFORNIA WATER SERVICE GROUP
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

Unaudited

(In thousands)

For the nine months ended:	September 30, 2009	September 30, 2008
Operating activities		
Net income	\$ 34,103	\$ 32,487
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	32,178	29,722
Gain on sale of non-utility property	(675)	(7)
Change in value of life insurance contracts	(3,555)	2,198
Other changes in noncurrent assets and liabilities	11,975	1,990
Changes in operating assets and liabilities:		
Receivables	(31,449)	(18,659)
Accounts payable	15,561	6,659
Other current assets	4,572	(647)
Other current liabilities	13,689	26,683
Other changes, net	764	589
Net adjustments	43,060	48,528
Net cash provided by operating activities	77,163	81,015
Investing activities:		
Utility plant expenditures:		
Company funded	(82,862)	(74,603)
Developer funded	(3,548)	(6,020)
Acquisitions		(14,341)
Purchase of life insurance	(1,711)	(1,366)
Proceeds on sale of non-utility property	750	
Net cash used in investing activities	(87,371)	(96,330)
Financing activities:		
Short-term borrowings	20,000	40,000
Repayment of short-term borrowing	(48,000)	
Advances and contributions in aid of construction	3,642	6,548
Refunds of advances for construction	(4,354)	(5,383)
Dividends paid	(18,353)	(18,289)
Proceeds from long-term debt, net of issuance cost of \$3,390	96,706	693
Repayment of long-term debt	(5,751)	(1,861)

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Issuance of common stock	30	
Redemption of preferred stock		(3,718)
Net cash provided by financing activities	43,920	17,990
Change in cash and cash equivalents	33,712	2,675
Cash and cash equivalents at beginning of period	13,869	6,734
Cash and cash equivalents at end of period	\$ 47,581	\$ 9,409
Supplemental information		
Cash paid for interest, net of interest capitalized	\$ 8,717	\$ 9,225
Cash paid for income taxes	\$ 717	\$ 6,586
Supplemental disclosure of non-cash activities:		
Accrued payables for investments in utility plant	\$ 8,013	\$ 10,248
Purchase of intangible assets with company common stock		\$ 1,300
Utility plant contribution by developers	\$ 13,940	\$ 11,519
See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements		

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CALIFORNIA WATER SERVICE GROUP
Notes to Unaudited Condensed Consolidated Financial Statements
September 30, 2009

(Amounts in thousands, except share and per share amounts)

Note 1. Organization and Operations and Basis of Presentation

California Water Service Group (the Company) is a holding company that provides water utility and other related services in California, Washington, New Mexico and Hawaii through its wholly-owned subsidiaries. California Water Service Company (Cal Water), Washington Water Service Company (Washington Water), New Mexico Water Service Company (New Mexico Water), and Hawaii Water Service Company, Inc. (Hawaii Water) provide regulated utility services under the rules and regulations of their respective state's regulatory commissions (jointly referred to herein as the Commissions). CWS Utility Services and HWS Utility Services LLC provide non-regulated water utility and utility-related services.

Basis of Presentation

The unaudited interim financial information has been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC) and therefore do not contain all of the information and footnotes required by GAAP and the SEC for annual financial statements. The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2008, included in its current report on Form 8-K as filed with the SEC on April 7, 2009.

The preparation of the Company's condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenues and expenses for the periods presented. Actual results could differ from these estimates.

In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments that are necessary to provide a fair presentation of the results for the periods covered. The results for interim periods are not necessarily indicative of the results for any future period.

Due to the seasonal nature of the water business, the results for interim periods are not indicative of the results for a twelve-month period. Revenue and income are generally higher in the warm, dry summer months when water usage and sales are greater. Revenue and income are lower in the winter months when cooler temperatures and rainfall curtail water usage and sales.

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

Note 2. Summary of Significant Accounting Policies

Revenue

Revenue includes monthly cycle customer billings for regulated water and wastewater services at rates authorized by regulatory commissions and billings to certain non-regulated customers. In addition, effective July 1, 2008 with the adoption of the Water Revenue Adjustment Mechanism (WRAM) and the Modified Cost Balancing Account (MCBA), Cal Water records the difference between what is billed to its regulated customers and that which is authorized by the California Public Utilities Commission (CPUC).

Under the WRAM, Cal Water records the adopted level of volumetric revenues as authorized by the CPUC for metered accounts (adopted volumetric revenues). In addition to volumetric-based revenues, the revenue requirements approved by the CPUC include service charges, flat rate charges, and other items that are not subject to the WRAM. The adopted volumetric revenue considers the seasonality of consumption of water based upon historical averages. The variance between adopted volumetric revenues and actual billed volumetric revenues for metered accounts is recorded as a component of revenue with an offsetting entry to a current asset or liability balancing account (tracked individually for each Cal Water district). The variance amount may be positive or negative and represents amounts that will be billed or refunded to customers in the future.

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Under the MCBA, Cal Water tracks adopted expense levels for purchased water, purchased power, and pump taxes, as established by the CPUC. Variances (which include the effects of changes in both rate and volume) between adopted and actual purchased water, purchased power, and pump tax expenses are recorded as a component of revenue, as the amount of such variances will be recovered from or refunded to the Company's customers at a later date. This is reflected with an offsetting entry to a current asset or liability regulatory balancing account (tracked individually for each Cal Water district).

The balances in the WRAM and MCBA asset and liability accounts fluctuate on a monthly basis depending upon the variance between adopted and actual results. The recovery or refund of the WRAM is netted against the MCBA over- or under-recovery for the corresponding district and is interest bearing at the current 90-day commercial paper rate. When the net amount for any district achieves a pre-determined level at the end of any calendar year (i.e., at least 2.5 percent over- or under-recovery of the approved revenue requirement), Cal Water will file with the CPUC to refund or collect the balance in the accounts. Account balances less than those levels may be refunded or collected in Cal Water's general rate case proceedings or aggregated with future calendar year balances for comparison with the recovery level. As of September 30, 2009 and December 31, 2008, the aggregated asset in regulatory balancing accounts was \$15,592 and \$4,629, respectively, and the aggregate liability in regulatory balancing accounts was \$7,486 and \$2,585, respectively.

Recent Accounting Pronouncements Adopted

In December 2007, the Financial Accounting Standards Board (FASB) issued accounting standards for business combinations. The new standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Among the more significant changes, it expands the definition of a business and a business combination; requires the acquirer to recognize the assets acquired, liabilities assumed and noncontrolling interests (including goodwill), measured at fair value at the acquisition date; requires acquisition-related expenses and restructuring costs to be recognized separately from the business combination and requires assets acquired and liabilities assumed from contractual and non-contractual contingencies to be recognized at their acquisition date fair values with subsequent changes recognized in earnings. Also, it requires that an entity record, generally through income tax expense, adjustments made after the measurement period (and adjustments during the measurement period that relate to facts and circumstances that did not exist as of the acquisition date) to (1) valuation allowances for acquired deferred tax assets and (2) acquired tax uncertainties. The Company adopted the new accounting standards for business combinations effective January 1, 2009.

In December 2007, the FASB issued accounting standards for noncontrolling interests in consolidated financial statements. The new standards establish accounting and reporting standards for the noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. The statement is effective for years beginning after December 15, 2008. The Company adopted the new accounting standards for noncontrolling interests in consolidated financial statements effective January 1, 2009, and it did not have a material impact on the Company's financial position, results of operation, or cash flows.

In May 2008, the FASB issued new standards to compute earnings per share with the assumption that instruments granted in shared-based payment transactions are participating securities. It requires unvested share-based payments that entitle employees to receive nonrefundable dividends to also be considered participating securities. The Company currently grants certain unvested share-based payments awards that include rights to dividends similar to common stockholders. The Company adopted the new standards effective January 1, 2009, and it did not have a material impact to its computation of earnings per share.

In April 2009, the FASB issued new accounting standards for interim disclosures about fair value of financial instruments. It requires interim financial reporting to require disclosures about the fair value of financial instruments for interim reporting periods that were previously only required for annual reporting periods. An entity is required to disclose the fair value of financial assets and liabilities together with the related carrying amount and where the carrying amount is classified in the Condensed Consolidated Balance Sheets. It is effective prospectively for interim reporting periods after June 15, 2009. The Company adopted the new disclosure, interim disclosures about fair value of financial instruments. See Note 9.

