Q1 2014 Earnings Call

Company Participants

- Edward D. Vallejo
- Jeffry E. Sterba
- Susan N. Story
- Walter J. Lynch

Other Participants

- Adam W. Muro, Goldman Sachs & Co.
- Dan L. Eggers, Credit Suisse Securities (USA) LLC (Broker)
- Jonathan G. Reeder, Wells Fargo Securities LLC
- Leslie Best Rich, JPMorgan Investment Management, Inc.
- Shar Pourreza, Citigroup Global Markets Inc. (Broker)
- Shivangi D. Tipnis, Global Hunter Securities LLC
- Spencer E. Joyce, J.J.B. Hilliard, W.L. Lyons LLC

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to American Water's First Quarter 2014 Earnings Conference Call. As a reminder, this call is being recorded and also being webcast with accompanying slide presentation through the company's website www.amwater.com. Following the earnings call, an audio archive of the call will be available through May 15, 2014 by dialing 303-590-3030 for U.S. and international callers. The access code for the replay is 4678978. The online archive of the webcast will be available through June 9th 2014 by accessing the Investor Relations page of the company's website located at www.amwater.com. During today's presentation all parties will be in a listen-only mode. Following the presentation the conference will be opened for questions. .

I would now like to introduce your host for today's call, 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. 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.

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 our 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. And such risk factors are set forth in the company's SEC filings.

And with that now I'd like to turn the call over to American Water's President and CEO Jeff Sterba.

Jeffry E. Sterba {BIO 1426511 <GO>}

Thanks, Ed. Good morning to all of you that are on the phone. I really appreciate you joining us today. As you probably know this my last earnings call with American Water, and it's pretty nice to be going out with such good results. Let me just say that it's been a true pleasure to work with the team here in the process of creating strong and sustained value for you our shareholders. I'm pleased to say that while we had a challenging quarter in terms of weather and subsequent impact on water main breaks, and in fact our water main breaks were higher than last year by on average over 35%, and of course we had the Freedom Industries chemical spill in West Virginia, which we've talked about.

Our employees delivered a very solid first quarter. Through our focus on growth and continuous improvement, revenue, net income and cash flow increased quarter-over-quarter and our O&M efficiency ratio continued to improve.

If you go to slide 5, you can see that our operating revenue increased about 7% and adjusted diluted earnings per share, which excludes the year-to-date impact of the West Virginia event of about $0.02, was $0.40 per share, up 25% from the $0.32 per share last year. This increase is mainly due to higher revenues in our regulated businesses driven by rate authorizations and infrastructure surcharges, as well as increases in our market-based place revenues mostly from capital projects associated with our military contracts. And Susan will go through that in more detail in her section.

And I do want to mention that in addition to Susan, who will join me in the presentation, and Walter Lynch who's always with us, it's a pleasure to have Linda Sullivan, our soon to be CFO and Aldie Warnock, our Head of External Relations, Communications and Public Policy with us in the room along with other of our senior execs.

And we also reported an increase in cash flow from operating activities of approximately $95 million, the drivers of which Susan will go into in a little more detail in a few minutes. And our adjusted consolidated ROE increased to 8.45% for the 12 months ending March 4, 2014 from 8.29% for the 12 months ending March 31, 2013.

And if you go to slide 6, you know that last week our Board of Directors authorized an 11% increase in the quarterly dividend from $0.28 to $0.31 per share. We have increased the quarterly dividend every year since our IPO in 2008. As a matter of fact, we're among the top quartile of regulated utility companies in terms of dividend growth, highlighting our ability and commitment to providing solid dividend growth for our investors while continuing to appropriately invest in our systems on behalf of customers and pursuit of growth opportunities.

This dividend increase is in line with our dividend practice of growing the dividend commensurate with earnings growth while targeting a 50% to 60% payout ratio.

If you turn to slide 7, I'd just like to highlight a couple of our business achievements so far this year that drive not only our current, but our future financial performance. Capital investments for the quarter totaled approximately $175 million, and that compares to about $115 million for the same period last year when you don't include the business transformation expenditures. So in terms of pipes in the ground, meters, et cetera, an increase in the amount of CapEx so far this year in spite of the cold weather which hampered the ability to do some construction.

As we've stated previously, we anticipate investing approximately $5.1 billion in our regulated operations in the next five years. And then in addition we've set aside about $700 million for acquisition and strategic opportunities. Now the majority of that $5.1 billion will be invested in needed system upgrades and improvements to ensure continued reliable service for our customers.

On the regulatory front year-to-date, the company received authorization from general rate cases in Iowa, primarily driven by infrastructure investments. We also received about $14.5 million in additional annualized revenues from infrastructure surcharges in several states, and among those I just want to point out that there was a key decision in Tennessee in which our Tennessee subsidiary filed an alternative regulatory mechanism case and successfully negotiated a settlement in this case which consisted of three investment riders and one expense pass-through clause. This was one of the states in which we did not those kinds of disc mechanisms and now we do. And we're very pleased to have the kind of reception that we did in Tennessee. It's an excellent example of how we are pursuing constructive regulatory mechanisms that speed the process of making needed investments in our systems for the benefit of customers while minimizing rate impacts.

On the cost side we continued to improve our O&M efficiency ratio to 38.2% for the 12 months ended March 31, 2014, compared to 40% for the same period the prior year. As we've discussed on previous calls, as we drive efficiency into our operations we can enable more of the needed investment in the aging water infrastructure without putting undue burden on the water bills of our customers.

