Q3 2013 Earnings Call

Company Participants

- Edward Vallejo, VP of IR
- Jeffry Sterba, President & CEO
- Susan Story, SVP & CFO
- Walter Lynch, Head of Regulatory Operations

Other Participants

- Heike Doerr, Analyst, Robert W. Baird & Company, Inc.
- Jonathan Reeder, Analyst, Wells Fargo Securities, LLC
- Kevin Cole, Analyst, Credit Suisse
- Neil Mehta, Analyst, Goldman Sachs
- Steve Fleishman, Analyst, Wolfe Research

Presentation

Operator

Good morning. Welcome to American Water's Third Quarter 2013 earnings conference call. As a reminder, this call is being recorded and is being webcast with the Company slide presentation through the Company's website, www.amwater.com. Following this earnings call, an audio archive of the call will be available through November 14, 2013 by dialing 303-590-3030 for US and international callers. The access code is 4643778. The online archive of the webcast will be available through December 6 by accessing the investor relations page of the Company's website located at www.amwater.com.

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

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

Edward Vallejo {BIO 16076814 <GO>}

Thank you. Good morning, everyone. Welcome to American Water's Third Quarter 2013 conference call. As usual, we'll keep our call to about an hour. At the end of our prepared remarks, we will have time for questions.

Before we begin, I would like to remind everyone that, during the course of this conference call, both in our prepared remarks and in answers to your questions, we may make statements related to future performance. Our statements represent our most reasonable estimates, however, since these statements deal with future events, they are subject to numerous risks, uncertainties, and other factors that may cause the actual performance of American Water to be materially different from the performance indicated or implied by such statements. Such risk factors are set forth in the Company's SEC filing.

And now I would like to turn the call over to American Water's President and CEO, Jeff Sterba.

Jeffry Sterba {BIO 1426511 <GO>}

Thanks, Ed. Good morning, to you all and I appreciate you joining us on this call. Susan Story, our Senior VP and Chief Financial Officer will join me in the brief presentation and then we, along with Walter Lynch, who, as you know, heads our Regulated Operations and Mark Chesla our Controller will respond to questions that you may have.

As have seen from the 10-Q in the press release, that we filed last night, while mild weather impacted the quarter, I am pleased to say that we have a solid performance to date with strong cost control, good growth in market-based operations, and good acquisition success. So based on that, we are now narrowing the earnings guidance from the year from $2.15 to $2.25 per share on a diluted basis to a range of $2.17 to $2.22 per share. For the quarter, we recorded decreases in income from continuing operations and earnings per share as compared to the same quarter in 2012. This was mainly due to decreased regulated business revenues due to lower customer usage related to weather, in addition to the ongoing usage decline that we see on the residential front, as well as higher depreciation expenses due to additional utility plant and service. That includes our business transformation SAP conversion project.

In addition, as we mentioned last quarter, as you look on slide 5, it appears in that slide that our 2013 year-to-date cash flow from operations is lower, but this is due to on how our bank overdraft is being treated, as a reduction to operating cash flow as opposed to a financing activity. And this is the result of the decision we made last year to internally manage our cash activities. Year to date this changing cash flow classification amounts to about $35 million.

Going to slide 6, let me take a minute to discuss the weather's impact on our business. The same type of weather that impacted our Second Quarter continued to pressure Third Quarter regulated revenues. As you can see by the cooling degree days chart from NOAA, which, as most of you cover the energy side so you're very well familiar with this, the country experienced cooler-than-normal temperatures throughout the Third Quarter.

Now we often talk about our geographical diversity across 16 states and how it helps mitigate things like weather impact and that was certainly the case this quarter in states like California where hotter weather caused higher usage. but even with that contribution we did experience an approximate $0.02 to $0.04 decrease in earnings per share from weather for this quarter, which when you add that to the $0.01 to $0.02 impact last quarter, you have a total of $0.03 to $0.06 total impact for the first nine months of the year.

Turning to the continued growth of our business, we've had successes that we want to report on briefly in both our core and on our enhanced growth through the quarter. We completed six tuck-ins during the quarter, four water and two wastewater systems. These were in the states of

Iowa, Pennsylvania, Illinois, and Missouri. For the first nine months of 2013, these efforts have added approximately 6500 customers to the regulated footprint, and we have several small tuck-ins that are currently pending approvals, and we expect those to close within the next three to six months or so.

Continuing on slide seven relative to the core growth, for the Third Quarter our military services group received contract modifications for infrastructure investments in every single one of the 9 military bases that we serve. These are for design and construction of water and wastewater system components to be completed over the next three years, and they vary in scale from small water reuse projects at one of the army fort places, Fort Sill, that is in Oklahoma, to a complete replacement of the two wastewater treatment facilities in Fork Polk in Louisiana. I will tell you that while there are still some things moving, it's the largest amount of awards for modification that we have received in the military operations since we started that business.