In May 2009, the FASB issued new accounting standards for subsequent events. It does not significantly change the prior accounting practice for subsequent events except for the requirement to disclose the date through which an entity has evaluated subsequent events and the basis for that date. The Company adopted the new disclosure requirements for the period ended September 30, 2009, and evaluated subsequent events through the time the financial statements were issued on November 9, 2009. All significant events and transactions that occurred after the balance sheet date and before the issuance of the financial statements are detailed in Note 10.

In June 2009, the FASB issued new accounting standards for the accounting standards codification and the hierarchy of generally accepted accounting principles (codification). The Codification is a reorganization and compilation of all existing authoritative U.S. GAAP recognized by the FASB to be applied to nongovernmental entities. Rules and interpretive releases of the SEC under

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authority of federal securities law are also sources of authoritative GAAP for SEC registrants. On the effective date of this statement, the Codification superseded all then-existing non-SEC accounting and reporting standards. This new accounting standard is effective for financial statements issued for interim and annual periods ended after September 15, 2009. The Company adopted the codification effective September 30, 2009.

Accounting Pronouncements Issued But Not Yet Adopted

In December 2008, the FASB issued new accounting standards for employers' disclosures about postretirement benefit plan assets. An entity is required to provide qualitative disclosures about how investment allocation decisions are made, the inputs and valuation techniques used to measure the fair value of plan assets, and the concentration of risk within plan assets. Additionally, quantitative disclosures are required showing the fair value of each major category of plan assets, the levels in which each asset is classified within the fair value hierarchy, and a reconciliation for the period of plan assets which are measured using significant unobservable inputs. The new disclosure requirement is effective prospectively for fiscal years ending after December 15, 2009. The Company will include the expanded disclosure requirement in the consolidated financial statements for the annual period ending December 31, 2009.

Note 3. Stock-based Compensation**Long-Term Incentive Plan**

The Company had a stockholder-approved Long-Term Incentive Plan (which was replaced on April 27, 2005, by a stockholder-approved Equity Incentive Plan) that allowed granting of non-qualified stock options. The Company had accounted for options using the intrinsic value method. All outstanding options (83,250 shares at September 30, 2009) have an exercise price equal to the market price on the date they were granted. The weighted average price of the options is \$24.90. All options granted under the Long-Term Incentive Plan are fully vested. No compensation expense was recorded for the three or nine-month periods ended September 30, 2009 and 2008 related to stock options issued under the Long-Term Incentive Plan.

Equity Incentive Plan

Under the Company's Equity Incentive Plan, which was approved by shareholders in April 2005, the Company is authorized to issue up to 1,000,000 shares of common stock. In the nine-months ended September 30, 2009 and 2008, the Company granted Restricted Stock Awards (RSAs) of 21,000 and 16,630 shares, respectively, of common stock both to officers and to directors of the Company. Employee options vest ratably over 48 months, while director options vest at the end of 12 months. The shares were valued at \$38.38 and \$37.60 per share, respectively, based upon the fair market value of the Company's common stock on the date of grant.

In addition, in the nine-months ended September 30, 2009 and 2008, Stock Appreciation Rights (SARs) equivalent to 71,500 and 47,070 shares, respectively, were granted to officers, which vest ratably over 48 months and expire at the end of 10 years. The grant-date fair value for SARs was determined using the Black Scholes model, which arrived at a fair value of \$10.50 and \$6.03 per share, respectively. Upon exercise of a SAR, the appreciation is payable in common shares of the Company.

The assumptions utilized in calculation of the SAR fair value were:

	2009	2008
Expected dividend yield	3.06%	3.11%
Expected volatility	36.97%	21.96%
Risk-free interest rate	1.89%	2.63%
Expected holding period in years	6.0	5.2

The Company did not apply a forfeiture rate in the expense computation relating to RSAs and SARs issued to officers as they vest monthly and, as a result, the expense is recorded for actual vesting during the period. For outside directors the Company did not apply a forfeiture rate in the expense computation relating to RSAs, as the Company expects 100% to vest at the end of twelve months.

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					Manufacture and sale of silicon wafers for semiconductors
Net income	\$	34,103	\$	32,487	
Komatsu Zenoah Co.		5,099	100.0		Manufacture and sale of agricultural and forestry equipment, construction equipment, and industrial machinery
Komatsu Castex Ltd.		4,979	100.0		Manufacture and sale of steel castings and iron castings
Komatsu Kinki Ltd.		1,700	100.0		Sale, repair and service of construction equipments
Komatsu House Co., Ltd.		1,436	87.4		Manufacture, sale and lease of commercial-use-prefabricated structures for businesses
Komatsu Logistics Corp.		1,080	96.3		Packing, baling, transportation, warehousing and port-and-harbor services
Komatsu Industries Corporation		990	100.0		Manufacture and sale of presses and sheet metal machines
Komatsu Chugoku Ltd.		984	100.0		Sale, repair and service of construction equipments
Komatsu Tokyo Ltd.		837	100.0		Sale, repair and service of construction equipment
Komatsu Machinery Corporation		600	100.0		Manufacture of machine tools and semiconductor material processing equipment
Komatsu Hokkaido Ltd.		487	100.0		Sale, repair and service of construction equipment
Komatsu Electronics, Inc.		390	100.0		Manufacture and sale of thermo electric modules and temperature control equipment for semiconductor wet process
Komatsu Used Equipment Corp.		290	95.2		Sale of used construction equipment
Komatsu America Corp.	US\$	995 mil	100.0		Manufacture and sale of construction and mining equipment and supervision of US subsidiaries operations
Hensley Industries, Inc.	US\$	14mil	100.0		Manufacture and sale of parts for construction and mining equipment
Komatsu do Brasil Ltda.	R\$	55 mil	100.0		Manufacture and sale of construction equipment and castings
Advanced Silicon Materials LLC			100.0		Manufacture and sale of polycrystalline silicon and silane gas
Komatsu Europe International N.V.	EUR	45 mil	100.0		Supervision of European subsidiaries operations and sale of construction equipment
Komatsu UK Ltd.	Stg.£	23 mil	100.0		Manufacture and sale of construction equipment

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Komatsu Hanomag GmbH	EUR	19 mil	100.0	Manufacture and sale of construction equipment
Komatsu Mining Germany GmbH	EUR	5 mil	100.0	Manufacture and sale of mining equipment
Komatsu Forest, AB	Kronas	157 mil	100.0	Manufacture and sale of forestry equipment
Komatsu Utility Europe S.p.A.	EUR	6 mil	100.0	Manufacture and sale of construction equipment
Komatsu Asia & Pacific Pte Ltd.	US\$	6 mil	100.0	Supervision of Asian Pacific subsidiaries operations, sales of construction equipment and industrial machines
P.T. Komatsu Indonesia Tbk	Rupiahs	192,780 mil	55.1	Manufacture and sale of construction equipment and steel and iron castings
Bangkok Komatsu Co., Ltd.	Bahts	620 mill	74.8	Manufacture and sale of construction equipment
Komatsu (China) Ltd.	US\$	34 mil	100.0	Supervision of business in China
Komatsu (Changzhou) Construction Machinery Corp.	US\$	21 mil	85.0	Manufacture and sale of construction equipment
Komatsu Shantui Construction Machinery Co., Ltd.	US\$	21 mil	60.0	Manufacture and sale of construction equipment

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- Notes:
1. In November 2002, the Company signed an agreement with Linde AG of Germany under which Linde would implement equity participation in the Komatsu Group's forklift trucks business. In accordance with the agreement, Linde AG acquired a 35% equity stake in Komatsu Forklift Co., Ltd. on March 31, 2004.
 2. The Company's subsidiary owns Hensley Industries Ltd. and Komatsu do Brasil Ltda..
 3. Advanced Silicon Materials LLC is a limited liability company incorporated under the laws of Delaware, USA and the Company invests in this company through a subsidiary. The cumulative investments made in this company, which are equivalent to capital, amount to US\$ 555 million.
 4. The ratio of voting rights shown for Komatsu UK Ltd., Komatsu Utility Europe S.p.A. and Bangkok Komatsu Co., Ltd. include the voting rights held by the Subsidiaries.
 5. The ownership ratios for Komatsu Hanomag GmbH, Komatsu (Changzhou) Construction Machinery Corp. and Komatsu Shantui Construction Machinery Co., Ltd. includes the ownership of the Subsidiaries.

