Q4 2014 Earnings Call

Company Participants

- Edward D. Vallejo
- Linda G. Sullivan
- Susan N. Story
- Walter J. Lynch

Other Participants

- Brian J. Chin, Bank of America Merrill Lynch
- James Ward, Macquarie Group

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. And welcome to American Water's Fourth Quarter and Year-End 2014 Earnings Conference Call. As a reminder, this call is being recorded and is also being webcast with the accompanying slide presentation through the company's Investor Relations website.

Following the earnings conference call, an audio archive of the call will be available through March 5, 2015 by dialing 1-412-317-0088 for the U.S. and international callers. The access code for the replay is 10059769. The online archive of the webcast will be available through March 25, 2015 by accessing the Investor Relations page of the company's website located at www.amwater.com. After today's presentation, there'll be an opportunity to ask questions.

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

Edward D. Vallejo {BIO 16076814 <GO>}

Thank you and good morning, everyone. And thank you for joining us for today's call. And as usual, we'll keep our call to about an hour. And at the end of our prepared remarks, we will have time for questions. But before we begin, I'd like to remind everyone that, during the course of this conference call, both in our prepared remarks and in 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, uncertainties and other factors that may cause the actual performance of American Water to be materially different from the performance indicated or implied by such statements. Such risk factors are set forth in the company's SEC filings.

We also encourage you to read our 10-K on file with the SEC for a more detailed analysis of our financials. We will be happy to answer any questions or provide further clarifications if needed during our Q&A session. All statements in this call relating to earnings per share refer to diluted earnings per share.

And now, I'd like to turn the call over to American Water's President and CEO, Susan Story.

Susan N. Story {BIO 3335156 <GO>}

Thanks, Ed. Good morning, everyone, and thanks for joining us. With me today are Linda Sullivan, our CFO, who will go over the fourth quarter and year-end financial results; and Walter Lynch, our COO and President of Regulated Operations, who will give key updates on our Regulated business. Also joining us today is the newest member of our executive leadership team, Mike Sgro, who was announced last week as our Senior Vice President and General Counsel. Mike is a 22-year employee of a company who has a deep understanding of our business, our customers and our employees. And we're excited to have him join our leadership team.

So, on to business. The employees of American Water delivered strong results in 2014 for both the fourth quarter and the full year. With customers at the center of all we do, we make smart and timely investments in our infrastructure to ensure the continued reliable delivery of clean and safe water and water services. And we leveraged our increasing operating and efficiency gains and technology deployment to ensure continued affordability for our customers.

As you can see on slide 5, our year-over-year revenues increased 4.6% to just over $3 billion. Adjusted net income from continuing operations was up 10% to $2.43 per share. The increase in EPS is due to the successful execution of our strategies, which Walter and Linda will discuss in just a few minutes.

Turning now to slide 6, you see, we delivered on our strategies in both the Regulated and the Market-Based businesses in 2014. We made about $1 billion in infrastructure investment, which is $100 million more than we originally planned. This increased investment is due to the hard work of our employees and our continuous improvement in both O&M and capital efficiency. It also demonstrates our flexibility to deliver on our growth goal, while keeping customer bills affordable. These needed investments helped improve service reliability and water quality for our customers. But the full value of these investments goes beyond infrastructure renewal.

Our investments also paid dividends by creating jobs and helping the economies of our community. According to data from the Water Research Foundation, every $1 million of infrastructure investment creates 5 direct jobs and 11 indirect jobs. This means, our total investment of $1 billion in 2014 helped fuel about 16,000 jobs in the communities and the states we serve. Using this framework, over the past five years, we've created about 75,000 jobs. And looking to the next five years, our $5.2 billion in regulated infrastructure investments out of our total $6 billion capital budget equals over 83,000 new jobs.

In addition to regulated capital investment in 2014, we also grew our company through regulated acquisitions. We formally closed on 13 acquisitions, adding about 4,500 customers to our regulated footprint. And we have 11 announced pending acquisitions for an additional 21,500 customers.

