Q2 2013 Earnings Call

Company Participants

- Ed Vallejo, VP, IR
- Jeff Sterba, President & CEO
- Susan Story, SVP & CFO

Other Participants

- Andrew Weisel, Analyst, Macquarie Capital Securities
- Angie Storozynski, Analyst, Macquarie Research Equities
- Brian Chin, Analyst, BofA Merrill Lynch
- Heike Doerr, Analyst, Robert W. Baird & Company, Inc.
- Jonathan Reeder, Analyst, Wells Fargo Securities, LLC
- Kevin Cole, Analyst, Credit Suisse
- Ryan Connors, Analyst, Janney Montgomery Scott
- Spencer Joyce, Analyst, Hilliard Lyons

Presentation

Operator

Thank you for holding, ladies and gentlemen. Good morning. Welcome to American Water's Second Quarter 2013 earnings conference call. As a reminder, this call is being recorded and is 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 August 15, 2013, by dialing 303-590-3030 for US and international callers. The access code for the replay is 4628550. The online archive of the webcast will be available through September 6, 2013, by accessing the Investor Relations page of the Company's website located at www.AMwater.com. 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. 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. 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, and such risk factors are set forth in the Company's SEC filings. And now I'd like to turn the call over to American Water's President and CEO, Jeff Sterba.

Jeff Sterba {BIO 1426511 <GO>}

Thanks, Ed. Good morning, to you all, and I appreciate you joining us today. Before Susan Story, our CFO, goes through our financial performance in detail, let me just hit upon some highlights. As you've probably seen from yesterday's press release, our year-over-year Second Quarter results were influenced by the above-average rainfall and cooler temperatures we've been experiencing versus the record-breaking drought and heat that was seen and felt in the Second Quarter of 2012. As you can see on slide 5, this caused a decrease in revenues and earnings per share as compared to the same quarter in 2012. Other items that impacted the quarter-over-quarter comparison include higher depreciation expense, which Susan will touch on, and a retroactive regulatory adjustment that occurred in the Second Quarter of last year.

In addition, looking at slide 5, it appears that our 2013 year-to-date cash flow from operations is lower than the first half of last year, but this is really due to how our bank overdraft is now being treated, as a reduction to operating cash flow as opposed to a financing activity. This is the result of a conscious decision last year to internally manage cash activities as part of our continuous improvement efforts. Year to date, this change in cash flow classification amounts to about $35 million.

Now, obviously, the weather has a significant impact on our business. Our quarterly results really reflect a tale of two springs. Much of the country experienced above-average rainfall and cooler temperatures in the Second Quarter of 2013, in sharp contrast to the same quarter in 2012 when much of the country was experiencing record-breaking drought and heat. If you look on slide six at the precipitation charts, which by the way come from NOAA, the same large swath of the Northeast and Midwest that experienced severely dry weather in Second Quarter of 2012 had either normal or, as is the case with the better part of the Northeast, much wetter than normal and even record wet weather this April to June, so clearly this was an impact on customer usage. However, due to our geographic diversity across 16 states, that impact was somewhat mitigated by increased water consumption in others of the states. Nonetheless, we do attribute approximately $0.01 to $0.02 decrease in earnings per share from weather when compared -- which, when you compare that to the $0.06 to $0.09 increase in earnings per share we attributed to weather during the Second Quarter of '12, that results in a total $0.07 to $0.11 impact of weather when you compare Second Quarter of last year to the Second Quarter of 2013.

Now, turning to the continued growth of our business, we introduced slide seven to you last quarter to illustrate our growth drivers. We have core growth, which includes efforts to reduce regulatory lag and achieve appropriate returns on capital investment, as well as the tuck-in acquisitions that we make and the continued improvement of our regulated O&M efficiency ratio, as well as the execution in our current military contracts and the homeowner services business. Enhanced growth includes larger acquisitions, new expansion into the military business, as well as expanding into new territories and providing new services on our homeowner services business, providing products and services that are new in the municipal and industrial space, as well as continued expansion of the shale gas opportunities that we see in certain territories. Combined, these are the opportunities that we are confident will deliver 7% to 10% long-term earnings per share growth goal.

On the core growth side, during the quarter we completed a wastewater tuck-in, the Koppel Borough tuck-in, in Pennsylvania, which has got about 400 customers and received regulatory approval on the water acquisition of Whitwell, Tennessee, that's about 2,800 customers. And in July we received regulatory approval for the Pratt, West Virginia, water system acquisition of about 450 customers. Those last two we expect will close later this year. But we also made progress on regulatory approval of our pending acquisition of Tri State Utility, which provides water service to about 3,500 customers in the growing Branson, Missouri, area. On the regulatory front, as you know, we filed rate cases in California, Iowa, and Pennsylvania for a total of about $98 million in annualized revenue. While the final rate authorizations have not yet been received, we reached a settlement agreement in West Virginia for an $8.5-million increase in revenues, that's sitting before the regulator for approval, and we implemented interim rate increases in Kentucky for the full $12.3 million just at the end of July and in Iowa for $2.7 million of that request. We've also received a total of $16 million in additional annualized revenues from infrastructure surcharges that become effective in Pennsylvania, Missouri, and New Jersey in the April-through-July period.

