Q1 2013 Earnings Call

Company Participants

- Ed Vallejo, VP, IR
- Jeff Sterba, President & CEO
- Susan Story, SVP & CFO
- Walter Lynch, President & COO, Regulated Operations

Other Participants

- Angie Storozynski, Analyst, Macquarie
- Heike Doerr, Analyst, Robert W. Baird
- Kevin Cole, Analyst, Credit Suisse
- Neil Mehta, Analyst, Goldman Sachs
- Ryan Connors, Analyst, Janney Montgomery Scott

Presentation

Operator

Good morning. Welcome to American Water's First 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 May 15, 2013 by dialing 303-590-3030 for US and international callers. The access code for the replay is 4613407. The online archive of the webcast will be available through June 7, 2013 by accessing the Investor Relations page of the Company's website located at www.amwater.com. [Operator Instructions]

I would now like to introduce the 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, everybody. Welcome to American Water's First Quarter 2013 conference call. As usual, we will keep our call to about an hour, and at the end of our prepared remarks, we will have time for questions.

So, although we do have a new CFO on the call today, we do have our same cautionary statements concerning forward-looking statements. So before we begin, I'd like to again 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.

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 appreciate you joining us for the call this morning.

Besides Ed, I'm joined in our presentation by Susan Story, our Senior Vice President and CFO, whom a number of you I know have had a chance to meet, and she certainly looks forward to visiting with you -- each of you all over the coming months.

In addition, Walter Lynch, Head of our Regulated Operations, and Mark Chesla, our Controller, are here to help as needed with your big questions.

Though we're pleased to present our First Quarter results, let me start by hitting on a few key themes for the quarter centered around our overall financial performance, execution of our regulatory strategy, and third, the success we've had in growing both our reg ops and our Market-Based business. Because, obviously, all three are important drivers of our long-term growth.

So going to slide five, you can see that we are off to a good start for 2003 with strong financial results. For the First Quarter, we reported a 17% increase in income from continuing operations and a 14% increase in earnings per share from continuing ops, as well as increases in revenues and cash flows. Our consolidated return on equity for the 12 months ending March 31 was 8.29%, an 83 basis point improvement from the 7.6% return for the comparable previous last 12 months. As Susan will go into more detail about those results in a moment, let me move to slide six and talk a bit about our regulatory strategy.

As you are probably aware, we have filed rate cases in Pennsylvania, Iowa, and California requesting approximately $98 billion in annualized revenues. With all three of these requests, the main driver is the needed investment in our system. As wastewater service and water providers, we have a responsibility to invest wisely, updating and maintaining the many components that assure the reliability of service for our customers. So, for example, in Pennsylvania, we've invested approximately $731 million since the last rate case in April of 2011. In Iowa we've invested $26 million since our last case, and in California, which remember has a three-year forward-looking rate case process, we anticipate a total investment of $130 million over the next three years.

Two of these filings, Pennsylvania and California, are future test year cases. And this is important because obviously what we've been talking about is, how do we reduce regulatory lag so we are promoting the expansion of future tests years and other mechanisms? So in Pennsylvania, Acta [ph] 11, which was passed last year, enabled full future test year cases. California has had them for a while.

In Iowa, the filing uses known and measurables for a forward period of investment, costs and usage to take into account the continued decline in usage from our residential customers.

In Pennsylvania, additionally, Acta 11, which was passed by the legislature last year, allows us to consolidate water and wastewater costs and rates, and this enables the rolling in of wastewater systems into our overall system and costs and facilitates wastewater system acquisitions. This will be the first case filed that implements those provisions of Acta 11.

Now, that said, we're also very mindful about the need to balance needed investments with the customer impact and we remain and will continue to be diligent about managing our costs. Our Regulated Businesses continue to increase operating efficiency, resulting in an O&M efficiency ratio over the last 12 months of 40% compared to 41.8% over the same previous 12 months. Now Susan will talk a bit more on how this focus on expense controls allows us to more efficiently use our capital and the headroom that we believe we've got under what would be appropriate rates.

We also continued to utilize mechanisms that reduced regulatory lag and maximized our ability to replace existing aging infrastructure. Our largest three states have the ability to recover CapEx costs through infrastructure surcharges, and that's certain CapEx elements, not all. It is typically the distribution infrastructure side where we are replacing infrastructure that doesn't add incremental revenues.

And, so, now that we have the DSIC mechanism in place for New Jersey, we anticipate about 39% of this year's CapEx spending, which is about $950 million, will qualify for recovery through these mechanisms. I think three years ago you'll go back and it was in the high teens. We are now at 39%, and I think that that shows the significant progress we've made in our regulatory strategy.

Turning to slide seven, let me just talk about the growth of our business a bit, and let's break it into two parts, as shown in the water picture slide that you can see, and I credit whoever came up with a water picture for a water company. It's so unique, so innovative. Just kidding.