(iii) Principal Affiliated Companies

Name	Capital (in JPY million)	Ratio of Voting Rights or Ownership (%)	Main Business
GIGAPHOTON Inc.	5,000	50.0	Manufacture and sale of excimer lasers for semiconductor exposures
Komatsu Cummins Engine Co., Ltd.	1,400	50.0	Manufacture of diesel engines
Cummins Komatsu Engine Company		50.0	Manufacture of diesel engines

Note: Cummins Komatsu Engine Company is a general partnership established under the laws of Indiana, U.S.A. The Company holds an equity interest in this company indirectly through its subsidiary whose investment amounting to US\$2 million.

(iv) Report on Business Consolidation

In December 2003, Komatsu Ltd. purchased two subsidiaries of the Finnish company Kone Corporation, i.e. Partek Forest AB, a manufacturer of forestry equipment based in Sweden, and Partek Forest Holdings, LLC, based in the United States. With this acquisition, both companies became wholly owned subsidiaries of the Company, and the name of the operating company Partek Forest AB was changed to Komatsu Forest AB.

Table of Contents**(5) Major Borrowing**

Name of Lenders	Balance of Loans	Number of Shares of the Company Held by Such Lenders	Ratio of Voting Rights in the Company
	(in JPY billions)	(thousand shares)	(%)
The Hokkoku Bank, Ltd.	9.0	9,549	1.0
Sumitomo Mitsui Banking Corp.	8.5	17,835	1.8
The Dai-ichi Mutual Life Insurance Co.	6.5	9,098	0.9
Taiyo Life Insurance Co.	5.0	56,864	5.8
Shinkin Central Bank	4.0		

The major lenders on a consolidated basis are Sumitomo Mitsui Banking Corporation (JPY33.4 billion), Mizuho Corporate Bank (JPY17.7 billion), The Bank of Tokyo-Mitsubishi (JPY17.5 billion), and Japan Bank for International Cooperation (JPY15.5 billion). (The amounts are the balance of loans.)

(6) Principal Business Offices

	Name	Location
Head Office	Head Office	Minato-ku, Tokyo
Research Division	Research Division	Hiratsuka City, Kanagawa Pref.
Plants	Awazu Plant	Komatsu City, Ishikawa Pref.
	Osaka Plant	Hirakata City, Osaka Pref.
	Mooka Plant	Mooka City, Tochigi Pref.
	Oyama Plant	Oyama City, Tochigi Pref.
Subsidiaries	Komatsu Forklift Co., Ltd.	Oyama City, Tochigi Pref.
	Komatsu Electronic Metals Co., Ltd.	Ohmura City, Nagasaki Pref.,
		Kiyotake-cho, Miyazaki Pref.
	Komatsu Zenoah Co.	Kawagoe City, Saitama Pref.
	Komatsu Castex Ltd.	Himi City, Toyama Pref.
	Komatsu Electronics, Inc.	Hiratsuka City, Kanagawa Pref.
	Komatsu America Corp.	Chatanooga, Tennessee, USA,
		Peoria, Illinois, USA
	Hensley Industries, Inc.	Dallas, Texas, USA
	Advanced Silicon Materials, Inc.	Butte, Montana, USA
	Komatsu do Brasil Ltda.	Suzano, San Paulo, Brazil
	Komatsu UK Ltd.	Birtley, UK
	Komatsu Hanomag GmbH	Hannover, Germany
	Komatsu Mining Germany GmbH	Dusseldorf, Germany
	Komatsu Forest AB	Umeo, Sweden
	Komatsu Utility Europe S.p.A.	Este, Italy
	P.T. Komatsu Indonesia Tbk	Jakarta, Indonesia
	Bangkok Komatsu Co., Ltd.	Chonburi, Thai

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Komatsu (Changzhou) Construction Machinery Corp.	Changzhou, Jiangsu
Komatsu Shantui Construction	Province, China
Machinery Co., Ltd.	Jining, Shandong Province, China

Note: The above also includes the major plants of the subsidiaries.

Table of Contents**(7) Directors and Statutory Auditors**

<u>Position</u>	<u>Name</u>	<u>Responsibility in the Company, or Principal Occupation</u>
Chairman and Representative Director President and Representative Director Director	Toshitaka Hagiwara *Masahiro Sakane *Kazuhiro Aoyagi	General Manager of Corporate Planning Division
Director	*Kunio Noji	General Manager of Construction & Mining Equipment Marketing Division
Director	*Kunihiko Komiyama	General Manager of Development Division and Engines & Hydraulics Business Division
Director and Counselor Director	Satoru Anzaki Toshio Morikawa	Advisor of Sumitomo Mitsui Banking Corporation
Director	Hajime Sasaki	Chairman and Representative Director of NEC Corporation
Standing Statutory Auditor Standing Statutory Auditor Statutory Auditor	Norimichi Kitagawa Masafumi Kanemoto Masahiro Yoshiike	Chairman and Representative Director of Taiyo Life Insurance Co.
Statutory Auditor	Takaharu Dohi	Attorney

- Notes:
1. Directors Toshio Morikawa and Hajime Sasaki satisfy the requirements for Outside Director provided in Article 188.2.7.2 of the Commercial Code.
 2. Messrs. Masahiro Yoshiike and Takaharu Dohi, each of them being a Statutory Auditor, are Outside Statutory Auditors as provided for in Article 18.1 of the Law for Special Exceptions to the Commercial Code Concerning Audit, etc. of Kabushiki-Kaisha.
 3. Each Director with the mark * concurrently holds the post of Executive Officer.

Director who resigned from his position during this term:

<u>Position at the time of resignation</u>	<u>Name</u>	<u>Date of resignation</u>
Director and Counselor	Tetsuya Katada	June 26, 2003

Table of Contents**(Reference)**

The Company has introduced the Executive Officer system, and the list of Executive Officers as of March 31, 2004 is shown below.

The four persons with the mark * simultaneously hold the post of Director and Executive Officer.

<u>Position</u>	<u>Name</u>	<u>Title and Responsibilities</u>
President and Representative Director	*Masahiro Sakane	
(Executive Officer) Director (Senior Executive Officer)	*Kazuhiro Aoyagi	General Manager of Corporate Planning Division
Director (Senior Executive Officer)	*Kunio Noji	General Manager of Construction & Mining Equipment Marketing Division
Senior Executive Officer	*Kunihiko Komiyama	General Manager of Development Division and General Manager of Engines & Hydraulics Business Division
Senior Executive Officer	Naomi Anesaki	Supervision of Compliance, Defense Systems and Environment & Safety
Senior Executive Officer	Susumu Isoda	General Manager of Production Division and General Manager of Procurement Division
Senior Executive Officer	Teruo Nagayasu	Deputy General Manager of Construction & Mining Equipment Marketing Division
Senior Executive Officer	Masahiro Yoneyama	Deputy General Manager of Corporate Planning Division
Senior Executive Officer	Shigeki Fujimori	General Manager of Defense Systems Division
Senior Executive Officer	Munenori Nakao	Supervision of General Affairs, Corporate Communications and Investor Relations
Executive Officer	Yasuo Suzuki	General Manager of Industrial Machinery Division
Executive Officer	Kenji Kinoshita	CFO (Chief Financial Officer)
Executive Officer	Makoto Nakamura	General Manager of e-KOMATSU Division
Executive Officer	Hiroshi Suzuki	General Manager of Underground Machinery Business, Construction & Mining Equipment Marketing Division
Executive Officer	Mamoru Hironaka	Deputy General Manager of Development Division
Executive Officer	Masao Fuchigami	General Manager of Research Division
Executive Officer	Masayuki Sato	Plant Manager of Oyama Plant and Deputy General Manager of Engines & Hydraulics Business Division
Executive Officer	Taizo Kayata	General Manager of Overseas Marketing, Construction & Mining Equipment Marketing Division
Executive Officer	Masaji Kitamura	General Manager of Strategic Planning Department, Construction & Mining Equipment Marketing Division
Executive Officer	Nobutsugu Ohira	Plant Manager of Osaka Plant, Production Division
Executive Officer	Nobukazu Kotake	Deputy General Manager of Development Division and General Manager of Construction Equipment Technical Center 1, Development Division

Table of Contents**(8) Remuneration for Directors and Statutory Auditors**

	Number of Persons Paid	Amount Paid (JPY million)	Reference
Directors	9	295	1. The amounts of remuneration for the Directors and Statutory Auditors were respectively resolved at the 121st Ordinary General Meeting of Shareholders and the 112th Ordinary General Meeting of Shareholders where the maximum amount to be paid to the Directors in total per month shall not exceed JPY30 million and the maximum amount to be paid to Statutory Auditors in total per month shall not exceed JPY5 million.
Auditors	4	50	
Total	13	345	2. In addition to the amounts indicated at left, a retirement benefit of JPY396 million is paid to a retiring Director.
			3. In addition to the payment shown at left, retained earnings were utilized for the payment of Directors' bonuses totaling JPY65 million and Statutory Auditors' bonuses totaling JPY11 million.
			4. There were eight (8) Directors and four (4) Statutory Auditors as at the end of the reporting period.