On enhanced growth, in May we announced an agreement to acquire Dale Services Corporation. This is one of the larger acquisitions. It's a medium-sized wastewater utility that serves 20,000 customers. We expect that transaction to close late this year. On the homeowner services front, recall that the name of that -- of the company, our subsidiary, is American Water Resources. It announced the non-exclusive partnership with the city of Houston to offer water and sewer line protection programs to more than 550 homeowners. And, last month, American Water Resources was notified by the city of Nashville of the intent to award the company an exclusive partnership to provide its protection programs to approximately 176,000 eligible homeowners. That's very similar to what we've done in New York, the program that we launched earlier this year. And just as an update on the service line protections in New York -- recall that's being offered in partnership with the city's Department of Environmental Protection -- we've seen just really good growth in that program. We've now got close to 100,000 customers enrolled, so that's a penetration rate of getting close to 20%, and nearly all of the customers are opting for both water and sewer line contracts.

Moving to slide 8, we've made some significant progress in two large projects in our California subsidiary since our last call that I want to raise to your attention. Last week, California American Water reached formal settlements with a number of parties, including major environmental stakeholders, in our plans to bring a stable water supply to the Monterey peninsula. These settlements recognize the value of the portfolio approach to the water supply challenge that's presented in that area, which includes an aquifer storage and recovery, groundwater replenishment, and a desalination plant. The range of capital investment that's reflected on this slide reflects the ultimate sizing of the de-sal plant and whether groundwater replenishment moves forward, as well as contingencies on the capital cost estimates. The next step is a pre-hearing on the settlement, which happens in a couple of weeks, and then going forward with the PUC approval, which we would not expect until towards the end of the summer next year. But we're very pleased to have this moving forward and real progress being made on this very critical project for the Monterey peninsula area.

In addition, in June, we broke ground on our landmark San Clemente Dam Removal and Carmel River Reroute Project -- and if you think that's not a mouthful for a project name, they were challenged on how many words they could fit in it. This will be a three-year construction project and is the largest dam removal project ever to occur in California. That's something we're really pleased to be involved in. It includes an innovative engineering approach of rerouting the river around accumulated sediment to restore it to its natural state. Removing the seismically unfit dam will provide many benefits to the region and its residents. First and foremost, it obviously removes a public safety risk posed by potential collapse of the dam in the event of a large flood or earthquake, but it also aids in the recovery of threatened south central California coast steelhead -- and as a fly fisherman that's something I'm particularly care about -- by restoring the natural sediment flow and providing an unimpaired access to over 25 miles of essential spawning and rearing habitat.

The neat thing about this is this really is an innovative partnership between our Company, state and federal governments, and NGOs. Our hats and thanks go out to the California State Coastal Conservancy, the National Marine Fishery Services, the Planning and Conservation League, the Nature Conservancy, and a number of others that we've worked with. We're grateful to our partners in this effort and pleased to see it moving forward. Between these two California projects, we will invest around $200 million or more over the next 3 to five years.

Now, turning to slide 9, combining our performance in the Second Quarter with the strong results of the First Quarter, we are reaffirming our 2013 earnings guidance range of $2.15 to $2.25 per diluted share for continuing operations. This represents an 8% to 13% increase over the weather-normalized earnings per share for 2012 at $1.99. With that, let me turn the call over to Susan for more detail on our finance.

Susan Story {BIO 3335156 <GO>}

Thank you, Jeff. Good morning to you all. It's a pleasure to be with you here today to review the quarter and the year-to-date results ending June 30. Jeff has already reviewed some of the key highlights. I will now take a few minutes to discuss the drivers of our results for the Second Quarter in greater detail.

Turning to slide 11, as Jeff mentioned, our Second Quarter results reflect the impact from unusually cool, wet spring weather with related decreases in revenue, net income, and earnings per share. During the Second Quarter, we reported operating revenues of approximately $724 million compared with $746 million reported for the Second Quarter of last year. Looking back at the exceptionally hot, dry spring we experienced in 2012 versus the weather in spring 2013 and so far this summer, this year-over-year impact on demand is not surprising. Also impacting this quarter's results versus last year's corresponding quarter was a significant one-time retroactive adjustment due to the California rate case effective in June 2012. Additionally, this past quarter, we experienced increased depreciation expenses due to additional utility plant placed in service, including approximately $3.3 million in expenses related to the implementation of our business transformation project. Lastly, the decrease in revenues is also attributable to a decrease in market-based operations, primarily due to the termination of certain municipal and industrial O&M contracts as a result of our on-going business portfolio optimization efforts. Our consolidated O&M expenses for the three months ended June 30 were roughly flat, decreasing $4.3 million [ph] corrected by company after the call [ph], or 1.3% over the same period last year.

Now, let's discuss, on slide 12, the different components of our income from continuing operations, starting with revenue. I also 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 decreased $21.3 million with revenues from our Regulated Business decreasing $19.7 million, or 3%, from 2012. The decrease in revenue associated with the lower demand was approximately $31 million, the year-over-year comparison obviously impacted predominantly by the weather effects, which we spoke of earlier. This demand decrease was partially offset by revenue increases of $15.8 million from rate increases obtained through rate authorizations awarded for a number of our operating companies and additional revenues associated with acquisitions of $2.2 million. Additionally, as I mentioned earlier, in the Second Quarter of 2012 we benefited from a retroactive adjustment totaling $7.2 million as a result of a California rate increase.