We have core growth, which includes efforts to reduce lag and seek appropriate returns on our capital investments, tuck-in acquisitions, the continued improvement of our Regulated operating efficiency, as well as continuing to grow our military contracts and homeowner services business. And then there's our enhanced growth, which includes medium to large acquisitions providing new products and services and expanding into new territories in our homeowner business, pursuing concessions and longer-term contracts and continuing the expansion of our shale gas opportunities and other new business lines. Combined, these are the opportunities that will deliver our 7% to 10% long-term earnings per share growth.

Since the beginning of this year, we've had a number of successes in both buckets. We've completed five tuck-in acquisitions already in the First Quarter and also signed two agreements for acquisitions, which all added together will add more than 22,000 customers to our base.

One of these agreements, which we show under the enhanced growth area, is the acquisition of Dale Service Corporation, a regulated wastewater utility in Virginia that serves approximately

20,000 customers. That's a sizable wastewater acquisition expanding our operations in this important sector.

As we've talked to many of you, we view the wastewater area as an area of significant growth potential for us. It's something that we're very heavy in on our Market-Based side, but it only accounts for about 4% or so of our Regulated operations.

Our Homeowner Services business reached its 1 millionth contract milestone this quarter, partly due to the launch of the partnership with New York City to provide service line protection programs to its 650,000 eligible homeowners. I've got to tell you. Response to this has been very strong. We now have more than 80,000 customers. So about a 12% penetration rate in only one quarter of marketing, and we have got nearly 160,000 contracts, which means that almost all of the customers signing up are taking two products.

On the shale energy front, we added five new connections with shale drilling companies and signed an additional agreement with XTO Energy. That's the third pipeline extension in Butler County to support drilling operations in the Marcellus shale area. And it also, as we've talked before when we extend our Regulated pipelines, it provides us the opportunity to provide the public in that area with much-needed treated water service.

So it's a positive for the environment also. XTO has told us that with those three pipeline extensions that we've done with them, they will have over 500,000 fewer water truck hauls on the roads of only one county, Butler County. So just within Butler County, it will be 0.5 million fewer water truck hauls over the next five years or so.

In addition, because they're using our treated water, one of the other things that they have told us is that they are able to use less chemicals in their injection fluids. Because they don't have to put in as much biocide, and that's important because biocide is the only non-food grade material that they use in the creation of their fluids. So we think there are some really positive environment environmental aspects to that.

Turning now to slide eight, this week our Board of Directors authorized a 12% increase in the quarterly dividend from $0.25 to $0.28 per share. This is in line with the dividend policy we articulated this time last year that more closely tied dividend growth to growth in earnings per share while targeting a 50% to 60% payout ratio.

With the strong results of the First Quarter, as you can see on slide nine, we are reaffirming our 2013 earnings guidance range of $2.15 to $2.25 per diluted share for continuing ops.

And with that, let me turn the call over to Susan for a more detailed discussion of our financials.

Susan Story {BIO 3335156 <GO>}

Thank you, Jeff. Good morning to those who are listening to our First Quarter 2013 earnings call. I'm excited to be here with you today, and I look forward to working with all of you.

Jeff has already reviewed some of our key highlights. I will now take a few minutes to describe in greater detail the drivers of our results for the First Quarter.

Turning to slide 11, as Jeff mentioned, we experienced solid financial results for the First Quarter of 2013 with increases in revenue, net income and earnings per share. These results were driven by our team's commitment to strategies that focus around delivering value to our customers, investing in needed infrastructure and controlling costs.

During the First Quarter, we reported operating revenues of approximately $636 million or a 2.8% increase over the approximate $619 million recorded for the First Quarter of last year. Growth in revenues was strong in our Regulated Businesses as we will discuss further in a few minutes.

But our Market-Based business was down for the quarter. This is primarily due to timing delays in starting some projects in our Military Services Group, which we fully expect will catch up during the latter half of the year.

Net income from continuing operations for the First Quarter was $57.6 million or $0.32 per share, representing a 17% growth over the prior year. Net cash also improved quarter over quarter, increasing to $149.6 million compared to $148.1 million for the First Quarter in 2012.

Now, let's discuss on slide 12 the various components of our income from continuing operations, starting with revenues. I also encourage you to read our 10-Q on file with the SEC for a more detailed analysis of both revenue and expenses.

Overall, operating revenues increased $17.6 million with revenues from our Regulated business increasing $31.4 million or 5.8% from 2012. This increase in revenue is primarily due to new rates in a number of our subsidiaries with an impact of approximately $25.3 million. Additional revenues of about $5 million were related to acquisitions, the most significant of which was our New York acquisition in the Second Quarter of 2012 and our increased surcharge and balancing account revenues of $5.2 million. These increases were partially offset by lower customer demand, which impacted revenues by approximately $3.6 million in the First Quarter of 2013 compared to the First Quarter of 2012.

For our Market-Based businesses, revenues for the First Quarter of 2013 decreased due to lower contract operations group revenues by $14.7 million. Of this decrease, about $9.8 million was due to delayed activities in our military-based contracts, which we expect to make up in the latter half of the year.

The remaining decrease was due to the termination of certain other contracts continuing our rationalization of the municipal and industrial contracts business. This decrease in Contract Operations Group revenues was somewhat offset by a $1.5 million increase in Homeowners Services revenues, which Jeff talked about earlier.