(9) Issuance of Share Acquisition Rights to Persons other than Shareholders on Preferential Terms

(i) Number of Share Acquisition Rights issued:

2,040 rights

Type and number of shares for Share Acquisition Rights:

2,040,000 shares of ordinary shares of the Company

Issue price of Share Acquisition Rights:

Share Acquisition Rights are issued gratis.

(ii) Share Acquisition Rights issued during the reporting term to persons other than shareholders on preferential terms

Number of Share Acquisition Rights issued:

1,280 rights (1,000 shares per Acquisition right)

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Type and number of shares for Share Acquisition Rights:

1,280,000 ordinary shares of the Company

Issue price of Share Acquisition Rights:

Share Acquisition Rights are issued gratis.

Per share payment upon exercise of Share Acquisition Rights:

JPY 595

Period for exercise of Share Acquisition Rights:

From August 1, 2004 to July 31, 2009

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Conditions for Exercise of Share Acquisition Rights:

- 1) Any of the persons granted Share Acquisition Rights may exercise his or her rights pursuant to the Agreement Concerning Issuance of Share Acquisition Rights (the Agreement) based on the resolution of this Meeting and the resolution of the Board of Directors Meeting even after the person is no longer a Director or an employee of the Company or a President and Representative Director of its major subsidiaries.
- 2) When a recipient is deceased, his or her heir may exercise the rights in accordance with the terms of the Agreement.
- 3) Other conditions are set forth in the Agreement.

Events and Conditions for the cancellation of Share Acquisition Rights:

Share Acquisition Right may be canceled gratis in the following events.

- 1) Pursuant to the Agreement, if the person granted Share Acquisition Rights loses his/her Share Acquisition Rights or if it becomes definitive that the Share Acquisition Rights will not be exercised.
- 2) If a merger agreement is approved stipulating that the Company is to be absorbed.

Content of preferential terms

The Company issued gratis Share Acquisition Rights to its Directors, employees, and President and Representative Directors of its major subsidiaries.

The recipients of Share Acquisition Rights and the numbers granted

Directors of the Company

Name	Number of Share Acquisition	Number of Shares subject to the
	Rights Granted	Share Acquisition Rights
	(units)	Granted (shares)
Toshitaka Hagiwara	80	80,000
Masahiro Sakane	80	80,000
Kazuhiro Aoyagi	60	60,000
Kunio Noji	60	60,000

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Kunihiko Komiyama	60	60,000
Satoru Anzaki	20	20,000
Toshio Morikawa	20	20,000
Hajime Sasaki	20	20,000

Table of Contents**Employees of the Company and Directors of Major Subsidiaries (top 10)**

Name	Number of Share Acquisition		Number of Shares subject to Share	Remarks
	Rights Granted	Acquisition Rights		
	(units)	Granted (shares)		
Naomi Anesaki	60	60,000		Senior Executive Officer of the Company
Susumu Isoda	40	40,000		Senior Executive Officer of the Company
Teruo Nagayasu	40	40,000		Senior Executive Officer of the Company
Masahiro Yoneyama	40	40,000		Senior Executive Officer of the Company
Shigeki Fujimori	40	40,000		Senior Executive Officer of the Company
Munenori Nakao	40	40,000		Senior Executive Officer of the Company
Takeo Shibuya	40	40,000		President and Representative Director of Komatsu Forklift Co., Ltd.
Yukio Tokura	40	40,000		President and Representative Director of Komatsu Zenoah Co.
Yasuo Suzuki	20	20,000		Executive Officer of the Company
Kenji Kinoshita	20	20,000		Executive Officer of the Company

Directors of the Subsidiaries to whom Share Acquisition Rights are allotted in a number exceeding the smallest number of relevant rights allotted to Directors of the parent company

Name	Number of Share Acquisition		Number of Shares subject to Share	Remarks
	Rights Granted	Acquisition Rights		
	(units)	Granted (shares)		
Takeo Shibuya	40	40,000		President and Representative Director of Komatsu Forklift Co., Ltd.
Yukio Tokura	40	40,000		President and Representative Director of Komatsu Zenoah Co.
Kanetake Nakatani	20	20,000		President and Representative Director of Komatsu Castex Ltd.
Akio Fukunishi	20	20,000		

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President and Representative
 Director of Komatsu Logistics
 Corp.

Breakdown of Share Acquisition Rights allotted to employees (other than Directors) of the parent company and Directors of subsidiaries

Classification	Number of Share Acquisition Rights Granted	Type and number of Shares subject to the Share Acquisition Rights	Number of recipients
	(units)	Granted (shares)	
Employees of the parent company	700	Ordinary shares 700,000	35
Directors of subsidiaries	180	Ordinary shares 180,000	10

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EXHIBIT 2

BALANCE SHEET

(As of March 31, 2004)

	<u>JPY Millions</u>
Assets	
Current assets:	
Cash on hand and in banks	28,946
Notes receivable	4,907
Accounts receivable - trade	141,315
Finished products	26,029
Materials and supplies	2,455
Work in process	23,005
Prepaid expenses	633
Deferred income taxes - current	12,120
Short-term loans receivable	52,306
Other current assets	19,364
Allowance for doubtful receivables	(928)
Total current assets	310,156
Noncurrent assets:	
Tangible fixed assets:	
Buildings	39,078
Structures	7,468
Machinery and equipment	24,401
Vehicles and delivery equipment	181
Tools, furniture and fixtures	5,946
Land	42,550
Construction in progress	407
Total tangible fixed assets	120,034
Intangible assets:	
Utility rights	176
Software	9,744
Other intangible assets	53
Total intangible assets	9,974
Investments and other assets	
Investment securities	45,368
Securities and other investments in affiliates	265,070
Bond of affiliates	500
Long-term loans receivable	11,695
Long-term prepaid expenses	1,463
Deferred income taxes - noncurrent	33,646
Other investments	5,330
Allowance for doubtful receivables	(4,067)
Allowance for investments valuation	(43,185)

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Total investment and other assets	315,822
Total noncurrent assets	445,831
Total assets	755,988

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	<u>JPY Millions</u>
Liabilities	
Current liabilities:	
Notes payable trade	2,515
Accounts payable trade	80,334
Commercial paper	15,000
Accounts payable	26,292
Accrued corporation taxes, etc.	5,178
Advances received	3,800
Deferred profit on installment sales	976
Accrued bonuses	4,367
Warranty reserve	4,764
Other current liabilities	4,827
	<hr/>
Total current liabilities	148,057
Long-term liabilities:	
Bonds	65,000
Long-term loans payable	67,000
Liability for employee retirement benefits	12,394
Liability for Director and Statutory Auditor retirement benefits	894
Other long-term liabilities	456
	<hr/>
Total long-term liabilities	145,745
	<hr/>
Total liabilities	293,802
Shareholders equity	
Common stock	70,120
Capital surplus:	
Capital reserve	140,140
Retained earnings:	
Legal earned surplus	18,029
Reserve for special depreciation	82
Reserve for losses on overseas investments	1
Reserve for advanced depreciation deduction	14,832
Reserve for special advanced depreciation account	548
General reserve	180,359
Unappropriated retained earnings	25,587
	<hr/>
Total retained earnings	239,441
Net unrealized gains on revaluation, net of tax effect	15,641
Treasury shares	(3,157)
	<hr/>
Total shareholders equity	462,185
	<hr/>
Total liabilities and shareholders equity	755,988
	<hr/>

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EXHIBIT 3

STATEMENT OF INCOME

(From April 1, 2003 to March 31, 2004)