On the regulated front, we received a rate case decision in West Virginia that is worth an annualized $8.5 million. After the quarter ended, about $7.2 million in annualized revenue from infrastructure surcharges became effective in Pennsylvania and Illinois. And also after the quarter ended, we received the rate authorization in Kentucky for $6.9 million of additional revenues on an annualized basis. As of today, we're awaiting final rate decisions in three pending cases that request a total of $97.4 million in annualized revenues. In one of these cases, Pennsylvania, we have a settlement with the staff, the office of Consumer Advocate, and the office of Small Business Advocate. This settlement for $26 million plus the $29 million of DSIC revenues that are currently being recovered under DSIC and which will become part of base revenues under the proposed settlement, that settlement is currently pending regulatory approval with the rates geared to go into affect January 1.

On the enhanced growth side on October 30, we received approval from the Virginia State Corporation Commission to acquire Dale Services Corporation, and we expect that transaction to close later this month. This regulated wastewater acquisition will add approximately 20,000 customers, most of whom already receive their water service from Virginia, American Water. The reason why this transaction I think is important is not just its size, but it marks the kind of transactions that we talked with many of you about. Where wastewater is only about 4% of our business, but we, so most places where we serve water, someone's providing wastewater it's not us. This is the result of the kind of targeted focused acquisition efforts that we're moving on to expand our wastewater operation, and this transaction also marks our entry into the wastewater service arena in the state of Virginia.

Our Home Owner Services business continued to expand its water and sewer line protection programs to home owners in Florida and Washington, DC, and our service line protection programs in New York City we now have a total of about one out of every seven eligible home owners is enrolled. Most of them, virtually all of them, have opted for both water line and sewer line protection. So far this year, we have added over 250,000 new contracts for a total of more than 1.2 million contracts national.

Before turning the call over to Susan, let me just mention what I think is a historic initiative, that launched in October. American Water and several other leading water industry organizations from both the public and private sector, as well as a couple of other companies, have come together under the name of Value of Water Coalition. The coalition's education campaign is aimed at helping to increase the public's understanding and awareness of water services. The value these services provide us and the need to upgrade and maintain this vital infrastructure, so that we can continue to rely on it now and for generations to come.

This effort marks the first time such a broad coalition of water businesses and non-profit associations have come together in a single voice. And we're doing so because it's critical to address the current state of water infrastructure and the need for significant investment to keep water services at the levels of quality and safety Americans have come to expect. We're already hearing good feedback from this outreach effort from regulators, staff, and consumers.

Let me just also mention that we have been reconfirmed as a member of the Dow Jones sustainability North American index, which demonstrates recognition of our ongoing long-term commitment to sustainability. We're the only US water utility on the index and we are honored to be on it.

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

Susan Story {BIO 3335156 <GO>}

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

Turning to slide 10, we reported a decrease in our Third Quarter 2013 income from continuing operations and EPS over the Third Quarter of 2012. This decrease is mainly attributable to decrease regulated business revenues, due to lower customer usage related to weather, general taxes, and higher depreciation expenses, due to additional plants, slates, and service, including expenditures related to our SAP implementation. As Jeff mentioned, we had above-normal rainfall and below-normal temperatures in several of our states in June and July, which was followed by cooler weather in August, which impacted our sales.

These related decreases in usage, and accompanying revenue, net income, and earnings per share were in stark contrast to the unusually hot and dry weather we saw in the summer of 2012. Our consolidated O&M expenses for the three months ending September 30 decreased by $11.5 million, or 3.2% compared to the prior-year period. The variance is primarily due to lower O&M costs in our regulated business segment of $7.1 million, mainly due to a reduction in employee-related costs and in our market-based segment of $3.7 million mainly as a result of a $3.8 million relief of contract reserves due to the resolution of certain outstanding issues and uncertainties.

Now let's discuss on slide 11 the different components of our income from continuing operations starting with revenue. I also encourage you to read our 10-Q on file with SEC for a more detailed analysis of both revenues and expenses. Overall, our operating revenues decreased $2.6 million or 0.3% with revenues from our regulated business decreasing by $7.7 million or 1% from 2012. The decrease in revenues associated with the lower demands was approximately $35.2 million. The year-over-year comparison was significant due to the diametrically opposite weather affects of 2013 contrasted with 2012 that we all spoke of earlier.

This demand decrease was partially offset by revenue increases of $18.4 million from rate increases obtained through rate authorizations, awarded for a number of our operating companies, and increased surcharge and amortization of balancing account of $9.9 million. At a high level, our continued success in earning an adequate and timely return on the capital we invest in infrastructure, as well as implementing alternative regulatory mechanism, such as; surcharges and balancing accounts, helps us to close regulatory lag. And particularly in this quarter, has helped us to mitigate the adverse impact of declining sales due to weather and declining usage.