For our Market-Based Businesses, revenues for the Second Quarter of 2013 decreased by approximately $2 million. The net decrease in revenues is primarily attributable to lower contract operations group revenue of $5.1 million. These decreases are predominantly related to the termination of certain municipal and industrial operations and maintenance contracts, which amount to around $6.9 million for the three-month period. These contracts were ended as a part of our business optimization effort, designed specifically to optimize margins in our contract operations business. Additionally, revenues from capital project activities associated with military construction decreased $900,000 for the three-month period due to lower levels of work as compared to the prior year.

As we mentioned last quarter, when the military construction revenues were more significantly impacted, the majority of this work should take place later in the year and we have every reason to believe that these projects will be completed as they already have been awarded and approved for construction. Also contributing to the decreases were lower revenues in our residual operations group of $1 million for the three months ended June 30, 2013, compared to the same period in 2012 due to lower levels of work performed. These decreases were offset, however, by a $2.3 million increase due to price re-determinations for three of our military contracts, as well as increases of $4.5 million for the three months ended June 30, 2013, in our homeowner services revenue associated with both customer and contract growth, most notably in New York City.

On slide 13, total operating expenses for the Second Quarter of 2013 increased by about $7.4 million, or 1.6%, from 2012. Operation and maintenance expense in the Regulated Business increased $2.3 million, or about 0.8%, roughly flat compared to the prior-year period. Production expense decreased approximately 3.4% for the three months ending June 30 as a result of the lower production in sales during the Second Quarter. Operating supplies and services increased $8.6 million, or 18.3%.

It's important to note this is primarily due to higher contracted services resulting from about $6.2 million of incremental temporary labor costs related to the continued maturing of the ERP process implementation related to Phase I of our business transformation project. These enhancements are necessary for ongoing and future efficiency improvement resulting from our new SAP system. Also contributing to increases in operating supplies and services in the Second Quarter of 2013 were operating costs associated with the New York acquisition. Partially offsetting these increases were lower transportation expenses due to a reduction in leased-vehicle cost.

Maintenance, materials and supplies decreased $1.8 million, or 11.1%, for the three months ended June 30, 2013, mainly due to lower tank painting costs in our New Jersey subsidiary of $1.4 million. Employee-related and other decreased $2.2 million, primarily due to decreased pension expense. The decrease in pension expense for the three and six months ended June 30, 2013, was primarily due to decreased contributions in certain of our regulated operating companies whose costs are recovered based on our funding policy, which is to fund at least the minimum amount required by the Employment Retirement Income Security Act, or ERISA Act, of 1974. Other operation and maintenance expenses include casualty and liability interest premium and regulatory costs. For the three months ended June 30, 2013, cost decreases were primarily driven by lower casualty interest costs as a result of historical claims experience and retroactive adjustment.

In the Second Quarter, we also reported a higher depreciation and amortization expense of $8.8 million and a higher general tax expense of $2.1 million. The increase in depreciation and amortization is primarily due to additional utility plant placed in service, including a depreciation expense of approximately $3.3 million for our business transformation project, which has a much shorter depreciation schedule than most of our other utility assets. None of our basic costs have been disallowed from rates at this time. The increase in general tax expense is primarily due to higher property taxes incurred as a result of our New York acquisition in the Second Quarter of 2012. The Market-Based Business operations decrease in total operating expenses corresponds with the decreases in revenues, which I have previously described.

Turning now to slide 14, we have included a new slide to better explain the period-over-period difference in our earnings per share figures. As you can see from this chart, we have broken out the positive $0.06 to $0.09 impact of weather for our 2012 results, as well as the net impact of the retroactive adjustment of $0.03 from the California rate case, which was booked in June of 2012. After taking these extraordinary events into account and using the midpoint of our weather impact, we get to what we consider a normalized earnings starting point for the Second Quarter of 2012 -- $0.555 per share, or $0.56 rounded up. From there, we have laid out various elements that explain the difference in our year-over-year earnings per share results.

I'm not going to go through each one, but I do want to point out a few things here. First, just for clarification, you do note here a $0.02 impact to earnings due to depreciation and we had shown a $9 million expense increase in the expense slide. For all of you modelers out there, the impact of a $9 million in depreciation expense is split on this slide between the $0.02 decrease in the depreciation bar, as well as being reflected in the 2012 California rate case decision and the New York acquisition bars. Second, we have broken out the weather impact for the Second Quarter of 2013 from declining customer usage from other factors on this chart. And lastly, you also see a teeny increase quarter over quarter due to lower interest expense, and this is due to us taking a proactive approach to looking at refinancing alternatives. For the quarter, our interest expense was reduced $2 million. For the June 30 year to date, it has been reduced by $3.5 million.

Now, let's look at the regulatory highlights for the quarter. Slide 15 utilizes the expanded rate base -- rate case template we introduced last quarter, showing formal rate cases awaiting final order, which we separated between those filed for 2013 versus those filed in 2012, and also any step increases or DSIC filings which impacted the quarter or are still pending. Including

Pennsylvania, Iowa, and California, we now have approximately $98.5 million in requested additional revenues from formal rate cases filed this year. And, looking at the timing of these rate cases versus previous years, the rate cases we expect to resolve in 2013 should be towards the end of the year versus mid-year in 2012 when we had three rate cases finalized in the Second Quarter.