	<u>JPY Millions</u>
Net sales	418,686
Cost of sales	314,933
Deferred profit on installment sales	(1,049)
Selling, general and administrative expenses	83,871
	<hr/>
Operating profit	20,931
Non-operating income:	
Interest and dividend income	8,899
Other non-operating income	1,223
Non-operating expenses:	
Interest expenses	2,050
Other non-operating expenses	9,062
	<hr/>
Ordinary Profit:	19,942
Extraordinary income:	
Profit on sale of investment securities	2,588
Profit on sale of shares of affiliates	14
Proceeds from sale of land	673
Extraordinary Losses:	
Valuation loss of investment securities	242
Loss on valuation of investments in affiliates	4,069
Loss on sale of land	1,034
Deferred allowance of securities investment valuation	1,950
	<hr/>
Income before income taxes	15,921
Income taxes:	
Current	7,813
Deferred	(2,480)
	<hr/>
Net income	10,588
Unappropriated retained earnings at the beginning of the period	17,986
Loss on disposal of treasury stock	9
Interim cash dividend paid	2,977
	<hr/>
Unappropriated retained earnings at the end of the period	25,587
	<hr/>

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Notes:

1. Significant Accounting Policies

(1) Valuation of Securities

Held-to-maturity debt securities: Carried at amortized cost.

Investments in subsidiaries and affiliated companies: Stated at cost determined by the moving-average method.

Available-for-sale securities:

Securities whose market value is readily determinable:

Stated at the market value, based on market quotation. Unrealized gains and losses are reported, with net of applicable taxes, in a separate component of shareholders' equity. The cost of securities sold is determined based on the moving-average method.

Securities whose market value is not readily determinable:

Stated at cost determined by the moving-average method.

(2) Method and basis of valuation of inventories

Finished products (excluding spare parts and real estate held for sale) and work in process: Stated at lower of cost (specific identification method) or market.

Spare parts: Stated at lower of cost (last-in, first-out method) or market.

Real estate held for sale: Stated at cost (specific identification method)

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Materials and supplies: Stated at lower of cost (periodic average method)

(3) Amortization of tangible fixed assets and intangible assets is computed according to the declining-balance method and the straight-line method respectively.

(4) Liability for Employee s Retirement Benefits:

In order to provide for the employees retirement benefits, the Company accrues liabilities for severance payments and pension at the amount calculated based on the projected benefit obligations and plan assets at the balance sheet date.

(With respect to the Company s pension system, as the pension assets exceed the liabilities for severance payments, the prepaid pension expense is recorded.)

(5) Allowance for valuation loss on investment securities is accounted for by taking into consideration the financial position of the issuer and fluctuation of the foreign exchange of the country of the issuer in order to prepare for losses from investing in domestic and overseas unlisted companies.

(6) Accounting method of lease transactions

Finance Leases that do not transfer ownership of leased property to the lessee are accounted in the same manner as operating leases.

(7) Accounting for consumption tax

Consumption tax is excluded from income and expense.

(8) Beginning with the reporting period, the Company has, in part, adopted terminology and forms in line with Regulations Regarding Terminology, Format and Preparation of Financial Statements, etc. Regarding affiliates, special provisions under the Commercial Code Enforcement Regulation are applied to description including notes.

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2. Notes to Balance Sheet

(1) Fractions of JPY one million have been discarded.

(2) Short-term receivables from affiliates: JPY164,281 million

Short-term debts payable to affiliates: JPY30,107 million

Long-term receivables from affiliates: JPY11,493 million

(3) Accumulated depreciation of tangible fixed assets: JPY302,883 million

(4) In addition to the fixed assets shown in the balance sheet, there are computers and peripherals leased and used as important fixed assets.

(5) Liability for Director and Statutory Auditor retirement benefits is an allowance accounted pursuant to Article 43 of the Commercial Code Enforcement Regulation.

(6) Guaranteed liability: JPY82,988 million

Balance under letters of keep-well agreements: JPY74,319 million

Maximum repurchase amount for the transferred claims for installment sales receivables: JPY539 million

(7) The amount of net assets prescribed in Article 124, Item 3 of the Commercial Code Enforcement Regulation: JPY15,641 million

(8) Type and total number of shares issued and outstanding at the end of the period: 998 million ordinary shares

Type and the number of shares held in treasury at the end of the period: 6 million ordinary shares

3. Notes to Statement of Income

(1) Fractions of JPY one million have been discarded.

(2) Trading with affiliates

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Sales: JPY239,927 million

Purchases: JPY152,900 million

Trading other than operating transactions: JPY13,082 million

(3) Net income per share: JPY10.50

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EXHIBIT 4

PROPOSAL FOR APPROPRIATION OF RETAINED EARNINGS

(For the period ending in March 2004)

	Unit: JPY
Unappropriated retained earnings at the end of the period	25,587,889,754
Reversal of reserve for special depreciation	30,623,090
Reversal of reserve for loss on overseas investments	83,300
Reversal of reserve for advanced depreciation deduction	1,266,327,571
Reversal of reserve for special advanced depreciation account	548,874,855
TOTAL	27,433,798,570
The foregoing amount is proposed to be appropriated as follows:	
Cash dividends (JPY4 per share)	3,969,953,104
Bonus for Directors (including JPY14,000,000 for Statutory Auditors)	170,000,000
Provision of reserve for special depreciation	3,182,200
Provision of reserve for advanced depreciation deduction	853,659,439
Unappropriated retained earnings carried forward to the next period	22,437,003,827

- Notes:
1. The total dividends applicable to this fiscal period would amount to JPY6,947,291,146 (including the interim dividends of JPY3 per share, totaling JPY2,977,338,042 paid on December 5, 2003).
 2. The amounts entered respectively for reversal and provision of Reserve for special depreciation, reversal of Reserve for loss on overseas investments, Reversal and Reserve for Reserve for advanced depreciation deduction and provision of Reserve for special advanced depreciation account are recorded in accordance with the Special Taxation Measures Law.

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EXHIBIT 5

[English Translation of the Auditors Report Originally Issued in Japanese Language]

Independent Auditors Report

May 6, 2004

The Board of Directors

Komatsu Ltd.

KPMG AZSA & Co.

Tadao Kuwano (Seal)

Representative Partner

Certified Public Accountant

Teruo Suzuki (Seal)

Representative and

Engagement Partner

Certified Public Accountant

Yoshiteru Yamamoto (Seal)

Engagement Partner

Certified Public Accountant

We have audited the statutory report, that is the balance sheet, the statement of income, the business report (limited to accounting matters) and the proposal for appropriation of unappropriated retained earnings, and its supporting schedules (limited to accounting matters) of Komatsu Ltd. for the 135th business year from April 1, 2003 to March 31, 2004 in accordance with Clause 1, Article 2 of the Law for Special Exceptions to the Commercial Code Concerning Audit, etc. of Kabushiki Kaisha . With respect to the aforementioned business report and supporting schedules,

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our audit was limited to those matters derived from the accounting books and records of the Company. The statutory report and supporting schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on the statutory report and supporting schedules based on our audit as independent auditors.

We conducted our audit in accordance with generally accepted auditing standards in Japan. Those auditing standards require us to obtain reasonable assurance about whether the statutory report and supporting schedules are free of material misstatement. An audit is performed on a test basis, and includes assessing the accounting principles used, the method of their application and estimates made by management, as well as evaluating the overall presentation of the statutory report and supporting schedules. We believe that our audit provides a reasonable basis for our opinion. Our audit procedures also include those considered necessary for the Company's subsidiaries.

As a result of the audit, our opinion is as follows:

- (1) The balance sheet and the statement of income present fairly the financial position and the results of operations of the Company in conformity with related laws and regulations and the Articles of Incorporation of the Company.
- (2) The business report (limited to accounting matters) presents fairly the status of the Company in conformity with related laws and regulations and the Articles of Incorporation of the Company.

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- (3) The proposal for appropriation of unappropriated retained earnings has been prepared in conformity with related laws and regulations and the Articles of Incorporation of the Company.

- (4) With respect to the supporting schedules (limited to accounting matters) there are no items to be noted that are not in conformity with the provisions of the Commercial Code.

Our firm and engagement partners have no interest in the Company which should be disclosed pursuant to the provisions of the Certified Public Accountants Law of Japan.

