Q4 2013 Earnings Call

Company Participants

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

Other Participants

- Andrew Weisel, Analyst, Macquarie Capital Securities
- Heike Doerr, Analyst, Robert W. Baird & Company, Inc.
- Jonathan Reeder, Analyst, Wells Fargo Securities, LLC
- Mike Gaugler, Analyst, Brean Capital, LLC
- Neil Mehta, Analyst, Goldman Sachs
- Shivangi Tipnis, Analyst, Global Hunter Securities
- Steven Fleishman, Analyst, Wolfe Research

Presentation

Operator

Good morning. Welcome to American Water's year-end 2013 earning conference call.

As a reminder, this call is being recorded and also has a webcast with accompanying slide presentation through the Company's website at www.amwater.com. Following the earnings call, an audio archive of the call will be available through March 6, 2014 by dialing 303-590-3030 for US and international callers. The access call for the replay is 4662798.

The online archive of the webcast will be available through March 28, 2014 by accessing the Investor Relations page of the Company's website located at www.amwater.com.

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

Ed Vallejo {BIO 20515524 <GO>}

Thank you. Good morning, everyone, and thank you for joining us for today's call. As usual, we will keep our call to about an hour, and at the end of our prepared remarks we will have time for questions.

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, as 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 segments. Such risk factors are set forth in the Company's SEC filings.

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

Jeff Sterba {BIO 1426511 <GO>}

Thanks, Ed. Good morning, to you all, and appreciate you joining us this morning.

Before going into the main topic for our call today, which is to discuss 2013 results, I think it would be useful to provide you some summary information on the Freedom Industries' chemical spill into the Elk River in West Virginia. Let me ask Walter Lynch, our President of Regulated Operations, to provide a brief summary of what happened, how West Virginia American Water responded, and the current state of the system. Walter?

Walter Lynch {BIO 6064780 <GO>}

Thank you, Jeff. Good morning everyone.

As most of you have been following this event over the last month, I'm not going to go into the timeline and details of the Freedom Industries spill. But rather want to provide you a brief overview, as Jeff said, of how well West Virginia American Water responded and where we currently stand.

As you may know, this is a very complex system with over 175 pressure zones. The average water system has about two to five different zones.

We are extremely proud of how our people responded in a difficult situation. Throughout the period following the Freedom spill, while federal and state emergency declarations were in effect, we provided our approximately 95,000 customers, about 300,000 people in nine counties, with water for basic sanitation and fire protection. This was done while dealing with the impacts of the spill.

Being able to provide these critical services to our customers was one of the reasons that it was necessary to keep the plant up and running during the event. On January 9, the date of the Freedom Industries' chemical spill, we consulted with the West Virginia Bureau for Public Health, and together reached the joint decision to issue a Do Not Use Order for drinking, cooking, or washing to our customers in the Kanawha Valley system, again affecting approximately 95,000 customers, or about 300,000 people.

During this time, West Virginia American Water also consulted with state and local public health officials and the Centers for Disease Control. This quickly led to an interagency team being formed in West Virginia comprised of West Virginia American Water employees, National Guard members, and representatives from the West Virginia Bureau for Public Health, the Department of Environmental Protection, and Kanawha County officials. Now, internally in American Water we formed an event management team to leverage our scale, expertise, and resources from around the country.

To give an example of some of the things were able to do. We deployed water tankers and truckload's of bottled water to assist at the bulk water distribution sites. We also secured large quantities of activated charcoal and potassium permanganate for use in the treatment process in addressing the chemical spill in the chemical there at Freedom Industries.

We added resources at our two national customer service centers, and we gave our West Virginia American Water customers priority service during this time. We were able to get 40 water quality specialists from throughout American Water working with our customers to address the water quality questions that our customers in West Virginia had.

We conducted extensive and continuous testing of water in the impacted areas, and this included river's raw water, finished water leaving the Kanawha Valley Water Treatment Plant, and hundreds of points across our distribution system. Working closely with federal and state health agencies and regulators in this massive sampling and testing program, we were able to lift we Do Not Use Order in stages over a five-day period beginning on January 13.

As of today, all points of testing throughout the water distribution system showed a level of MCHM Freedom Industries' spill are below 10 parts per billion. Now, 10 parts per billion was established by the interagency team as a non-detect level of MCHM in the water distribution system.

