Q2 2012 Earnings Call

Company Participants

- Ed Vallejo, VP IR
- Ellen Wolf, Chief Financial Officer
- Jeffry Sterba, President and CEO
- Walter Lynch, President of Regulated Operations

Other Participants

- Brian Chin, Analyst, Citigroup
- Gerard Sweeney, Analyst, Boenning & Scattergood Inc.
- Jonathan Reeder, Analyst, Wells Fargo Securities, LLC
- Kevin Cole, Analyst, Credit Suisse
- Michael Roomberg, Analyst, Ladenburg Thalmann & Company Inc.
- Neil Mehta, Analyst, Goldman Sachs
- Steve Fleishman, Analyst, BofA Merrill Lynch
- Tim Winter, Analyst, Gabelli & Co.

Presentation

Operator

Good morning. Welcome to the American Water Second Quarter 2012 earnings conference call. As a reminder, this call is being recorded and also being webcast with an accompanying slide presentation through the Company's website www.amwater.com. Following the earnings conference call, an audio archive of the call will be available through Friday, August 10, 2012, by dialing 303-590-3030 for US and international callers. The access code for the replay is 454-8322. The online archive of the webcast will be available through August 31, 2012, by accessing the Investor Relations page of the Company's website, located at www.amwater.com.

At this time, all participants have been placed into a listen-only mode. Following the management's prepared remarks, we will then open the call for questions. [Operator Instructions]

I would now like to introduce your host for today's call, Ed Vallejo, Vice President of Investor Relations. Mr. Vallejo, you may begin.

Ed Vallejo {BIO 20515524 <GO>}

Thank you. Good morning, everyone. Welcome to American Water's Second Quarter 2012 conference call. As usual, we will keep our call to about an hour, and at the end of our prepared remarks, we will have time for questions. Before we begin, I would like to remind everyone that during the course of this conference, both in our prepared remarks and answers to your questions, we may make statements related to future performance.

Our statements represent our most reasonable estimates. However, since these statements deal with future events, they are subject to numerous risks and uncertainties and other factors that may cause the actual performance of American Water to be materially different from performance indicated or implied by such statements. These risk factors are set forth in the Company's SEC filings, which are available to the public on the Company's Investor Relations website. With that, I would now like to turn the call over to Jeff Sterba, our President and CEO.

Jeffry Sterba {BIO 1426511 <GO>}

Thanks, Ed. Good morning, all, and thanks for joining us this morning. In addition to Ed, I've also got with me Ellen Wolf, our Chief Financial Officer; and Walter Lynch, our President of the Regulated Operations. It's great to speak with all of you as we announce very strong quarterly results, our most recent in a consistent string of record-setting quarterly earnings reports. Underlying the performance for the quarter is frankly one thing, consistent execution of our strategy.

From investing appropriate capital to managed supply and delivery issues -- and that's particularly given the weather challenges and drought conditions that we're facing throughout the country, to drive operational expertise through developing a culture of continuous improvement, and to growing our market-based opportunities within and outside of our footprint is really execution that counts. All the while keeping the essential regulated feel of our cash flows, a risk profile that you would expect when investing in the water utility sector, while providing multiple avenues for solid growth.

So to summarize the quarter on slide 5, you can see we delivered very strong Second Quarter and year-to-date results. An 11.5% increase in revenue quarter-over-quarter was coupled with solid cost control that resulted in an operating efficiency ratio for last 12 months of 41.7%, compared to 45.2% for the prior 12 months. These two items fueled a 56% increase in earnings per share from continuing operations quarter-over-quarter or more than a 42% increase for the first six months compared to the same period in 2011.

We saw similar improvements in cash flow from operations with a 67% and 21% increase for the quarter and six months, respectively. This provided an additional $55 million of internal cash so far this year to help fund our regulated investments. This all reflects in our earned ROE, which for the last 12 months, increased almost a full percentage point over the prior 12-month period. And as you know, in May, our Board of Directors increased its quarterly cash dividend payment, which is payable in September, by 8.7%.

Also, based on our performance so far and prospects for the balance of the year, we are increasing our earnings guidance for 2012. Recall that the range that we have had in place for the year is $1.90 to $2 per share. We estimate the Company's 2012 earnings now will be in the range of $2.12 to $2.22 per share for continuing operations, assuming normal weather patterns for the balance of the year. And by that, I mean from August going forward. Included in that range of $2.12 to $2.22 is $0.13 to $0.16 per share, which is our best estimate of what we think is associated with increased pumpage experienced throughout the end of the July due to weather -- both in parts of our eastern operations, as well as particularly the Midwest.

So we're increasing our guidance range by $0.22 a share, of which 60% to 70% is weather-related and the balance is improvement in our baseline performance. The midpoint of the new range translates into about a 22% increase in earnings per share from continuing ops over 2011 and roughly a 14% increase once you take out what we've indicated are the likely impacts of weather through July.

Turning to page 6, let me to touch on some of the highlights since our last quarterly review with you, that helped fuel some of this earnings performance. As you know, we closed on the New York acquisitions and the sale of our systems in Ohio. I'm very pleased with how this positions us from a cost, growth, and regulatory perspective. I think this was truly a transaction that benefits both of the parties.