For our market-based businesses, revenues for the Third Quarter of 2013 increased by $4.7 million. Mainly due to an increase in our home owner's service revenue of $5.4 million, resulting from contract growth most notably in New York City. This increase was offset by lower contract operations group revenues of $900,000, predominantly related to the termination of certain municipal and industrial operations and maintenance contracts totaling approximately $2.4 million. The contracts were ended as part of our business optimization efforts designed specifically to optimize margins in our contract operations business.

Further, those contract terminations were offset by net increase of $1.7 million from price redeterminations from our military contract. You may recall that price redeterminations are periodic adjustments to our monthly service fees for O&M costs, plus the systemic renewal and replacement of aging assets. These are prospective price adjustment. But because price determination can take many months or even years to finalize, the government makes a one-time payment retroactive to the effective date of that price redetermination period.

On slide 12, operating expenses for the Third Quarter of 2013 increased by about $1.1 million from 2012, roughly flat compared with the prior-year period. Operation and maintenance expense and the regulated business decreased $7.1 million mainly as a result of lower production costs and lower employee-related costs, including decreased pension expense and group insurance. The market-based business operation decreased in total operating expenses of $3.7 million is mainly due to the termination of certain municipal and industrial operations and maintenance contracts in 2012 that I mentioned earlier. And a relief of a portion of the lost contracts reserve in the Third Quarter of 2013.

In the Third Quarter, we also reported a higher consolidated depreciation and amortization expense of $6.5 million, and higher general tax, parent elimination, and other expense of $5.4 million. The increase in depreciation and amortization was principally as a result of additional utility plant placed in service, including phase 1 and phase 2 of our business transformation SAP project that went into the service during the Third Quarter of 2012, and the Second Quarter of 2013 respectively. The increase in general tax expense is primary due to higher property taxes incurred, partially as a result of the inclusion in 2012 of credit adjustment to our Indiana and Missouri property taxes.

Turning now to slide 13, to more clearly explain the period-over-period difference in our earnings per share figures, we have broken these out per category similar to our presentation D last quarter. As you can see, we have adjusted for the positive $0.06 to $0.08 impact of weather for our 2012 results. Taken the mid-point of this adjustment for the unseasonably hot and dry weather, we have a normalized earnings starting point for the Third Quarter of 2012, $0.80 per share. From there, we lay out the various elements that explain the difference in our year-over-year earnings per share result. I think these are straight forward, so I'm not going to go through these, but I'll be happy and others will be happy to provide further clarifications during our question-and-answer session today if you do have questions.

Going to slide 14, we show our O&M efficiency ratio. For the 12 months ending September 30, we maintained a 40.3% ratio, which is in line with the 40.4% ratio we had last quarter for the 12 months ended June 30 and the earlier annual period shown here. On slide 15, as Jeff has already said, we have narrowed our guidance to $2.17 to $2.22 diluted EPS from continuing operations, which reflects our year-to-date performance and assumes no unusual events that would impact water sales volume for the remainder of the year. This includes the impact of the release of the lost contracts reserve in the Third Quarter of 2013 that I mentioned earlier, but excludes costs of our recent tender offer.

Slide 16 outlines some of the actions we have recently taken to increase our financial flexibility and reduce exposure to capital market volatility. To briefly summarize, on September 9, we announced we had increased our revolving credit facility from $1 billion to $1.25 billion under its original term. At the same time, we raised our commercial paper program from $700 million to $1 billion. The higher credit facility, along with the increase commercial paper program and cash from operation, provides for the Company's near-term financial liquidity. We also announced through our financing subsidiary, American Water Capital Corp, a cash tender offer for up to $300 million, a 6.085% senior note due in 2017, which represents a portion of what we typically referred to as our parent company debt.

On October 8, we retired $226 million of these notes, meaningfully reducing our exposure to the capital markets in 2017. Also, as a result of the retirement of this debt, and based upon our current commercial paper borrowing rate, we would expect to have a pretax interest expense savings of $13 million in 2014. On November 1, we issued a notice of redemption of securities with 8.25% and 10% coupons aggregating to approximately $150 million. These notes will be retired on December 1. Additionally, we have debt maturity and $101 million on December 21. We are really pleased with the results of our ongoing debt management program and from time to time, and as market conditions warrant, we may engage in additional long-term debt retirement via tender offers, open market repurchases, or other viable transactions.

Turning now to slide 17 and Jeff's mentioned several of these. I will just go back through some of the highlights. A number of our rates-related regulatory activities occurred during the Third Quarter of 2013. On July 1, 2013, additional annualized revenue of $3.7 million and $4 million resulting from infrastructure charges in our Pennsylvania and New Jersey subsidiaries, respectively, became effective.