This was based on the measurement capabilities of the multiple laboratories used during the event. This is 100 times below the 1 part per million standard established by the Centers for Disease Control that was used as the basis for the lifting of the Do Not Use restriction.

We continue sampling water in our distribution system, and since February 14, from working with laboratories to measure levels down to 2 parts per billion, as we help address remaining odor issues from the Freedom spill. We know that odor has added to customer concern, regardless of levels, and we are going to continue to test and flush our distribution system to address this issue.

We have also decided to provide our residential customers with a 1,000-gallon credit to allow them to flush their water system without cost. This equates to approximately 10 days of normal water usage for our average residential customer in West Virginia. Additionally to aid small businesses in this difficult time, we're providing a financial credit equivalent to 2,000 gallons to approximately 5,300 commercial customers.

Throughout this event, our primary focus has been and remains the safety of our customers and our employees. We remain fully committed to working with the federal, state, and local officials to provide information, address concerns, and protect our customers' tap water.

I want to thank our West Virginia American Water team. They've worked around the clock since this event began on January 9, and they continue to do so because of their dedication and their commitment to our customers.

With that, I will turn it back to Jeff.

Jeff Sterba {BIO 1426511 <GO>}

The Freedom Industries chemical spill, as you all know, is a serious event and it placed the water supply to almost 300,000 people at risk. As Walter said, we are very proud of our folks at West Virginia American Water and how they responded to help ensure fire protection and basic sanitation, as well as bottled and bulk water for consumption starting the next morning and through the recovery period.

This incident should be used as a catalyst for public policy discussion about protecting source waters from contamination from fixed and mobile sites. As a water utility, we take our responsibilities to meet or exceed all regulations very seriously, and we are proud of our record doing such.

It is not our role to establish those regulations; that belongs to governmental agencies. But we do hope that constructive engagement can occur on increased tank safety, provision of greater information to water utilities on tank contents, and stronger communication linkages between regulators, tank operators, and water utilities.

As you may know, there is over 100 known contaminants that are regulated and that we protect customers from, and about the same number of what are called emerging contaminants, which are being evaluated and we are actively studying. But there are also about 85,000 unregulated chemicals in the EPA toxic inventory and hundreds of thousands of other compounds not registered, including one stored in fixed and mobile tanks like the MCHM and PPH involved in the Freedom Industries chemical spill.

Water systems cannot detect, much less protect customers from all of these. That protection must come from ensuring such leaks, if they ever do occur, cannot enter source waters.

With that as a kind of a brief summary, let's turn to our 2013 year-end results. If you go to Slide 6, you can see that we continue to advance not only our numbers, but our strategic growth initiatives, improve our operational efficiency, and generate strong financial performance despite cooler, wetter weather across much of our service areas.

You can see our operating revenue increased year over year to $2.9 billion, and our adjusted earnings from continuing operations, excluding a one-time charge of $0.14 per share, was $2.20 per diluted common share compared to $2.11 per share in 2012. If you take into account the weather differences between the states, 2012 earnings were benefit by hot, dry weather that was worth about $0.14 per share, while 2013 earnings per share was adverse due to cool and wet weather to the tune of about $0.05.

In addition, we reported cash flow from operating activities of almost $900 million compared to about $950 million in 2012. This decrease was primarily driven by some working capital changes, and Susan will cover this in more detail.

The adjusted ROE decreased slightly from 8.42% in 2012 to 8.29% due to the weather difference. If the difference in weather is taken into account that we talked about earlier, the 2013 ROE exceeded the earned 2012 ROE by about 56 basis points.

Turning to Slide 7, let me just speak briefly on how our results compare with the goals we set out to achieve at the start of the year. On the regulatory front, the Company received authorizations from general rate cases for an annualized revenue increase of approximately $41.5 million.

We also received about $49 million in additional annualized revenues from infrastructure surcharges in several states. This is the first time that the amount of surcharge revenue has in fact exceeded the amount of rate case-related revenue, which ties, as we've talked before, to moving to a much higher percentage of our CapEx being recovered through infrastructure surcharges, looking at something in the 60% range as we move into this year.

As of now, we are awaiting final orders in three states in response to our request for additional revenues on an annualized basis. Those cases amount to about $58.4 million.