We also have completed the purchase of four tuck-ins during the quarter, and we signed a public/private partnership agreement to install new waterlines to bring high-quality public water to a community in Pennsylvania that is struggling with contamination from water-borne pollutants. This solution, which is we think one of the ways in which we really do help our customers, is a partnership between our Pennsylvania subsidiary, the township, and the Department of Environmental Protection in Pennsylvania.

Also in Pennsylvania, we recently entered into an agreement with Rex Energy to build about a 3.5-mile water pipeline extension in Butler County that's geared to support shale gas, gas development. With construction of a booster station, this extension will also provide local residents who currently rely on private wells the option to receive public water service and support potential future commercial and residential development projects in this area. Through June of this year, we've provided about the same amount of water to Marcellus drillers as we did in all of 2011.

On another note, something we announced yesterday that we're very pleased and proud about, our Homeowner's service subsidiary has entered into a five-year contract with the City of New York to provide the 600,000 Homeowners in its five boroughs with the opportunity to purchase water and sewer line protection. This is the largest US city to offer this kind of service contract to its residents, and we expect to launch that program before the end of the year. The arrangement provides us access to the New York customers, as well as allows us to utilize the city's water build. Experience shows that these two kinds of elements lead to a significantly higher market penetration rate.

On the regulatory front, rate cases have been resolved in three states during and subsequent to the quarter, and one new case has been filed. The decisions received in California in the general rate case, which was for 2012 through '14, the cost of capital case, and our proposal to remove the San Clemente Dam are particularly important because they provided resolution for issue that were outstanding for some time. The decision in the San Clemente Dam removal is significant, as it enables us to provide a positive, environmentally-friendly outcome in a manner that ensures full-cost recovery.

In addition, you know that in New Jersey, we -- the commission approved the ESIC, or the rules associated therewith, and we have now made the foundational filing to accelerate the rate at which we can invest in our systems there. If this filing is approved, which we would expect to occur within 90 days, this could result in the investment of an additional $140 million over the next two years to help improve the underground infrastructure in New Jersey.

Our drive to create a culture of operational excellence and continuous improvement is, frankly, really taking hold. It is just, it's tickling to see how our people are responding to the number of initiatives that we have and, frankly, helping create them. I think a number of indicators of that the flat operating cost trends, substantively improving operational efficiency ratios. And also going live earlier this week on the first phase of our business transformation effort, which you'll recall is the implementation of SAP foundational platforms. The ones that we have taken live this week involve our financial systems and the human resource management systems.

These are always bumpy roads. I've been through them before. You all have seen companies go through these, and they're always a challenge, because it's not just new systems, but you're changing the way people think. You're causing them to do something different than they've done for years, and that's a process of change. We recognize and fully expect that we will encounter some of the same kinds of productivity declines that any other company implementing this kind of a massive change goes through. But I'm just tickled and pleased with the way our folks have been able to get to this point and doing everything else relative to the business that we've asked them.

Now, before Ellen goes through our financial performance in more detail, I would like Walter to give you a brief update on the weather, and its impacts on us, and our overall system conditions.

Walter Lynch {BIO 6064780 <GO>}

Thank you, Jeff. As we all know, part of the story this quarter is weather. And if we can go to slide 7, this map shows the extent of the drought throughout the country. The yellow shades are areas of moderate to severe drought and the red shades are areas of extreme drought. You can also see the blue areas on the slide, which indicate our service territories. Generally, our water supply across the country is in good shape. Providing reliable service is fundamental to our business, and this quarter, the record heat and lack of rainfall in many of our states have posed some challenges, but only in limited cases do we have potential water-supply issues. I want to talk about a few of those now.

In Pennsylvania, there is a drought watch in effect for 15 western counties. We serve customers in nine of those counties, and there are no restrictions in place at this time. Our reservoirs are at normal levels this time of year. In Missouri, the state is encouraging water conservation. The Merrimack River, which is one of our sources of supply for St. Louis County, is at historic low levels, but there are no restrictions at this time. Also in Joplin, Missouri, we've issued voluntary water conservation requests, and we're asking that our customers conserve water during this time. Indiana is under a statewide drought watch, but we have adequate supplies at this time.

While we can't control the weather, we do and can prepare for. And it this is where American Water truly has some great stories to tell. For example in Joplin, Missouri, we installed a new gate system on top of our dam to increase its depth by 2 feet. This will add approximately 68 million gallons of water to the reservoir. Also in Missouri, we're in the process of installing additional intake pumping capacity in the Merrimack River. This work will be completed in the next few days. It's well ahead of when we estimate we'll need it, should the river level continue to fall. In central Kentucky, our new treatment plant and facilities that opened in 2010 have kept our Company well ahead of demand, despite the extreme weather they've experienced there. This really shows the value of our long-term planning. This plan addressed the long-term water supply challenge in central Kentucky.

But it's more than our investment and our systems that keep our service reliable. It's also our outstanding employees. In West Virginia in late June, storms paralyzed the state, leaving approximately 700,000 residences without power, which means you don't pump water. Our crews worked around the clock with emergency generators and other equipment to ensure continuous flow of water to our customers and we are proud of their efforts and accomplishments. Now I would like to turn the call over to Ellen, and she's going to provide details on our financial performance.