Additionally, in a joint press conference on February the 3rd, the City of Mt. Vernon and Illinois American announced an agreement in principle for us to purchase their water and wastewater systems, which serve about 6,500 water customers and 6,200 wastewater customers. The parties are working to finalize details of the transaction and a city council vote is expected in the near future.

Constructive regulatory mechanisms and legislation in many of our states help us to make needed investments for the benefit of our customers, while minimizing their bill impacts. Some of the newer and more progressive actions that provide these opportunities include New Jersey's new Water Infrastructure Protection Act signed into law just this year, Pennsylvania's wastewater DSIC mechanism which became effective January 1, and Tennessee's year-old investment in economic development riders and environmental pass-through clause.

Our Market-Based business also had an excellent year. Our Military Services Group won two competitively bid contracts within the U.S. Department of Defense, and our Homeowner Services Group expanded into eight new states and received notice of intent to be awarded an exclusive utility services protection agreement with the Orlando's Utilities Commission.

In 2015, we'll be launching this exclusive partnership, which will include our water line, sewer line, in-home plumbing and interior electric protection programs. Additionally, our exclusive partnerships with the City of New York and Nashville's Metro Water Services continue to grow, as does our contract with Burlington, Iowa, which was recently renewed. American Water values our public private partnership, also known as PPP, and we enjoy partnering with these strong and successful public entities in mutually beneficial initiatives.

And always critically important, we show on slide 7 our ongoing commitment to our shareholders. The American Water board of directors again declared quarterly cash dividend payments in 2014 and raised the dividend to $0.31 per share this past May. We're proud to note that we have increased our dividend every year since our IPO in 2008 and we are one of the fastest dividend-growing utilities in the nation. In fact, in the last one-year, three-year and five-year periods, we have achieved top-quartile dividend-paid growth compared to the companies in the Dow Jones Utility Average and our water peers.

We are reaffirming our 2015 earnings guidance from continuing operations to be in the range of $2.55 to $2.65 per share. This is despite the headwind of increased pension expenses due to mortality table changes of around $0.03 per share and our previously disclosed estimate of West Virginia legal cost of about $0.02 per share. As noted, this $0.05 is included in our affirmed guidance range. Linda will discuss this issue in more detail in just a few minutes.

We remain confident in our ability to delivery on our long-term EPS growth goal of 7% to 10% through 2019, anchored from our 2013 earnings.

With that, Walter will now give an update on our Regulated business.

Walter J. Lynch {BIO 6064780 <GO>}

Thanks, Susan, and good morning, everyone. As Susan mentioned, we're very pleased with our accomplishments in 2014. Our regulated operations achieved significant growth, continuing to our commitment to investing in our infrastructure. And through increased efficiency and effective cost management, we're able to mitigate the rate impacts to our customers.

A good example of this is our recent New Jersey rate filing. Last month, New Jersey American Water filed with the New Jersey Board of Public Utilities for a rate increase of slightly less than 10%. The company's last filing was 3.5 years ago and, since then, the company invested more than $775 million to replace, rehabilitate and upgrade its treatment pumping and distribution facilities statewide.

By our continued focus on efficiencies, the company actually reduced its operating and maintenance expenses by more than $19 million. We estimate that every $1 in O&M expense reduction allows a capital investment of about $6 with no impact on customer bills. So, that $19 million in cost reductions supported approximately $125 million of investment with no impact on customer bills.

If approved this file, the typical residential customer's average monthly water bill will increase approximately $5 to $8 per month, and the majority of our wastewater customers will see no increase and some will actually see a small decrease. In this filing, the company filed a consolidated tax adjustment methodology as per the new BPU policy.