We also have had success on the growth front, closing three regulated acquisitions in Indiana and Missouri while having a total of five acquisitions that are pending approval. On the market-based front, we announced that our Military Services Group won a contract with Hill Air Force Base in Utah which is currently worth about $280 million over its 50-year life, which means that we've now got about $1.3 billion in backlog.

And our Homeowner Services Group expanded into four new states since the beginning of the year. Now you'll remember that we talked last time about seeing an increase in the inside plumbing claims given the extremely cold weather. Well, I'll tell you that that was more than offset with revenue growth and other cost controls within the Homeowner Services business line.

Before we continue, I know we spent a good amount of time on the year-end earnings call discussing the Freedom Industries chemical spill and our response to it. So I won't go into those details, but I do want to provide you a very quick update. The chemical has been at non-detect at two parts per billion or below since February 25 of this year, which is 500 times lower than the level considered safe by the CDC. Six of the 16 activated carbon filters have been changed out of our Kanawha Valley plant, and water samples taken from the first six filters completed in this project showed no detection of the chemical at the lowest laboratory reporting level available. Again, we are exceptionally proud of how our team at West Virginia American Water handled this situation and how they have continued to do everything they can to serve our customers through what is without a doubt a very difficult situation.

So with that, we're reaffirming our annual earnings guidance to be in the range of $2.35 to $2.45 per share excluding the impact of the Freedom Industries chemical spill. The impact of the spill through the first quarter of this year was $0.02 per share, and we estimate an additional impact of $0.01 to $0.02 per share impact for the remainder of this year. We remain confident in our ability to deliver on our long-term earnings per share growth goal of 7% to 10% through execution of our growth strategies and continued operational efficiency gains.

Turning to slide 9, let me just hit on some other news during the quarter. First, we have two new faces on our leadership team which I introduced a moment ago. Linda Sullivan, who will become our Chief Financial Officer tomorrow, as many of you know, comes from Southern California Edison where she was the CFO, and brings with her more than 25 years of financial leadership experience. Having most recently led a successful company-wide program to enhance growth and optimize SoCal's cost structure, her experience directly correlates with American Water's financial, strategic and long-term goals. We are thrilled to have her on the board with us, and I know she looks forward to meeting with you all in the near future.

We also recently announced the addition of Aldie Warnock to our executive leadership team. I've known Aldie for over a decade and his sterling reputation with regulators, legislators and other key constituencies is the hallmark by which we wanted him to join us, and we're so glad that he did. He'll greatly add to our company's capacity to grow, influence public policy and constructively engage with key constituencies. You're up for that, right, Aldie?

Before I turn it over to Susan for a financial update, I do want to mention that this is also the time of year when all water providers issue their annual water quality reports. In 2013, American Water again scored above 99% for compliance with EPA standards. This is truly an exceptional achievement. In fact, based on the current information from the U.S. EPA, American Water performs 20 times better than the industry average for compliance with drinking water quality standards and 150 times better than the industry average for compliance with drinking water reporting and monitoring requirements. These results are delivered because of truly our employees' commitment to our customers and the ongoing and proactive program to upgrade all of our facilities.

Our commitment to providing our customers with innovative solutions is also evident from the recent worldwide agreement we signed with Abengoa to license our NPXpress technology. We've talked about the NPXpress technology before and the creation of our innovation development team. The NPXpress technology helps wastewater utilities reduce electricity and chemical costs when removing nitrogen and phosphorus through certain kinds of mechanisms.

So we're very excited to bring this product into the market through such a great company as Abengoa.

And with that, I'll turn the call over to Susan Story for more detail on our financials.

Susan N. Story {BIO 3335156 <GO>}

Thank you, Jeff, and good morning to you all. It's a pleasure to be here with you today to review the first quarter 2014 results. Jeff has already reviewed many of the key highlights. I'll take just a few minutes to discuss the drivers of our first quarter result in just a bit more detail.

Turning to slide 12, as Jeff mentioned, first quarter 2014 we did yet another quarter of solid financial results. We saw increasing revenues, and we also continued our progress in improving our operating efficiency. For the three months ending March 31, 2014, we reported operating revenues of $681.9 million, which is $45.8 million higher than the first quarter 2013. This increase is a result of higher revenues in both our regulated businesses and in our market-based operations, which I'll discuss in a little more detail on the revenues bridge slide.

We also reported for the first quarter net income of $68.1 million or diluted earnings per share of $0.38. This compares with net income of $57.6 million or diluted EPS of $0.32 for the first quarter of 2013. As Jeff mentioned previously, included in the $0.38 is a $0.02 charge related to the Freedom Industries chemical spill in West Virginia. Excluding this $0.02 one-time impact, our adjusted EPS for first quarter 2014 was $0.40 per share.

We also paid a dividend of $0.28 per share during the quarter. There was no dividend payment in the first quarter of 2013 because we accelerated that payment to December 2012 so our investors could take advantage of the lower dividend taxes before the new tax changes that took place on January 1, 2013.

On March 31, 2014 we reported cash flow from operating activities of $244.9 million compared to $149.6 million in 2013. The increase in cash flow from operations was primarily due to three things. First, stronger cash flow from core growth in the business; second, a decrease in pension and post-retirement benefit contribution; and third, changes in working capital mainly due to the timing of vendor payments.

This timing of vendor payments issue was due to us making fewer payments in the first quarter of 2014 compared to the first quarter of 2013. We may recall that we implemented our new ERP system, which included an accounts payable module, in August of 2012. Because of this, there were some delays in making payments to our vendors and service contractors in late 2012. Upon system stabilization significant catchup payments were made in the first quarter of 2013 with decreased cash flow from operations for that quarter as compared to the first quarter of 2014.