Ellen Wolf {BIO 1854557 <GO>}

Thank you, very much, Jeff and Walter. Welcome to those of you who are joining us on the call today. Let me take a few moments now to describe the underlying factors that drove our Second Quarter results, as always, built around our commitment to ensure reliable service to our customers and results to our shareholders.

Turning now to slide 9, as Jeff indicated, for the Second Quarter, we delivered very strong financial results, with increase in revenues, net income, and earnings per share, as well as continued improvement in our O&M efficiency ratio. These results were driven by our team's commitment to strategies that focus on investing-needed capital, providing value to our customers, controlling costs, and as well as previously mentioned, hot, dry, weather.

For the Second Quarter ended June 30, 2012, we reported operating revenues of approximately $746 million, a $77 million, or 11.5%, increase over the approximately $669 million reported for the Second Quarter of 2011. Income from continuing operations for the Second Quarter was approximately $117 million, or $0.66 per common share, compared with around $75 million or $0.42 per share in 2011, or an approximate 56% growth over the prior year. As Jeff mentioned earlier, hot and dry weather in a number of our states led to record pumpage, which had a significant impact on earnings. We believe that this may have added in the range of $0.06 to $0.09 to earnings per share for the Second Quarter.

Growth and cash flow also showed solid growth for the quarter. Net cash provided by operating activities for the three-months ended June 30, 2012, was around $169 million, compared to around $101 million for the Second Quarter in 2011, mainly due to the increase in operating revenues and changes in working capital.

Now, I'd like to discuss the various components of our income from continuing ops, starting, of course, with revenues. Revenues from our regulated business increased by a net of around $73 million, or around 12% from June 30, 2011, to '12. Driven mainly by new rates awarded and various surcharges generated by regulators related to our continued investment in infrastructure and higher customer demand over the prior year. For the Second Quarter, the 2012 impact of these rate increases was approximately $32 million. The increase in revenues associated with higher demand amounted to approximately $27 million. In addition, we also received increased revenues from acquisitions of around $8 million, the most significant being our New York acquisition in the Second Quarter.

In June, our California general rate case was approved, authorizing additional annualized revenues. These revenues are retroactively effective to June 1, 2012, and in some California districts, retroactive to 2011. The total amount of the California retro-adjustments included in the quarter was around $7 million. During the same period, our market-based operations revenues increased slightly, primarily as a result of higher Homeowner Service Group revenue.

Turning to the slide on rates, slide 11, as you know, our ability to invest in our infrastructure is driven by our ability to earn an appropriate rate of return on our investments. Slide 11 shows rate cases that have been filed and those that are awaiting final orders on, as well as, rate cases and infrastructure charges that have been recently granted. During the Second Quarter of 2012, we filed a general rate case in Tennessee, which would generate approximately $10.6 million in total additional revenues if approved as filed. As of August 2, we are awaiting final orders in three states requesting additional annualized revenues of around $54 million. There is, of course, no assurance that all or any portion thereof, of any requested increase will be granted.

Looking at rate cases and infrastructure charges that have been granted for the Second Quarter and through the end of July, the Company received annual rate case authorizations in New Jersey, Indiana, and California, for additional annualized revenues of around $65 million. As of August 2, year-to-date we have been granted additional annualized revenues assuming constant sales volume from generate rate cases totaling $95 million and $8.4 million in additional annualized revenues from infrastructure charges.

Turning our attention to water sales volumes, total Company sales increased from the quarter ended June 30, 2011 to 2012 by 6.6%, and 2.7% for the six-month period. This increase in water sales volumes was primarily driven, as seen -- as you can see, by our residential customer class, which is up 6.7% from the Second Quarter of 2011. It's clearly driven by the hot, dry weather in our eastern and Midwestern states, mainly New Jersey and Missouri.

Total operating expenses for 2012 Second Quarter increased by $7.5 million, or 1.6% from the 2011 Second Quarter. Operation and maintenance in the regulated business was relatively flat, actually decreasing by 0.5%. Production cost increased, mainly attributable to increased sales, while employee-related costs decreased 1.9%, primarily due to decreased group insurance and pension expense as a result of lower head count. Customer billing decreased 19% mainly due to improved collections of our receivables. The increase in other expense is attributable to higher insurance costs from the resolution of prior years' claims.

The market-based business operations decrease in total operating expenses of $1.8 million was primarily driven by a $1.6 million, or 2.2% decrease in O&M's expense, which mainly is the result of lower production and supply costs in the quarter. We also experienced higher depreciation expense of $5 million due to additional utility plant placed in service, and increased general taxes of $2.3 million, mainly attributable to the ongoing cost of our New York acquisition.

Overall, our regulated O&M efficiency ratio improved from 43.2% for the quarter ended June 30, 2011, to around 38% ended June 30, 2012. This quarter's operating efficiency ratio was, of course, aided by the extra revenues we received in the quarter, primarily from weather.

Turning to the next slide, 14, as mentioned in our press release, we also announced that we now see minimal need for future equity offerings in the normal course of business. This is driven by many factors, including the continued growth in our net income, which means continued growth in our cash flow as well. In fact, S&P cited our, quote -- strengthened financial profile -- end quote, when they reaffirmed our rating and revised our outlook to positive. These factors allow us to believe that our on going routine cash requirements will be met with cash flow from operations and debt bond, while continuing to maintain a stable equity ratio.

