Q3 2014 Earnings Call

Company Participants

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

Other Participants

- Jonathan G. Reeder, Wells Fargo Securities LLC
- Michael E. Gaugler, Brean Capital LLC
- Rich A. Verdi, Ladenburg Thalmann & Co., Inc. (Broker)
- Ryan M. Connors, Janney Montgomery Scott LLC
- Shivangi D. Tipnis, Global Hunter Securities LLC
- Spencer E. Joyce, J.J.B. Hilliard, W.L. Lyons LLC

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. And welcome to American Water's Third Quarter 2014 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 conference call, an audio archive of the call will be available through November 14, 2014, by dialing 1-412-317-0088 for U.S. and international callers. The access code for replay is 10053559. The online archive of the webcast will be available through December 6, 2014, by accessing the Investor Relations page of the company's website located at www.amwater.com. After today's presentation, there will be an opportunity to ask questions.

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

Edward D. Vallejo {BIO 16076814 <GO>}

Thank you and good morning, everyone. And thank you for joining us for today's call. As usual, we'll keep our call to about an hour. And at the end of our prepared remarks, we will have time for questions. But before we begin, I'd like to remind everyone that during the course of this conference call, both in our prepared remarks and in answers to your questions, we may make statements related to future performance.

Our statements represent our most reasonable estimates. However, since these statements deal with future events, they are subject to numerous risks, uncertainties and other factors that may cause the actual performance of American Water to be materially different from the performance indicated or implied by such statements. And such risk factors are set forth in the company's SEC filings. All statements in this call relating to earnings per share refer to diluted earnings per share.

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

Susan N. Story {BIO 3335156 <GO>}

Thanks, Ed. Good morning to everyone and thanks for joining us on the call. I'm joined today by Linda Sullivan, our CFO, who will go over the third quarter results; and Walter Lynch, COO and President of Regulated Operations, who will discuss key matters in our Regulated Business.

I'm pleased to report that, through the hard work of our 6,600 employees at American Water, we delivered a quarter of solid performance, although most of our states experienced significantly cooler temperatures this summer. During this quarter, we achieved increases in revenues and earnings per share, made significant progress growing our Regulated and Market-Based Businesses, and we reached a settlement with our unions on national benefits after a four year impact, all while delivering water services to our customers safely and reliably.

In addition to the 2,200 customers in regulated acquisitions that we closed on this quarter, we had some exciting news on Tuesday. The residents of Haddonfield, New Jersey; Arnold, Missouri; and Russiaville, Indiana all voted to sell their community's water and wastewater systems to American Water.

We're honored that they put their votes of confidence in our company, to bring safe, clean, affordable and reliable services to them. And we look forward to welcoming our newest 19,000 customers in the near future following regulatory approval. These communities are adjacent to our current water and wastewater system. So we can bring economies of scale and existing resources to run these systems effectively and efficiently.

As you can see on slide five, our revenues increased nearly 3% for the quarter. Income from continuing operations rose 4.5% to $0.87 per diluted share, which is not adjusted for that weather impact of $0.04 to $0.06 per share. Walter will discuss the weather in more detail in just a few minutes.

Excluding the midpoint of this impact, the weather normalized income from continuing operations was an EPS of $0.92 for the third quarter. The increase in earnings per share is mainly due to the success of our Regulated Business and a pending rate authorizations and surcharges that support our rate-based growth through infrastructure investments.

We also continued strong cost management across our businesses. While we saw a slight decrease in cash flows from operations for the quarter, primarily due to the weather, of $0.04 to $0.06, we continue to improve our earned return on the equity. Our adjusted ROE for the last 12 months ended September 30, 2014, increased by 80 basis points to 8.85% compared with the same period last year.

Turning now to slide six. We continue to invest in the pumps, plants and pipes that deliver water and water services to our customers. This quarter, we invested $314 million in needed improvements. Year-to-date, we have made capital investments of over $700 million. And we expect to spend about $1 billion by year's end.

We completed four acquisitions this quarter adding 2,200 customers. Year-to-date, we've added about 3,700 customers on closed acquisitions. At this time, we have about 25,000 additional customers in pending acquisitions, which includes the 19,000 in Haddonfield, Arnold and Russiaville, which I've talked about earlier.

We grew our Market-Based Business through the expansion of our homeowner services territory, as well as through our military group. This past week, we received notification from the Orlando Utilities Commission of its intent to award American Water Resources a home warranty protection agreement to market to its 260,000 customers, pending contract negotiations.

During the quarter, we also announced our second military award this year, Picatinny Arsenal in New Jersey. We now serve 11 military installations across the country. The Department Of Defense had not awarded any new contract the size we target since 2009 until the two this year. We won both of those through competitive bids. We are always honored to have the privilege to serve the men and women who protect our freedom and liberties every day.

During the quarter, we made progress on our ongoing goal to actively address regulatory lag and promote constructive regulatory frameworks. Notably, as Walter will discuss, the New Jersey Board of Public Utilities approved modifications to consolidated tax adjustment. And in California, a general rate case settlement was reached with the Office of Ratepayer Advocates and other interveners. We also filed for additional infrastructure investment revenues in Missouri and Tennessee which Linda will discuss further.