On the cost side, we achieved our O&M efficiency ratio goal of under 40% system-wide by 2015 two years early, with a ratio of 38.7% for the 12 months ending December 31. The commitment to continuous improvement and process excellence is really becoming ingrained in the fabric of our culture.

Just last year we had more than 400 employees applying new skills in more than 180 specific projects that were completed last year, generating savings of over $10 million annually. That doesn't include the $12 million of savings coming through supply chain initiatives. In fact, as we talked about in December, our five-year plan will generate operating cost savings of over $900 million in the five years from 2014 through 2018 compared to business as usual, and our goal is to further reduce the O&M efficiency ratio on average across our system to 35% by 2018.

Capital expenditures for the year totaled $950 million for needed system improvements to provide reliable service to our customers. We know that as we drive efficiency into our operations, we can enable more of the needed investment in the aging water infrastructure without putting undue burden on the water bills of our customers.

Lastly, 2013 was a year marked by growth, as evidenced by adding about 30,000 customers to our regulated customer base, through the acquisition of 10 water and 5 wastewater systems. It is also important to note that 20,000 of those customers were obtained through an acquisition of Dale Services Corporation wastewater business where we already provided water, and as we've talked about, that is one of our key strategies going forward. We also expanded our homeowners services business into 10 more states and launched our service line protection partnership with New York City, as well as announcing partnerships with Houston and Nashville.

As we look to 2014 on the next slide, we are reaffirming our annual earnings guidance that was provided on December 17 to be in the range of $2.35 to $2.45 per share, excluding the impact of the Freedom Industries chemical spill. The impact of that spill through earlier this week, February 26, 2014, is estimated to be $0.02 per share.

We remain confident in our ability to deliver on our long-term EPS growth goal of 7% to 10% through the execution of the growth strategies that we discussed in December and continued operational efficiency gains.

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

Susan Story {BIO 3335156 <GO>}

Thank you, Jeff. Good morning to you all. It is a pleasure to be here with you today to review the year-end 2013 results.

Jeff has already reviewed many of the key highlights. I'll just now take a few minutes to discuss the drivers of our 2013 results in more detail.

Turning to Slide 10. As Jeff mentioned, our 2013 results reflect the wetter, cooler weather conditions in 2013 as contrasted to the hot and dry weather we had in 2012. Despite the unfavorable weather conditions, 2013 was another year of solid financial results with increasing revenues, as well as continued progress in operating efficiency.

For the year ending December 31, 2013 we reported operating revenues of just over $2.9 billion, which is approximately $25 million higher than in 2012. The increase was mainly a result of rate case resolutions and infrastructure mechanisms in place, which allow more timely recovery of capital investments in infrastructure. As we mentioned previously, this was partially offset by decreased consumption which was significantly driven by the wet, cool weather the year.

This past year, we've recorded net income from continuing operations of $369.3 million, or diluted earnings per share from continuing operations of $2.06. This compares with net income from continuing operations of a little over $374 million, or diluted EPS from continuing operations of $2.11 in 2012.

As Jeff mentioned previously, net income for 2013 included a charge recorded in the Fourth Quarter for the execution of a debt tender offer that we had announced in September of 2013 and that we close on in October. Excluding this $24.8 million, or $0.14 loss per diluted share, for the tender, our adjusted EPS for 2013 was $2.20 per share.

The main drivers for our growth in 2013 were increased revenues due to rate increases, including the surcharge mechanisms that Jeff described, and lower O&M expenses. This increased revenues were partially offset by higher depreciation and amortization expense, and general taxes.

For December 31, 2013 we reported cash flow from operating activities of approximately $896 million compared to $956 million in 2012. There are a few reasons for this reduction in cash flow from operations, given changes in working capital which can be viewed in more detail in the 10K.

However, a special note, with the ERP implementation in 2012, we were delayed in executing accounts payable at normal volume. This is contrasted with the CIS implementations in 2013 which had the opposite effect, and resulted in some delayed billing and receivables.

This was due to the intentional decision we made to hold and review some billings, in order to ensure the accuracy of the new system before sending these bills to our customers. We expect our billing operations to be more normal as we progress into 2014.

Now let's discuss the different components of our income from continuing operations, starting with revenues on Slide 11. Again, I encourage you to read our 10K on file with the SEC for a more detailed analysis of both revenues and expenses.