Based on our year-to-date performance, the weather impact in the Second Quarter, our continued focus on expense control, and appropriate returns on needed investments, we are updating our 2012 earnings guidance. We now estimate that our 2012 earnings will be in the range of $2.12 to $2.22 per share for continuing ops. This estimate includes our preliminary view of water sales through July and assumes a normal weather pattern for the balance of the year. This range includes $0.13 to $0.16 per share for the year related to the weather, and the previously mentioned $0.06 to $0.09 for the Second Quarter is accounted for in that 13% to 16% [ph]; see press release "$0.13 to $0.16" [ph] range. With that, I'd like to turn the call back to Jeff for closing comment before then opening it up for your questions.

Jeffry Sterba {BIO 1426511 <GO>}

Thanks much, Ellen. On slide 16, we have the -- what we always close with, which what we said at the beginning of the year you could hold us accountable for. I won't go through these in any detail, other than to say that every single one of these items is well under-- it's either been completed, well underway, and ongoing effort going on with it.

Let me just close with two quick follow-ups relative to O&M costs. The first is that you keep in mind that the impacts of the discontinued operations, the sale of Ohio, the acquisition of New York, does not affect the measures because those discontinued ops are taken out of all calculations, whether it be of what we show as total regulated O&M costs or it be the operating efficiency ratio.

The other one is, one of the things -- this is just from, I guess, doing this for a few years, one of the things you always look at as you are building a change process, if you will. Building on the things that a company does really well today, but also trying to enhance the things that maybe we're not quite so good at. On the operating costs is how diversified is the reductions or the savings that you're seeing. Sometimes you'll see it happen in one part of the business and that's it. That can make you a little nervous.

What I'm so pleased about seeing it is that it is across the entire Company. It's all of the pieces of the business are operating at a more effective way, and that gives you a lot more comfort about the long term and the fact that what you're trying to change is actually taking hold and people are jumping on it with excitement. So with that, that's the end of our comments, and we will open it up for any questions you all may have.

Questions And Answers

Operator

Thank you, sir. [Operator Instructions]

Our first question comes from the line of Kevin Cole with Credit Suisse. Please go ahead.

Q - Kevin Cole {BIO 18674088 <GO>}

First, congratulations on your continuous O&M improvement program effectiveness. It's very impressive.

So I guess, Ellen, my first question is for you with the equity. Can you help put some more color or some duration around your ability to stay out of issuing block equity, as it does appear that your internally generated cash, plus maintaining your measured dividend payout ratio and use of NOL and DRIP, that you can stay out for a long time? Is that an accurate description of the possible time frame?

A - Ellen Wolf {BIO 1854557 <GO>}

The way I would look at it is a couple of things. Our NOL carried forward has probably another 10 years, give or take, so you look at it in terms of the ability to get the benefit of firm -- the NOLs, that's another 10 years. Our DRIP is only providing a small amount. We'd love to see it increase and encourage all to utilize it, but it's just a little bit happening with the equity. But really, to look at it over the long term is to look at -- as long as we have and continue to grow net income the way we're growing, and to continue with cash the way we're going, we really don't see a need to do an equity offering.

Q - Kevin Cole {BIO 18674088 <GO>}

Okay. And then now with New Jersey having the DSIC program, what percentage of your CapEx program do you think fits under earning real-time returns?

A - Jeffry Sterba {BIO 1426511 <GO>}

About 25% of our CapEx is being recovered through DSIC-like mechanisms, and that's going to increase. But, remember that for New Jersey, we won't see that take effect until -- what, Walter? -- what, Third Quarter?

A - Walter Lynch {BIO 6064780 <GO>}

Third quarter.

A - Jeffry Sterba {BIO 1426511 <GO>}

So it will start, and that $140 million will -- that investment will start after we get approval of the program -- of the foundational filing.

Q - Kevin Cole {BIO 18674088 <GO>}

Great, thank you, guys. Have a good day.

Operator

Thank you, and our next question comes from the line of Neil Mehta with Goldman Sachs. Please go ahead.

Q - Neil Mehta {BIO 16213187 <GO>}

Jeff and Ellen -- so your 7% to 10% EPS growth that you affirmed this morning in guidance -- is that off the weather-normalized 2012 base? So if I was to strip out the pumpage, that's $206 million to $209 million?

A - Jeffry Sterba {BIO 1426511 <GO>}

Yes, Neil -- the way to think about it is the 7% to 10% is not a year-over-year number. It is a long-term projected growth rate, and it assumes the things that we don't control, like weather, are normal. So it does -- you should think of it in terms of normalizing that amount out.

Q - Neil Mehta {BIO 16213187 <GO>}

Got it. And even if we were to strip out the pumpage benefit, you still would have raised guidance here, so what specifically contributed to the balance of the guidance raise relative to the base case plans?

A - Jeffry Sterba {BIO 1426511 <GO>}

Well, you're right. We were in the 7% to 11% in the original guidance and the midpoint -- so a midpoint of say, 9%. And we're now in the 14% range, at the midpoint of the new guidance, if you take out weather. Fundamentally, is what I talked about, Neil, in terms of execution -- it's execution of the strategy, both in terms of building a culture based on continuous process improvement and operational excellence. It's having multiple avenues for growth, and one of the things that -- if you just think about water utilities in general, well, you think, okay, it's a function of the regulatory rate relief and maybe a little bit of weather.