On slide 13, total operating expenses for the First Quarter of 2013 increased by about $13 million or 2.9% from 2012. Operation and maintenance in the Regulated business increased $11 million or 4.3% in the First Quarter of 2013 compared with the prior year period.

Production expense increases include an increase in chemical costs related to the acquisition in New York and price increases and increased chemical dosages as a result of some unfavorable water conditions in our Illinois subsidiary due to drought.

Operating supplies and services increased $6.3 million or 13.2%, primarily due to higher contracted services. This was mainly a result of incremental contractor costs related to the stabilization of our ERP projects, as well as costs involving projects that improve our processes and our operating efficiencies over the long-term also due to the ERP implementation.

Maintenance, materials, and services, which include emergency repair, as well as costs for preventive maintenance, increased $2.1 million or 12.9%. This was mainly a result of higher than normal main breaks in a number of our subsidiaries, increased costs as a result of the New York acquisition and an increase in tank cleaning costs in California.

Customer billing increased $1.3 million due to an increase in uncollectable expense, and we also experienced a $1.8 million increase in casualty and liability insurance premiums. Employee-related costs decreased $2.5 million or 2.1%, driven by decreased group insurance and pension expense. The reduction in group insurance costs was mainly attributable to higher capitalization grants. Salaries and wages expense were relatively flat compared with the prior year period. The Market-Based business operations decrease in total operating expenses coincides in part with the decreases in revenue which I have described previously.

Turning now to regulatory highlights of the quarter. Slide 14 shows our new expanded rate case update template. We wanted to make it a bit easier for you folks to look at the rate case activity in the quarter, be it formal rate cases awaiting final order, which we separate on this slide between those filed in 2013 versus those filed in 2012, and also any step increases or district filings which impacted the quarter or are still pending.

Including Pennsylvania, Iowa, and California, we now have approximately $135 million in requested additional revenues from formal rate cases, and looking at the timing of these rate cases versus previous years, the rate cases we expect to resolve in 2013 should hit towards the end of the year versus midyear in 2012 when we had three rate cases finalized in the Second Quarter.

Turning now to slide 15, as you all know, internally we challenge ourselves to build a culture of continuous improvement and excellence as a way of providing a path for sustainable earnings growth. As part of that effort, we strive to manage our cost structure as efficiently as possible. And this slide shows that the results of that focus are paying off for our customers. We've graphed for you the incremental revenue requirements across our state for three different time periods.

As you can see, just a few years ago, about 60% of our rate case filings were to recover operating costs. Thanks to our focus on operating efficiency and expense control, we began to see a change, and in subsequent filings in 2011 through 2012, we lowered by more than a third the level of operating expenses we were seeking to recover to just 16%. And, in fact, if you look at the most recent rate cases filed, that percentage is now approximately 6%. Fully 94% of our recent cases filed are driven by needed capital expenditures in our infrastructure. This is a solid and sustained improvement and a testament to the discipline and cost controls that I see at American Water, which provide a tremendous benefit to our customers.

In fact, on slide 16, this continued effort to drive operating efficiencies also translates into an improved O&M efficiency ratio, which Jeff mentioned earlier, now at 40% for the 12 months ended March 31, 2013, compared with 41.8% during the same timeframe last year. I have to tell you as a new member of the American Water team, it's great to see this type of commitment across the business to continuous improvement to benefit our customers.

And now I'll turn the call back to Jeff for his closing comments and for your questions.

Jeff Sterba {BIO 1426511 <GO>}

Thanks, Susan. If you go to slide 17, this is the slide that you see each quarter. It shows the expectations of what you can hold us accountable to and kind of measure our progress. Since we are really only into the First Quarter, let me talk about our plans for the rest of the year.

We'll pursue the completion of our pending rate cases in West Virginia, Kentucky, Pennsylvania, Iowa, and California, as well as continue to evaluate appropriate timing for additional rate cases that could be filed possibly later this year or in 2014. We'll continue to focus on operational excellence and increased efficiencies, and we expect to beat our five-year goal, which is to have an O&M efficiency ratio of 40% or below in 2015. We'll beat that by one or two years.

We'll also begin to leverage some of the efficiencies gained through our business transformation project, though the real savings associated with that really won't come into play until about 2015 or very late 2014.

The second phase of our BP project which involves the customer information system and enterprise asset management, which is obviously the management of all of the assets that we are putting in place, should be substantially complete by the end of this year.

We'll also maintain our investment in our systems with an estimated spend of about $950 million in 2013, and we'll further leverage our supply chain initiatives to realize additional improvements in both our capital and O&M efficiencies.

We'll continue to leverage our IDP offerings. As you will recall that we've talked about what we've been doing on the innovation and development side because we've developed some very interesting technologies that we are starting to use and are starting to be put into place elsewhere in the industry. They are small. They are meant to be small. They don't consume our capital. But they have the potential for growing significantly in the future.