Also on July 1, 2013 we filed an update to our proposed application in California that was originally filed on May 1 of this year, requesting $33.5 million of additional annualized revenue, which includes increases in 2016 and 2017 of $8.3 million and $2.7 million respectively. On October 9, California American filed an update to the final general rate case application adjusting the request to $32.4 million. On July 9, 2013 our West Virginia subsidiary entered into a joint stipulation in their water and wastewater general rate case that was filed on December 14, 2012.

On September 26, 2013, a final order consistent with the stipulation agreement was approved and provides for additional annualized revenue of $8.5 million, effective October 11, 2013. On August 30, 2013, our Missouri subsidiary filed for an infrastructure surcharge amounting to $2.4 million in additional annualized revenue. The surcharge is expected to be approved and would become effective in the Fourth Quarter of this year.

On September 16, 2013, our Pennsylvania subsidiary, as Jeff said, reached a settlement in principle for its general rate case filed on April 30 of this year with the PUC staff, the Office of Consumer Advocates and the Office of Small Business Advocates. The settlement agreement if approved would provide $26 million in additional annualized base rate revenue effective January 1, 2014, and as mentioned previously this is in addition to the $29 million of DSIC revenues currently being recovered, which will become part of the base revenue. This agreement is pending regulatory approval.

Turning now to developments which have occurred following the end of the Third Quarter. On October 1, 2013, additional annualized revenue of $6.7 million and $500,000 resulting from infrastructure filing in our Pennsylvania and Illinois subsidiary respectively became effective. Also, on October 1 our Indiana subsidiary submitted an infrastructure charge filing to increase revenues by an additional $4.4 million on an annualized basis. On October 4, 2013, our Tennessee subsidiary filed four alternative mechanisms, requesting to increase revenues on an annualized basis of $500,000. These alternative rate mechanisms were filed and compliant with Tennessee House Bill 191 that was signed into law in April of this year. Finally, on October 25, a final order was received for new annualized revenue of $6.9 million for our Kentucky American Subsidiary.

So in summary, we have had a lot of regulatory activity in the Third Quarter, and we are currently awaiting $97.4 million in requested additional revenues in Pennsylvania, Iowa, and California from formal rate cases we filed this year. Last quarter, we created a new slide which you can find in the appendix, slide 25, entitled regulating utilities, rate base and allowed return on equity, which shows detailed regulatory information for our 10 largest states.

Many of you had requested this data to showing each of our regulated businesses, authorized rate base, authorized ROE, authorized equity, and the effective date of the rate case that we used. 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 better our rate environment.

Finally, as a part of our commitment to shareholder value on October 27, we announced that our board of directors declared a quarterly cash dividend payment of $0.28 per common share payable on December 2, 2013 to all shareholders of record as of November 15, 2013, which continues our commitment to an annual dividend payout goal of 50% to 60% of net income.

Now I will turn the call back to Jeff for his closing comments and your questions.

Jeffry Sterba {BIO 1426511 <GO>}

Thanks Susan.

If you go to slide 19, this is the slide on expectations for the year that you have seen we use every quarter. We've really already spoken about the progress on each of these efforts, which will anchor our long-term earnings per share growth of 7% to 10%. Let me just expand on one item that Susan briefly talked about, and that is our business transformation effort. In October, the last phase of this effort went live; this has been a 4.5 year project to install SAP platform systems as we've talked about before. I got to tell you, while these kinds of conversions, and this is the third one I have been through, they're never pretty, there is always a big impact on productivity, so they talk about averages of 30% to 40%.

We certainly haven't incurred that kind of loss of productivity, but -- so they're messy but I am just really tickled and pleased with how well it's gone. And when you step up and look at it from the broad prospective, we've implemented new financial systems, new supply chain systems, new customer service systems, and new asset management systems. And it has gone quite well. So kind of hats off to all of our folks because it has impacted every single one of our employees.

Before we open the call for questions, I want to remind everyone that we're hosting our 2013 analyst day at the New York Stock Exchange on Tuesday, December 17. To confirm your interest in attending, please call the investor relations phone number you see on the slide. We certainly hope that you will be able to join us that afternoon and we'll talk about the future in that session.

With that, we'd be happy to take questions that you may have.

Questions And Answers

Operator

[Operator Instructions]

Your first question will come from the line of Neil Mehta of Goldman Sachs. Please go ahead.

Q - Neil Mehta {BIO 16213187 <GO>}

Good morning.

A - Jeffry Sterba {BIO 1426511 <GO>}

Hey, Neil.

A - Susan Story {BIO 3335156 <GO>}

Morning.

Q - Neil Mehta {BIO 16213187 <GO>}

Congratulations on being able to keep guidance despite this unfavorable weather here. I guess that is my question in a sense that, a big part of the reason you were able to maintain the guidance was cost management. How sustainable are the cost cuts or were you just putting thumb on the expenses this year to kind of offset the weather?