For us, if we do four tuck-ins like we did this past quarter, that's an element of growth. When you sign a deal to be able to extend line protection to 600,000 customers, that's like adding a New Jersey to that business. A multiple of different avenues of growth, so it's really all of those combined.

Q - Neil Mehta {BIO 16213187 <GO>}

Great. My last question is around weather normalization and the rate case process. How many of your jurisdictions weather-normalized? So if you were to file in 2013, as you're going to do in multiple jurisdictions with the '12 test year, will the commissions strip out the benefit of this hot and dry weather?

A - Ellen Wolf {BIO 1854557 <GO>}

Generally, when we file for rate cases, Neil, we use what I'll call the off months, the more normal months -- November through, let's say, March -- to show the trend in usage. And generally what we've also found, because some years -- if you'll remember about three years ago, we saw the exact opposite impact, where usage was way down because of weather. And this year, we see it's up because of weather. So I think both the regulatory side and our side tries to take the impact out.

Q - Neil Mehta {BIO 16213187 <GO>}

Perfect. Thank you, so much.

Operator

Thank you. Our next question comes from the line of Michael Roomberg with Ladenburg Thalmann & Company. Please go ahead.

Q - Michael Roomberg {BIO 16581852 <GO>}

A question on the economics of the New York City contract -- maybe if you can provide an estimation of what the premiums are per year, per customer? And then also maybe talk more broadly about the other jurisdictions where you have this ability to put this on the bill itself, what your penetration rates are in those territories?

A - Jeffry Sterba {BIO 1426511 <GO>}

Yes. Great question, Michael, but I'm not going to answer We just won't go into that much detail, as you can probably understand. That's a competitive market. So that kind of detail is quite protected. I would just say that, where you have access to customer lists and you have the ability to utilize the local utility's bill, you get substantively higher penetration rates than in those areas where you don't.

We already today operate outside of our footprint -- our regulated footprint -- in providing this competitive service. We have it both with a couple of communities through the same relationship with New York City, as well as just in other communities where we've done direct mail. It's a full competitive business. New York is unique in that it's the largest one of this kind that's ever been issued. And we're very pleased with that, but this is -- it's not a spigot that you turn on. It takes a while to build. And since it hasn't been offered in the past, it will be a new product for a lot of the folks in New York, but we're very excited about the opportunity.

A - Ellen Wolf {BIO 1854557 <GO>}

If I can also add one thing from a customer perspective -- being able to add the cost onto their water bill, we find the customers are much more satisfied with that than having to get a separate bill, separate and distinct. So we get higher customer satisfaction.

A - Jeffry Sterba {BIO 1426511 <GO>}

That's right.

Q - Michael Roomberg {BIO 16581852 <GO>}

Got it. And then just one follow-up for Ellen -- the reduction in uncollectible account expense of about $2 million in the quarter -- is that going to recur over the next 12 months? I think that was the first time that it had shown up in a quarterly result.

A - Ellen Wolf {BIO 1854557 <GO>}

We are seeing a reduction in our uncollectibles. We will see what happens in the Third Quarter, since there are some very large bills that will be going out -- larger bills. I wouldn't say large versus other utilities, but larger bills. But we are seeing better on the collections, and I give credit to many of those in Operations and our customers' response.

Q - Michael Roomberg {BIO 16581852 <GO>}

Got it. Thank you.

Operator

Thank you. Our next question comes from the line of Gerard Sweeney with Boenning & Scattergood. Please go ahead.

Q - Gerard Sweeney {BIO 15217227 <GO>}

Looking at the O&M side, volumes were up about 6.6%. And then actually on the, I think on the regulated side, the expenses were down 1.4%. These are obviously great results, but is there any more detail you can give into how this accelerated so quickly? It seems like a very large improvement in a short period of time. Understanding there is a weather component, but that's -- volumes go up, there's some costs associate with that, and on a year-on-year basis, the actual figures stayed, in real terms, stayed almost stagnant.

A - Jeffry Sterba {BIO 1426511 <GO>}

Maybe just a couple of things, and I'll let Walter and Ellen to add in anything they want.

I wouldn't say that this is some cliff thing that's happened. Obviously you don't see the month-to-month-to-month, just the quarterlies; but this is the building of a trend. And there's no single component. It's exercising of our supply chain more aggressively and effectively. It's some labor, a couple of reductions that we've had. In fact, you'll recall that we expensed some charges in the First Quarter for severance for some downsizing, fairly small downsizing that we did.

If you look at the breakout of our costs, our production costs actually went up, which you would expect. But they didn't go up nearly as much, because of the things that we have done relative to acquisition -- chemicals, power -- to help drive down the variable costs associated with production. Walter?

A - Walter Lynch {BIO 6064780 <GO>}

Right on, Jeff. It's really due to favorable pricing in chemicals and the continued execution of driving the cost down, primarily on the power side. We executed some contracts that were much more favorable. Some are large states, and we're seeing the benefit of that.