As Jeff noted earlier, West Virginia's water and wastewater cases have a settlement agreement in place reached by West Virginia American Water, the PSC staff, and the Consumers' Advocate Division, subject to the formal PSC ruling expected in the Fourth Quarter. Kentucky rates were increased $12.3 million on an interim basis, subject to refunds effective in July. Under Kentucky regulation, if an interim increase is put into effect, only the full amount of the rate increase request is allowed prior to the formal PSC decision, which we expect in October of this year. Of note, our first infrastructure charge in New Jersey took effect on July 1 for $4 million in additional annualized revenues.

In our continuing efforts for transparency, we have created a new slide, which you can find in the appendix, slide 25, entitled Regulated Utilities -- Rate Base and Allowed Return on Equity. Many of you have requested this data showing each of our regulated businesses' authorized rate base, authorized ROE, authorized equity, and the effective date of the rate case used. We have included this information for our 10 largest regulated subsidiaries on this slide. These are historic cases and we advise you to review the footnotes for a fuller understanding of the particular case in question. While you can never project how any new case will be determined, we hope this will help you understand our rate environment.

Turning now to slide 16, this is a slide we introduced to you last quarter, which illustrates our commitment to keep our cost structure efficient and utilize the majority of our requested customer rate increases to fund capital investments, which improves infrastructure, system resiliency, and customer service. This is also a validation of our continuing efforts to meet our O&M efficiency ratio goal as shown on slide 17. You will note that, despite the revenue challenges we faced in 2013's Second Quarter, we have maintained a 40.4% ratio for the last 12 month ended June 30. And, finally, as part of our commitment to shareholder value, last week we announced that our Board of Directors declared a quarterly cash dividend payment of $0.28 per common share, payable on September 3, 2013, to shareholders of record as of August 19, 2013. This continues our commitment to an annual dividend payout goal of 50% to 60% of net income. With that, I'll turn the call back over to Jeff.

Jeff Sterba {BIO 1426511 <GO>}

Thanks, Susan. If you go to slide 19, this is a slide on expectations for the year that we use every quarter. Nothing's changed. We've already really spoken about our progress on all of these efforts, which will anchor our long-term earnings per share goal of 7% to 10%, which we continue to be committed to and believe is achievable. Let me call your attention to one item and that's the issuance of our new corporate responsibility report, which covers the years 2011 and 2012 in terms of data, and you can find this on our website. Our commitment as a Company, from the Board level down, to Corporate responsibility and sustainability is truly one of our Company's guiding beacons, and we're proud to be the only water company in the US that's included in the Dow Jones sustainable index. Lastly, let me also just remind you, I know a number of you probably have it already marked off on your calendars, but we will be hosting our 2013 Analyst Day at the New York Stock Exchange on Tuesday, December 17, and we'll provide you more information about this in the coming months. With that, we'd be happy to take any questions you may have.

Questions And Answers

Operator

Thank you, sir. [Operator Instructions]

Kevin Cole, Credit Suisse.

Q - Kevin Cole {BIO 18674088 <GO>}

I see in June the EPA released another study indicating that the US will acquire about $400 billion in clean water infrastructure -- I think it was next 15 years or so -- but I guess if I look back those dollars are rarely spent. Do you see any changes in federal or state policy, either on the policy front or the enforcement front, to actually require action going forward on either the clean or the wastewater side?

A - Jeff Sterba {BIO 1426511 <GO>}

Kevin, I think, frankly, it's enforcement actions being taken largely through consent decreases on the wastewater side that are really starting to create some challenges and tension for a lot of municipalities. On the water side, the drinking water side, probably a little less so. There isn't a driving issue like arsenic was a few years ago that's mandating investment, although probably the next one that has attracted some attention is the chrome 6 issue, which is one that we've really got our hands around already. So again, it's this notion of -- that infrastructure is out of sight out of mind the level of investment is trailing. That's why you see the average investment cycle of 250 years really going up to 350 years whereas we as a Company are about 125. It's an issue that's attracting attention, but I don't think there's a solution. Well, there's not necessarily a solution that a lot of municipalities are yet facing up to and that solution is really you've got to bring private capital in because the federal money is just not going to be there.

Q - Kevin Cole {BIO 18674088 <GO>}

I guess I saw a couple weeks ago like San Antonio, I guess the EPA forced San Antonio to spend around $1.2 billion given they were -- they didn't scale up their systems to population growth so they're viewing waste waters, I guess just raw waste into the water. So are you seeing that as the most actionable vehicle of growth given the EPA is actually fining those systems?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes, the wastewater site is the one that is more susceptible to enforcement and you've got -- gosh, I can't -- I saw recently the number of cities that are under enforcement action. I don't remember the number but whether it's Kansas City, which is a large metropolitan area, or a smaller city like Chattanooga, Tennessee they've got multi $100 million enforcement actions. The challenge will be how strongly does the EPA enforce the timing of it. Do they give them slack so that instead of it needing to be done in the next five years, oh well, we'll give you seven or 10? That's where we've seen slippage in the past.