Overall, operating revenues increased $25 million, or 0.9%, with revenues from our regulated business increasing by $29.5 million, or 1.1% from 2012. Regulated revenues were lower by approximately $64.5 million associated with lower demand year over year, in large part due to the unseasonably hot weather of 2012 that both Jeff and I talked about.

However, revenues increased approximately $72.4 million, primarily from rate increases obtained through rate authorizations awarded for a number of our operating companies. Additionally, surcharge and balancing accounts increase revenues by another $16.4 million.

Revenues were also higher by almost $10 million, $9.9 million, as a result of regulated acquisitions. The most significant was our New York acquisition in the Second Quarter of 2012, which brought in additional four months of revenue in 2013. Additionally, the acquisition of Dale Services by our Virginia subsidiary in the Fourth Quarter of 2013 also contributed to this increase in revenue.

For our market-based businesses, revenues for 2013 decreased by $4.9 million, mainly due to lower revenues of $17.3 million related to the termination of certain municipal and industrial O&M contracts which mainly occurred in 2012. Most of these contracts were ended as a part of our business optimization effort, which we have designed specifically to optimize margins in our contract operations.

Additionally, revenues from capital project activity associated with military construction decreased $8.4 million compared to the prior year, resulting from delays in project work which we believe will resume in 2014. These decreases were offset by a net increase of $4 million from price predetermination for several of our military contracts, as well as an increase of $16.6 million in our homeowners services revenues associated with contract growth, mostly in New York City. Parent, Elimination and other was $4.3 million lower compared to 2012.

On slide 12, total operating expenses for 2013 increased by about $4.1 million from 2012, roughly flat compared with the prior year. Operation and maintenance expense in the regulated business decreased $24.5 million, or 2.2%.

Within the regulated O&M expense category, customer billing and accounting expenses increased $3.4 million. This increase is primarily due to uncollectible expenses associated with aging of receivables, most of which is due to our CIF implementation, and to a lesser extent to rate increases during the year.

Operating supplies and services and the other category increased $7.3 million. Operating supplies and services cost increased $4.8 million, mainly due to higher contracted temporary labor costs, associated with both stabilizing and leveraging efficiencies for our ERP system that we implemented in 2012. The other expenses include casualty and liability insurance premiums and regulatory costs, which increased $2.5 million, primarily due to higher casualty insurance costs as a result of historical claims experienced and retroactive adjustments.

Production expense decreased $3.6 million, or 1.3%, for the year as a result of lower water production and sales during 2013. Employee-related costs, including salaries and wages, group insurance and pension expense, decreased $16.4 million, or 3.5%, for 2013 compared with the prior year, primarily due to decreased pension expense. These employee-related costs represent approximately 41.2% of O&M expense for 2013.

Maintenance, materials, and supplies decreased $15.2 million, or 18.8%, for the full year 2013. This decrease is mainly attributable to increased preventative maintenance expenses throughout our regulated subsidiaries that we performed in 2012, and we realized the positive impact of those expenditures in 2014.

The market-based business decrease in total operating expense is mainly due to the termination again of those certain municipal and industrial operations and maintenance contracts in 2012, as well as the release of the loss contracts reserve of $3.8 million in 2013. In 2013, we also reported a higher consolidated depreciation and amortization expense of $26.2 million and higher general tax, parent, and other of $12.8 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 project. You will remember Phase 1, our ERP system, was placed into service during the Third Quarter of 2012 and Phase 2, our CIS, or customer information system, as well as our EAM, or enterprise asset management system, was placed into service in two waves during the second and Fourth Quarters of 2013. The increase in general tax expense, is primarily due to higher property taxes of $5.2 million, most of which is the result of incremental taxes associated with our New York acquisition.

Turning now to Slide 13. To better explain the period-over-period difference in our earnings per share figures, we have the EPS bridge we began showing you last year. As you can see, we normalized our 2012 diluted EPS from continuing operations for weather and a foundation contribution, as we have shown you consistently.

Next, we outlined the various financial drivers which get us to our 2013 year-end number, most of which I have already described in the revenues and expenses discussion. The 2013 GAAP diluted earnings per share is $2.06. We have added back the one-time debt tender impact of $0.14, which brings our adjusted earnings per share to $2.20.