So we'll continue to push that through the commercialization process. And in the Marcellus shale space, we expect our number of connections to steadily increase as we continue to have discussions with numerous energy companies about opportunities to expand our pipelines to improve water service to these growing areas. So far, these have all been on the regulated side, though as we've said before, we are open to both regulated and unregulated pipeline expansion to meet market needs with the right risk return profiles for those.

These efforts will anchor our long-term earnings per share growth of 7% to 10%. We seek to provide investors with a long-term double-digit total return investment on a thesis centered around investing in our country's infrastructure in an industry whose product is essential to all people.

Before we go into the Q&A side, just a reminder that our annual stockholder meeting will be held here in Voorhees New Jersey and also online through the virtual stockholder meeting this coming Monday the 13th. I believe it's at 10 a.m. All stockholders are invited to attend, and if you all have not voted your proxy for any of the holders that are online, we certainly encourage you to do so.

And with that, we'd be happy to take any questions that you all may have.

Questions And Answers

Operator

[Operator Instructions] Ryan Connors, Janney Montgomery Scott.

Q - Ryan Connors {BIO 15032883 <GO>}

One sort of tactical question and two bigger picture items. Just in the short term, obviously 1Q is a seasonally slow quarter, and then now we move into 2Q, 3Q and more of a stronger seasonal demand period, and last year was a real strong year. So can you kind of update us with your perspective on obviously the challenging comparisons and how we should be looking at year-over-year growth potential and you know maybe even any early perspective a little over a month into Second Quarter on how that issue of tough comparisons is playing out?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes, Ryan, let me just touch on that briefly. Remember, this is the reason why last year we provided a sense of what the impact on earnings from continuing operations was from the unseasonable weather. We indicated it was about $0.13 to $0.16 so that you could kind of normalize out the impact last year.

So our suggestion is to kind of look at that from a trending side to look at the performance as we go through this year. We're not going to give you much -- say much about what's going on in any quarter until the end of the quarter. But I'll just say that certainly April, it didn't give us any cause for concern on the sales side at all. We'll have to see what happens to weather.

You know, the thing that's -- this is one of the things that we are really starting to focus on. Regardless of what your views on climate change are and whether you believe in anthropogenic causes or not, the reality is, we're going to face significantly more volatile and variable weather patterns. They will be extreme. So we will see significant changes. And so one of our real focuses is building resiliency into our system, both physically and financially so that we can manage these kinds of swings while maintaining the same kind of financial risk profile and ensuring that we have systems that will allow us to meet those customers' needs.

So we'll just have to wait and see what happens in the second and Third Quarters, but at this stage, we're very comfortable with the earnings guidance we've given.

Q - Ryan Connors {BIO 15032883 <GO>}

Okay. That's great. Thanks, Jeff. And then can you just update us on your assessment of the regulatory climate broadly as it relates to awarded ROEs? Obviously interest rates remain low. That puts downward pressure on cost of capital calculations. Economic backdrop is mixed. And so how do you see commissions responding to that environment here as you gear up for a few fairly significant rate cases in the pipeline as you talked about?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, let me put in a few words, and then I'd like Susan to add her thoughts coming out of the same kind of regulated marketplace.

You know, clearly it's been down downward pressure on returns. You know, one of the things we remind regulators is, look, you have to be very careful about looking at what the -- what an artificially held down risk-free rate is and use that as the basis for calculating what a cost of equity capital is because it's being artificially held down through monetary policy for specific broad-based governmental reasons.

But, that said, the other thing that we share with our regulators is the notion that more than probably any other company in the utility industry, we have a capital allocation decision. And it's not that we're not going to do what is essential, but in terms of the variable capital, which is a big chunk of capital, it will move where there is the opportunity to earn our full returns in a timely manner.

I think the clearest example is the additional commitment that we made into New Jersey once the DSIC was put into place, the incremental capital that we committed into Missouri, and where, frankly, some capital has been extracted. Again, we're going to make sure we provide service to customer, but it's an issue of investment in the longer term.

Okay. That must be someone's phone ringing. Anyway. So, we certainly see returns coming down a bit, and we've factored that in in our game plan going forward. But we think we can without -- certainly not in a threatening way help people understand that we've only got so much capital spend, and it's got to be allocated where it's going to get the greatest return.

A - Susan Story {BIO 3335156 <GO>}

Absolutely. I agree with Jeff. And I think also remember that when you look at the rate cases that we have filed, we are holding the line on O&M expenses. We're trying to be good stewards of going into the Public Service Commissions and Public Utilities Commissions so that when we go into these, it's for infrastructure improvement. We know from several reports from the Society of civil Engineers, the water infrastructure is struggling nationally, we believe, and we have continued to make investments in that. We know that utility commissions recognize management efficiency, which we think that we are showing by how we are controlling our O&M costs so that we are going in for recovery basically for the investment that we're making to improve reliability, safety, and making sure that the water is available when it needs to be available.