I would say one of the things Sandy brought to light was the risk when you have increased volatility of weather and the risk of flooding and the like, whether it be from storm surge or rain or what have you, is the amount of untreated or only partially treated wastewater that got dumped, and that is, I think, a risk that is starting to attract a lot more attention. Just with Sandy it was over 11 billion gallons of raw sewage that was dumped and so that's a broader-base challenge but it puts a focus on the issue of adequate wastewater treatment and doing the right things relative to storm water. So I'm hopeful that the EPA will keep the pressure up to ensure that we as a country are doing the right things. I think it's important that environmental groups and others help support that.

Q - Kevin Cole {BIO 18674088 <GO>}

Thanks. Actually I have an obnoxious question for slide 23 just because I know somebody's going to ask me this question later.

A - Jeff Sterba {BIO 1426511 <GO>}

How obnoxious?

Q - Kevin Cole {BIO 18674088 <GO>}

Is your 7% to 10% -- is it right to think about your 7% to 10% EPS growth rate being anchored to 2012, or if I'm looking at 2014 should I re-anchor it to the midpoint of 2013?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes, we've always talked about it as long-term growth rate and so that's the anchoring in 2012. I know every year we get pushed about, well, so is it off the new base and we're trying to say, look, 7% to 10% is the long-term growth rate and yes, we're anchoring it off 2012, even though our range is above that and, of course, we'll provide you a range for 2014 as we get -- probably in the December session.

Q - Kevin Cole {BIO 18674088 <GO>}

Okay. And then is this chart to scale, because if I look at -- if I apply a 10% growth rate to the $1.99 I get $2.19 and that's kind of close to the midpoint of this year's guidance not at the bottom. So am I just not understanding the chart or is it just not to scale?

A - Ed Vallejo {BIO 20515524 <GO>}

Hey, Kevin, it's Ed. Yes, it should be up to scale so let me know when you have that service that sees if it is to scale if it doesn't work out or not, but on our side it is.

Q - Kevin Cole {BIO 18674088 <GO>}

Okay. Great. Thank you.

A - Jeff Sterba {BIO 1426511 <GO>}

I always get nervous because we've got both engineers and financial players and whether it's something they put it on logarithmic paper or what I always get a little nervous. Just kidding, Kevin.

Operator

Ryan Connors, Janney Montgomery Scott.

Q - Ryan Connors {BIO 15032883 <GO>}

So I wanted to get some thoughts on the regulatory side and we're coming off of the recent NARUC summer meetings, I'm sure you had folks there and you got some briefings, Jeff. Anything jumping out at you in terms of the evolution of the regulatory environment in water, either positive or negative and either specific to any mechanism in a specific state or just the terms of the overall tone?

A - Jeff Sterba {BIO 1426511 <GO>}

I guess the ones -- a couple that I'd just touch on. We are getting increased understanding and recognition about the issue of declining use. I think this is one where the industry was slow on the up take but is rapidly trying to move this forward. So frankly, there hadn't been much of anything done up until really probably the last three years or so, except in California where there's an overall policy mandate. So I think that's on the positive side.

I think on the risk side is, okay, so what does -- where do returns go and how successful are we in helping people understand that when you have artificially held down risk-free rates that that doesn't necessarily change the cost of equity and I think we've seen what's probably best described as mixed results. There are some states that have gone fairly low. I think the majority of our states have approached that with a more reasoned and tempered response in thinking about what that cost of -- what's an appropriate cost of equity. I think the two things that we keep a real ear on are the issue of degree of rate change so that we don't push that frontier too hard, yet at the same time we have great reception to the investment of capital. And so as we've talked to regulators about the chart that Susan has talked to you all about how we've shifted how much rate increases are capital versus O&M base that's something that they perceive as positive. I think those are the issue of declining use and now, frankly, you're starting to hear a lot of electrics say, oh, we no longer have growth and so they're starting to scramble on that issue.

Q - Ryan Connors {BIO 15032883 <GO>}

How do you see that evolving, Jeff? Will it be -- is the talk of a California-style ram based decoupling, or are there other approaches that you see prevailing?

A - Jeff Sterba {BIO 1426511 <GO>}

I think each state has to approach this on the basis of its own regulatory background and philosophy. There are some that they look at the California ram mechanism and they wonder if it's too complex for them, is there a different way do it, is there a way we can build it in the base rates? What is it we're trying to protect against? Is it all changes in consumption, or is it just the intrinsic on-going reduction in use per customer so what is it that we normalize at? So I think we'll see and we are seeing states take a number of different approaches. I think the one that most states move to most readily is, okay, let's take into account what you've seen over the last set of years -- five years, eight years, whatever it might be -- and build that into your future and let's try to step and then we negotiate how far forward do we step to get the billing determinants, if you will, the denominator right.

I think automatic adjustment mechanisms create some nervousness of regulators unless they come out of that mechanism. For example, Florida has a number of mechanisms, California has a number of mechanisms and New York has a number of mechanisms that has just been part of their regulatory psyche. Other states a fuel and power adjustment clause, and on the water side maybe an electric energy supply clause or something like that. That may be about all they're comfortable with so I don't know how many states will adopt an automatic mechanism as opposed to recognizing the pressing nature but do it in a different way. Susan, do you have anything to add?