Just as we adjusted the 2012 reported EPS of $2.11 to $1.99 to reflect weather impact, we felt that for a weather-normal reference, we should now show the 2013 weather impact on our EPS. The midpoint of our 2013 weather impact is approximately $0.05, which we described in both second and Third Quarters. This is the number we will use for inclusion on our long-term EPS guidance wedge, shown on Slide 21 in the appendix.

As I mentioned, the other components were discussed earlier. We will be happy to answer any questions or provide further clarifications if we need to during our question-and-answer session.

Slide 14 shows our O&M efficiency ratio. For the full year 2013, we achieved a 38.7% ratio, which is a considerable improvement from the 40.1% ratio we had for the full year 2012. As we shared with many of you at our Investor Day this past December 17, our goal is to achieve a 35% O&M efficiency ratio by 2018.

Let me just talk just a moment about the impact of these cost efficiencies. This is demonstrated in our Indiana rate case which we filed last month.

Our filing in Indiana by Indiana American Water reflected a $7 million reduction in O&M expenses from 2010 to 2015. If we had allowed those expenses in 2010 to rise just at inflation, it would have been a 23% increase in O&M, or $15.7 million rather than a $7 million reduction.

We are very proud of that. The team in Indiana has done a great job, as have the teams across our entire service area.

Now let's look at recent regulatory highlights. Slide 15 shows the expanded rate case template that we introduced last year, showing formal rate cases awaiting final order, as well as listing any step increases or de sic [ph] filings which impacted the quarter or are still pending. As you can see from the chart, we received resolutions in rate cases in Michigan, Kentucky, West Virginia, and Pennsylvania in 2013 for an annualized revenue increase of approximately $41.5 million.

Additionally, $7.5 million dollars in step increases from prior rate cases became effective in early 2013. Infrastructure charges awarded in 2013 and in January of 2014 totaled $49.2 million, and represent the ability to recover capital which we invest to improve both infrastructure and customer service. As of February 26, 2014, we are awaiting orders for the general rate cases in three states, infrastructure charges in three states, and a step increase in one state.

Last year we created a new slide, an updated version of which you can find in the appendix, Slide 22, entitled Regulated Utilities, Rate Base and Allowed Return on Equity. Many of you have requested this data showing each of our regulated states, authorized rate base, authorized ROE, authorized equity, and the effective date of the rate case issued [ph].

These are historic cases, and we advise you to review the footnotes for a fuller understanding of the particular case in question. While you can never project how any new case will be determined, we hope this will help you understand our current rate environment.

Finally, as part of our commitment to shareholder value, on December 13, 2013 we announced that our Board of Directors declared a quarterly cash dividend payment of $0.28 per common share, payable on March 3, 2014 to all shareholders of record as of February 3, 2014, which continues our commitment to an annual dividend payout goal of 50% to 60% of net income, while growing dividends at a rate commensurate with earnings per share growth.

With that, I'll turn the call back over to Jeff.

Jeff Sterba {BIO 1426511 <GO>}

Thank you, much, Susan.

On Slide 17 you will recognize the growth triangle that we introduced at the Analyst Day event in December to give you a sense of the components of our growth and their approximate size. The triangle components, as we discussed then, will change over time, and what you see here is our projected 2014 earnings, that achieve our estimated guidance of $2.35 to $2.45 per share, excluding the impact of the Freedom Industries spill. The impact of that spill, as we talked about, is estimated to be about $0.02 per share through February 26 of this year.

This is probably a 7% to 10% growth rate from 2013 results. We also are reiterating our comfort level with the guided 7% to 10% long-term earnings per share growth rate. As we've done more detail in our planning and progressed it the way we have, we can see the pathway much more clearly about where we will be able to generate that kind of growth, provide better service to our customers at an average annual rate increase across all of our states of about or below 2% per year.

Slide 18 was also in the Analyst Day presentation and provides the identification of specific things that you can hold us accountable for achieving during the year and that we will report progress on. At this early date in the year, all things listed there are moving forward on schedule.

Last, for those of you who may not yet have talked with him, let me take the opportunity to introduce Durgesh Chopra who is now working with Ed in investor relations. Durgesh came put of our New Jersey rates group, and I know he will do a great job working with all of you over the next set of years.

With that, we would be happy to take any questions you may have.

Questions And Answers

Operator

[Operator Instructions]

Shivangi Tipnis, Global Hunter Securities.