A - Jeffry Sterba {BIO 1426511 <GO>}

No Neil as we talked about before, our whole focus in cost management is around driving excellence through business process and continuous improvement. So the things that we are doing they're not one offs, they're not slash and burns, they're not just headcount reductions, they're geared around changing what we pose as the three questions. Is what we're doing is it any value? If not, stop doing it. If it does add value is it being done through an efficient process? If not, let's change the process and once it's being done through an efficient process what's the error rate and how do we reduce the errors to zero? That helps create a systematic approach to the way in which we think about our costs and cost drivers and one of the things and Walter may want to make a few comments about it, we're still working on is this integration across all of our states to take the best practice in one place and move them in a standardized way across the other states.

A - Walter Lynch {BIO 6064780 <GO>}

Thanks, Jeff. This is Walter. We're as Jeff said; taking best practices because we're doing things wonderfully in many parts of our company we're expanding that across our entire footprint in reg operations and throughout the entire business. Because we can learn back and forth in the market based businesses through regulated operations. One of the other things too, is the continuous improvement culture. Really focused on driving improvements long-term, and we have a lean leader program where we have more than 100 people throughout our company looking at ways to improve our processes and looking at ways that we can reduce errors. That is contributing significantly now and will contribute significantly in the future as we root out errors and we become more efficient.

A - Jeffry Sterba {BIO 1426511 <GO>}

And just one other thing. While that is our, that is our baseline. And we believe that provides us a great deal of ability to minimize operational cost increases and add more capital to the base and that is the basis for rate increases. As we implement SAP just as end of last year we had some additional expenses incurred because of that recovery and that reduced productivity. We'll see some of that and we have seen some of that this year. You don't necessarily see it because we're even doing a better job in reducing our other costs so net-net, we're still down. But we will see those kinds of things and we'll make sure that we pay attention to them.

Q - Neil Mehta {BIO 16213187 <GO>}

Perfect and the other question around dividend growth strategy, obviously a double digit dividend step up this year. How do you think about the pace of dividend growth from here and where you want to be relative to the 50% to 60% payout ratio?

A - Susan Story {BIO 3335156 <GO>}

Yes Neil, this is Susan. As we've said before, we have two guiding principles. One is that we correlate the growth of our dividend along with our EPS growth, and we have been very transparent about that, and we have a target of saying between 50% and 60% payout. And as you know we're on the low end of that so we have head room.

Q - Neil Mehta {BIO 16213187 <GO>}

Okay, and then the final question of the California project in Monterey; can you provide an update of where you stand there?

A - Jeffry Sterba {BIO 1426511 <GO>}

Yes, I'll ask Walter to add a few things them me put a few on the table. Frankly, things are moving well. It's always, this is the project that will cause rates to increase in this double-digit fashion, so it's under a lot of scrutiny and it's obviously a water constrained area particularly in Monterey. But this project is in fact moving forward quite well. We would expect a commission-recommended decision by August next year.

A - Walter Lynch {BIO 6064780 <GO>}

August 2014. Right Jeff, and there is along the way obviously there's a lot of things that have to occur for that to happen, but there is informal hearings scheduled for early December and we have come to settlements with a number of parties out in the Monterey area and during the hearings, is when everyone will be able to put their case forward. We feel confident that we're working cooperatively with the people in Monterey to get the right solution.

A - Jeffry Sterba {BIO 1426511 <GO>}

Two other things we're in the bid process right now for the constructor for that project, and so, that is going along quite well and the testing the initial results of testing relative to the aquifer are, have been very promising. So these pins, the pins that kind of stand in the way are getting knocked down we still have a few to go.

Q - Neil Mehta {BIO 16213187 <GO>}

Terrific. Thank you.

Operator

Your next question will come from the line of Jonathan Reeder of Wells Fargo. Please go ahead.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Hey. Good morning, Jeff, and Susan, and Walter. Following up on Neil's question just a bit, so should we interpret the guidance revision or narrowing today as implying that results would have been in the upper half of the original range had it not been for the weather impact?

A - Jeffry Sterba {BIO 1426511 <GO>}

You can probably look at it that way. I mean we said that weather is worth $0.03 to $0.06 a share and we narrowed it to basically the mid-point of the range.

A - Susan Story {BIO 3335156 <GO>}

What we prefer to say that we're closer to the end of the year, have a little more look into where we would end up, and so we are good with the range.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. Essentially, what is keeping you in the midpoint of the range is not unsustainable stuff?

A - Jeffry Sterba {BIO 1426511 <GO>}

No.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Like you mentioned before, right?

A - Jeffry Sterba {BIO 1426511 <GO>}

Right. When I think about Jonathan about some of the things we have gotten done this year, and both on the cost control efforts, the growth in the market-based business, and the success we're having on the tuck-in, and acquisition sides those are going along exceptionally well.