A - Susan Story {BIO 3335156 <GO>}

I think consistent with what Jeff said, we take very seriously our responsibility on water efficiency and so we are proactively working with all of our states in terms of how we can promote water efficiency and to address the kind of usage through, as Jeff has said, either decoupling tight mechanisms, looking at revenue adjustment for future test years, looking at performance incentives for some of the water efficiency programs, so we're really looking at lots of different options to address the same issue. And also on the key elements coming from NARUC and looking at some of the commentary, as well as hearing from some of the people there, the commitment of state regulators to the replacement of aging infrastructure may be as strong as it's ever been. The recognition that this is something we have to address and that if we begin to address it today that it will be far better than waiting until we have more severe problems in terms of main breaks, leaks and the economic impact of that. So I think that we've seen increasing and growing commitment to that and as Jeff said, what that means to us is how do we find a way to promote that investment while also controlling price increases to the customers and that is through our control of O&M so that any, or most the majority of price increases will be for investment and -- the CapEx investment and not O&M expense.

A - Jeff Sterba {BIO 1426511 <GO>}

One of the things that I think that all that says is -- and of course, we may have bias but if I was going to focus on communities that have the greatest potential for growth and expansion because they're going to be able to provide service to customers and not have main breaks, et cetera, I'd look to those communities that are -- have provided service by privately-held companies that are regulated. Because Susan's exactly right, we're seeing recognition of that on the regulatory side, unfortunately not in all communities but in a number of communities your a politician elected today that's an out of sight out of mind investment, it's a little harder to make or a little easier to set aside and not necessarily keep up with that infrastructure. I think there are some cities, which -- and I commend. I'll commend Chicago for what they're trying to do and

Philadelphia for what they're trying to do in terms of their green cities initiative. I don't mean solely them, I think New York also is there and there are others that are there. But boy, there is a whole host of that 50,000 communities, or individual utilities that that's not necessarily getting done.

Operator

Heike Doerr, Robert W. Baird.

Q - Heike Doerr {BIO 15084832 <GO>}

First off, thank you for the added details in your earnings material, I know it's high effort, it's much appreciated by all of us.

A - Jeff Sterba {BIO 1426511 <GO>}

We try to listen to you all, Heike.

Q - Heike Doerr {BIO 15084832 <GO>}

We like to keep you busy, Jeff.

A - Jeff Sterba {BIO 1426511 <GO>}

You're succeeding.

Q - Heike Doerr {BIO 15084832 <GO>}

Can you share with us what ROE was stipulated in the settlement that's pending in West Virginia?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, yes, sort of. What happened is that the party submits as part of their testimony a basis for the cost of service that's been agreed to. It is a black box settlement so there isn't a formal ROE. What we have submitted and what -- and I'm trying to remember which party it is that joined us with that --Consumer Advocate submitted -- we submitted a cost of service and the Consumer Advocate did that the ROE is at 9.9% whereas the staff has submitted a cost of service that uses a 9.75%. They get to the same revenue requirement, so it gets to the same rate levels, they just go about it in a different way. So I think it's --

Q - Heike Doerr {BIO 15084832 <GO>}

Understood.

A - Jeff Sterba {BIO 1426511 <GO>}

We've [inaudible] 9.9%, but it's in that range.

Q - Heike Doerr {BIO 15084832 <GO>}

Okay. Can you give us an update on where you are on portfolio optimization? Are there still states you're weighing whether or not it makes sense to be in and where on the contract operations side are we on that process?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, on a regulated side, as we've said before, the lions' share of any optimization has been done. We will remain open to looking at whether it's interstate or intrastate opportunities. I can't tell you that there's a state -- we're not in the process of saying there's a state we want to exit. We're comfortable with what we've got but we will always look at opportunities to optimize that. On the contract operations side, by and large most of it has been accomplished, moving us into a set of contracts that we can operate in a much more profitable way, starting to shift the way that we're thinking -- we're looking at how that business expands and being very specific and focused about what we won't go back into. We had to work -- our people did a heck of a job in extracting ourselves out of some contracts and arrangements that just were not profitable and the last thing we'll do is go back into those.

Q - Heike Doerr {BIO 15084832 <GO>}

Okay, that's helpful. How should we think about your CapEx budget and this Monterey Peninsula water supply project? Will that project -- I know it's spread over a longer time period, will it just push you up within that band, or may there be some years that you'll need to spend above that $1 billion we've been talking about at the top end?

A - Susan Story {BIO 3335156 <GO>}

Heike, this is Susan. The expenditures for those projects are included in our forecast for -- we this year have said we will spend about $950 million in CapEx. We are looking and there is a range you saw based on some things that haven't been decided yet; the size of the plant, how we're going to approach I believe it's 6.4 million gallons per day versus 9.6 million and 6.4 million would have bigger groundwater replenishment. So we're really working through right now what that will be based on some of the final decisions on that project, but we anticipate those will be rolled into our CapEx guidance for each year.

Operator

Jonathan Reeder, Wells Fargo.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Following up on Heike's question there a little bit. So on a going forward basis is $950 million, is that going to be the bottom end of the range or can we get above the $1 billion, especially when I guess you're looking at the rate cases that are driven more on the CapEx side than the O&M side. Do you have room to get more aggressive with the CapEx budget?

A - Jeff Sterba {BIO 1426511 <GO>}

Jonathan, I guess -- the answer I'm going to give you is we're certainly looking at the level of CapEx given what we think our future expenditure level will be that we can put in and maintain the kind of rate levels that we think we can sell with our commissioners and customers. We'll talk more about that in December in terms of what that really looks like, but is there a potential for an $800 million -- the $800 million to $1 billion that we've used for the last couple years to shift over the next five years? The answer to that is yes. What it shift -- what it might shift to and how much it shifts, if it shifts at all, we'll talk more about it in December.