We recognized the important balance between making needed investments in our systems and helping our customers have affordable bills. To do that, we continue to improve our O&M efficiency ratio, which, adjusted for West Virginia and weather, improved 330 basis points from this 12-month ended period compared to last year.

We also reached an agreement on October 31 to sell Terratec Environmental Ltd., the Market-Based residuals management subsidiary of our Canadian residuals division. And we expect to close in the coming weeks. Our main driver for this portfolio optimization was to exit the Class B biosolids business and concentrate on Class A biosolids, which is a more specialized market and is more aligned with our Market-Based Business model.

Lastly, I'm pleased to report that American Water and the Utility Workers Union of America, representing the company's union, reached a settlement regarding our national benefits agreement. Walter will also provide more detail on that momentarily.

Moving to slide seven. In our ongoing commitment to our shareholders, American Water's board of directors on September, the 19, declared a quarterly cash dividend payment of $0.31 per share, payable on December 1, 2014, to all shareholders of record as of November, the 10. This continues our annual dividend payout target of 50% to 60% of net income, while growing dividends at a rate aligned with earnings per share growth.

Based on our performance this year, we are narrowing our earnings guidance for adjusted continuing operations for the year from $2.35 to $2.45 to a range of $2.38 to $2.44. This range is not adjusted for the $0.04 to $0.06 per share effective adverse weather. But it does exclude the impact of the Freedom Industries chemical spill in West Virginia.

We remain confident in our ability to deliver on our long-term EPS growth of 7% to 10% through execution of our investment and growth strategies, as well as continuing operational efficiency gains. Also, we plan on providing 2015 guidance on a conference call at 11 AM on Monday, December, the 15. So stay tuned for additional details and please mark your calendars.

Walter will now give an update on our Regulated Business.

Walter J. Lynch {BIO 6064780 <GO>}

Thanks, Susan, and good morning, everyone. Let's start with an update on the weather. This was a very cool and mild summer, as evidenced by the NOAA climate data on this slide. We've seen the same theme from electric and gas utilities throughout these regions during this third quarter earnings season.

In some of our service areas in Missouri, Illinois and Indiana, we experienced record cool temperatures. At the same time, we saw above normal precipitation levels in Indiana, Illinois and parts of Pennsylvania. This did impact demand and revenues. And we estimate the weather impact to be about $0.04 to $0.06 for the quarter. As always, we did take appropriate management actions to address this revenue shortfall associated with this unfavorable weather.

In contrast, California continues to experience a record drought and the hottest year on record. In response, California American Water has conducted extensive conservation outreach, mailings, bill messages, e-mail, social media campaigns and community events. We developed a special section of our website dedicated to keeping customers updated on this drought, its impacts and the resources we have available to help.

California American Water is calling for voluntary conservation from its customers in all districts, with the exception of one district, Larkfield district, which is in Sonoma County, which instituted mandatory conservation on October 23. State-wide water system delivery is down about 10% since the previous year. And in the third quarter, each California districts saw decreases in water use. Because of mechanisms in place, the company's revenues will not be impacted by declines in sales due to conservation efforts.

As Susan relayed earlier, in our California general rate case for rates effective 2015 through 2017, we and the Office of Ratepayer Advocates, along with others, filed a settlement. If approved, the settlement would provide $13.6 million in additional annualized revenues in 2015. And subsequent increase is presently estimated at $5 million for 2016 and $6.3 million for 2017.

We're awaiting a California PUC decision on this settlement in the general rate case at this time. Our California team also continues to make progress on the Monterey Peninsula Water Supply Project. The test well permit will be considered before a state agency next week. And construction work and drilling on the test well could begin this month.

And, finally, for California, our San Clemente Dam Removal Project is making great progress. Sediment has been relocated and a new path for the river has been cut. When the next rain occurs there, it will be the first time that water will actually flow through these new channels. This project is on time and on budget with substantial completion expected in late 2015 or early 2016.

Moving on to New Jersey on the regulatory front. As Susan said, the Board of Public Utilities approved changes to consolidated tax adjustments. The BPU is recognizing the more standard practice that other states have to encourage investment. These approved changes include limiting the look back to five years and additionally allocating 75% of the savings to the company and 25% to utilities' customers.

I also want to reiterate what Susan said about Tuesday's vote in Haddonfield, New Jersey. We're so pleased that the Haddonfield residents voted to sell their water and wastewater systems to New Jersey American Water. We'll now seek the approval by the Board of Public Utilities, which we expect to take place sometime in mid-2015.

Because, we already provide those services to surrounding communities, we're able to leverage existing resources to more efficiently and effectively operate these systems. Immediately after closing, we're going to begin to make the much-needed upgrades to the systems.

In fact, just to give you some transparency on it, in the first year after closing, we've committed to spending $6.5 million on several critical projects to significantly improve the wastewater system. An additional $9.5 million will be invested in the following four years to modernize these systems.

Haddonfield, along with Arnold, Missouri and Russiaville, Indiana, are great examples of the type of solutions that we can offer communities challenged by competing budget priorities and deteriorating water and wastewater systems. They're also great examples of our local business model. Our employees live and work in the communities and in these referendum efforts help to inform voters about the ways American Water can work with them to address their challenges.