A - Ellen Wolf {BIO 1854557 <GO>}

And one other thing to add -- because of the lack of rain, we have had lower turbidity in our water so that we did not have to do quite as much treatment as you would expect.

Q - Gerard Sweeney {BIO 15217227 <GO>}

Was this above your -- or below, however you want to look at it -- of your plan at the beginning of the year?

A - Jeffry Sterba {BIO 1426511 <GO>}

Our plan was baked into our $1.90 to $2 a share guidance, and there's a lot of moving parts. I don't think we'll get into a point of starting doing the pluses and minuses of each individual part. We're doing, obviously, quite well relative to that entire plan.

Q - Gerard Sweeney {BIO 15217227 <GO>}

So, we'll look at this as a permanent change in terms of the costs associated on this.

A - Jeffry Sterba {BIO 1426511 <GO>}

Well, remember --

Q - Gerard Sweeney {BIO 15217227 <GO>}

All things being equal. There's -- understanding the weather, and everything else but there's --

A - Jeffry Sterba {BIO 1426511 <GO>}

Well, think about power costs for a second, Gerry. There are two things that affect power costs for us. One is, what is happening in that overall power market? So, obviously when natural gas prices are low, power prices are going to be lower, unless there's some fundamental demand-supply imbalance that shifts prices up dramatically. But the other piece of it is, how effective are we in acquiring that power? So there's two different pieces to it.

I can't tell you how much is which piece. Obviously, we're going to continue to do everything we can to improve our acquisition prowess and the tools that we use to do that. But at the same time, we can't control what happens to natural gas prices. So you can't say it's permanent, unless you are going to say, well, it's normalized out what happens to power prices, chemical prices, all those kinds of things.

Q - Gerard Sweeney {BIO 15217227 <GO>}

Okay, understood. I appreciate it. Thank you.

Operator

Thank you. Our next question comes from the line of Brian Chin with Citigroup. Please go ahead.

Q - Brian Chin {BIO 5763426 <GO>}

Question for Ellen -- when you talked about not needing equity for the current time frame, how far out does that go? Does that comment apply to '13 and '14 as well?

A - Ellen Wolf {BIO 1854557 <GO>}

The way I would look at it, Brian, is in terms of, again, what would drive our need to equity. And as we have said, we have had the benefit in the past -- the higher your net income, the more ROs, the less you need equity. The stronger your cash flow, the less we need equity. And again, I would add, with those NOLs that we're able to carry forward, those give us more cash. So what we're saying is, right now, we don't see a need; and as long as those things continue and we continue to see the balance sheet strengthen, we don't see a need for going forth with an equity offering.

Q - Brian Chin {BIO 5763426 <GO>}

Okay. And then one more question -- really more, Jeff, for you. When you talk about the long-term 7% to 10% EPS growth rate, in your mind, how much of that comes from things like acquisitions and tuck-ins versus pure, organic growth at the Businesses that you currently already own?

A - Jeffry Sterba {BIO 1426511 <GO>}

Well, I think the way to think about that, Brian, is we've said that investing $800 million to $1 billion, midpoint of $900 million a year, basically provides the engine to fund about 6% growth. And it could be a little higher, maybe a little lower, but it's right in that range, 6%, 6.5%. The key for us, obviously, is being able to put that in and getting the value of that through the rate-making process. And so that is where we really focus on our cost control so that our rate cases are really capital-based and we keep the size of the increase at a manageable level.

So going beyond that, that means whether it's tuck-ins, acquisitions, new products and services, and new markets. So new markets, for example, moving into New York City; new products and services, for example, moving into -- and I'm just using homeowner services in this case -- is moving into the indoor plumbing business. Or on in our existing service territories, it's moving more into wastewater instead of just potable water. So those are extensions, what I will call logical, organic extensions, that can add in addition to acquisitions.

So, you remember that -- what we sometimes euphemistically refer to as the sandbox chart, that's got the four colors, and it shows how, over time, the weight of those components will change as our efforts and success in improving our ROE on existing assets gets to a point where we're earning our full cost of capital.

Q - Brian Chin {BIO 5763426 <GO>}

Got it, thank you.

Operator

Thank you. Our next question comes from the line of Steve Fleishman with Banc of America. Please go ahead.

Q - Steve Fleishman {BIO 1512318 <GO>}

This question was asked, but maybe in a different way. When you look at the efficiency targets, obviously, since it's a cost% of revenue, the revenue has been a little benefited by the strong weather. So if we're trying to think about, is there a way to weather-normalize where you really are on this efficiency ratio --or to put it another way, should we expect that to pull back a little next year, if it's a normal weather year before you get there?

A - Jeffry Sterba {BIO 1426511 <GO>}

Yes, Steve -- remember, we're doing a 12-month rolling average. It's not a quarter-over-quarter. If you looked at the quarter-over-quarter, it would clearly have a big dip for this quarter, and you should expect it to come back up a little bit. Given that we're -- and that is why we think quarterly measures for something like this don't make a lot of sense. So you look at it on a 12-month rolling average, which normalizes out some of that. It still -- this quarter has a significant impact because of how good it was, but it won't have nearly as dramatic an impact. When we report the Third Quarter earnings, we'll have to see if it's sticking in the same range, creeping up a little bit; but our long-term goal is below 40 by 2015. And I'd say we're well on target to hit that.