A - Susan Story {BIO 3335156 <GO>}

And to add to that Jonathan, and Walter and Jeff talked about this the BT implementation, the SAP implementation, as Jeff mentioned, we actually had and we have shown this through the years, disclosed it in the Q, we have actually had increased costs in the contract services because we've had to back fill a lot of positions to get the ERP system working to the level that we want it to work to get to the point where it can generate the data and we could do more value added analytics. That will go away next year and as they both mentioned, in addition to the process improvement, the ability to have a integrated system, throughout our company, we're just now starting to look at some of the efficiencies and enhancements we can make as a result of that implementation.

Q - Jonathan Reeder {BIO 18909775 <GO>}

So when we look at costs next year, not from, I guess, the O&M Efficiency ratio standpoint, but just an absolute basis with implementation costs falling off, I mean where do you expect it to be? Is it flat is it still modestly up?

A - Walter Lynch {BIO 6064780 <GO>}

I assume, I trust that you will be with us on December 17, and we'll talk about that.

Q - Jonathan Reeder {BIO 18909775 <GO>}

How did I know that answer was coming? Okay. Quickly, just going to the military services group and the contact modifications. It sounds like they're kind of meaningful, something that is going to provide a boost in 2014 and maybe 2015 results. Is that accurate and then does that kind of cause a head wind potentially in 2016 or so, if you get similar size and contracts moving forward?

A - Jeffry Sterba {BIO 1426511 <GO>}

Well, I guess, two things. You're right about the timing. Most of these projects are two, one to two and occasionally three years so for example; the major rebuild on the wastewater system at one of the installations that could slip beyond two years. So, but you know, we're always hoping, and looking, and working with our customers on the bases as to what will occur in the next year. The other piece is, as we've said before, there are a number of military installations that are out for bid today. Now we don't go after every single military installation we go after the ones where we believe we truly can add value and that value can be recognized through the size of the contract. We have quite a lot going on in that area and we want to make sure that the ones we take on we can truly excel at, and we have a number of those out in the bid stage today with awards that could happen as early as, let's say early first of next year through 2014, so what we look to is to be able to expand the base of business through the addition of new bases to the portfolio, and that this additional modification capital is really supplemental to the fundamentals that we have within the business.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay, so any kind of falling off from the contract modification you think would be replaced by a larger number of bases operated and everything?

A - Jeffry Sterba {BIO 1426511 <GO>}

Yes and probably more than offset.

Q - Jonathan Reeder {BIO 18909775 <GO>}

And then last question on the parent debt balance. What is it, I guess, to not associate the subsidiary rate base. Where are you going to be year-end and how does that compare to where you were say Q2 before taking some of these actions?

A - Susan Story {BIO 3335156 <GO>}

Right, well, Jonathan, if you remember, it was about $1.2 billion, which we reported $750 million, matured, matures in 2017 and another $450 million matures in 2018. What we did was take out

$226 million of the $750 million that was set to mature in 2017.

Q - Jonathan Reeder {BIO 18909775 <GO>}

And then you said later in the quarter by year-end, you are going to take out some more, is that correct?

A - Susan Story {BIO 3335156 <GO>}

Well what we had, not necessarily of that parent company debt, what I mentioned is that we have, we issued redemption notices on November 1, last Friday, for about $149.8 million, $150 million of bonds that or debt that has coupon rates at 8.25% and 10%. That is going to be a nice pickup and we have maturing debt of about $101 million by December 21.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay, so you'll be refinancing that and not taking it out?

A - Susan Story {BIO 3335156 <GO>}

Yes.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. Great. Thank you, so much.

Operator

Your next question comes from the line of Kevin Cole of Credit Suisse. Please go ahead.

Q - Kevin Cole {BIO 18674088 <GO>}

Good morning.

A - Jeffry Sterba {BIO 1426511 <GO>}

Hi, Kevin.

A - Susan Story {BIO 3335156 <GO>}

Good morning.

Q - Kevin Cole {BIO 18674088 <GO>}

Just with home owner services becoming increasingly important and a bigger part of your business, can you talk about the risk profile of the business? Meaning, are you wearing the event risk or are simply offering a product that is wrapped by a third party insurer and then do your policies cover like systematic or any catastrophic events that could impact a large number of your customers at once?

A - Jeffry Sterba {BIO 1426511 <GO>}

Good questions Kevin, a couple of things; no we don't use third party reinsurance we basically self insure, but most of these are capped. There is a cap on the total amount that we're exposed too so we'll do the repair or replacement up to X dollars, so that is the way that we manage the ultimate exposure but really, the primary exposure, is our contractor management process, which is a very thorough vetting of both, what's done, how it's done, the oversight of that, and who's doing it. We don't have unlimited exposure for situations we also, obviously will look at, we price differently in different areas. There is not a uniformed price across the United States, and that is because systems are different. Their age is different; the soil chemistry will be different. So, they will have different risk patterns. That gets taken into account and as well as the cost of repairs gets taken into account in that pricing strategy.