In all three of these communities, local government leaders, along with our local employees, ensured that the citizens have the data they needed to make informed decisions on Election Day. That's what it means to be a local company and that's how we like to operate in the states where we're privileged to serve. We're committed to continuing the partnerships we developed with Haddonfield, Arnold and Russiaville. And I want to thank all of our employees who have volunteered to help in our growth efforts.

Additionally, last week, American Water and the Utility Workers Union of America, representing the company's unions, jointly announced the ratification of a settlement related to the complaint filed by the Utility Workers Union of America regarding our national benefits agreement. Part of this settlement included a new healthcare and benefits package for our workforce through 2018.

This benefits package remains competitive compared to other plans offered in the utility industry. We're pleased to reach a settlement that we believe is fair for both our employees and our customers. We look forward to working together with our unions in a collaborative way on issues such as safety, employee training and development and growth opportunities.

And, finally, I want to provide a brief update on the Freedom Industries chemical spill in West Virginia. From an operational perspective, we continue to monitor raw water for MCHM and PPH. And we're pleased to report that there were no traces of these substances in any samples taken.

We'll continue to do this monitoring until the Freedom Industries' site is certified as decontaminated by the West Virginia Department of Environmental Protection as this site right now is being completely torn down. We anticipate that this will occur in the next few months. Otherwise, we're back to business as usual in West Virginia.

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

Linda G. Sullivan {BIO 7300156 <GO>}

Thank you, Walter, and good morning, everyone. It is a pleasure to be here with you today to review our third quarter financial results in more detail.

Turning to slide 13, third quarter 2014 had solid financial results. Despite the cool summer temperatures, our revenue, operating income, operating margin and earnings improved over the third quarter of last year. In addition, we continued to make progress on improving operating efficiency.

More specifically, for the quarter, we reported operating revenues of approximately $846 million, $24 million or about 3% higher than the third quarter of last year. Both periods were impacted by weather, which I will cover in more detail in a moment.

Operating income rose to $337 million or about $14 million higher than the same period last year, resulting in just over a 0.5% increase in operating income margin. Third quarter income from continuing operations was approximately $157 million or $0.87 per share. This compares to $150 million or $0.84 per share for the third quarter of 2013.

As Susan mentioned previously, we reached an agreement to sell Terratec Environmental Ltd., which was part of our Market-Based Business segment. As a result, both the loss on the sale and the operating results have been classified as discontinued operations. This resulted in a combined loss from discontinued operations of $0.02 per diluted share for the quarter and

$0.03 per diluted share on a year-to-date basis. Although we reported a loss on the sale of this transaction, the transaction is structured to monetize about $4 million in tax benefits.

As mentioned earlier, both periods presented were impacted by weather. In the third quarter of 2014, weather impacted our results in the range of $0.04 to $0.06 per share. Last year, the weather impact was $0.02 to $0.04. Excluding the midpoint of these impacts, adjusted weather normalized earnings per share from continuing operations was $0.92, which is a $0.05 or approximate 6% increase compared to the weather normalized third quarter of last year.

We also paid a dividend of $0.31 per share during the quarter, which represents an approximate 11% increase over the $0.28 per share payment in the third quarter of 2013. We reported cash flow from operating activities of about $390 million for the quarter, relatively flat compared to the same period last year, despite the larger weather impact experienced this summer.

Now let's discuss the different components of our adjusted EPS growth from continuing operations on slide 14. On the left side of this page, our starting point is third quarter 2013 recorded earnings per share from continuing operations of $0.84. Last year was cooler and wetter than normal, so we have adjusted up for the midpoint of the weather impact or $0.03, which gets us to what we consider a weather normalized earnings starting point for the third quarter of 2013 of $0.87 per share.

And now, I will walk through each of the EPS drivers, which gets us to our third quarter 2014 adjusted weather normalized EPS of $0.92 per share from continuing operations. First, we had lower revenue in the third quarter of 2014 due to cooler weather in many of our states. This impact was in the range of $0.04 to $0.06 per share for the quarter and shown on the EPS bridge is the midpoint of that range or $0.05.

The next item shows the impact from both income and general taxes, which were higher by $0.03 per share over the same quarter last year due to two items: higher income tax true-ups of about $0.02 and higher property taxes of about $0.01, primarily from tax assessments in Pennsylvania and Kentucky.

Next, in the third quarter 2014, we reported higher consolidated depreciation and amortization expense of about $0.02, principally from growth associated with our capital investment programs, including our SAP project that was placed into service during 2013.

Next, EPS for our Market-Based Business was a $0.01 lower than the same quarter last year. However, there are two one-time items in the third quarter of 2013 that lowered the quarter-over-quarter comparison by $0.02 per share, including $0.01 from price redeterminations in the military services business and $0.01 from the release of contract reserves due to resolving uncertainties on certain O&M contacts.

Adjusting for these 2013 items, the Market-Based Business segment would have actually increased $0.01 per share on a quarter-over-quarter basis, driven by additional capital projects associated with our military contract and contract growth in homeowner services, mainly with our New York City contract, as well as expansion into other geographic areas.