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EXHIBIT 6

[English Translation of the Board of Statutory Auditors Report Originally Issued in Japanese Language]

BOARD OF STATUTORY AUDITORS REPORT

AUDIT REPORT

May 7, 2004

Having been reported by each Statutory Auditor on the method and results of the audit in regard to the performance of duties by the Directors of Komatsu Ltd. (the Company) for the 135th fiscal year (beginning on April 1, 2003 and ending on March 31, 2004), the Board of Statutory Auditors of the Company prepares this Audit Report on deliberation and reports as follows:

1. Outline of Method of Examination

In accordance with the policy of audit and the assignment prescribed by the Board of Statutory Auditors, each Statutory Auditor participated in meetings of the Board of Directors and other important meetings of the Company, received reports from the Directors, etc. on matters relating to the business operations of the Company, read important approval documents, etc., investigated at the head office and the major places of business of the Company into matters relating to the management of business and the status of property thereof, and requested subsidiaries to report on business as considered necessary. We also received reports and explanations from the independent certified public accountants and examined the contents of the Company's financial documents and supplemental schedules.

We requested reports from Directors, etc. as necessary, in addition to the above method of audit, for matters such as those concerning the Directors' involvement in transactions competitive with the Company's business and in transactions which may conflict with the Company's interests, the Company's bestowing benefits, the Company's unusual transactions with subsidiaries and shareholders and the Company's acquisition or disposal of its treasury shares, and investigated such transactions in detail.

2. Results of Examination

We are of the view:

(1) that the method and results of the audit conducted by KPMG AZSA & Co., the Company's independent certified public accountants, are appropriate;

(2)

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that the contents of the Business Report (other than accounting information) present fairly the conditions of the Company as required by related laws and regulations and the Articles of Incorporation of the Company;

- (3) that there are no matters which we are required to mention in the Proposal for Appropriation of Profit in the light of the financial conditions of the Company and other circumstances;
- (4) that the Supplemental Schedules (other than accounting information) properly contain information required to be contained therein and that there are no matters which we are required to mention; and

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- (5) that in connection with performance of duties by the Directors including their duties relating to subsidiaries, we did not find any unlawful act or any material fact which constitutes violation of laws and regulations or the Articles of Incorporation of the Company. Further, with respect to matters such as the Directors' involvement in transactions competitive with the Company's business and in transactions which may conflict with the Company's interests, the Company's bestowing of benefits and the Company's unusual transactions with subsidiaries and shareholders, and the Company's acquisition or disposal of its own stocks, we are of the opinion that there was no breach of obligation of Directors.

Norimichi Kitagawa (seal)
Standing Statutory Auditor

Masafumi Kanemoto (seal)
Standing Statutory Auditor

Masahiro Yoshiike (seal)
Statutory Auditor

Takaharu Dohi (seal)
Statutory Auditor

Note: Messrs. Masahiro Yoshiike and Takaharu Dohi of Statutory Auditors are Outside Statutory Auditors provided in Article 18, Paragraph 1 of the Law for Special Exceptions to the Commercial Code Concerning Audit, etc. of Kabushiki-Kaisha .

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REFERENCE MATERIALS FOR

EXERCISING VOTING RIGHTS

1. Total Number of Voting Rights Held by All the Shareholders:

981,148 voting rights

2. Explanations of Items of Business:

Item 1: Approval of the Proposed Appropriation of Retained Earnings for the 135th Business Term (April 1, 2003 - March 31, 2004)

The proposal for appropriation of retained earnings is as described in EXHIBIT 4.

Based on our comprehensive consideration of our current fiscal year's performance and dividend pay out ratio, the Company decided for the amount of cash dividend per share as of the end of this period to be JPY4.00 per share, an increase of JPY1.00 from the previous term. Accordingly, with the interim dividend JPY3.00 per share, the total amount of dividend per share of this period is JPY7.00 per share.

Item 2: Partial Amendments to Articles of Incorporation

1. Reasons for Amendments:

- (1) The scope of business activities specified in Article 2 is being widened to prepare for future business operations.
- (2) Pursuant to the enforcement on September 25, 2003 of the Law Concerning Amendments to the Commercial Code and the Law for Special Exceptions to the Commercial Code concerning Audit, etc. of Kabushiki Kaisha (2003 Law No. 132), companies are allowed to acquire their own shares in accordance with a resolution of the Board of Directors if their articles of incorporation stipulate so. To make possible the execution of a flexible capital policy that can respond to changes in the economic climate, the Company shall add a new provision regarding acquisition of the Company's own shares (Article 7 in proposed draft).
- (3) The Law for partially amending the Commercial Code, etc. (2002 Law No. 44) came into force on April 1, 2003, and a system has been established under which shareholders can purchase additional shares when they hold an amount less than one unit (*tangen*). To improve services for shareholders, a new provision (Article 9 in proposed draft) shall be added to provide for the adoption of a system for such purchases of additional shares. In conjunction with this new article, revisions shall be made as necessary to the present articles 8, 9 and 10.
- (4)

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The Law for partially amending the Commercial Code, etc. (2001 Law No. 128) came into force on April 1, 2002, which allow a company to remove the provision for handling of convertible debentures from its Articles of Incorporation. In addition, the Company totally redeemed all outstanding convertible debentures during the reporting term. Thereby, the current provisions of Articles 40 and 42 are to be removed.

- (5) Numbering of other articles shall be revised as necessary in conjunction with the above amendments.

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Details of the Amendments:

The amendments to be made are as follows:

(Amendments are shown in underlines)

Current Articles of Incorporation

Proposed Amendments

CHAPTER I. GENERAL PROVISIONS

CHAPTER I. GENERAL PROVISIONS

Article 2. Objectives and Purposes

Article 2. Objectives and Purposes

The objectives and purposes of the Company shall be to engage in the following businesses:

The objectives and purposes of the Company shall be to engage in the following businesses:

- | | |
|---|---|
| <ol style="list-style-type: none"> 1. Manufacture, repair, sale and purchase of construction machinery, agricultural machinery, industrial machinery, automobiles, internal combustion engines and various other machinery and equipment and parts thereof 2. Manufacture, sale and purchase of various iron and steel goods 3. Tempering, processing, sale and purchase of various types of iron and steel, pig-iron, ferroalloys and other special metals 4. Manufacture, sale and purchase of various types of electric materials and equipment 5. Manufacture, sale and purchase of various synthetic resin products 6. Manufacture, repair, sale and purchase of various arms and parts thereof 7. Mining industry, and sale and purchase of minerals 8. Designing, executing, supervising and contracting various types of civil engineering and construction work for plants, dwelling houses, and other structures 9. Sale and purchase of lumber, processed lumber products and various types of civil engineering and construction materials, machinery and equipment 10. Sale, purchase and lease of real property 11. Manufacture, sale and repair of industrial waste and general waste treatment device 12. Collection, transportation, treatment and recycling of industrial wastes and general wastes, sale of the recycled products, and consulting on these matters 13. Development, creation, sales and consulting on computer software and computer systems 14. Electronic commerce using networks such as the Internet | <ol style="list-style-type: none"> 1. 2. 3. 4. 5. 6. 7. 8. 9. 10. 11. 12. 13. 14. |
|---|---|

Unchanged

15.	Information processing and information providing service	15.
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- (New)
16. All business incidental to each and every one of the preceding items
17. Investing in other companies or promoting organization of other companies.

16. Financing services
17. All business incidental to each and every one of the preceding items
18. Investing in other companies or promoting organization of other companies.

CHAPTER II. SHARES

(New)

Article 7. (Omitted)

(New)

Article 8. Transfer Agent

The Company shall appoint a transfer agent relating to the shares. The transfer agent and the place for providing shareholder service shall be designated by a resolution of the Board of Directors and published by the Company. The Register of Shareholders, the Register of Beneficial Owners of the Company, and the Register of Lost Share Certificates shall be kept at the place for shareholders service of the transfer agent.

The Company shall have such transfer agent handle registration of change of holders, registration of pledge of shares, indication of shares held in trust, re-insurance of share certificates, receiving of various notifications, preparation of the Register of Beneficial Owners, receiving of beneficial owners notification, registration of lost share certificates, purchase of shares less than one unit (*tangen*) of shares, and any other services concerning shares. The Company shall not handle these services.

CHAPTER II. SHARES

Article 7. Acquisition of Own Shares

Pursuant to the provision of Article 211.3.2.1 of the Commercial Code, the Company may purchase the Company's own shares by a resolution of the Board of Directors.