Right now we've got a plan that, as Susan said, has California included in it. Remember, one of the things that's happening is we've been spending about $100 million a year on BT. That disappears this year so there's $100 million there that was going to that project which now is going to be available to go into hard infrastructure on the regulated side so that's still at the current -- at the same current level. But we are -- we're still not spending for a 100-year replacement cycle, for example, and that's our goal, to get to a 100-year replacement cycle because that's really the outer limit of what we think the life of most of these systems are.

A - Susan Story {BIO 3335156 <GO>}

And there's a lot of things we look at, Jonathan, on this. Part of it is, again, not just the flat amount but what does that mean in terms of our equity needs. We've gone on the record that we do not anticipate issuing equity under normal business operations for the foreseeable future so we run a lot of scenario now. We also are looking, for example to Jeff's point, of next year not having to be key expenditures. What does that mean in terms of our distribution system infrastructure charge, which reduces regulatory lag? This year about 39% of our CapEx will be [inaudible] just as a matter of the DQ rolling off, which isn't eligible, that% could go up next year. When we run the analysis of the overall target we look at a lot of factors, including both the reg side and the market [inaudible].

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay, then I guess as we are looking out our cash flows continue to improve if CapEx doesn't meaningfully increase, what's the balance you're looking at between, I guess, equity -- appropriate equity ratio at the consolidated level, dividend increases, redeploying the cash, everything like that?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, you kind of gave what the basket of opportunities are. We are clearly not going to weaken our cap structure, but as we've talked about before we don't necessarily see an over riding need to strengthen it necessarily either. So the 44% equity that we're at today will by nature go up a bit, but we've got room to issue debt to the extent that our total CapEx or other expenditures, for example the kinds of acquisitions like the one we're doing in Virginia that's a little larger, more of those, so we've got head room to do that. If you are poking around at so is there a stock buy back on the horizon, those are things -- we do not have stock buy back planned at this stage. Those are things that are an ongoing part of the business. We're focused on the right amount of capital first to invest in the business and that's a function of both what we can afford through rate making process and the amount of free cash flow that we have in head room on the debt side so I kind of leave it there. We'll give you more color about -- of a forward look at the five years as we hit December.

A - Susan Story {BIO 3335156 <GO>}

And that's December 17th, analyst day.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay, and, yes, Jeff, you're right. And then I guess last question, maybe more for Susan. As we look at the operating expenses and everything, why weren't production costs maybe down a little more than what they were given the large decrease in customer demand?

A - Susan Story {BIO 3335156 <GO>}

Most of the -- most of our biggest expenses in production is in energy and chemicals and we did see a decrease in both of those. Chemicals we did have in some areas a little bit of an increase due to just some of the operations but they were consistent. Production cost decreases were relatively consistent with the sales decrease. Remember, on the revenue the $15.8 million make up in the revenue we only showed $8.6 million on the slide because that netted out to $7.2 million from 2012 from the California retro, so in terms of anything else on the production.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. So you're saying the production costs were down in line with the decreased customer demand as you would have expected?

A - Susan Story {BIO 3335156 <GO>}

They were down in line, mostly energy chemicals. Chemicals may not have gone down as much on a straight-line correlation because we did have some chemical increased costs in a few areas, but energy was and chemicals were down and those are the two predominant components of those expenses.

Operator

Spencer Joyce, Hilliard Lyons.

Q - Spencer Joyce {BIO 17611965 <GO>}

I'll also thank you for the additional slide color out there this morning.

A - Jeff Sterba {BIO 1426511 <GO>}

Good.

Q - Spencer Joyce {BIO 17611965 <GO>}

Two hopefully pretty concise questions for you. One, on the New Jersey desic [ph] that we had go into effect in July how often should we look for reups on that? Is it going to be a little bump every three months like PA, or maybe semi-annually like the isserus [ph] in Missouri? How often can we look for a bump there?

A - Susan Story {BIO 3335156 <GO>}

That's a great question and I'm glad you asked. The regulations say we can file up to twice a year in New Jersey for the desic. Some of you may have noticed there was some earlier material that said we filed for $6.3 million and I just noted that have annualized increase of $4 million. Because of the way that the regulation was worded it appeared that we could go in and so we had anticipated doing seven months on our first filing, five months on our second. The staff really -- and rate counsel really preferred that we do six and six so that accounts for difference in six, three and the four, but rather than being affective August the 1st it was effective July the 1st. So short answer, it's twice a year, up to twice in 12 month, and we have further guidance that the preference is every six months.

Q - Spencer Joyce {BIO 17611965 <GO>}

Okay, fantastic. Second other question, totally switching gears. Congrats on the Nashville and Houston awards there on the market base side. What's the roll out time on those, how soon can we -- or should we be expecting some material revenue impact from those?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, Nashville, we've got go through the con -- the formal contract and so that can take 30, 60 days, something like that so it takes a little while and then we have to put together the plan with the city because in that instance this is an exclusive arrangement and it will go on their bill. It won't be until close to the end of the year before it could get rolled out.