Q - Steve Fleishman {BIO 1512318 <GO>}

Okay. Thank you.

Operator

Thank you. [Operator Instructions]

Our next question come from the line of Kevin Cole with Credit Suisse. Please go ahead.

Q - Kevin Cole {BIO 18674088 <GO>}

Yes, just one quick follow-up question. Given your footprint in the Marcellus and the likely EPA regulation coming next year on frac water recycling, do you see this as a meaningful growth opportunity for your non-regulated Businesses?

A - Jeffry Sterba {BIO 1426511 <GO>}

It is a business opportunity that we're taking a hard look at. There's a lot that goes into what kind of systems will be used. And by that I mean centralized versus decentralized, what we may want to take on, and the kinds of technologies that will afford the lowest costs for doing this. But I come from a part of the world in the West where water reinjection is done all the time. But the difference is, in the western formations, there's almost a giant sucking sound trying to pull that water back down into the ground.

In the East, given the geology, they have to put it under such high pressure, and I think that is creating a lot of concerns around the reinjection of water in the Marcellus area, because it is just a different geology. And that puts more pressure, maybe, on going into the water treatment side. So we'll look at that as a business opportunity. Obviously if we do it, we're going to do it in as good and safe and appropriate a way as possible.

Q - Kevin Cole {BIO 18674088 <GO>}

How big do you think this opportunity could be?

A - Jeffry Sterba {BIO 1426511 <GO>}

I think this is one of these markets that's got so many different vectors it could go, it's hard to say. It could be very large. One of the things that you've got to remember is that these wells -- these are not long-lived wells. You go into the West and you'll see a lot of wells that will produce for 10, 15 years. And then you put a pumper on it. But these wells are shorter-lived. So in order to keep the gas flowing, they've got to keep drilling. I think both -- obviously that industry is very focused on how do we reduce the amount of water that we need to frac each well, because now it's about 5 million gallons. So they're trying to figure out how can they reduce the amount of water. That will reduce the amount of flow-back and what's going to be the drill rate.

If you look in Pennsylvania, you have seen about a 25% reduction in drilling rigs operating just this year. It's stabilized and maybe it will come back a little bit as natural gas prices have firmed up, but it's -- frankly, there's been a significant downturn. One of the things about our approach into this business is, we're fundamentally leveraging our infrastructure by which we serve retail customers throughout Pennsylvania. And what we're finding is that a lot of extensions that we make, we will serve some drillers. This Rex Pipeline is a classic example. But it really opens up the path for expansion of our territory and to serve new residential customers. And our regulators are comfortable with this approach.

From a business perspective, one of the things that means is we take on less risk, because we don't really have commodity or volumetric risk, and we are going to recover those costs over a reasonable period of time. But there may be other situations that will appropriately be done on the other side, where you have a dedicated line that will only serve one set of customers. I think that model is what will hold true if the water treatment, the flow-back water treatment market develops, because those treatment facilities have to be different just because of some of the compounds and the level of TBS that you're having to remove.

Q - Kevin Cole {BIO 18674088 <GO>}

Great. Thank you, very much.

Operator

Thank you. Our next question come from Jonathan Reeder with Wells Fargo. Please go ahead.

Q - Jonathan Reeder {BIO 18909775 <GO>}

First of all, thanks so much for finally breaking out the weather impact I know we have asked for that for quite some time.

A - Ellen Wolf {BIO 1854557 <GO>}

It's our preliminary and best guess.

Q - Jonathan Reeder {BIO 18909775 <GO>}

That's all we ever asked for.

A - Jeffry Sterba {BIO 1426511 <GO>}

We had to lease a quarter of the supercomputer in California to calculate this, I want you to know.

Q - Jonathan Reeder {BIO 18909775 <GO>}

No, it is very helpful to just try to see the magnitude of that. But, Ellen, just a follow-up on your equity comments -- is there any change to your 45% to 50% target equity ratio? Or you are just saying, even without any external raises, you naturally grow into that over the next few years?

A - Ellen Wolf {BIO 1854557 <GO>}

We're talking about naturally growing into our environment on equity. I should also add one other point on this. It does assume, as we're talking about this, the continuation of $800 million to $1 billion of investment in our infrastructure.

Q - Jonathan Reeder {BIO 18909775 <GO>}

It looks like --

A - Jeffry Sterba {BIO 1426511 <GO>}

Ellen just mentioned the S&P. That's really what it's based on.

A - Ellen Wolf {BIO 1854557 <GO>}

Right.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Right, it looks like even with those CapEx levels and everything, that in the next five years, you're getting close to almost being self-funding. Is that where you see yourself being?

A - Jeffry Sterba {BIO 1426511 <GO>}

Could you say that again? We had a little disconnect.

Q - Jonathan Reeder {BIO 18909775 <GO>}

I was just saying, assuming the $900 million of annual CapEx, its looks like over the next five years, given NOLs, and the growing cash flows and everything, it looks like you're almost getting close to being self funding. Is that where you see yourself from a net-debt perspective?

A - Ellen Wolf {BIO 1854557 <GO>}

By self-funding, you're talking about also no new debt issuances?