Article 8. (Same as the current Article 7)

Article 9. Purchase by a Shareholder of Shares Less Than One Unit (*tangen*) of Shares

In accordance with the Share Handling Regulations, a shareholder (including hereinafter Beneficial Owners) who has shares less than one unit (*tangen*) of shares may request the Company to sell to him/her such number of shares as, together with the shares less than one unit held by him/her, would constitute one unit of shares.

Article 10. Transfer Agent

The Company shall appoint a transfer agent relating to the shares. The transfer agent and the place for providing shareholder service shall be designated by a resolution of the Board of Directors and published by the Company. The Register of Shareholders, the Register of Beneficial Owners of the Company, and the Register of Lost Share Certificates shall be kept at the place for shareholders service of the transfer agent.

The Company shall have such transfer agent handle registration of change of holders, registration of pledge of shares, indication of shares held in trust, re-insurance of share certificates, receiving of various notifications, preparation of the Register of Beneficial Owners, receiving of beneficial owners notification, registration of lost share certificates, purchase and sale of shares less than one unit (*tangen*) of shares, and any other services concerning shares. The Company shall not handle these services.

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Article 9. Share Handling Regulations

Types of shares, and the handling of registration of change of holders, registration of pledge of shares, indication of shares held in trust, re-issuance of share certificates, preparation of the register of Beneficial Owners, receiving of beneficial owners notification, registration of lost share certificates, purchase of shares less than one unit (*tangen*) of shares, and any other handling of shares shall be governed by the Share Handling Regulations established by resolution of the Board of Directors.

Article 10. Registration of Shareholders, etc.

Shareholders (including hereinafter beneficial owners of shares), registered pledgees or their legal representatives, shall notify the transfer agent appointed by the Company of their names, addresses and seal impressions in the form prescribed by the Company. Any changes in the matters prescribed in the preceding sentence shall likewise be notified. Foreign nationals who are accustomed to using their signatures may substitute their signatures for their seal impressions.

Articles 11 to 39 (Omitted)

CHAPTER VI. ACCOUNTING

Article 40. Conversion Time of Convertible Debentures

With respect to the first distribution of dividends or interim dividends on the shares issued upon request for conversion of convertible debentures issued by the Company, such conversion shall be deemed to have been made on April 1 if such request for conversion is made between April 1 and September 30 and October 1 if such request is made between October 1 and March 31 of the following year.

Article 41. (Omitted)

Article 11. Share Handling Regulations

Types of shares, and the handling of registration of change of holders, registration of pledge of shares, indication of shares held in trust, re-issuance of share certificates, preparation of the register of Beneficial Owners, receiving of beneficial owners notification, registration of lost share certificates, purchase and sale of shares less than one unit (*tangen*) of shares, and any other handling of shares shall be governed by the Share Handling Regulations established by resolution of the Board of Directors.

Article 12. Registration of Shareholders, etc.

Shareholders, registered pledgees or their legal representatives, shall notify the transfer agent appointed by the Company of their names, addresses and seal impressions in the form prescribed by the Company. Any changes in the matters prescribed in the preceding sentence shall likewise be notified. Foreign nationals who are accustomed to using their signatures may substitute their signatures for their seal impressions.

Articles 13 to 41 (Same as the current Articles 11 to 39)

CHAPTER VI. ACCOUNTING

(Deleted)

Article 42 (Same as the current Article 41)

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CHAPTER VII. SUPPLEMENTARY PROVISIONS

Article 42. Transfer Agent for Convertible Debentures Issued in Foreign Currency

The Company shall appoint a transfer agent in the United States relating to convertible debentures denominated in U.S. Dollars.

In addition to the case prescribed in the preceding paragraph, the Company may, if necessary, appoint transfer agents abroad relating to the convertible debentures denominated in foreign currency.

CHAPTER VII. SUPPLEMENTARY PROVISIONS

(Deleted)

Item 3: Appointment of Ten (10) Directors

The terms of office of eight (8) Directors will terminate as of the close of this Ordinary General Meeting of Shareholders.

In order to strengthen the management system, an election of the following ten (10) Directors, an increase of two (2) from the previous eight, is requested.

DIRECTOR CANDIDATES

Name	Brief Personal History	Number of Shares of the Company Held
<u>(Date of Birth)</u>	<u>(Representative positions in other companies)</u>	<u>(shares)</u>
Toshitaka Hagiwara (June 15, 1940)	12/1969 Joined the Company 6/1990 Director 6/1995 Managing Director 6/1997 Executive Managing Director 6/1999 Executive Vice President and Representative Director 6/2003 Chairman and Representative Director (current position) [Representative positions in other companies] President and Representative Director of Komatsu Building Co., Ltd.	60,399
Masahiro Sakane (January 7, 1941)	4/1963 Joined the Company 6/1989 Director 6/1994 Managing Director 6/1997 Executive Managing Director	68,100

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6/1999 Executive Vice President and Representative Director
6/2001 President and Representative Director (current position)

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Kazuhiro Aoyagi (April 14, 1943)	4/1967	Joined the Company	45,000
	6/1993	Director	
	6/1998	Managing Director	
	6/1999	Senior Executive Officer	
	6/2001	Executive Managing Director	
	4/2003	General Manager of Corporate Planning Division (current position) Director and Senior Executive Officer (current position)	
Kunio Noji (November 17, 1946)	4/1969	Joined the Company	31,710
	6/1997	Director	
	6/1999	Executive Officer	
	6/2000	Senior Executive Officer	
	6/2001	Managing Director	
	4/2003	General Manager of Construction & Mining Equipment Marketing Division (current position), Director and Senior Executive Officer (current position)	
Kunihiko Komiyama (May 5, 1945)	4/1968	Joined the Company	33,000
	6/1996	Director	
	6/1999	Senior Executive Officer	
	6/2002	Managing Director	
	4/2003	General Manager of Development Division and General Manager of Engines & Hydraulics Business Division (current position) Director and Senior Executive Officer (current position)	
Satoru Anzaki (March 3, 1937)	4/1961	Joined the Company	136,488
	3/1985	Director	
	11/1988	Managing Director	
	6/1991	Executive Managing Director	
	6/1995	President and Representative Director	
	6/2001	Chairman of the Board	
	6/2003	Director and Counselor (current position)	
Toshio Morikawa (March 3, 1933)	4/1955	Joined The Sumitomo Bank, Ltd. (currently Sumitomo Mitsui Banking Corporation, the Bank)	0
	6/1980	Director of the Bank	
	2/1984	Managing Director of the Bank	
	10/1985	Executive Managing Director and Representative Director of the Bank	
	10/1990	Vice President and Representative Director of the Bank	

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	6/1993	President and Representative Director of the Bank	
	6/1997	Chairman and Representative Director of the Bank	
	6/1999	Director of the Company (current position)	
	3/2001	Counselor of the Bank	
	4/2001	Counselor of Sumitomo Mitsui Banking Corporation	
	6/2002	Advisor of the Bank (current position)	
Hajime Sasaki	4/1961	Joined NEC Corporation	2,100
(April 6, 1936)		(NEC Corporation, the Corp.)	
	6/1988	Director of the Corp.	
	6/1991	Senior Vice President of the Corp.	
	6/1994	Executive Vice President of the Corp.	
	6/1996	Senior Vice President and Representative Director of the Corp.	
	3/1999	Representative Director and Chairman of the Board of the Corp. (current position)	
	6/2003	Director of the Company (current position)	
		[Representative positions in other companies]	
		Representative Director and Chairman of the Board of NEC Corporation	
Masahiro Yoneyama	4/1970	Joined the Company	19,000
	6/1996	General Manager of Human Resources Dept.	
(July 3, 1946)	6/1999	Executive Officer	
	11/2001	Deputy General Manager of Corporate Planning Division (current position)	
	4/2003	Senior Executive Officer (current position)	
Yasuo Suzuki	4/1970	Joined the Company	9,000
(January 28, 1948)	6/1999	President and Representative Director, Komatsu Industries Corp. (current position)	
	4/2002	General Manager of Industry Machinery Division (current position)	
	6/2002	Executive Officer	
	4/2004	Senior Executive Officer	
		[Representative positions in other companies]	
		- President and Representative Director of Komatsu Industries Corp.	
		- President and Representative Director, Komatsu Artec Ltd.	
		- Chairman, Komatsu Industries (Shanghai) Ltd.	