On Houston, frankly, I think that's already out there. We are starting to take customers into it, we've had advertisements and releases that have gone out and it's hit the newspapers in Houston. It is non-exclusive and so it's a little easier. They're basically just endorsing a couple of programs. That one's moving forward. Nashville one, because it is exclusive, has more potential, probably won't really be out and customers signing up until the end of the year.

Q - Spencer Joyce {BIO 17611965 <GO>}

Another question just popped up. On the exclusive or non-exclusive, looking over some of the historical places that you've serviced what's the penetration rate difference between places you serve exclusively and non-exclusively?

A - Jeff Sterba {BIO 1426511 <GO>}

In those areas where we are on the bill, so we're on the water or a wastewater bill, we see penetration rates that are up into the 30s and we have disclosed that before, so in the low 30s kind of range.

Q - Spencer Joyce {BIO 17611965 <GO>}

Okay.

A - Jeff Sterba {BIO 1426511 <GO>}

When you're not on a bill it noticeably drops off.

Q - Spencer Joyce {BIO 17611965 <GO>}

Okay.

A - Jeff Sterba {BIO 1426511 <GO>}

But we don't give specific penetrations.

Operator

Angie Storozynski, Macquarie.

Q - Angie Storozynski {BIO 15115714 <GO>}

I wanted to talk about two things about your enhanced growth. So first of all, the military contracts I know that you are awaiting a number of them to be announced, do you see any impact from the federal sequestration on the timing of those tenders being announced?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, it's always hard to tell on the timing. The schedule -- the optimistic schedule is 18 months from the time first bids are made to the time that awards are made and that hasn't necessarily ever happened. So honestly, we are still seeing strong activity, in fact it's picked up. The challenge is now there is a 20% sequestration in a number of the areas the we work with because they didn't do it until the second half so they're having -- they're a little higher on the furlough side, and so we are seeing a little bit of a slow down. But I can't -- it doesn't seem like it's significant. Things are still moving forward and we're seeing a pick-up of activity, particularly in the Air Force. In one sense I wish I could tell you we're still seeing strong response but we keep the eye out about are they really going to be able to keep the pace.

Q - Angie Storozynski {BIO 15115714 <GO>}

Secondly, you mentioned potentially larger acquisitions as the way to the enhanced growth of earnings going forward. Could you put it a bit of in a context? We have some sour memories from the large acquisitions and how dilutive they used to be, equity needs and regulatory lag, how can you avoid these and also how can you convince the big sellers to give their assets at book value without any goodwill issues and things like that?

A - Jeff Sterba {BIO 1426511 <GO>}

Very good question and there's a couple pieces to it. In the sense I would give is the Dale Service. In the send of how big our Company is it doesn't seem large, but 20,000 customer is a large acquisition in this world. Those kind -- these acquisitions, we're very disciplined about the ability to get what we pay in rates. If we don't think we can get it into rates we're not paying it. Now, that does not mean there won't be a premium because there are some states that allow a premium under certain circumstances.

So if we're able, by virtue of that acquisition, to avoid a capital investment or to lower overall costs then acquisitions can be allowed. Now we're still sitting on acquisition premiums made with the Citizens, for example. You're not going to see something like that. Neither Susan nor I nor anybody else in this Company has any appetite for paying major premiums that you're basically going to be accepting a lower return on because that's just not our philosophy about this. But things -- you are seeing certain communities that get challenged and we have a very disciplined approach about what is it that that state will specifically allow and if they want more than that, well, that's interesting. We're not going to pay more.

Q - Andrew Weisel {BIO 15194095 <GO>}

Is it easier for you to buy large wastewater systems as opposed to fresh water?

A - Jeff Sterba {BIO 1426511 <GO>}

Easier? None of this stuff's easy because it's got politics wrapped around it and all sorts of other stuff. To me, and I think to us, wastewater is much more of an area that's got greater growth potential because wherever we serve water someone's providing wastewater and so we're already known in those communities and that most of the time is not us. We think that provides a market, particularly given that wastewater is not necessarily held as dear on the municipal side as drinking water is even though it's all one water, so we think that wastewater has significant potential for us.

Operator

Brian Chin [ph], Merrill Lynch.

Q - Brian Chin {BIO 20276978 <GO>}

On the Monterey Peninsula water supply project, obviously this has been a long-running project, could you give us a sense in the settlement to what extent you have cost over-run protections and/or are there monitoring requirements as the project is underway that help give regulators and yourselves a sense of how expensive the project cost is projected to be?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes, at this stage we only have estimates and that's what's reflected in the agreement and part of that is because there are some -- a couple of outstanding issues in terms of the recharge project so there isn't the ability to have certainty on what those costs are yet. As we get those resolved -- those kinds of significant issues resolved then I would expect that we'll have much firmer -- that's why we're giving you a range at this stage, so there isn't a number that someone can say, oh, well, it can't exceed this because its specifics of the project are not yet fully resolved.

Operator

Thank you, sir, that was your final question.

A - Jeff Sterba {BIO 1426511 <GO>}

Let me just thank you all very much for your questions and for your interest and we look forward to talking to you next quarter and don't hesitate to call Ed if you've got any questions in the interim. Thanks much.

Operator

Thank you. That concludes the American Water Second Quarter 2013 results conference call. Thank you for participating, you may now disconnect.