In the next bar, the incremental revenue from regulated acquisitions increased a $0.01 per share, due mainly to our acquisition of Dale Services Corporation in Virginia in the fourth quarter of 2013. We also had a $0.05 increase from higher regulated revenue. This increase over the prior quarter was made up of three key items.

First, authorized rate increases for a number of our operating companies increased $0.08 per share. Second, increased surcharge and amortization of balancing account increased $0.01 per share. And, third, these increases were partially offset by decreased demand of about $0.04 per share as we continue to experience declining usage, primarily for our residential customers, in the 1% to 2% range.

Next, regulated O&M decreased $0.05 per share for the quarter compared to last year due to three main drivers. First, employee related costs, which were the single biggest contributor, decreased by $0.03 per share or 6.5% for the quarter, primarily from reduction in pension and postretirement benefit costs due to the change in the discount rate.

Second, operating supplies and services decreased $0.01 per share, primarily driven by lower contract services, as last year we had additional contractors assisting us with our SAP system stabilization and we experienced higher regulatory expenses. Lastly, production costs decreased $0.01 or 3.2%, primarily due to lower chemical cost in our Illinois subsidiary.

In the appendix of the slide deck, we have included our traditional revenue and expense bridge slides to provide more detail to the earnings variances I just discussed. I will not cover these in detail today as most items are a duplicate of what I discussed on the earnings bridge.

Also, I encourage you to read our 10-Q on file with the SEC for a more detailed analysis of both revenues and expenses. We'll be happy to answer any questions or provide further clarification, if needed, during our question-and-answer session.

On slide 15, we show our O&M efficiency ratio. We continued to see progress in this metric. For the 12 months ended September 30, 2014, we achieved a 36.8% ratio, which is a considerable improvement over the 40.1% ratio we had in the same period last year.

This ratio adjusts for weather and excludes the expenses related to the Freedom Industries chemical spill. As we have shared with many of you previously, our long-term stretch goal is to achieve a 35% O&M efficiency ratio by 2018. There is a full calculation of this ratio in the appendix section of the earnings call slide deck.

Now, let's look at recent regulatory highlights on slide 16, which shows formal rate cases awaiting final order, as well as step increases and infrastructure filings, which impacted the quarter or are still pending. But before I cover this slide in detail, I want to point out what is really key about this slide. And that is that you can see a shift in the way that we recover capital from formal rate cases to infrastructure surcharges.

As you may remember, in past years, we would have eight, maybe 10 rate cases outstanding and few or no infrastructure filings. Now, we have eight surcharge filings approved this year.

And, as you know, we recover our capital faster with these mechanisms, which improves our return on equity, provides more flexibility around the timing of formal rate cases, as well as providing better customer service and moderating bill impacts for our customers.

Back to the slide itself, in terms of pending rate cases, as of today, we are awaiting orders for general rate cases in two states, California and Indiana. In California, we now have a settlement with the Office of Ratepayer Advocate and other interveners, as Walter mentioned. Our Missouri and Tennessee subsidiaries filed for additional annualized revenues from infrastructure investment charges for a combined total of $11.1 million.

Shifting to rates that became effective in 2014, we had $2.4 million in step increases from prior rate cases in New York and California. A total of $25.6 million in additional annualized infrastructure investment charges have been awarded this year with the latest one being the July 1 approval of our annualized distribution system improvement charge of $7.4 million in New Jersey.

As I mentioned earlier, these infrastructure charges represent the ability to more timely recover capital, which we invest to improve both infrastructure and customer service. Additionally, we implemented new rates effective January 1 of this year in Pennsylvania and effective April 18 in Iowa for a combined annualized total of $29.8 million.

These are the highlights of these cases. And we advise you to review the footnotes for a fuller understanding of particular cases. And while we cannot predict the outcome of these cases, we hope that this will help you understand our current rate environment. And in the appendix, you will also find an updated version of our largest 10 states with our authorized rate base and allowed return on equity.

Lastly, as Susan mentioned, we are now narrowing our adjusted earnings per share guidance for continuing operations for the year to a range of $2.38 to $2.44 per diluted share, which is not adjusted for the adverse weather impact of approximately $0.04 to $0.06. This guidance does exclude the impact of the Freedom Industries chemical spill in West Virginia.

And, remember, that our year-end guidance is a range to account for a variety of factors during the year, with the largest being weather. Unless there are extreme weather impacts, this range should absorb those impacts. Our quarterly earnings are points, not ranges. So we like to disclose weather effects to give you more insight into our actual performance. Now, given that the guidance is not adjusted for weather, you should use the $0.87 reported in this quarter on your way to building our annual 2014 performance versus our $2.38 to $2.44 guidance range.

With that, I will turn it over to Susan.

Susan N. Story {BIO 3335156 <GO>}

Thanks, Linda. As we discussed last quarter, we will conclude each of our earnings call by highlighting initiatives or recent news than maybe outside of what we would typically cover in an earnings call. This quarter, we're going to highlight American Water's addition to the Dow Jones Utility Average.

We are very proud to be added to this index. The utility average is a 15 member index that represents the stock performance of large, well-known U.S. companies within the utility sector. During its 78-year existence, there have only been three major reorganizations of the index and only 40 companies have been part of that average since it was introduced in 1929.