Additionally, through our DSIC filings, we renewed over 160 miles of mains, valves, hydrants and other eligible assets. So you can clearly see that through cost reductions, efficiency improvement and regulatory mechanisms like DSIC, we're making the needed infrastructure improvements to ensure reliability and quality for our customers, while keeping the cost of that service affordable.

Moving on to California. Our subsidiary, California American Water, along with three other Class A water companies, have reached an agreement with the California Public Utility Commission to defer the next cost of capital application to March 31, 2016. So this extends our authorized return on equity of 9.99% through 2016.

Lastly, we've reached a settlement in our Indiana rate case filing. The agreement includes a forward-looking rate base, with an increase in ROE to 9.75%. The $5.1 million or 2.6% increase in operating revenues is based on more than $220 million of investment in our water and wastewater systems across the state, balanced by reducing our operating and maintenance expenses.

Similar to New Jersey, our $5.5 million in cost reductions in Indiana supported approximately $33 million of investment with no impact on customer bills. For most of the company's residential customers, this increase in water rate is approximately 2% of their current bill or just under $0.03 per day.

I also want to give you a brief update on the train derailment that occurred in West Virginia last week. As many have heard media reports, on February 16, West Virginia American Water's Montgomery treatment plant was shut down as a precaution after a train carrying crude oil derailed beside a tributary of the Kanawha River and that was a few miles upstream of our plant. For clarification, this was a different plant than the one was impacted by the Freedom Industries chemical spill.

Our customers in the Montgomery area, who had water until the system storage was depleted, were notified of the shutdown and our team in West Virginia sourced local bottle water suppliers as well as largest supply of water for our customers. The West Virginia National Guard 35th Civil Support Team and technicians at our laboratory performed three rounds of water quality testing, confirming that water quality samples taken at different locations in the river and at the plant show non-detectable levels of the components of crude oil.

Following our discussions with the West Virginia Bureau for Public Health, we restarted the plant at 1 p.m. on February 17, starting the restoration of service for fire protection and sanitation, and we subsequently issued a precautionary boil water advisory for customers.

Water service was restored to all customers the morning of February 18 and the precautionary boil water advisory was lifted just before 1 p.m. on February 19, after the results of water quality testing confirmed that water quality met all the drinking water standards. And once again, our team in West Virginia did an outstanding job in this event.

Turning to slide 11. You can see how our significant progress in driving operating efficiencies in our business over the last few years has really made a positive impact. Our O&M efficiency ratio has gone from 44.2% in 2010 to 36.7% in 2014. As many of you know, our initial target was to be at or below 40% by 2015. So we actually met our goal a couple of years early. Thanks to the remarkable achievement of our employees in driving costs out of the business and as a result of our sharp focus on continuous improvement, we established a new long-term target of 34% or less by 2020.

I talked about the impact of this in our New Jersey rate case specifically, but this achievement can be seen in all of our rate filings. A few years ago, nearly half of our revenue requirement in rate filings was based on recovery of operating expenses. In a very short period of time, we successfully turned that around into recovery of invested capital.

By 2013, 95% of our revenue requirement in our filings was due to recovery of capital. And in 2014, we reached the 100% mark for filings that went into effect that year. Actually, the story is even better than this, because as I noted earlier, our O&M cost reductions have allowed us to make significant investments without corresponding revenue requirement increases.

As I've said, all these efforts to operate as efficiently as possible enable us to minimize rate impacts on our customers. Our five-year plan calls for an average price increase on customer bills of about 2%, which is in line with the current rate of inflation. We're thrilled with this progress and, once again, it goes back to putting the customers at the center of everything we do.

I'll now turn the call over to Linda for a more detailed review of our financial performance.

Linda G. Sullivan {BIO 7300156 <GO>}

Thank you, Walter, and good morning, everyone. I will start on slide 13. This is a new format intended to expand the transparency of our disclosure, based on feedback from you and other investors, by showing the contribution to earnings per share by each business segment for 2014.