Now let's discuss the different components of our financials, starting with revenues on slide 13. Again I encourage you to read our 10-Q on file with the SEC for a more detailed analysis of both revenues and expenses.

Overall, operating revenues increased $45.8 million or 7.2%, with revenues from our regulated business increasing by $34.4 million or 6% compared to the first quarter of 2013. Regulated revenues were higher primarily due to the first four items you see on this slide. First, authorized rate increases for a number of our operating companies was $19.8 million. Second, higher water usage of $5.8 million, which we believe was partly due to customers letting faucets drip to prevent frozen pipes in the extremely harsh winter. Third, increased surcharge and amortization of balancing account of $5.3 million, and fourth, a $3.3 million benefit from our 2013 acquisitions with the most significant being Dale Services Corporation in Virginia.

Before I move on to market-based operations revenue, I'd like to quickly discuss the increase in billed water sales volume across all classes in the first quarter of this year. And let me remind you we report both billed and unbilled revenue, but we only report billed volume. The billed volume that we had was $6.7 billion gallons this quarter or 8.9% higher than the same period last year. This increase is primarily due to higher billed revenue versus unbilled as a result of system stabilization in the first quarter of 2014, especially reflected in commercial and industrial segments.

With the implementation of our CIS system, unbilled revenues at December 31, 2013 were significantly higher than the historical levels due to billing delays in certain accounts. During the first quarter of 2014, we addressed the majority of those delayed billings. Therefore as a result, there is a corresponding increase in billed versus unbilled revenues this quarter, which is reflected in the billed volume. Please see our 10-Q on file with SEC for additional details.

Continuing with our market-based business, revenues for the first three months of 2014 increased by $11.5 million. The largest contributor to this increase was $7.6 million in our Contract Operations Group, primarily related to additional revenues from capital project activities associated with our military contracts. Homeowner Services contributed $5.3 million attributable to contract growth mainly as a result of our New York City partnership. These increases were offset somewhat by a reduction in revenues attributable to terminated municipal and industrial operations and maintenance contracts in 2013.

On slide 14, total operating expenses for the three months ended March 31, 2014 increased by about $24 million compared to the same period in 2013. Operation and maintenance expense in the regulated business increased $8.9 million or 3.3%. Within the regulated O&M expense category, production expenses were the biggest single contributor to increased expenses by $8.8 million or 14.6% for the quarter. This increase is a result of purchased water costs including price increases in our California subsidiary as well as higher fuel and power cost due to the increased sales. This was due both to increased customer demand and higher supplier prices in several of our operating facilities.

Customer billing and accounting expenses increased $3 million or 29.8%. This increase is primarily due to uncollectible expenses associated with the aging of receivables as a result of slower than normal collection pattern, and to a lesser extent, to the rate increase impact. We believe the increase in our receivables aging is a result of temporary changes made in our billing and collection processing with the implementation of our new CIS system in 2013, and we expect these issues to lessen throughout the year.

Maintenance, materials and supplies, which include emergency repairs as well as costs for preventive maintenance, increased $2.2 million or 11.9% for the three months ended March 31, 2014 compared to the same period in 2013. As Jeff has mentioned previously, with the abnormally harsh winter weather in most of our operating areas, we incurred a significantly higher number of water main breaks, which resulted in an increase in paving, backfilling and other repair costs.

The operating supplies and services and other category increased about $900,000 overall. These costs increased $1.9 million or 3.5% in the quarter mainly due to increased legal cost for our West Virginia subsidiary associated with the Freedom Industries chemical spill in January of 2014. These costs were partially offset by a $1 million or 8.1% decrease in the other expense. This category includes casualty and liability insurance premiums as well as regulatory costs, which were favorable for the quarter year-over-year.

Employee-related costs, which includes salaries and wages, group insurance and pension expense decreased $6 million or 5.3% for the three months ended March 31, 2014 compared to the same period last year. The overall decrease in employee-related cost for the three months ended March 31 of this year was primarily due to decreased pension and post-retirement benefit cost.

The market-based business increase and total O&M expense of $6.6 million or 11.2% is mainly due to operating supplies and services being $6.3 million higher. This is attributable to the increase in construction project activities for our military contract which corresponds with an increase in revenue.

In the first quarter of 2014, we also reported a higher consolidated depreciation and amortization expense of $6.4 million, and a $2.1 million increase in general tax, parent and other. The increase in depreciation and amortization was principally as a result of additional utility plant placed into service, including phase two of our SAP project. You may remember that phase two, our CIS and EAM systems were placed into service in two waves during the second and fourth quarters of 2013.

Turning now to slide 15, to better explain the period-over-period difference in our earnings per share figures, you see here our EPS bridge. As you can see, our starting point is first quarter 2013 EPS of $0.32. Next we outlined the various financial drivers which get us to our first quarter 2014 number, most of which I've already described in the revenues and expenses discussion. The three months ended March 31, 2014 GAAP diluted earnings per share is $0.38. We have added back the one-time West Virginia event impact of $0.02, which brings our adjusted earnings per share to $0.40. As I mentioned, the other components were discussed earlier. We will be happy to answer any questions that provide any further clarification during our question-and-answer session.

Slide 16 shows our O&M efficiency ratio. As Jeff mentioned earlier, for the last 12 months ending March 31, 2014, we achieved a 38.2% ratio which is a considerable improvement from the 40% ratio we had the same period last year. As we have shared with many of your previously, our long-term goal is to achieve a 35% O&M efficiency ratio by 2018. Continuing our drive for effectively managing our O&M allows us to invest much needed capital in our aging infrastructure to improve customer service and reliability while holding down the impact of doing so on our customers' bills.