A - Jeff Sterba {BIO 1426511 <GO>}

Susan raises something that we're going to start helping make sure our regulators understand more fully. If you look how far this Company has come in a pretty short period of time about improving its cost structure and really getting focused on how we serve customers in different ways, the kinds of things that we do that others don't do about helping ensure continuation of service where we have had very little lost service during these weather events and have been lauded in virtually every state where we've had those events because of the way we manage our field force and what we do relative to the loss of electric power. So, that's something that we think can help move up for a little bit of the lower natural returns to regulators.

Q - Ryan Connors {BIO 15032883 <GO>}

That's great perspective. Thank you. And then one last question for me. Pretty big privatization opportunity in Allentown, Pennsylvania that did not go to either yourselves or any of your investor-owned peers. Can you just talk a little bit to us about that process and what you learned from it as regards to both the appetite for privatization and then also how you will approach that type of opportunity in the future?

A - Jeff Sterba {BIO 1426511 <GO>}

Sure. You know, I would tell you that I am exceptionally proud of the team that we had working on that project, the way they conducted themselves, the development of the proposal, and I'm very comfortable with what we did. We would not have paid what someone else is saying they will pay.

So, in terms of the process, that's fine.

I guess a couple editorial comments. I think from a public policy side, there is a real issue to be had about an entity being able to use subsidized tax-exempt financing. It is being subsidized by all tax payers to buy assets or enter into an agreement where you're paying for lease assets at above cost -- above the original costs. The notion of using tax-exempt debt to enhance a public system that already exists is one thing. But to acquire a system and to effectively compete by using something that is subsidized by other taxpayers I think is a public policy issue that's going to end up being addressed in Congress.

You know, in the kind of economic conditions that this country is in, to continue to allow those kinds of subsidizations I think are the things that the policymakers ought to look at. And I think we also have to recognize that they are paying whatever the price is. $220 million, I guess, was the price. You know, it's a heck of a lot more debt that they don't have to issue, the $220 million, because of the bond reserve funds and everything else. They don't have any equity capital associated with that.

So I hope it works for them. They made a decision. We'll see what happens. I'm very comfortable with how we conducted ourselves and the price that we put forward. It does not dissuade us from pursuing the right kinds of opportunities for the future, approaching it with the same care and deliberation that we did this with.

Q - Ryan Connors {BIO 15032883 <GO>}

So it will be interesting -- we will watch to see how it plays out. Thanks for your time this morning.

Operator

Neil Mehta, Goldman Sachs.

Q - Neil Mehta {BIO 16213187 <GO>}

In California, one of the things we've seen with some of the electric utilities are general cases are taking a lot longer to resolve. You just filed in California. How should we think about the timing of final resolution, and do you think there is any readover from the timeline in California for some of the electric needs to how we should think about water case resolution?

A - Jeff Sterba {BIO 1426511 <GO>}

We have Walter to answer that.

A - Walter Lynch {BIO 6064780 <GO>}

Yes, Neil, it's Walter. In California there is a three-year cycle. So we file on that on that timing. We filed in May. The rates are going to be effective in January 1 of 2015 based on that three-year cycle. So we expect to take a good portion of it and have the rate case finalized before January 1, 2015. So it's on a regular cycle, and all the water companies are on those cycles.

A - Jeff Sterba {BIO 1426511 <GO>}

You know, Neil, if you look at the flat rate base, the decision was about what, five or six months late? But there is the risk because you are right. They are running behind. There is the risk that case could slip, but it's -- the rates are retroactive. That's what gives us a little comfort is that it's not an issue where we won't make that revenue. And it may be delayed where the actual flow comes a little bit late, but it will be retroactive to that date.

Q - Neil Mehta {BIO 16213187 <GO>}

Got it. All right. And then on your comments on dividends, obviously you had a nice dividend bump a couple of days ago. To get to the midpoint of your 50% to 60% payout, you'd likely have to grow your dividend by faster than EPS growth. So just to get back to your dividend philosophy, is it possible that you grow your dividend in excess of that 7% to 10% to get closer to the midpoint of your payout range?

A - Jeff Sterba {BIO 1426511 <GO>}

You know, I just love it when a 12% dividend increases -- a nice dividend increase. You know, there is a balance, as I know you understand, between the rate of growth that we have in that, and we're going to always be a little conservative on this because -- and looking forward, it's -- we had balanced that issue of the what the opportunities we have for investment.

And I guess the short answer to your question is, certainly there is the potential that it will grow at a rate faster than earnings maybe in any one year. But, remember, that we talk about 7% to 10% as a long-term growth rate. Not every year on year. So a year in which we have, let's say, 7% growth or 7.5%, the dividend rate will be higher than that. In a year in which we have 15% growth as we had for the last three years, it probably wouldn't be or probably likely wouldn't be above that.

So, as we go forward, we'll keep looking at that. I think the key for us is to provide a predictable, stable level of growth in the dividend. We've increased it by $0.01 in each of the last three years because it was appropriate to do so. Whether we're now at a $0.03 per quarter level increase, so that is 12%. Whether we go above that, we'll wait and see how our future continues to unfold.

Q - Neil Mehta {BIO 16213187 <GO>}

Got it. Okay. Thank you, very much.

Operator

Kevin Cole, Credit Suisse.