Note: Messrs. Toshio Morikawa and Hajime Sasaki, candidates for Directors, satisfy the conditions of Outside Directors provided in Article 188.2.7.2 of the Commercial Code.

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The term of office of the Statutory Auditor, Mr. Norimichi Kitagawa, will expire at the close of the Meeting.

Accordingly, it is proposed that one Statutory Auditor be elected and the following candidate is nominated for the position.

For information, this item for resolution was reviewed and approved by the Board of Statutory Auditors.

STATUTORY AUDITOR CANDIDATE

Name	Brief Personal History		Number of Shares of the Company Held
<u>(Date of Birth)</u>	<u>(Representative positions in other companies)</u>		<u>(shares)</u>
Makoto Nakamura	4/1971	Joined the Company	7,000
(May 31, 1946)	7/1997	President, Komatsu America Corp.	
	6/2001	General Manager of International Business Division	
	6/2001	Executive Officer (current position)	
	4/2002	General Manager of e-KOMATSU Division (current position)	

Item 5: Gratis Issue of Share Acquisition Rights under Employee Stock Option Plan

Pursuant to the provisions of Article 280-20 and Article 280-21 of the Commercial Code, the Company shall issue gratis Share Acquisition Rights to its Directors, employees, and President and Representative Directors of its major subsidiaries for the reasons stated below and in the following manner and hereby requests for approval of the shareholders.

1. Reason for issuing gratis Share Acquisition Rights to persons other than Shareholders:

For the purposes of raising the motivation and lifting the morale of the Directors, employees, and President and Representative Directors of major subsidiaries of the Company which shall contribute to the improvement of the consolidated performance of the Company, the Company wishes to issue gratis rights to acquire new shares to the recipients in the form of stock options (Share Acquisition Rights). As described below, the amount to be paid upon exercise of the Share Acquisition Rights shall be based on the market price of the share at the time of issuance of Share Acquisition Rights.

2. Manner of issuing Share Acquisition Rights:

(1) Persons who will receive Share Acquisition Rights:

Directors and employees of the Company, and Representative Director and Presidents of its major subsidiaries

(2) Type and number of shares subject to Share Acquisition Rights:

A maximum of 1,430,000 ordinary shares of the Company. Provided, however, if the number of shares to be issued due to exercise of Share Acquisition Rights should be adjusted due to below (3) (including transfer of treasury shares instead of issuance of new shares; hereinafter the same), the above maximum of the total number of shares shall also be adjusted in accordance with such increase or decrease in the total number of shares.

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(3) Total number of Share Acquisition Rights to be issued:

A maximum of 1,430 rights shall be issued.

The number of shares subject to one Share Acquisition Rights shall be 1,000 shares. Provided, however, if the Company effects stock splits or stock consolidations, the number of shares subject to Share Acquisition Rights that have not been exercised at such time shall be adjusted in accordance with the following formula and fractions of less than one share shall be discarded.

Number of shares after adjustment = number of shares before adjustment × ratio of stock split (or reverse stock split)

(4) Issue price of Share Acquisition Rights:

Share Acquisition Rights shall be issued gratis.

(5) Amount to be paid to exercise the Share Acquisition Rights:

The amount to be paid at the exercise of Share Acquisition Rights shall be the amount obtained by multiplying the amount of one share to be issued at the exercise of each Share Acquisition Right (the paid-in amount) by the number of shares that are the subject of one Share Acquisition Rights.

The paid-in amount shall be the amount calculated as the average of the closing price of the Company's ordinary shares of each day (excluding days on which there are no trades of the shares) of the month immediately preceding the month in which the date of issue of Share Acquisition Rights falls, at the Tokyo Stock Exchange, multiplied by 1.05, with fractions less than one yen being rounded up to a whole yen. However, the paid-in amount shall not be less than the closing price of the Company's ordinary shares on the issue date of such Share Acquisition Rights.

If the Company effects stock splits or reverse stock split after issuing the Share Acquisition Rights, the paid-in amount shall be adjusted as follows with fractions less than one yen being rounded up to a whole yen.

$$\text{Paid-in amount after adjustment} = \text{Paid-in amount before adjustment} \times \frac{1}{\text{Ratio of stock split (or reverse stock split)}}$$

If the new shares are to be issued at a price below the market price (excluding the case of executing Share Acquisition Rights,) the paid-in amount shall be adjusted in accordance with the below formula with fractions less than one yen being rounded up to a whole yen.

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		Number of		Number of newly		Amount paid
		currently issued	+	issued shares	×	per share
		shares		Market price per share		
Paid-in amount	=	×		Number of currently issued shares		
After adjustment				+ Number of new shares issued		

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(6) Period for exercising Share Acquisition Rights:

From August 1, 2005 to July 31, 2012. Notwithstanding the foregoing, if any of the persons who are granted Share Acquisition Rights dies before the end of the exercising period, his or her heir may exercise the rights within 24 months of the date of the death of the person.

(7) Conditions for exercising Share Acquisition Rights:

- (i) Any of the persons granted Share Acquisition Rights may exercise his or her rights pursuant to the Agreement Concerning Issuance of Share Acquisition Rights (the Agreement) based on the resolution of this Meeting and the resolution of the Board of Directors Meeting even after the person is no longer a Director or an employee of the Company or a President and Representative Director of its major subsidiaries.
- (ii) If any of the persons granted the Share Acquisition Rights dies, his or her heir may exercise the rights pursuant to the Agreement.

(8) Events and conditions for cancellation of Share Acquisition Rights:

Share Acquisition Rights may be canceled gratis in the following events:

- (i) Pursuant to the Agreement, if the person granted Share Acquisition Rights loses his/her Share Acquisition Rights or if it becomes definitive that Share Acquisition Rights will not be exercised.
- (ii) If the Company executes a merger agreement pursuant to which the Company will become the dissolving company.

(9) Restrictions on transfer:

The transfer of Share Acquisition Rights shall be subject to the approval of the Board of Directors.

(10) Handling in the event of share exchange or mandatory share transfer:

If the Company effects a share exchange or a mandatory share transfer for purpose of the Company becoming a wholly-owned subsidiary of another company, the Company's obligations with respect to Share Acquisition Rights shall be succeeded by the company which shall become the 100% holding parent company as a result of such share exchange or mandatory share transfer.

(11) Other matters:

Other matters concerning the issue of Share Acquisition Rights shall be referred to the Agreement.

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Item 6: Amendment to Amounts of Remuneration for Directors and Statutory Auditors

At the 121st ordinary general meeting of shareholders held on June 28, 1990, shareholders approved monthly remuneration for Directors of not more than JPY30 million and, at the 112th ordinary general meeting of shareholders held on March 30, 1982, they approved monthly remuneration for Statutory Auditors of not more than JPY5 million. These limits remain in force today.

However, in response to subsequent changes in the Company's business environment, as well as in consideration of various resolutions approved at a Board of Directors meeting held on May 7, 2004, including the gradual reduction and eventual elimination of retirement allowances for Directors and Statutory Auditors and the elimination of bonuses for Statutory Auditors beginning with the fiscal year ending March 31, 2005, and other factors, the Company would like to propose the limitation of the total monthly remuneration payment for all Directors of not more than JPY60 million and of the total monthly remuneration payment for all Statutory Auditors of not more than JPY10 million.

As is currently the case, remuneration for Directors does not include salaries paid for duties performed as employees of the Company.

If shareholders approve items 3 and 4 as submitted, there will be 10 Directors and 4 Statutory Auditors.

Item 7: Approval of Payment of Retirement Benefit to a Retiring Statutory Auditor in Recognition of His Services to the Company

As of the close of this meeting, Mr. Norimichi Kitagawa will retire from the office of the Statutory Auditor. To reward him for the services he rendered, the Board of Directors proposes to pay retirement benefit in reasonable amounts in accordance with the rules prescribed by the Company.

It is also proposed that the details of the benefit in terms of the amount, time and method of payment be determined by the Board of Statutory Auditors.

His brief personal history is as follows:

<u>Name</u>	<u>Brief Personal History</u>
Norimichi Kitagawa	6/2001 Standing Statutory Auditor (current position)

END

Notice

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On January 1, 2004, the Company's Independent Auditor, Asahi & Co., changed its name to

KPMG AZSA & Co.