Q - Shivangi Tipnis

Thank you, guys for taking my question. My first question is, there is nice growth for your industrial volumes in Q4 sequentially, as well year over year. What kind of drivers for the industrial volume growth quarter [ph] and do we expect to see the same positive growth, even in 2014?

A - Jeff Sterba {BIO 1426511 <GO>}

I'm sorry. We're having real trouble hearing your question.

Q - Shivangi Tipnis

Okay, sorry. Are you able to hear me now?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes.

Q - Shivangi Tipnis

Okay. There is a nice growth in your industrial volumes in Q4 sequentially as well as year over year. What were the drivers for the volume growth industrials, and do we expect to see the trend ahead in 2014 as well?

A - Susan Story {BIO 3335156 <GO>}

If I understand your question correctly, you said the quarter-over-quarter Fourth Quarter, the growth, what was driving the growth and do we expect to see that to continue, is that what you're asking?

Q - Shivangi Tipnis

Yes. I'm talking about the industrial volume growth.

A - Susan Story {BIO 3335156 <GO>}

Yes. What happened with the industrial volume, I mentioned that the customer information system implementation, we held several of the more complex bills, and it impacted industrial and the public sales more than it did commercial and residential.

So what we do is, if you look at our 10-K, while we look at billed and unbilled revenue, on water volume we just report billed water volume. As we were holding bills, we had somewhat of a delay in terms of the amount of industrial volumes that we were able to bill.

That's where you might see a little bit of a disconnect. We do expect that to normalize through the year.

We have gone through those bills that are complex, ensured that the new system was generating accurate bills, and we've released the majority of those. Now, we had two waves of implementation.

The first wave was in May. Those bills, we've released those. We're on the normal billing cycle. Our second wave was on October 20 is when we implemented it. So after the First Quarter, we should see more normalizations there.

Q - Shivangi Tipnis

Okay, that sounds helpful. My second question is on the O&M side. You did a great job lowering it down from 40.1% to 38.7%, the expense ratio. So, the run rate of 35% is already -- which was expected on 2015, was already achieved.

Do we expect to see a gradual slowdown in the run rate going ahead, or if you look at the same run rate then I think we can expect you to achieve the 35% rate, even before 2018? Can you provide some color here?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes. The way I'd answer that is we have established a goal of 35% by 2018. We are not driven by that metric so much, as by doing the right thing in managing our cost structure.

That may enable us to get there earlier, but we certainly wouldn't forecast that at this stage. As you move up the tree, collecting fruit, it does become a little more challenged and difficult, but that's why our whole process is around continuous improvement and process excellence. And the reason why we're trying to engage as many of our folks as possible so that this becomes self-sustaining.

So, yes, I think we've had great progress. I think when I came here it was about almost 48%. So we've cut it actually by 10percentage points, or over 20%, almost 25%.

Going forward, we probably won't see it go down at nearly the rate that it has over the last five years, but we're still going to stay focused on it. Walter, you got anything you'd want to add?

A - Walter Lynch {BIO 6064780 <GO>}

We are addressing this as we know in multiple fronts, and Jeff you talked about Yellow Belt programs and the savings that are driving there, but we continue to look at our cost. The biggest cost we have are power, chemicals, fuel, and we continue to address those, along with labor costs. As you said, we're geared towards 2018 of 35%, and we are working right now to get there.

Q - Shivangi Tipnis

Okay. So my next question would be, in case you get this 35% quite earlier to 2018, what would you say would be a sustainable ratio? You would definitely not keep looking at lowering the ratio in terms of costs. So what would be a ratio that makes you happy, and you would say, this is the ratio that I would like to maintain?

A - Jeff Sterba {BIO 1426511 <GO>}

One of the things that you get when you really go through all the data that we, from a management side look at, you see that there are differences by state. For example, California has a higher ratio just by operating in California because, well, it's an extended process to operate in California, and so every utility that operates there has higher ratios.

We happen to be very good in California and so we have a lower ratio than others, but it's higher than it is in many other states. So a lot of what is the right ratio will depend on where our growth occurs.

So if we see growth occurring in some states that have higher cost structures because of the way they operate or their regulatory approach, then we think about it in that way. We look at the 35% on the basis of where we expect to see growth, but also on the basis of our current business. I don't think you can say, here's the optimal percentage.