Q - Kevin Cole {BIO 18674088 <GO>}

I guess with the shale development, can you, I guess, help me think how the earnings levels will work when you invest in the business, and is it purely a rate-based business, or do you get some volume kicker from it as well? Then also with the XTO agreement and similar agreements, how much CapEx will you be thinking that you're investing?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes, let's take that in two parts. First, let me do the second part first. In most of these agreements, frankly, what we've got is the driller investing a good chunk of the capital or providing a good chunk of the capital as a contribution today. And then the whole investment is rolled into our rates, and the property is deeded to us. So they then end up paying for treated water. That's what we've done on the regulated side.

So, in between rate cases, we get a bump from those additional revenues and sales. We also have the opportunity to then serve the retail growth that can prop up around that pipeline or for, in many of those areas, customers that are having well water difficulties, to have them come onto the line so that is additional revenue. And then, if the drillers end up leaving, then we don't have any risk associated with those investments that are rolled into rates, and we'll stay in there for the long term.

So that's how the ones that have happened so far are being treated, and I think that the value of that, remember, is twofold. First, we're getting the revenues from that driller today. In the longer term, we are getting additional certificated territories. So when we make those extensions, the Pennsylvania commission actually certificates additional territories for us. And that will put us in the position if, for example, this cracker is built to be able to serve what the people estimate from anywhere from 15,000 to 40,000 new jobs in that area.

So, now, as I said and we've said for at least the last year or so, while we focus on regulated investments to serve drillers, we will also consider market-based investments if the risk reward profile is right and it meets what the customer needs and wants. So far, that hasn't been what the customers have preferred. It hasn't been necessary or appropriate. But those things can change, and that obviously has to have the right risk reward relationships.

Q - Kevin Cole {BIO 18674088 <GO>}

So, this is a zero-like business then given the contribution you made?

A - Jeff Sterba {BIO 1426511 <GO>}

We've put in some capital, but I've got to tell you, we haven't put in -- I don't know what the number is, Kevin. I couldn't tell you what the specific is, but it's not much. It may be $1 million or a couple of million dollars. It's probably a couple of million dollars so far. Because a big chunk of it is put up by the driller, and then they deed the property to us at no cost. They don't get a deduction in their rates. So they pay for the pipeline, and then they pay the regular price for the water.

Q - Kevin Cole {BIO 18674088 <GO>}

Have you provided the rate base growth opportunity for this?

A - Jeff Sterba {BIO 1426511 <GO>}

I am sorry. Can you speak up?

Q - Kevin Cole {BIO 18674088 <GO>}

Have you provided the rate base growth opportunity for, I guess, the shale development shift?

A - Jeff Sterba {BIO 1426511 <GO>}

No, no, we have not.

Q - Kevin Cole {BIO 18674088 <GO>}

And then, Susan, with your comments on the non-reg side, I'm sorry if I missed this, but was the revenue and the net income decrease a function of a slowdown in ability to get new businesses, or was it -- this kind of more of a contract issue, and then also how do you expect to backfill later on this year?

A - Susan Story {BIO 3335156 <GO>}

Yes, thanks for that question, Kevin. Actually the military services group -- just for a little background, these contracts are O&M contracts, but they are actually full scale -- we're the EPC contractor, and we provide the O&M services with 50-year contracts.

So we're the ones who get the permit. We actually also get a bill of sale for the asset, but because it's on the government installations and we can't make any decisions that the government doesn't approve, we don't carry those on the American Water book.

So, what happens is, we have projects that are already awarded. These are not projects we're hoping will happen. They've been budgeted. They've been awarded. We're in process. There was small delay in terms of getting some construction permits on the majority of these sites.

So we fully expect these projects to continue for this year. It will probably be more toward the third or Fourth Quarter and also understanding how this works because we are EPC, we have an agreement that we actually book revenue during certain percentages of the completion of the project. So once we start the project, based on where we are in the design field, we are able to bring revenues in. So it's merely a matter of the timing, and most of that is due to the construction permit.

Q - Kevin Cole {BIO 18674088 <GO>}

Great. Thank you. That is helpful. Appreciate it.

A - Jeff Sterba {BIO 1426511 <GO>}

Let me add one thing to that, Kevin. I think as people are finding out, there is an impact of sequestration that is kind of the hidden impact, and it is that even if there aren't -- people aren't being furloughed or anything, or even if they are, you're losing some effectiveness there. But what really happens is everyone in the government talks about what's going on, and that produces effectiveness efficiency. And so stuff has just gotten slower, and that's a natural thing to happen. But it isn't going to stop moving forward at this time.

A - Susan Story {BIO 3335156 <GO>}

Yes, I mean the sequestration should not affect the projects that we've got, and also, even going forward, because we are doing water and wastewater infrastructure, these are critical elements.

So as long as there are military bases, the work will be done. The question is, who's going to do it, and we're going to compete most effectively for those projects.

Q - Kevin Cole {BIO 18674088 <GO>}

Great. Thank you. And Jeff, I like the slide seven. So now I can end the call with, may your cup runneth over.