The tremendous impact of the work that our employees have achieved with these cost efficiencies is demonstrated in our rate case outcome for the past few years as shown on slide 17. In 2013, 95% of effective rate increases were dedicated to recovering capital investments rather than for O&M recovery, up from 56% in 2010. If you look at the rate cases effective to date in 2014, our efforts to operate as efficiently have resulted in a full 100% of the incremental revenue requirement attributable to capital investment.

Further the incremental revenue requirement for O&M in 2014 was actually reduced by 25% as a result of lower operating expenditures in Iowa and Pennsylvania combined, offering the opportunity for further capital investment without impacting the customer's bill. We are very proud of the effort and the results of all of our employees to reach this level of operating efficiency.

Now let's look at the recent regulatory highlights on slide 18, which shows formal rate cases awaiting final order as well as it lists step increases and DSIC filings which impacted the quarter or are still pending. As you can see from the chart we implemented new rates effective January 1, 2014 in Pennsylvania and also have new rates effective April 8, 2014 in Iowa for a combined annualized total of $29.8 million. Additionally, $1.2 million in step increases from a prior rate case in our New York subsidiary became effective April 1, 2014.

Infrastructure charges already awarded to be effected in first and second quarters of 2014, totaled $14.5 million annually and represents the ability to more timely recover capital which we invest to improve both infrastructure and customer service. As of May 8, we are awaiting orders for general rate cases in two states, infrastructure charges in one state and a step increase in one state. And in the appendix you will find an updated version of our largest 10 states with their authorized rate base and allowed return on equity.

These are historic cases, and we advise you to review the footnote for a fuller understanding of the particular case in question. While you can never project how any new case will be determined, we just hope that this helps you understand our current rate environment. And with that I'll turn the call back over to Jeff.

Jeffry E. Sterba {BIO 1426511 <GO>}

Thanks very much, Susan. Just turning quickly to slide 19, this was in our Analyst Day presentation, and it provides the road map of the specific things we can be held accountable for during the course of the year and that progress will be reported on. We've really talked through all of these and I think have conveyed that all of them are moving forward on schedule.

Before we turn the call over to questions, let me just make a couple of brief personal comments. When I joined American Water four years ago, it was clear that there were many challenges and those become opportunities, right? But what I had confidence in was when I met the employees. And I know it's a kind of cliché to say, but I can't tell you how true it is here. All the employees that I've met, they care deeply about the customers they serve and about the job that they do but more than that, they're eager to learn how to be better. And that's the key ingredient for success, and it's what's helped us be so successful through this past period of time. And I know that will continue.

For those of you that are analysts, I want to thank you for your candor with us. It has helped shape our thinking, not just in how we communicate thing, but also our strategy. For those of you who are investors, I very much am humbled by your investment in us and the knowledge that we have that we will continue to earn that trust and investment for the future.

And I want to close by saying that I couldn't be happier or more comfortable in turning the reins of the company over to Susan. She is a tremendous leader. She has a great team that will continue to provide tremendous results for you as investors and also for the communities we serve and our employees. So it is easy for me to try retirement the second time knowing that this company will be in the great hands that it is.

So with that, let's take any questions you may have.

Q&A

Operator

. And our first question comes from the line of Adam Muro with Goldman Sachs. Please go ahead.

Q - Adam W. Muro {BIO 20408630 <GO>}

Good morning, guys. And Jeff and team, congrats on a wonderful quarter. I'm filling in for Neil Mehta here. Had a quick question here on your long-term dividend growth, especially after the recent dividend raise. What factors do you guys look at and consider when you are thinking of increasing or decreasing this?

And then the next thing is, on the many tuck-in acquisitions you guys have announced in several states recently, how material are these and what cost saving opportunities should we be thinking about when we review these?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Why don't you take the first one?

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

Okay, on the dividend question, Adam, we have a dividend practice that we want to grow our dividend commensurate with our EPS growth and we target a payout ratio of 50% to 60%, very important for us also to have predictable, stable earnings growth.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

And on the acquisition side, it depends is the simple answer. And this is one of the reasons why we have a significant focus in the wastewater area, because when we are already providing water in a community and then take over the wastewater system, there are significant cost savings opportunities because we will be using the same rolling stock, a lot of the same equipment and the same people. Obviously, it's different pipe and some of the equipment is different, but there's a lot of similarities and so there is the opportunity for lowering the cost per customer or per mile of pipe or however you want you look at it.

Other than that, it will just vary based on the size of the acquisition, its proximity to existing territory. Most of them are tuck-ins to basically adjacencies, so we're able to integrate it fairly effectively. But obviously, they also vary in size from 100 customers to 20,000 customers. So it kind of depends on the specifics of the acquisition, but we – as we've said before, we are more encouraged with the ability to do these kinds of acquisitions. With the success we had last year and so far this year, we've got eight.

Operator

Thank you. And our next question comes from line of Dan Eggers with Credit Suisse. Please go ahead.

Q - Dan L. Eggers {BIO 3764121 <GO>}

Hey. Good morning, guys. I guess, Jeff, congratulations. Maybe this is the second retirement where we've said good-bye to you on I suppose?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Yes, sir. Yes, sir. You want to say thank God, it's going to be the last one, isn't it?