On the left side of the page, we show our typical annual and fourth quarter results. Adjusted EPS from continuing operations was $2.43 per share, up 10% over last year, and for the quarter was $0.52 per share, up 8% over the same period last year.

On the right side of the page is where we added disclosure to show the contribution to 2014 adjusted EPS from each business segment. The Regulated segment continues to be the largest contributor towards earnings at $2.45 per share. Our Market-Based businesses contributed $0.22 per share. And our parent company drag, which is primarily interest expense on the parent debt generated from the RWE acquisition of American Water, was $0.24 per share. On a year-over-year basis, the adjusted EPS of each of our Regulated and Market-Based segments grew at about 10%. I trust you find this new format helpful.

Now, let me discuss the different components of our fourth quarter adjusted EPS growth from continuing operations on slide 14. Our starting point is fourth quarter 2013 adjusted EPS from continuing operations of $0.48 per share, which excludes last year's cost of the tender offer of $0.14. The fourth quarter of 2014 came in $0.04 above 2013 adjusted EPS at $0.52 per share. The major drivers of this $0.04 increase were, first, $0.02 from higher regulated revenue, which is the net impact of authorized rate increases and incremental revenue due to acquisitions, partially offset by decreased demand as we continue to experience declining usage in the 1% to 2% range annually.

Next, earnings per share of our Market-Based businesses was up $0.03 per share, driven by additional projects associated with our military contracts and growth in Homeowner Services, mainly with our New York City contracts as well as expansion into other geographic areas. Lastly, we had higher depreciation expense of about $0.01 per share, principally from growth associated with our capital investment programs at the Regulated business. In the appendix of this slide deck, we have included our revenue and expense bridge slides to provide more detail to the variances I just discussed.

On slide 15, we show our annual EPS bridge. Similar to the fourth quarter, we had increases in Regulated revenues and Market-Based businesses, offset by higher depreciation and taxes. I will not cover this in detail today, as most items are duplicative to what I discussed on the previous slide and in previous earnings calls.

Now, let me cover the regulatory highlights on slide 16, which shows rate cases and infrastructure filings awaiting final order and new rates that become effective in 2014 through today. In terms of pending rate cases, we are awaiting orders for the general rate cases in three states for a combined total rate request of $67.1 million, which includes our New Jersey rate case filed in January, which Walter discussed earlier. Also we continue to await a proposed decision in our California rate case settlement with ORA and other interveners. And our Tennessee subsidiary filed for additional annualized revenues from infrastructure investment charges of $2.4 million.

For rates that became effective in 2014 and through today, we received $88.4 million in additional annualized revenues from general rate cases, step increases and infrastructure surcharges. This includes the Indiana rate case settlement which became effective in January. These are the highlights of these cases, and we advise you to review the footnotes in the appendix for a fuller understanding of particular cases. Also in the appendix, you will find an updated slide of our largest 10 states and their authorized rate base and allowed return on equity.

Slide 17 is a summary dashboard of our performance in 2014. Through successful execution of our strategy, we achieved increases in all metrics, earnings per share, cash flow from operations, and return on equity, while increasing our investments in infrastructure to $1 billion for the year.

On slide 18, we are reaffirming our 2015 earnings guidance from continuing operations to be in the range of $2.55 to $2.65 per share. Please note that within this guidance range, we have a revision from our December guidance call. We have adopted the new mortality tables issued by The Society of Actuaries, which increases pension and other post-retirement benefits expense by $0.03 per share. By driving additional cost savings and efficiencies, we are now absorbing this $0.03 impact within the guidance range. Also, as a reminder, the 2015 guidance already includes, as part of that range, a $0.02 impact due to West Virginia legal cost from the Freedom Industries chemical spill.

Now, let's talk about variables to the guidance range. Weather, of course, is the biggest variable. Our guidance range is expected to cover normal weather variability. Weather extremes beyond this band are not included in the guidance range. As has been our practice, we will continue to quantify and disclose weather impacts for greater transparency. We also expect a certain amount of volatility in the Regulated business, mainly from the timing and amount of rate case decisions and O&M expense variability.