Are there limitations on the coverage? Absolutely. And then they run from things like you have to have been a customer for usually a 30 days sometimes it's longer than that before any claim can be processed and that is to help ensure that we don't have somebody who realizes they have a leak and try to pick up, I'm sorry, I didn't use that word, warranty for it. And then it also goes to certain limitations relative to acts of God and things of that nature so we protect ourselves in a variety of different ways relative to what that exposure can be.

A - Susan Story {BIO 3335156 <GO>}

And added to what Jeff said, we have a robust system where we evaluate frequency and severity of each of the events and we look at where those events are, we look at severity, in fact this year we disclosed in an early Q at the end of the First Quarter, that we had a spike in severity so we started managing looking at where that was, evaluating contractors, and we actually were able to remedy that and it's back to its historic rates. We have a really strong system around managing those risks by looking at what is happening, where it's happening, and to just point how we process.

A - Jeffry Sterba {BIO 1426511 <GO>}

Some of you met Sharon Cameron who runs our market based business. She came out of home owner services and was instrumental in its start-off and bringing it to this level. She'll be with us at the December 17 meeting so you get a chance to visit with her.

Q - Kevin Cole {BIO 18674088 <GO>}

Great. And just so I'm clear on the final part of what you said, you do not insure against like act of God, right, like hurricanes and earthquakes, and large-scale events like that?

A - Jeffry Sterba {BIO 1426511 <GO>}

Yes there is always definitions about what is included and which kind of thing, but the answer to that is generally yes.

Q - Kevin Cole {BIO 18674088 <GO>}

Do you have like a notional like value at risk measurement that we could follow?

A - Jeffry Sterba {BIO 1426511 <GO>}

You know that is a good question. We do not put one forward but, you know what, Kevin that is something we want to think about because there are things that we look at but we don't make those available. And part of it is the business size, but we want to think about that. Good, good job.

Q - Kevin Cole {BIO 18674088 <GO>}

Thank you, guys. Have a good day.

Operator

Your next question will come from the line of Heike Doerr of Robert W. Baird. Please go ahead.

Q - Heike Doerr {BIO 15084832 <GO>}

Thank you. Good morning.

A - Jeffry Sterba {BIO 1426511 <GO>}

Hi Heike.

A - Susan Story {BIO 3335156 <GO>}

Good morning, Heike.

Q - Heike Doerr {BIO 15084832 <GO>}

It should come as no surprise that I would like to talk about regulatory strategy. If I look at the last two years the amount of rate awards you have gotten in total has been 100 to 120 of rate cases separate from the surcharges even if we assume that the Pennsylvania settlement is completed we're looking at a total amount of rate increases awarded of only about a third of that, I am wondering is this just an off year are we looking at the new normal? How should we think about your rate case cycle and how you manage rate increases versus infrastructure surcharge increases?

A - Jeffry Sterba {BIO 1426511 <GO>}

Good question, Heike. Let me pose it in I guess three ways. Remember, if I go back 3, four years ago, the amount we were generating from automatic adjustment clauses was about 13% of the capital investment every year. That was a lower level of capital investment than we're at today and today it's about 40% of all invested capitals coming back through those mechanism. So, the importance of those mechanisms has, and this has been very targeted and strategic, has increased relative to the total amount of rate relief, if you will. The second one is we went through a period of rate-case catch up as we've talked about before, and we're largely out of that today and our focus is in moving the rate cases that we do file to a much higher percentage of capital cost recovery rather than operating cost recovery.

You'll remember the slide that Susan used that would show if you go back through 2008 though 2010 the, I think it was 56% of the recovery was really operating costs and only about 44% was capital costs whereas now, it's 94% is capital cost, so I guess the point there would be its I am not sure it's effective to look just at the dollars of rate recovery, it's what is driving those dollars, is it capital or operating costs? Also, then what are the other ways in which that revenue is picked up? Because one of the things we're very focused on is to ensure we can drive efficiency in our business to minimize the rate-of-rate increase while getting the capital investment that needs to made in the ground.

A - Susan Story {BIO 3335156 <GO>}

And remember, if most of your rate case is capital the more of that you can actually recover through surcharges, then you can extend out your general rate cases, and again, not to be another advertisement, but on December 17, we will give a look into incentive that we think can be covered next year.

Q - Heike Doerr {BIO 15084832 <GO>}

Great. Thank you. And kind of as a follow-up question, we used to think of you as loosely on a two-year rate case cycle for most states outside of California. Has that strategy been revisited now or if we're capital focused on rate increases, does the two-year cycle still make sense.