Q - Dan L. Eggers {BIO 3764121 <GO>}

Well, I will withhold comment. How does that sound? Could we talk a little bit about the kind of non-regulated, the services side of the business, what you're seeing as far as kind of backlog development is concerned and where that business if you look at kind of what's in queue or what you guys are talking about? How much business is sitting there and kind of confidence in the rate of growth on that side?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Well, let me start with a few comments and ask Susan to chime in. You kind of look at it in its different pieces, take Military Services. We're pretty bullish about the opportunities that are present in the Military Services side. There has been a hiatus, as we've talked about before, of about three years when no awards were made, or at least none of significance because we're really only focused on the larger bases. And now we're starting to see that shake loose.

We're very pleased with the amount of additional capital awards that were made last September-October to us. That's about $142 million, and that's in fact what's driving a lot of the revenue growth in the Military side first quarter of this year. In fact, it would have even been higher but the cold weather impaired the ability to do some of the construction. So we think that there remains good growth opportunity within the Military Services side. You've got – the Air Force has now become much more engaged in the process. The Army has a number of bases that still will go forward. So we can see 40 to 50 facilities out for bid in the next, say, four years or so. Now obviously not all of them will we bid on because a lot of them will be smaller outposts that we're just not – that's not going to attract our attention.

Homeowner Services, on the heels of New York and now Nashville, the opportunities that we see in partnering with some large municipalities to provide services on bill is very positive. I mean we've seen very significant growth in that business. The keys will be managing the cost side and the customer service side as it grows so that we maintain good profitable margins.

And in the balance of the Contract Services business, we've gone through a very specific process of weeding out what I'll just call frankly bad contracts. And it drove our revenues down out of that business, but our margins went up substantively. And we've now got that business positioned where it is taking on some new contracts for the first time that are adding to that margin and adding to revenue, but we had to, what I'll call clean up the system first.

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

Right. And Jeff is exactly right. In the two growing areas that we have disclosed to you all before in terms Military Services and Homeowner Services, we're continuing to see great opportunity for growth. Additionally, we're looking at adjacencies where, for example, we serve military bases, other federal facilities.

We're looking at the Homeowner Services Group, as Jeff said, has been very successful and we're repeating success because we have people who know what we're doing. We understand how to serve customers and we're seeing that area grow and we're looking at adjacencies. He mentioned for example the in-house plumbing. We previously said we were looking at things like HVAC. So we see growth in the areas we defined and we also – our Group is consistently and constantly looking for new opportunities that leverage the core competencies we already have and provide opportunities for us to provide a great service for customers.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

And just keep in mind Dan, as we've talked about before, we're going to – that business will grow at a higher rate than the regulated business, but we're going to do it in a way that does not substantively change the overall risk profile of the company. That's where the Military Services piece is important. The duration of the contracts that we enter into and the cost recovery mechanisms in the Contract Services side, those things that help make sure that these are not significantly different in their risk profile.

Q - Dan L. Eggers {BIO 3764121 <GO>}

I know it's a simple process, but if you look at the increasing revenues on that business and an increase in cost in the quarter, looks like about a 42%, 43% incremental margin on the revenue dollars brought in. Is that a reasonable rule of thumb or do you think there's too much clutter this quarter to kind of use that as an operating assumption?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

The answer is yes, Dan. There's too much clutter, and that's the same answer you'll get every quarter, only because it's fluid. It moves around. And we're not going to give insight into specific margins for those businesses because it's that they're very competitive. But you'll be able to see in toto I think strong margins, because of the way that we're growing that business.

Q - Dan L. Eggers {BIO 3764121 <GO>}

Okay. And I guess just you know one more question with the drought conditions ongoing in the West, how should we be thinking about the effect on results this year. And are you – you get into more conversations of other water resource alternatives that could spur growth for you guys as people maybe get a little less comfortable with traditional water resources?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Yeah, I guess a couple of things. You remember in California we have the RAM mechanism, so usage is decoupled from revenues. The revenues are decoupled from usage. The one area that was not that way was Sacramento. However, we have filed because of the restrictions and are in position of voluntary conservation measures in Sacramento. We have filed and gotten approval to initiate a memorandum account to track the reduction in revenues in Sacramento so it can be rolled into the RAM also. So we feel really good about that.

In terms of the new technology opportunities, obviously we've got our desal project moving forward, and I've got to tell you it's picking up more steam particularly on the political front, because we've got a group of mayors in the Monterey Peninsula who truly understands this is the last best opportunity for that area to have water security, and that's very important. We're seeing more interest in what I'll call smaller scale desal opportunities that were – we've got some ongoing discussions regarding. And the notion of reuse is going to be really be price-driven. And so I think for in California reuse is getting more and more economic.

In other parts it needs a push because it just doesn't – with the molecule being effectively free, it just doesn't have enough oomph, except in places like in certain parts of New York City where they're subsidizing it or in California where the prices are getting to a point. Walter?

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

Yeah, just one more thing back to California is I just want to say that we do have adequate water supplies in all of our districts throughout California, and we're monitoring that very closely, our ground water and the purchased water. But we're also working with the fire department to make sure they have adequate fire flows to fight the wildfires that are ongoing out in California.

Q - Dan L. Eggers {BIO 3764121 <GO>}

Okay. Thank you, guys.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Thanks, Dan.

Operator

Thank you, and our next question is from the line of Shar Pourreza with Citigroup. Please go ahead.

Q - Shar Pourreza

Good morning everyone.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Good morning.

Q - Shar Pourreza

Give the tenor of the market-based operation contracts, the cash flow certainty, as well as price certainty, have you looked at alternative financing vehicles as a way to lower your cost of capital as you bid on further projects?