In the Market-Based businesses, we experienced volatility around the timing of awarding new contracts, military price determination and the opportunity for additional contracts and partnerships. And lastly, shale activity could vary plus or minus $0.01. On the right side of the page is a look at the expected growth for 2015 by category, consistent with our earnings guidance.

With that, I'll turn it back over to Susan.

Susan N. Story {BIO 3335156 <GO>}

Thanks, Linda. Last year we began concluding each of our earnings call by highlighting initiatives or recent news that may be outside of what we would typically cover during this call. This quarter, we're going to highlight American Water's activity in the shale energy market, which is based on our ability to provide water services in a sustainable, environmentally-responsible manner to our customers and to the communities we are privileged to serve.

On the Regulated side of our business, our Pennsylvania American Water subsidiary currently has 45 active connections to the shale energy well. We sold 604 million gallons of water to gas producers in 2014. While most energy companies have reduced their 2015 CapEx spending projection, many of these companies have delivery commitments to midstream pipeline and so they should continue to drill in 2015 to meet those commitments.

The E&P companies we partner with continue to rely on us as a primary source of water for shale gas development activities in Western Pennsylvania. The overall oil and gas activity in the state increased only about 10% in 2014 over 2013, but our water sales have increased at a much greater rate. The increase in 2014 revenues was due to a number of infrastructure improvement projects that became operational during the latter part of the year.

The same factors are expected to support similar performance in water sales for Pennsylvania American in 2015. Consistently, the Marcellus and Utica are considered by the E&P companies as their lower-cost gas plays to develop, and they should remain so. Further, a large number of our regulated water services fall within the Marcellus wet gas region, which historically has been more profitable than the dry gas areas.

In our Market-Based business focused on shale, we're exploring longer-term water supply plans with key producers. With reduced CapEx in place for many of these companies, we could possibly see opportunities for water supply contracts, as the E&Ps focus their prioritized capital for well development rather than ancillary services. It is uncertain how this will play out, but American Water is evaluating various scenarios.

As a reminder, Market-Based shale represents 0% to 1% of our EPS growth triangle for 2015 and 0% to 2% of our long-term earnings growth plan. While we are pursuing opportunities in this area, we are disciplined in our approach, and we don't have to rely on shale to hit our long-term EPS guidance.

With the opportunities shale presents for our nation's present and future energy security and for our company's potential role in that future, we announced last week that Karl Kurz was elected as an independent member of the American Water board of directors. Karl is the former Chief Operating Officer at Anadarko Petroleum Corporation, one of the largest independent oil and gas exploration and production companies in the world. Most recently, Karl served as a Managing Director of CCMP Capital Advisors, a global private equity firm. We're excited to have somebody with Karl's experience become part of American Water.

And with that, we're happy to take any questions you might have.

Q&A

Operator

We will now begin the question-and-answer session. Our first question comes from James Ward of Macquarie Capital. Please go ahead.

Q - James Ward {BIO 17914166 <GO>}

Hi. Good morning, guys.

A - Susan N. Story {BIO 3335156 <GO>}

Hi, James.

Q - James Ward {BIO 17914166 <GO>}

Hi, there. Could you give us a bit more color on acquisitions of wastewater systems and roughly how many you anticipate for the next year or two years?

A - Walter J. Lynch {BIO 6064780 <GO>}

Well, this is Walter. I'll take that question. It's one of our strategic focus areas is growing on the wastewater side and we've been in discussions with a number of municipalities on just that, acquiring the wastewater systems. And you can see from some of the acquisitions we've done over the last year that it's really taken hold.

We're going to continue to have those discussions primarily at the state level. The state teams are focused on having those discussions and convincing the municipality that there is a benefit to becoming part of American Water, and we've been pretty successful there. But it is a key focus area for us and we're going to continue to have those discussions in the hopes of acquiring the systems.