Additionally, we're the only water utility to ever be part of the index. And, interestingly, we've been a member twice. When it was started in 1929, the original members of the Dow Jones Utilities Average included our predecessor company, American Water Works & Electric Company. In 1947, under the newly implemented Public Utility Holding Company Act, six holding companies, including our predecessor, were dissolved and removed from the Utility Average. Now, 67 years later, we're back. And, of course, we're better than ever.

Being included in the Utility Average is a tremendous honor for American Water in the entire water and wastewater industry for several reasons. First, having the index recognize the critical role the water industry plays in the utility space. And the economy is important. The legacy of our country's prosperity is rooted in infrastructure investments. And water and wastewater represent vital infrastructure necessary, not just for economic growth, but for quality of life.

Second, water is critically needed for electricity and energy production and for the growing of food. The EPA's November 2013 report on the importance of water to the U.S. economy notes that 94% of our economy is linked to this water, energy, food mix.

And, finally, being included in the Utility Average is a testament to our ability at American Water to deliver on our investment and operating strategies and provide dependable value to our customers and our shareholders. This achievement is a direct reflection of the dedication and expertise of our employees, who are committed to the customers and communities that we serve every single day.

In my six months as CEO, I've had the pleasure of visiting the majority of our work locations. And I've met with the incredible people of American Water, who every day delivers safe, affordable and reliable water services to our customers. These are the same people, who dedicated more than 4,700 charitable service hours to the communities that we serve, just during September, in our dedicated Month of Service. Our employees are very inspiring to me for these reasons and more. And I appreciate the privilege of being part of their team.

So now, we're happy to take any questions you might have.

Q&A

Operator

We will now begin the question-and-answer session. Our first question comes from Ryan Connors from Janney Montgomery Scott. Please go ahead.

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

Hi, Ryan.

Q - Ryan M. Connors {BIO 15032883 <GO>}

Great. Thanks. Hello. How are you?

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

Good.

Q - Ryan M. Connors {BIO 15032883 <GO>}

Great. So a couple questions. First off, I wanted to just talk about this New Jersey CTA issue a little bit and you gave a really nice discussion of it, Walter. But could you kind of talk to us a little more about the financial impact of that on the P&L and the timing of that in terms of how we quantify that and go about translating that into an actual earnings contribution?

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

Ryan, this is Linda. And this is a step in the right direction, we believe, for New Jersey. This decision will impact us when we file our next rate case in New Jersey. That is when it would become effective for us. And, as you know, we filed our last rate case in New Jersey in 2011. And that rate case was a black box settlement. So we cannot disclose the financial impact of this. But when we look at the timing of our rate case and the flexibility that we have in terms of timing around our infrastructure mechanisms in New Jersey, we take all of those things into consideration to help determine when we will file that next rate case and be able to implement this new change.

Q - Ryan M. Connors {BIO 15032883 <GO>}

Okay. But really no estimate or guidance on kind of the magnitude of the impact?

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

Because it was a black box settlement, last rate case, we really can't disclose that.

Q - Ryan M. Connors {BIO 15032883 <GO>}

Got it. Okay. Fair enough. And then just the other question I had was just more kind of tactical, but – and I guess we'll get more detail on this on December 15, but just talking about the weather from a big picture perspective. So we had the cool temperatures in the Midwest, but, as you mentioned on the call, last year's third quarter was also negatively impacted by weather. So, as we look into 2015, is it safe to say we've got a very easy comparison, so to speak, as we sort of think about growth next year in demand?

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

So what we do from an earnings guidance perspective is we'll give you weather normalized earnings guidance for 2015, which, as we indicated earlier, will occur on December 15.

Q - Ryan M. Connors {BIO 15032883 <GO>}

Okay.

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

Ryan, as Linda mentioned, just as the electrics do also, we put a range for guidance, because while we look at budgets and everything weather normalized, we understand that there are going to be variabilities. We disclosed at Investor Day last year – a set of those variabilities. And, for us, just like the electrics, the largest potential variable is weather. In a typical year, we account for some of that variability in our range, unless there is extreme weather. And, for example, back in 2012, the positive uplift was between $0.13 and $0.16 for American Water. That's a little beyond what you would have as normal variability. So when we look at weather, you don't want to start having a lot of guidance ranges that are weather affected and this type of thing. So we try to keep it as clean as we can.

Q - Ryan M. Connors {BIO 15032883 <GO>}

Okay. Great. And then one last one before I hop out, is just on your payout ratio. Can you talk to us about where you're running right now and how you feel about where you're at and whether you would up that payout ratio a bit going forward, depending on your equity capital needs and so forth? Thanks.

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

Our payout ratio is currently at 2.5% and the way that we look at – I'm sorry that's the – I'm sorry. Let me correct that. Our payout ratio is just over 50%. We have a target range for our payout ratio of 50% to 60%. And we plan to – our goal is to grow our dividend commensurate with our EPS growth.

Q - Ryan M. Connors {BIO 15032883 <GO>}

Okay. Great. Thank you.

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

Thanks, Ryan.

Operator

Our next question comes from Michael Gaugler from Brean Capital. Please go ahead.

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

Hi, Mike.