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

Shar, thank you for the question. One of the things as we look at our market-based businesses, they're extremely capital light. We have very little capital investment in that part of the business. It's more revenue, O&M, those type of things. In the Military, even though we build these projects, as we've said before, predominately we just deploy working capital and then we get reimbursed at certain stages. So with that said as we look at the future, we're looking at everything, but right now it's not as big of an issue because of that.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

And if we end up with a greater flow of concessions and things like that, we're going to remain open to whatever structures will help us lower cost of financing without fundamentally changing risks. And that's one of the – that's why for example we're so aggressively pursuing the defeasance issues on municipal bonds so that we can retain and maintain against the low cost stuff that may have been put in place on our facility. So we'll continue to look at that, but Susan's right. So far it is very capital light.

Q - Shar Pourreza

Terrific, terrific, and then just one last question. As you look at your market-based operations and the viewpoint that you will – the mix will remain at a level where it doesn't increase the risk profile of the company, where does I guess shale opportunities fit into that outlook?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

A very good question and the answer is both. So far it has virtually all been on our regulated side of the business. We have a very good framework and model that we've been deploying with fairly rapid growth in southwestern Pennsylvania, mostly in the Marcellus, a little bit of Utica. But we do continue to have discussions with drillers on scenarios where a market-based solution may be more appropriate. But as we've said, if it's a market-based solution, we are willing to take risk on returns. We are not willing to take risk on return of. So the return on the capital that's business. But we're not going to place the return of capital at risk. So whether it's through take-or-pay contracts or some other mechanisms or commitment of acreage, we will manage the risk that way. So far it's been on the regulated side.

Q - Shar Pourreza

Got it. Terrific and congrats, Jeff, on the retirement again.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Thanks, Shar, appreciate it.

Operator

Thank you and our next question is from the line of Jonathan Reeder with Wells Fargo. Please go ahead.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Now, Jonathan?

Q - Jonathan G. Reeder {BIO 18909775 <GO>}

Yes?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

No, you don't get to go first. All of us in this room rooted for Notre Dame women in the basketball, and it still didn't do any good.

Q - Jonathan G. Reeder {BIO 18909775 <GO>}

No. No, it didn't. UConn just has our number in the tournament. We have them in the regular season, but I don't know what else to say. Hey, Jeff, congrats on a job well done and hopefully retirement does last a little longer for you this time.

Susan, I'm just trying to understand the usage a little better during the quarter and kind of wanted to sure that I understood it correctly. The 8.9% billed sales growth is attributable to the difference between billed versus unbilled and just kind of timing-wise, right?

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

Well, we roughly estimate that 75% of that billed volume is attributable to the billed-unbilled situation. The other 25% to 30% we attribute to two things. One I mentioned earlier, what we call the drip theory or the drip effect which we typically every year see in for example West Virginia, but it was so cold this year we saw it in other states. And the second piece of the volume increase we believe is due to the acquisitions. So yes, primarily it is the billed-unbilled because we don't report unbilled volume, but that's about three-quarters of it. But the rest we attribute to actual consumption increase.

Q - Jonathan G. Reeder {BIO 18909775 <GO>}

Okay. So that other 25% or 30% is that I guess what attributes to that 2% increase that you said, or the $0.02 increase quarter-over-quarter?

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

Yes, that we call the demand, because remember on revenue we report billed and unbilled revenue. So the revenue is pretty clear. It's the volume that we only report billed.

Q - Jonathan G. Reeder {BIO 18909775 <GO>}

Right. So the 25% to 30% translates into that $0.02.

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

Yes, that's correct.

Q - Jonathan G. Reeder {BIO 18909775 <GO>}

Okay. Would you say – I mean, I guess from an economic standpoint things have been improving in your service territories. I mean does that have any play or is it just kind of too early to see in terms of natural customer growth and higher usage?

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

We look at some – we consider some very small organic growth. It's a little too early, Jonathan, you're correct. It's very early in the first quarter, but we have in our projection seen a very small organic growth.

Q - Jonathan G. Reeder {BIO 18909775 <GO>}

Okay. And then on the military base businesses, do you expect I guess the elevated pace of construction to continue for the remainder of the year? I think Jeff you alluded that had Q1 not been so cold there actually would have been more?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Yeah. In fact we expect that it will not go not just this year, but next year, because typically the awards that they usually made at end of the fiscal year that's where the $142 million of new awards came through. A lot of them are one, no more than two-year construction projects. They may bleed into year three. So that really will affect the next couple of years. And then again when we hit September-October this year, we should see another round of awards, but we are also optimistic and hopeful that we'll see some additional base awards following on the heels on the last one we got.

Q - Jonathan G. Reeder {BIO 18909775 <GO>}

Yeah, that kind of leads to my next question. So I know you were talking about a pretty high number of RFPs or bases that you think are going to come up over the next four years or so. Any in the near term that you think will be decided on that you guys are participating in? And then the kind of second part, when will the new Utah base start impacting results?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

So we'll take the second question first. Utah, frankly, this is a very quick transition. Our folks are really already on the ground. We're going through the hiring process of the employees, et cetera, and I can't remember the specific date. Is it September? September we will be operating the facility.

On the others, in terms of new, I think we have said that there are about six or so that we are – that are in various stages. We're very leery about saying when the awards comes, because it is a process that has ebbs and flows and so it's supposed to be an 18-month process, but quite frankly it's usually three or more years. So they are in various states.

We do think that there will hopefully be some within the next 12 months that will come forward. And when I talked about the roughly 40 or so bases that will be out in the RFPs, remember we're not going after all those. For us they really need to be in the $250 million range or higher or have some strategic positioning value where it may be a smaller contract, but it's got a lot more potential for growth or it's tied to one of the other bases that we're already on. So we will only go bid on a percentage of those.