A - Jeff Sterba {BIO 1426511 <GO>}

I like that! I like that!

Operator

Angie Storozynski, Macquarie.

Q - Angie Storozynski {BIO 15115714 <GO>}

I just wanted to clarify comments, Susan, about the timing of rate cases and the revenue contributions and how it ties into your guidance. So, is this just purely about the quarterly allocation of revenue increases, or that's -- I mean the timing of those rate case resolutions, together with the delay in the military contracts, should weigh on your results in 2013 versus your guidance?

A - Susan Story {BIO 3335156 <GO>}

Angie, that's exactly correct. Last year, the three rate cases were finalized, and we received the orders in the Second Quarter. When you look, for example, at Kentucky and West Virginia, the water and wastewater in West Virginia and the case in Kentucky, of course, we don't know. We would hope that by the third and Fourth Quarter, we would get a final order on those. With Pennsylvania it could be through the First Quarter of 2014, but there's a chance it could be the latter part of this year and Iowa probably 2014. So a lot of it is due to the timing from last year compared to this year.

Q - Angie Storozynski {BIO 15115714 <GO>}

But you already knew about it, and it is embedded in your guidance, right?

A - Susan Story {BIO 3335156 <GO>}

Yes, for the year guidance. That's why we reaffirmed our guidance, the annual guidance we reaffirmed our guidance.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. Now how much of a help did you guys have in the realized ROE over the last 12 months from the weather? So if I were to look at the weather normalized realized ROE?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes, I'm trying to remember the number. Something like about 40 basis points?

A - Walter Lynch {BIO 6064780 <GO>}

Yes. It was around 30 basis points, and Angie, I can give that to you after the call.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. And then when we think about your earnings drivers going forward, how big of an ROE lag we should assume, and especially as it ties into potential refinancings of debts and further bridging of the gap between allowed and realized ROEs from -- through rate cases?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, if we look at the regulated return, which I think it was on a weather adjusted basis, was somewhere just at or under 9.0%, right around 9%. We are seeing -- we've got a regulatory lag, but it has shrunk considerably. Our goal is to drive it to 0. We think that's appropriate.

As we go forward, what helps us get us there? Well, expansion of DSIC. If you look at the 39% of our CapEx that qualifies for DSIC, remember that of the $950 million we've got this year, a chunk of that is for BT. BT doesn't qualify for DSIC. As we go forward next year, at this stage, into 2014, we are subject to further decisions. But we don't see backing away from the total level of investment, so probably a greater amount of investment will be eligible for DSICs.

We've got more future test year rate cases moving forward. So we're doing the things that will help close that gap. I certainly don't expect it to increase from what we've got right now, which just looks to be about 80% -- 80 basis points.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. And that's on the regulated side. How about on the corporate level?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, on the corporate level, Angie, the major piece, as we've talked about before, is the parental level debt. Its impact is declining just because our earnings are becoming much bigger, not that the total hit associated with that interest is shrinking. It's really not.

Remember, we did hedge off a piece of that. There's no -- through a swap. Not really an ability to do much more of that today, but -- and remember that the biggest chunk of that, I think, is about $750 million is subject to -- comes up in 2017.

So we will always look for opportunities to manage that debt in a better way. We did a lot of refinancings about $500 million or so last year of other debt, which has helped reduce our overall cost of debt. But the substitutes at the parent we have limited capacity to do anything before we face the issue of it coming up in 2017.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. So and then the last question, so you keep showing us the 7% to 10% earnings growth, and when I look at your drivers of earnings and the level of CapEx that you keep deploying, I kind of struggle with the 7% growth. What would be -- how can I get comfortable with that low case of earnings growth? Because it's hard to imagine, is this more a function of -- are you basically giving yourself a cushion, and that's why it's a 7% the low end of the range? Or is there something long-term that I'm missing that could actually weigh on your earnings growth?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, Angie, since we're talking long-term, I think it's appropriate to think about a range. And obviously we're going to drive as long as it's based on long-term decision-making, we are going to drive to be on the higher end, but there's a lot of things that can happen. You know, if we get in a period of as some people think will happen where we've got an inflationary period monetarily driven, then, for entities like us, that forces interest costs, as well as other costs up at a higher rate. So it exacerbates whatever regulatory lag you have.

So there's a lot of things that can happen on the Regulatory side and as well as on the Market-Based side. So I think it's appropriate to think about a range, and that's where you all get to kind of make your own judgments and decide where within that range we may fall long-term. Because we'll run a bunch of sensitivities that can drive us -- remember, the tornado chart that we've used with you all before that can show how things can affect us, and a number of them can drive us inside or outside of that range very, very quickly whether it's on the sales side or particularly on the level of sales side. So, I think we are comfortable with the 7% to 10% range.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. Thank you, very much.

Operator

Heike Doerr, Robert W. Baird.

Q - Heike Doerr {BIO 15084832 <GO>}

I wanted to return to this topic of military-based business for a moment. Can you perhaps comment on how the sequestration impacts the trend towards further privatization of military bases?