Q - James Ward {BIO 17914166 <GO>}

So, just to get a sense, number-wise, do you see it roughly coming along at the same pace? Do you see an acceleration? I'm just trying to – from a modeling perspective, trying to get a sense of how many you'd see going forward.

A - Walter J. Lynch {BIO 6064780 <GO>}

Well, so far – I mean, we're adding about two-thirds wastewater and one-third water...

Q - James Ward {BIO 17914166 <GO>}

Yeah.

A - Walter J. Lynch {BIO 6064780 <GO>}

...which just shows, I think, the opportunity that we have within the marketplace that wastewater is a prime opportunity for us to continue to grow. So we think it'd be continuing on in that way, maybe half to two-thirds on the wastewater side. But it's hard to give numbers at this point.

Q - James Ward {BIO 17914166 <GO>}

Sure. Okay. Thank you very much for that. And then my second question, to get a bigger picture, on the 7% to 10% EPS range, how do you see over the next few years and, well, particularly maybe on 2015? Where do you see things shaping up, a little bit closer to the higher end or lower end?

A - Susan N. Story {BIO 3335156 <GO>}

As always, we give our guidance range to be the $2.55 to $2.65.

Q - James Ward {BIO 17914166 <GO>}

Fair enough. Okay. Just had to ask.

A - Susan N. Story {BIO 3335156 <GO>}

But that was a really nice try.

Q - James Ward {BIO 17914166 <GO>}

Sorry. Congratulations again, guys. Thanks a lot.

Operator

Our next question comes from Brian Chin of Bank of America. Please go ahead.

Q - Brian J. Chin {BIO 20276978 <GO>}

Hi. Good morning.

A - Susan N. Story {BIO 3335156 <GO>}

Hi, Brian.

Q - Brian J. Chin {BIO 20276978 <GO>}

Just a general quick question. Some of the other utilities out there that have reported this quarter have made a few comments on bonus depreciation. I don't think I heard any comments from you guys on that regard. But just any color you could give on how we should think about that for you guys going forward?

A - Linda G. Sullivan {BIO 7300156 <GO>}

Yeah, Brian. This is Linda. Remember, we are in a net operating loss position. So we are currently evaluating the bonus deprecation deduction for 2014 and its impact on each date as well as the overall NOL utilization of the company. And we have until September of 2015 to make the final decision on that.

Q - Brian J. Chin {BIO 20276978 <GO>}

Okay. Great. I guess we'll take a look at that point and what you decide to do. Thanks. Appreciate it.

A - Linda G. Sullivan {BIO 7300156 <GO>}

Thank you.

A - Susan N. Story {BIO 3335156 <GO>}

Thanks, Brian. Operator, are there any other questions? If not, I can go to closing.

Operator

At this time, I see no further questions.

A - Susan N. Story {BIO 3335156 <GO>}

Okay. Well, just in closing, I just want to recognize and pay tribute to our outgoing Investor Relations VP, Ed Vallejo. Ed has headed up our IR function since our IPO back in 2008, and I think he is the very best in the entire utility industry. Those same leadership skills, financial acumen, customer focus and knowledge and experience led us to promote him to his new position of VP of Financial Strategy, Planning and Decision Support. In his new role, Ed will have all of the state and division finance directors reporting to him, as well as overall responsibility for financial strategy and planning, and he will lead our newly formed Revenue Analytics Group.

Despite this big new job, he has continued in the IR VP role to help us through the transition. Just to remind you of what has taken place in Ed's tenure, check out the total shareholder return in the market cap charts on the slide that you see. As you can see, we're very proud of what Ed has done, only to be eclipsed by what he is going to do for us in his new role. Thanks, Ed. We're happy you're part of our team. And he did not know I was going to do this. So you should see his slides right now.

So, with that, thanks everybody for participating. We appreciate it. And we will talk to you again in a couple or three months.