Q - Jonathan Reeder {BIO 18909775 <GO>}

Yes. Right, not quite there but getting pretty close.

A - Ellen Wolf {BIO 1854557 <GO>}

Yes. Again, as long as the cash flow continues to grow, the answer will be yes to that, but again, --

A - Jeffry Sterba {BIO 1426511 <GO>}

With some debt.

A - Ellen Wolf {BIO 1854557 <GO>}

-- with some debt, there will be some debt.

A - Jeffry Sterba {BIO 1426511 <GO>}

That debt, Jonathan, obviously is because our net income is growing, increases our earnings. So we have the ability to issue some debt and maintain the same Cap structure.

A - Ellen Wolf {BIO 1854557 <GO>}

Right.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. And then, Jeff, you mentioned, with the New Jersey DSIC, assuming that goes through, I think it was $140 million -- is it $140 million of additional CapEx above your $800 million to $1 billion?

A - Jeffry Sterba {BIO 1426511 <GO>}

No. What it really does is, it will -- it may keep us a little more the middle or upper part of that. Because, remember, for example, this year, our total CapEx will be over $900 million, largely because of BT [ph]. So, in fact, it may keep us up in that range. And that $140 million is over two years.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay.

A - Jeffry Sterba {BIO 1426511 <GO>}

So it's roughly $70 million a year, you can look at it that way.

Q - Jonathan Reeder {BIO 18909775 <GO>}

A little of it will be allocating your current budget more to New Jersey, given the more constructive recovery mechanism?

A - Ellen Wolf {BIO 1854557 <GO>}

Right.

A - Jeffry Sterba {BIO 1426511 <GO>}

That's exactly right, Jonathan. It's where the opportunities provide, we've got scarce capital, we'll allocate it where it's encouraged to be invested.

Q - Jonathan Reeder {BIO 18909775 <GO>}

And then, finally -- how should we be thinking about the dividend payout ratio and growth? With the strengthening balance sheet, do you continue to target the lower end of that 50% to 70% range to strengthen that equity ratio? Or might you get a little more aggressive with the dividend increases?

A - Jeffry Sterba {BIO 1426511 <GO>}

Well, I guess two things. When we announced in May, we narrowed that to really 50% to 60%. We talked about the comfort that we had relative to the growth, and we said that we would expect the dividend to grow more in line with the growth rate in our net income, or in our earnings per share, I'm sorry. So you would expect to see it grow in that kind of a range, where on the low end -- and certainly with what we're now projecting for this year we're on the low end. But if earnings are growing at a more rapid rate, we're going to have it grow more in line with what that earnings per share is.

A - Ellen Wolf {BIO 1854557 <GO>}

As we've said in the past, Jonathan, we'll always continue to have that balance between what is right for the shareholder and the cash flow needs of the Company.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. Great. Thanks for the additional details.

Operator

Thank you. Our next question come from the line of Tim Winter with Gabelli & Company. Please go ahead.

Q - Tim Winter {BIO 1518628 <GO>}

Congratulations, guys, on a great quarter.

A - Ellen Wolf {BIO 1854557 <GO>}

Thanks, Tim.

Q - Tim Winter {BIO 1518628 <GO>}

I wanted to ask a big picture question, and it's on that map on page 7. I really don't mean for this to be a softball question, but given the drought conditions and the weather and the regional impact it's having on the economy, the municipal budget situation, what have you -- are you seeing any material change in movement towards larger regional water projects or desalination? Or are you being called in for helping with anything? Or is it just too early that this quarter's impact is having on that movement?

A - Jeffry Sterba {BIO 1426511 <GO>}

Tim, in terms of regional water development or people going, oh, my gosh, we've got to create more supply -- I think it's causing people to think. If you're of the belief that the weather patterns will become more volatile and droughts and precipitation will become more extreme, it does cause you to have to think about water supplies differently.

And for us, one of the key elements is to start really thinking about one water as opposed to these different streams of potable water, waste water, and storm water. But think of it a lot more holistically so you can get the right resource to the right use. And that's where we think reuse will become more than a tickling fancy in some constrained areas. It will become more mainline, mainstream, if you will. I wouldn't say that we're seeing a major awakening or aha, but I do believe that you are seeing people become -- going, oh, gee, this could get serious. And I think that helps put a focal point on both the infrastructure as well as the opportunity to advance technologies like reuse.

The other push, which is raising more opportunities, questions, doors, but we'll wait to see what it really translates into, is the realization by municipalities that Uncle Sam is not going to bail them out of dire capital requirements or pension obligations that are taking away from their ability to invest on infrastructure and things like that. So I think there's a lot of churn, which I would not jump to the conclusion is results-based, yet.

Q - Tim Winter {BIO 1518628 <GO>}

Thank you.

Operator

I'm showing no further questions. I would like to turn the call back to Management for closing remarks.

A - Jeffry Sterba {BIO 1426511 <GO>}

Well, I just thank you very much for joining us today. Stay cool. Stay safe. And we'll look forward to talking with you in our Third Quarter.

Operator

Ladies and gentlemen. this concludes American Water's Second Quarter earnings conference call. If you'd like to listen to a replay of today's call, you can dial 303-590-3030 with the access code of 454-8322. We thank you for your participation. You may now disconnect.