A - Susan Story {BIO 3335156 <GO>}

You know, it's interesting because in looking and talking with the people that we've got working on that, the issue of sequestration has a lot of questions, first of all. So we don't want to speculate. We know that there were talks of furloughs that did not happen. What we do know is that originally -- and I think we have reported in early earlier earnings calls -- the Department of Defense was planning about $11 billion worth of water and wastewater project privatization from 2012 to 2016. We have not gotten information that says that has significantly changed. Again, when you look at a lot of spaces, many were built around post-World War II different areas. Water, wastewater infrastructure -- if you're going to have bases, you're going to need those services.

So, anything we talk about is speculation. However, in some respects, the military I know, for example, on renewables and different things has actually said that because of things like sequestration and budget cuts, they would prefer to privatize because they take that risk off, and that's not their core competency. We don't know that for sure. We are monitoring closely. We work with the Department of Defense frequently. We have a team that does that, and at this point the projects that we have, we don't see an impact from sequestration but from what Jeff mentioned, which is if things happen a little more slowly because the discussion and talks about sequestration.

Looking forward, if we need to revise our forecast, we will. But at this point, we still see projects on the table that will be awarded to someone.

A - Jeff Sterba {BIO 1426511 <GO>}

Let me add one other piece of color. I think the probability of a BRAC -- another BRAC is very high, probably in the 2014 to 2015 timeframe. Those are very difficult and exhaustive processes. And consolidation and efficiency of overall deployment is one of the keys.

So I think you can think about the likelihood that we will see some baseloads.

Now, when they do consolidation, there is always an issue about one of the big bases going by the wayside. Frankly, what typically happens is you see consolidation of smaller bases. A lot of the smaller outposts, frankly, we don't even bid on because they are just not big enough for us to mess with. We tend to focus on the larger scale bases, and there are some large scale bases that are on the blocks for this privatization today. You never know when a BRAC process goes through what the outcome might be. But I think you know two things. A], it takes a while because it's a political process and that they're going to be driving for efficiency gains. I don't think anyone can prejudge today whether that means we could lose one of our bases or we could have a greater opportunity to serve a new base that's bigger than it otherwise would be. I don't -- I agree with Susan. I don't think that sequestration in and of itself is going to impact the privatization, except it may just slow down because of the process and people being distracted because of just the general notion of sequestration. But they will come back after a period a couple of months or whatever of settling down and get back on stride.

A - Susan Story {BIO 3335156 <GO>}

And tagging onto what Jeff said, not only the issue that we serve the larger bases but because of our size and scale and the fact that we have a national marketplace, it would provide us more opportunities because we are not constrained by regional lines. So it actually could provide us even more opportunities.

Q - Heike Doerr {BIO 15084832 <GO>}

And can you remind us what that process is? If tomorrow they opened up these projects -- forbid -- what's the process, what's the quote-unquote normal timing of that process?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, the timing that the federal government will talk about is an 18-month period. We haven't seen one get done in 18 months. So, there is always something that slips. But it is a very structured process that's multistage. [multiple speakers]

Q - Heike Doerr {BIO 15084832 <GO>}

So it would be a 2015 earnings event at the earliest?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes. Except that there are some that are in process now. So, there is already some that are on the table, and we're started in 2012.

So, when will they come to a conclusion? Well, it really depends. Do we see 18 months, or do we see 24 or 26 months? So we don't talk about which ones that we bid on that are currently in process, but they are some very attractive faces.

Q - Heike Doerr {BIO 15084832 <GO>}

And then as a final question, can you, Jeff, provide us with an update on the New York City contract services contract?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes, as I mentioned earlier, we started the market marketing process in early to mid-January. So through the first round of mailings to about 650,000 people, we've got 80,000 customers. So that's over about a 12% penetration rate, and almost all of them are taking two products. So we've got about 160,000 contracts out of it.

So, it's going well. It's certainly exceeding what we expected.

Q - Heike Doerr {BIO 15084832 <GO>}

Can you share with us what the target is for that by the end of the year or --?

A - Jeff Sterba {BIO 1426511 <GO>}

No. We won't give specifics on targets and stuff like that. But I'll just tell you that we are pleased with how it's going. But there's also shakedowns that occur -- maybe that's not the best choice of words -- shakeouts that occur when you go into a new territory because, remember, that our key -- the two key things that make that business work are contractor management and customer care.

And so, on the customer care side, we had to significantly expand our capacity to take on New York City, and on the contractor management side, these are a bunch of new contractors because we didn't really serve in New York City before. So we've got to go through the process that you always will have a little shakeout as we bring new people onto the customer care side, and we have new contractors that we are serving.

So we are pleased with how it's going, and there probably isn't much more to say about that.

Operator

[Operator Instructions] And I show no further questions in queue at this time. I'd like to turn it back to management for any closing remarks.

A - Jeff Sterba {BIO 1426511 <GO>}

Well, let me again thank you for joining us this morning. We'll see some of you at the Brean conference on Monday, and thanks, again, for your following and support. Take care.

Operator

Ladies and gentlemen. that does conclude our conference call for today. We'd like to thank you for your participation, and you may now disconnect.