Q - Michael E. Gaugler {BIO 7139923 <GO>}

Good morning, everyone. I've actually got a follow-up on the CTA to Ryan's question. Just wondering given the changes and how you think holistically about where you're going to deploy future investment. Is that enough to put New Jersey at the top of your list?

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

When we look at the prioritization of our capital, ROE is one of the key items that we look at in the prioritization of capital in addition to what are the needs for the investment in the states. And – so, that is a factor that we will look at, as we move forward and file a rate case in New Jersey. So, all of those factors come into play when we look at the capital prioritization. This is something that is moving in the right direction. So, although, externally we have seen lower ROEs being authorized in New Jersey, we see that this will offset those lower ROEs moving forward.

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

And, Mike, this is Walter. Given the DISC program that was approved a few years ago, as you know, we've invested a lot more in New Jersey than we have in prior years. So it is one of our top states and we'll continue to do so, because of the DISC mechanism and the needed investment that we have to make in New Jersey.

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

And, Mike, as you know, and you've heard us say over and over, in our capital program, we will invest what we need in every state to meet our customer needs. We will make sure that our water is safe and clean and reliable. So you also know that that we do have some discretion. After we have committed those funds, we have discretion with other funds. And, as Linda and Walter both said, we look at a variety of factors, including ROE, and, as Walter said too, where you have mechanisms, you can get the return in a more productive and reduced regulatory lag. So, all of those factors come into play. So we look at our capital very carefully. We make sure that every single state has what they need to deliver services to customers than that which is discretionary. We look at these other factors.

Q - Michael E. Gaugler {BIO 7139923 <GO>}

All right. Then I have just one other question, probably for Walter, just kind of wondering how you're feeling about water supply in California. It seems like some of your peers are getting just a tad bit nervous looking out into 2015.

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

Well, right now, Michael, we're still okay with water supply. But, again, we've asked for voluntary conservation of all of our districts. We put mandatory conservation in, in one of the districts.

We're obviously participating as a partner in the state to reduce water usage and we'll continue to monitor it.

Q - Michael E. Gaugler {BIO 7139923 <GO>}

Okay. That's all I had. Thank you.

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

Thanks, Mike.

Operator

Our next question is from Richard Verdi from Ladenburg. Please go ahead.

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

Hi, Rich.

Q - Rich A. Verdi {BIO 15139674 <GO>}

Hi. Good morning, everybody. Great quarter and thanks for taking my call. I just have one quick question which pertains to the efficiency ratio. At the Analyst Day last year, the company had highlighted the goal of achieving a 35% efficiency ratio by 2018. And, obviously, that's been the objective since it's shown on slide 15 today. Let's hypothetically fast forward to 2018 and say the target has been reached. Would a new target be set? And if so, what would it be? How long could it maybe take to achieve? And what would the driving force behind the reduction be? Because I would think there is probably going to be more room to go.

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

So let me start with just an overview of the progress that we've made. So we've made significant progress on the metrics. And we continue to make progress. Yeah. As we move through times, the progress will tighten a little bit. As we work through and we file additional rate cases, our revenue will be trued-up as we return these savings that we have recognized back to our customers. And so the improvement will begin to tighten as we get closer to the 35% target for 2018.

And we will continue to look at are there other ways that we can continue to improve the metrics. Are there technologies that we can deploy or other operational efficiencies that we can drive in the business? Because, really, this is about how do we operate the business from an overall perspective. We know we have more infrastructure investment to make. And to continue to make that affordable for our customers, we need to make sure that we're managing every dollar on the operating efficiency side.

Q - Rich A. Verdi {BIO 15139674 <GO>}

Okay. Great. I'm thinking. Is there any chance that smart metering could be used? Any chatter about potentially creating some sort of smart grid, like the electricity side did, for the water side?

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

Rich, I'm so glad you asked that question. So the answer is yes. And I will tell you that, we actually have some information on our website. And we'll be happy to send it to you. We're actually pioneering a lot of work on the smart meter grid. We have our own R&D group. And we have an innovation development process. So what we're looking at on the smart grid, we're 85% AMR and AMI right now on the American Water system.

We also are doing a lot of research on water sensors near meters that can monitor flow and pressures. And we're working with an Israeli company to look at how to look at dynamic flow monitoring, so that we can reduce pressure at night at times of low demand, which will also reduce leaks. So, we're actually looking at the whole system from the customer meters to the pipes, smart sensors on the pipes looking at flows in valves and finding ways that we can do more predictability, more predicted maintenance that reduces costs, as well as provide more information to our customers.

The water industry, as you know, is behind the electricity industry on this, mainly because of costs. Water bills aren't as expensive as electricity. And you also have a very fragmented industry. So, you don't have a lot of entities like American Water, with the size, scope and scale to actually embark a partner on a lot of these research opportunities. We're very excited about it. And I would tell you that the efficiencies we're looking for going forward are much more heavily weighted, as you mentioned, to technology and automation and better ways to do the business.

Q - Rich A. Verdi {BIO 15139674 <GO>}

That's super. Thank you, Susan, and great quarter all the way around. Thank you, again.

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

Thanks, Rich.

Operator

And the next question is from Jonathan Reeder at Wells Fargo. Please go ahead.

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

Hey, Jonathan.