A - Susan Story {BIO 3335156 <GO>}

But Shivangi, I think to your point, though, there is a point at which it's very difficult, because remember when we talk about cost efficiency, these are long-term efforts to take cost out of the business. These aren't quarter-to-quarter, year-to-year cuts.

As we look at more automation, more innovation, there are levels that you could sustain. But you're right, at some point you look and say, are we doing all we can do? Then there is usually a step change and something we can do in technology that maybe will help us further, but we don't know what that is right now.

Q - Shivangi Tipnis

Okay. And maybe my last question, and then I will get back in line. So the estimated costs that you are expecting out of the Freedom chemical spill will be about $0.02 at this point in time.

I want to mention you have been doing a smooth execution, and it was really great. But then are there any headwinds that can still drive the costs ahead? And when we get a clear understanding that it's not just $0.02, and maybe a little more over $0.02?

A - Jeff Sterba {BIO 1426511 <GO>}

Susan can maybe give you a little more detail about what's included in the $0.02 and the costs we have occurred so far. Going forward, it's really dependent on how the legal process goes, because that's really the thing that will continue for some period of time, and that's really hard to estimate.

We think a lot of the claims that have been made are easily dismissible. Other claims may have to go a little further before we can get free from them.

But that's what's probably the biggest unknown, is how the legal process will go forward. For example, we recently filed on some of the claims to have them moved into federal court.

We won't know whether that's successful for a while because people may try to get them back into state court. Those kinds of things can help drive what those legal costs will be. So that's why there's uncertainty around that.

A - Susan Story {BIO 3335156 <GO>}

But you are correct. This is a First Quarter event. And when we look at the charge for the credit that we mentioned earlier, when you look at the extra production costs, the labor, you look at O&M, you look at the cost of the tankers, bottled water, the legal expenses, the $0.02 that we reported reflect the expenses through February 26.

Going forward, as Jeff said, we see the predominance being mostly the legal. Now, because it's a First Quarter event, we will have more information at the First Quarter earnings call where we should be able to be a little more specific.

Q - Shivangi Tipnis

Okay. Thanks for the color, guys. I will get back in queue. Thank you.

Operator

Neil Mehta, Goldman Sachs.

Q - Neil Mehta {BIO 16213187 <GO>}

Good morning.

A - Jeff Sterba {BIO 1426511 <GO>}

Good morning, Neil.

A - Susan Story {BIO 3335156 <GO>}

Good morning.

Q - Neil Mehta {BIO 16213187 <GO>}

Congratulations to your team on the response to the spill in West Virginia. I had a couple of easy questions here. So at the Analyst Day, you outlined several wastewater acquisition targets. Just wanted to get a status update in terms of how that process is faring.

A - Jeff Sterba {BIO 1426511 <GO>}

Well, I think we're moving forward on a number of fronts in acquisitions in discussions and negotiations, which obviously we can't talk about who or where they are, both in the wastewater and water arenas. And as we get to a point of any of those being signed we will obviously let you know. That's probably about all I could say, Neil, at this stage.

A - Susan Story {BIO 3335156 <GO>}

Except for, as you know, we really benefit the following year from the acquisitions we made in the previous year. We mentioned in our acquisition increase revenue, a large part of that was from New York that we had the full year and not just eight months. So for 2014, we will be benefiting from acquisitions we made in 2013.

Q - Neil Mehta {BIO 16213187 <GO>}

All right, fair enough. As you think about your dividend, you've got a payout that's below your long-term target and you've got above average EPS growth. So can you talk through your dividend growth expectations as you look at 2014, but then also beyond that?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes. Neil, as we've talked about before, we have a series of criteria that have been what we've established as our dividend philosophy, which is the target of 50% to 60% payout ratio and have a growth rate in dividends that's more in line with our earnings growth rate. So we are slightly below the 50% to 60%.

So in one sense that gives us some flexibility, and we're still believe in the long-term growth rate of 7% to 10%. That's really the guidance that we have relative to dividends. Obviously we just sent out the last one.

The next one is, if you follow our track record, is typically the one where we have announced an increase. So we'll let you know what that will be when we announce it.

Q - Neil Mehta {BIO 16213187 <GO>}

Okay. In California, the Monterey Peninsula, you've got a couple of big projects out there. Could you give a status update on those?

A - Jeff Sterba {BIO 1426511 <GO>}

Let me ask Walter to do that.