A - Jeffry Sterba {BIO 1426511 <GO>}

Well it's not just; it also involves the DSIC treatment in that state, et cetera. I think you will see slightly longer because we really were on an 18; to 24-month. You will see slightly longer periods in some states it may go to three years and other states, in other states it will be 2.5, some states will still, will have to, may stay in the 2-year range because we don't have those kinds of cost recovery mechanisms or we also have an issue, of it's not a future test year state, we've got declining usage, so it will vary by state, but I think the drum beat of 18 to 24 months is broken. That's not our future.

Q - Heike Doerr {BIO 15084832 <GO>}

Got it. Great. Thank you. Appreciate it.

Operator

[Operator Instructions]

The next question will come from the line of a Steven Fleishman of Wolfe Research. Please go ahead.

Q - Steve Fleishman {BIO 1512318 <GO>}

Yes, hi. Good morning.

A - Jeffry Sterba {BIO 1426511 <GO>}

Hi Steve.

Q - Steve Fleishman {BIO 1512318 <GO>}

Hey Jeff, just a little more color on the military business then the homeowner services, relative to this year could you give us events of how they're coming through are they kind of on plan, ahead of plan? Just a little color there would be helpful.

A - Jeffry Sterba {BIO 1426511 <GO>}

Well I think home owner services has done better than we really expected in terms of the rate of subscriptions in the New York area. I just, we really didn't expect that it would be as well-received as it has been and I think part of that is because of the strength of the partnership with New York City in the administration that it has been, they have done a lot to help promote it. And then picking up Nashville, which is another opportunity for a 175,000 customers, we're pleased with the way home owner services has come long and their strong performance. On the military side, you know I tell you, the folks that we have that run that business do a very, very strong job on behalf of their customers, the military, and both in terms of holding cost down and also in terms of quality of performance and bringing home enough of a return that we say this is a good business to be in. I would say that the issues of federal budgets, sequestration to some of extent and then the stand down for awhile does, did impact some timing issues, and so for example; there is an award we thought may have already originally it would have been made by now it's delayed a bit. And it has nothing to do with policy it's all got to do with people being able to be at the office and do the things necessary to issue awards so it has that side maybe has moved a little slower, but it really hasn't impacted the performance of our overall business and as I said the mods that we received recognize that these bases are old and they need capital investment and we're going to be there to provide it, so we're pleased with the kind of awards that we received in that regard. So both of those business lines have had a very good year so far.

A - Susan Story {BIO 3335156 <GO>}

And to add to that, Steve, you know after the First Quarter we talked about that some of the capital projects were delayed, there still will be a certain amount of those that will roll over into 2014. We have made up some of the ground, but we feel our folks in that area feel like that which won't get done this year will all roll over in 2014.

Q - Steve Fleishman {BIO 1512318 <GO>}

Okay. One other question, we saw over the last I think few weeks an Illinois law that might support more privatization of distressed water companies and then Indiana might be looking at one. Can you talk more about is that something that you're seeing and could be significant for you? Or more marginal?

A - Jeffry Sterba {BIO 1426511 <GO>}

You know Steve, one of the things that we have got built into our strategy and we will talk a little bit about this in December, but is we have our key strategic objectives and metrics associated with it, but we have enablers. It's the enablers that we strategically focus on because without those enablers, that objective is really interesting but you can't get there, so for example, having legislation pass that allows the, a premium to be paid on a troubled system in order to get that under good control and under the state's oversight is one of the enablers. Another enabler is the law that we got passed in Pennsylvania that was geared around being able to roll wastewater rate bases into overall rates to be able, so that the repair work that you have to do with a newly acquired wastewater system doesn't cause such rate shock by a 1005 rate increase just on the few customers that are served by that wastewater system, or the legislation that we got passed this year down in Tennessee which opens the door for frankly, the filing that we just made requesting a number of different elements of cost recovery and capital recovery, so these enablers are very targeted. We look at each state, so we have general theorems about what we want to get done, but what you need to do in each state will be different. In some states, we may not make it the first time so we go back, or we work with the commission and find out that the commission understands it. They may not be willing to do it unless the legislature speaks, okay, so we go work with the legislature, so there is a very specific plan around those items, and they're all geared to open up the pathways for what we believe can be that continued strong growth. Not only of our business, but of frankly, better service to customers.

Q - Steve Fleishman {BIO 1512318 <GO>}

Great. Thanks a lot.

Operator

And Mr. Sterba, there are no further questions at this time. Please continue.

A - Jeffry Sterba {BIO 1426511 <GO>}

Well thank you all very much for joining us today. Have a great rest of the week and for those of you that we see in December, we'll look forward to talking then. And if you have any questions, you all, obviously, you know who to call, Ed. If anything comes up in between. Take care.

Operator

And thank you. Ladies and gentlemen. this does conclude the conference call for today. Again, we thank you for your participation, and you may now disconnect your line.