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

Good morning, all. I hope everyone is well. Congrats on a big win last weekend, Susan.

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

Yeah. But in the SEC, it's one game at a time, Jonathan.

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

So, it's a tough road ahead still. So, just have a couple questions here if you don't mind. The $0.03 discontinued loss on the sale of Terratec, how much of that was due to the sales price versus operations? Or perhaps maybe a better way of asking it, how much of the loss from Terratec operations was assumed in your previous guidance range?

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

So there's a couple of questions there. Let me – for the second quarter, what we have included the loss on sale is $3.8 million and the remainder of that is associated with the loss from operations, both the second quarter as well as the year-to-date. Included in that loss is a book write-off of taxes of $1.5 million, which, as I mentioned earlier, we were able, through the structure of this transaction, to monetize about $4 million in tax benefits that we otherwise wouldn't be able to monetize. In terms of the guidance in going forward, in our earnings guidance for 2014, we had a very small loss included in our guidance for Terratec. So, it doesn't have a real material impact either this year or going forward.

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

When you look at AWE, Jonathan, it's about 10% of our revenues and even less of operating income. Terratec is even a really small part of AWE.

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

Okay. Okay. So I mean just the way to view it is, have we had normal weather, your revised range would have been, I guess, what, the $2.43 to $2.49?

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

No. In our earnings guidance, for 2014, we had a very small loss from the operations of Terratec included in that guidance. We did not project the loss on the sale in that guidance. And so it really rounded out in the beginning of the year when we set forth our guidance.

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

Right, right. I'm just saying have you had normal weather in Q3, the revised guidance range, essentially we could just bump it up $0.05 if we wanted to compared to apples-to-apples to your original range?

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

No, Jonathan. Because, remember, we build in some variability to our range. So, we – and this is interesting. From weather normal, it's always an art, not a science, right? So, what happens is when we do our range, part of having a range for us is including some weather variability.

So – and we showed last year, at the Investor Day, that weather could be plus or minus $0.07. So, we build in variability to the weather. So the range that we're guiding to now is what we would have, again, non-weather normalized just assuming that you have some variability built in. And most companies do that.

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

Okay. I got you there. And then going back to New Jersey, could you remind us what the revenue increased cap is on their infrastructure mechanism? And I guess how much have you increased rates under that mechanism thus far?

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

Yeah. The revenue cap is 7.5%. And we continue to invest within that cap. And we'll be able to do so. So -

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

How close are you to the 7.5% at this juncture?

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

We're making progress -

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

We still have some room on that, Jonathan.

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

Making progress to the 7.5%.

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

And, remember, Jonathan, we had two infrastructure increases this year, 10.1% in January and then the recent one of 7.4%.

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

Okay. And then, you've done a good job lately on the M&A front. Congrats on that. I know you gave us the customer count. Is there any way you can describe it in terms of either the purchase price or kind of the rate base that those deals represent?

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

Yeah. And back – so the customers, as Susan said, and we talked about, we're going to be adding 19,000 customers. The rate base varies obviously and tied back to our acquisition price there, but anywhere from $20 million to $25 million per -

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

And also to clarify, because some people report it differently. When we say 19,000 customers, that's actually customer connections.

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

Right.

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

Those are meters, not the number of people. So – and also, interestingly, of those 19,000, 13,500 are wastewater, very consistent with our target of going after wastewater. In Arnold, Missouri, we already serve water to those residents.

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

And back to Haddonfield, what I meant by that was $28 million was our purchase price for Haddonfield for those 9,000 customers, 4,500 water, 4,500 wastewater?

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

And remember, these were approved -

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

Could you – purchase price for the sale -

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

These were approved through the referendum, but we have not yet closed on those transactions.

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

That's right. We've got to get Board of Public Utilities approval on that. And, again, as I said, that'll take about six months to eight months to typically – that's typical and we're looking at mid 2015 before we get that approval.

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

Right. Do you have the Arnold and Russiaville purchase price in here? Were those disclosed?

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

We don't but we can get – whatever is disclosed we will get to you.

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

Okay. And then last question and I'll hop off. Any idea when that government might act on another military privatization? I mean you've got the last two, including one recently. Do you expect more in the near future to be announced?

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

Well, predicting the Department of Defense with the federal government is an art that we have not perfected yet. We do have outstanding RFPs that actually go back all the way to 2010. And understanding who is going to award win is something that we continually monitor. And it depends on the service and it depends on the base, quite honestly. A lot of times it depends on the situation they've got with infrastructure. We do have outstanding RFPs. We are hearing that the Air Force may also have addition wins that they bid out. So, again, it's hard to predict. But let me go back to something else.

There's three ways that we make money in military. Awarding new awards is something that because it's so difficult to predict that we work hard on the other two, which is our O&M contracts. But also, once we have a base, they engage us to look at what the infrastructure needs are on that base. And each year within their budget, we bring them potential projects and they choose from those projects, which also increases the amount of work we do on bases. So, we don't just wait for a big award and say great, it was success. For us, success are all three components.

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

Okay. Thanks. I appreciate the time this morning.

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

Thanks, Jonathan.

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

And, Jonathan, one thing – one correction. On the desk (50:07) in New Jersey, the cap is 5% of revenues, not 7.5%. I want to correct that for the record here.