Q - Jonathan G. Reeder {BIO 18909775 <GO>}

Got you. All right, thanks for the additional clarity and congrats on a great quarter.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Thanks Jonathan.

Operator

Thank you. And our next question is from the line of Leslie Rich with JP Morgan. Please go ahead.

Q - Leslie Best Rich {BIO 19171675 <GO>}

Hi, just a couple quick questions. In your earnings release, you talk about Rex Energy and XTO Energy. Could you give a little more detail about what you did during the quarter with them?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Yeah. Both of these are entities that we have done a fair amount of work with. These are line extensions where we're building a pipeline a distance, and they'll vary on the distance, but to an area where they have got drill sites. And then what happens is they will contribute capital into that pipeline construction. We've put capital into it. It then gets rolled automatically into rates and then the revenues flow as they purchase retail water.

Then any other customers that want to be served off that pipe, we have the right to serve. And so we effectively end up with a certificated service territory awarded by the Commission for the right to serve everywhere around that pipeline. So most of these are going into areas that don't have water supplies today. It gives us that longer-term growth potential through both commercial and retail applications of water.

Q - Leslie Best Rich {BIO 19171675 <GO>}

I'm sorry. How long did you say the pipelines were? Like how many customers around there could you potentially hook up?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

We've done half a mile to 10-mile line extensions. I don't think we've done any that I can think of, Susan, that are bigger than 10 miles yet. But we've done – well, I don't want to give you a number because I don't remember the exact number, but more than a handful of these.

Q - Leslie Best Rich {BIO 19171675 <GO>}

Okay. And then just on the expense side, you said that lower pension expense was a benefit in terms of the lower employee-related costs. What do you expect for the full year on that front?

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

Leslie, we disclosed at Investor Day last December that we thought that pension and other post-retirement employee benefits would have about a $0.06 to $0.08 impact this year.

Q - Leslie Best Rich {BIO 19171675 <GO>}

So most of that was in the first quarter?

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

No, it's evenly spread throughout the year. It is – annually it is a long-term impact. 2014 has a larger impact than the succeeding years.

Q - Leslie Best Rich {BIO 19171675 <GO>}

Okay. And then finally, there was an item that you called 2013 tax benefit from market-based reorganization?

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

Yes.

Q - Leslie Best Rich {BIO 19171675 <GO>}

What is that?

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

Last year in the first quarter we reorganized American Water Resources, which was technically part of the market-based business, structurally legally into AWE and that allowed us to utilize state NOLs that we might otherwise have not been able to utilize. And that was a one-time occurrence the first quarter of 2013 that we did not replicate this year.

Q - Leslie Best Rich {BIO 19171675 <GO>}

Got you. Okay, great. Thank you, and Jeff, good luck.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Thank you.

Operator

Thank you and our next question is from the line of Spencer Joyce with Hilliard Lyons. Please go ahead.

Q - Spencer E. Joyce {BIO 17611965 <GO>}

Good morning, folks. First things first. Congrats on a good quarter, and Jeff, congrats on retirement. You will be missed.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Thanks, Spencer. I appreciate it.

Q - Spencer E. Joyce {BIO 17611965 <GO>}

Yeah. We're getting kind of long here, so I'll try to keep it brief. I was just wondering if you all could give us a little bit of color on the additional $0.01 to $0.02 in West Virginia that are expected to be incurred over the balance of the year? Is that some quantifiable legal liability that you have or is it potentially are you still seeing some demand destruction there? Just what's behind that $0.01 to $0.02?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

It is a combination of things. Yeah, there is a little bit of demand destruction, but it is getting smaller and smaller. But as you know, I think we now, we have 58 suits that we've been named in. They're largely against Freedom Chemical, but they are in bankruptcy, so we're thrown in there. We have had some good success so far in the cases where we moved them into the federal court and the federal judge to which one of them was assigned has taken the action – has taken a very key interest in this and has taken the steps to consolidate all of the cases into one case, which is good thing for the remand purposes. Right.

And so there's – but these things can play out for a while, so it's an allowance for legal costs. It's an allowance for there's still – we may – we're going to continue to do a heightened level of testing for a while, so there's those types of costs that are built into it and little bit of demand destruction.

Q - Spencer E. Joyce {BIO 17611965 <GO>}

Okay. So it...

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Yeah. There's no liability in there.

Q - Spencer E. Joyce {BIO 17611965 <GO>}

Okay.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

We don't believe there is any liability. Kellye, our General Counsel, is making sure that we say it, because it is absolute correct that there is no liability expectation and we have not build that into any of our projections.

Q - Spencer E. Joyce {BIO 17611965 <GO>}

Okay. So at this point, most of it would be more ongoing, as you said, testing, paying the lawyers, things of that nature, but no specific liability?

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Yeah. We tried to see if we could pay the lawyers in-kind through water and they didn't – that didn't work so well.

Q - Spencer E. Joyce {BIO 17611965 <GO>}

Yeah. That would be nice. One final real quick one, you all went into great detail on the Rex Energy and the XTO process there, how you're getting the pipe in and how you're recovering that investment. Is it safe to say – and this can be just kind of a quick one or two-word answer, the regulatory framework there is still pretty favorable. You're not getting any kind of pushback from either local governments or the state regulators relative to what you expected in getting these types of ventures off the ground.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Just the opposite.

Q - Spencer E. Joyce {BIO 17611965 <GO>}

Okay, fantastic. Good quarter. Thanks guys.

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

Thanks.

Operator

Thank you. And our next question is from the line of Shivangi Tipnis with Global Hunter Securities. Please go ahead.