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

Okay. Thanks.

Operator

The next question is from Spencer Joyce of Hilliard Lyons. Please go ahead.

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

Hi, Spencer.

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

Hey. Good morning, folks. Thanks for taking my call. Just wanted to touch very briefly on the ballot initiatives that were approved. I think from my standpoint, it was very positive to see a New Jersey, Missouri and Indiana, kind of, across the footprint approvals there. And my question is did you all go three for three on these initiatives or were there a handful that maybe weren't approved?

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

No. I'd like to – we're batting 1.000, three for three. Really I think the recipe for success here was to make sure that our employees and the community leaders were hand-in-hand talking about the value that American Water can provide to the communities. That's really what, I think, was driver of success on all three of these.

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

And, Spencer, what was even more exciting, we didn't just win the ballot initiatives. We were two to one or greater on all of them. In favor of.

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

Okay.

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

And that's what we were very proud of.

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

Yeah. And I thought you all may have insinuated this a little bit, but these weren't areas where perhaps the American Water brand was already somewhat of a household name. Is that correct?

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

Well, I'll tell you in Haddonfield, New Jersey, we surround the system. So we have a big presence in this area. So the brand is out there. And that's right. And also, in Arnold, we bought the wastewater system, but we have the water customers. So our brand has been out there. And I think that's helped us.

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

Okay.

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

But the key to this has been our passionate employees, going door-to-door and talking about, again, the value that American Water can bring to the communities.

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

Okay. Great. Thanks. That's all I had. Nice quarter.

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

Thanks, Spencer.

Operator

And our next question comes from Shivangi Tipnis from Guggenheim (sic) [Global Hunter Securities] (52:18). Please go ahead.

Q - Shivangi D. Tipnis

Hi, guys. Thank you for taking my questions. I'm a little under the weather, I hope I'm audible enough on the call. I just wanted to ask you about your CapEx for Q4. Your earlier guidance in Q2 said it was about $1.1 billion. And year-to-date, it's about $700 million. And you expect it to be now $1 billion for the full year. So I was wondering if the Q3 CapEx was less than what you earlier anticipated or are you expecting a little lower CapEx, about $100 million lower, in Q4?

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

Yeah. This is Linda. Let me answer that. The CapEx for the third quarter was what we expected. That was related to the regulated investments. What we are seeing this year is lower than planned investment on the acquisition side. And so that has enabled us to deploy more capital in certain areas on the regulated side. And that's really a timing issue associated when we deploy the capital. So, yes, we're still on plan for $1 billion. And, as a result of the timing issues associated with the acquisition, we have been able to deploy more capital on the regulated side.

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

And that's why, Shivangi, we started looking at a five-year capital plan. Prior to 2014, we reported capital year-to-year. We know that by separately disclosing last year's strategic and regulated acquisition capital apart from regulated investment capital that there would be some years that because of delays in being able to close on a deal, for example, if you have to have a referendum, et cetera. So what we saw is, just as Linda said, that you're going to have some timing issues. So that's why we disclosed now our five-year capital plans.

Q - Shivangi D. Tipnis

Okay. Sounds good.

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

And – I'm sorry.

Q - Shivangi D. Tipnis

Go ahead.

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

No, no. Go ahead. After you're concluded.

Q - Shivangi D. Tipnis

Okay. My next question is actually on the gallon usage on your slide 23 based on the customer class. The weather impacts are primarily related, I guess, to your residential usage of water, especially on the outdoor activities. However, your commercial and public gallon usage appears to have declined about 4% and 3%. How do you understand these declines and can you just provide some color on that?

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

Absolutely. There's actually quite a bit of noise that's included in these numbers, because we implemented our customer information system last year in two ways. And so the third quarter of 2013 includes a time period in the first wave of the implementation to where we were looking at our bills in more detail to make sure that they were appropriate before we sent them out. And so, in the industrial class mainly, we have lower billed water sales volume, because we were holding those bills. And so, there is some timing issues there as well. If we were to kind of normalize that, we would expect our industrial usage to be more in line with what we have seen historically.

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

Yeah. And one more point on the Arnold acquisition. The total purchase price is $13 million and that's got to be trued-up as we work through the approval process. We're buying the collection system, not the treatment plant. And that's why it's a little bit on the low end as far as total purchase price for that number of customers. I'd just wanted to provide that clarification to everyone.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Susan Story for any closing remarks.

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

Thank you so much. I appreciate all of you on the call. I know that we typically are at the tail end of a very long quarterly earnings call season and that you all are very tired. And we appreciate the time and effort. I just want to close with just a couple of sentences.

And I just had to tell you. Walter mentioned it and so did Linda. We had a really good financial quarter. We are poised for long-term growth and a healthy company. And it's because of the employees we've got. I cannot tell you enough going around looking at the expertise, but, as Walter said, the passion that our employees have for our customers and for growth and finding ways not just to grow the numbers for financials, but to bring new customers in on our system, so that they can enjoy the benefits that our current customers do.

So it's a great time to be in the water business. We look forward to a great year. And we hope that everything goes well for you all. And if Jonathan Reeder is still on the call, I just want to tell you War Eagle. See you all next quarter.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.