Q - Shivangi D. Tipnis

Thank you guys. Congratulations on a good quarter, and congratulations, Jeff.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Thanks.

Q - Shivangi D. Tipnis

My first question is on, like, you had a very strong first quarter. So wondering what makes you keep the guidance and not really raise it. We would have really liked to see some improvement in the low end of the guidance range. So are you being a little conservative or there are some pieces missing and we would like to know.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

The thing that you find in the water business is the summer makes or breaks the year. And so until, from our perspective, it would take something significant before you change guidance before you get through or at least largely through the summer, because it just can have a significant impact.

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

And also remember that we give annual guidance. We don't give quarterly guidance because of differences in the quarter. We don't reveal our budget, and we don't give quarterly guidance. So for us it's an annual play.

Q - Shivangi D. Tipnis

Okay, thank you for the color. Okay. I'm looking at your slide presentation on slide 23. It looks like your water sales in gallons for industrials, commercial and public is on the rise year-over-year compared to the residential sales. Can you provide some color on exactly what's going on there? Is it kind of a new trend developing or just like lower residential sales due to the weather impact?

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

Actually in my earlier comments, it's about 70% to 75% of this, especially given industrial and commercial, is due to the fact that we report only billed volume while we report billed and unbilled revenue. So at the end of 2013 we held some bills back because of our new system to ensure they were correct for our industrial customers and some of our large commercial. So we actually were able to fix that in the first quarter, so we had a lot more revenue go from unbilled to billed. So when it went to billed revenue we also reported billed volume. So you saw a marked increase. About three-quarters of that increase is due to the fact that we were making up the billings that we had in industrial and commercial especially and some residential.

Q - Shivangi D. Tipnis

Okay. Got it. Thank you. And one question on the market-based operation, so what is the duration of your Homeowner Services business warranty contracts, and how does the pricing and cost recovery mechanism work there?

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

The duration is typically a year. It can be – we can either choose to continue it or the customer can. We have about an 85% renewal rate or higher especially in areas where we currently serve or we have partnerships.

Q - Shivangi D. Tipnis

Okay. And are you able to get – expand this customer base out of these cities where you actually provide your regulated services?

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

Well, when we have exclusive partnership, for example in our Homeowner Services we offer it to our existing customers in several of our states, most of our states and of course they know us and we put it on our bill. Where we have exclusive partnerships specifically New York City and Nashville and we're able to actually put it on bill with the water bill, we tend to see higher take rates.

Q - Shivangi D. Tipnis

Okay. Thank you for the color.

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

And renewal.

Q - Shivangi D. Tipnis

And one last quick – I'm sorry. Go ahead.

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

And renewal, both take rates and renewal rates.

Q - Shivangi D. Tipnis

Okay. Thank you for the color. One last quick question in continuation of the information on the Rex and XTO Energy contracts. Where exactly do you report them? Is that in the industrials or the commercials?

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

It's actually in our regulated segment and it's in industrial.

Q - Shivangi D. Tipnis

Okay. And how big are these contracts and what's the scope of increasing your energy exposure?

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

I think we have reported that last year I believe we sold about $3 million or $3.2 million, $4 million, $3.2 million I think in revenues last year at the regulated on the shale.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Yeah, and this year it's growing strongly. But from a risk perspective keep in mind that the capital that we spend and the investments when it's done on the regulatory side, they're automatically rolled in the rates. So we're not really taking what I would call a capital risk. And the Commission is willing to do that because we're bringing water to areas that don't currently have it and so they view as a very positive development, economic development opportunity for those communities.

Q - Shivangi D. Tipnis

Okay, great. Thank you for the color and congratulations guys.

Operator

Thank you. And I'm showing no further questions. I'll turn the call back to management.

A - Jeffry E. Sterba {BIO 1426511 <GO>}

Okay. Well, I wanted to thank you all again. And I know that you will give Susan and the team the same kind of sharp look and opportunities that you have over the last four years, and I thank you very much.

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

Wait. Before you're off the line, Jeff – given that this is Jeff's last call, I just want to take a few minutes to recognize him. Now Jeff does not know that I am doing so I'm glad that you can't see the look that he's giving me right now as he sits to my right. I do want to just mention we have a slide we want to pull up.

American Water has achieved some extraordinary things during Jeff's tenure as President and CEO. In terms of financial performance, American Water has grown its market capitalization from less $4 billion to more than $8 billion without an equity issuance. We've strengthened our balance sheet with increases in revenue, net margin and cash flow. We've garnered credit ratings increases from both agencies. We achieved our stretch O&M efficiency ratio goal two years early, and both our regulated and market-based businesses have seen impressive growth.

In fact if you have been a shareholder, which you should have, since Jeff joined us back in 2007, you have enjoyed an almost 130% total shareholder return. That has led to a dividend increase year-over-year and today we are one of the leaders in dividend growth. Not too shabby for less than four years' work.

But that's just part of what Jeff is done here at the company from taking the lead in raising the value of water idea on a national basis to shepherding American Water to become the first U.S. water provider on the Dow Jones sustainability index, to creating a culture of continuous improvement. There just aren't many CEOs who have accomplished so much and especially in such a short time. And he's done it in a way that leaves a lasting legacy for us to continue to build upon.

Some of you know Jeff hates to wear a coat and tie. He is much more comfortable in blue jeans riding horses, so right now we tip our hats to him, our leader, our mentor and our friend. And we wish him the best as he rides off to enjoy the new challenges his future brings. And now we're done.

Operator

Ladies and gentlemen, this concludes our conference. Thank you for your participation. You may now disconnect.