A - Walter Lynch {BIO 6064780 <GO>}

Okay. First on the dam. We are working through our timeline on the dam and we expect to have that torn down and the river rerouted sometime in 2015, according to our schedule. So that's progressing on time, and the team's done a great job out there.

Also on the Monterey Peninsula water supply project, we're working through the issues out there, and we're working cooperatively with municipalities and with the Commission. We're working with the Commission to look at the environmental impact report, which we expect now in the First Quarter of 2015, and things are going according to plan.

Q - Neil Mehta {BIO 16213187 <GO>}

Terrific. Thank you, very much.

Operator

Mike Gaugler, Brean Capital.

Q - Mike Gaugler {BIO 7139923 <GO>}

Good morning, everyone.

A - Jeff Sterba {BIO 1426511 <GO>}

Hello, Mike.

A - Susan Story {BIO 3335156 <GO>}

Good morning.

Q - Mike Gaugler {BIO 7139923 <GO>}

Congrats on the nice quarter.

A - Jeff Sterba {BIO 1426511 <GO>}

Thank you.

Q - Neil Mehta {BIO 16213187 <GO>}

Jeff, you spoke about total contaminants. Those you test for, those EPA has under consideration, and some others. Given it wouldn't be cost effective to test for all contaminants as a Company, has AWK ever attempted or proposed to regulators to we expand testing beyond state/federal guidelines to encompass all contaminants in a region within a specific radius of a watershed? On the surface, it would seem possible by scanning MSDS sheets in a region, and my thought behind the question is, it would appear to be a win-win scenario -- greater public safety and also an additional avenue for CapEx investment.

A - Jeff Sterba {BIO 1426511 <GO>}

Very good question, Mike. Let me raise a couple of points with you. There are, for example, on the Ohio River, there is, as a result of I think it was the Ashland spill back in the 1980s, there has been a network of testing, and some of it's automated, some of it's still not automated, but a network of testing over, I think it's over 200 miles of the Ohio River, where each of the entities plus some federal monitoring that's being done, is checking. But now, it is not checking all elements.

Part of the problem is that even if you have the sheets, what they put in these tanks changes. And so even once we can get to a point of having the required disclosures of what are in these tanks, then it's also a matter of keeping up with any changes that occur.

Today, take this tank in West Virginia. When I was meeting with the governor of West Virginia, and also with the former governor who's now the Senator, Manchin, one of the things that they said is, look, this tank, this is a material that was deemed non-hazardous. They don't even have to tell us what's in that tank.

So the first thing we've got to do is get more transparency, what the heck is in the tanks. Then it's a question of okay, how, for all of these other compounds can you develop, or can you develop, readily testing mechanisms, and you also have to establish a standard.

Take, for example, arsenic or mercury. We know those are contaminants, but they're naturally occurring. And so the regulations say, you can't have more than X in water.

It doesn't say zero, because frankly it's been naturally occurring for thousands of years, but they're concerned about it going above a certain level because there's been epidemiological study to determine what's the level at which it can create harm for people. The first thing you've got to do on these 86,000 toxic chemicals, and all the others, is figure out what the heck a standard is.

So I think there's quite a ways to go, Mike, before we even can think about testing because you don't have a standard, and you don't even know what all the compounds are. I agree with your point that there needs to be examination of what other kinds of testing can be done for broad-based contaminants that you know may be upstream, but it's a bit more complicated, just because we don't even have standards for most of these chemicals.

Q - Mike Gaugler {BIO 7139923 <GO>}

Okay. That's all I had. I appreciate the clarity.

A - Jeff Sterba {BIO 1426511 <GO>}

You bet. Thanks, Mike. Thanks for the good question.

Operator

Andrew Weisel, Macquarie Capital.

Q - Andrew Weisel {BIO 15194095 <GO>}

Hi. Good morning. I'm filling in for Angie. The only question we have is wondering about the warranty business you have on water pipes, given the deep freeze this winter in so many of your states. Have you seen any increase in the activity in terms of people either requesting to add warranties and protection or in terms of actual claims filed?

A - Susan Story {BIO 3335156 <GO>}

This is Susan, Andrew. When we talk about the warranties, we offer water, sewer, and in-home. We have seen an increase in the in-home, not so much on the water and sewer because they are buried deeper in the ground.

But the in-home is such a small part of our warranty business, it may be 6% of the homeowner services revenue. So really, yes we've seen an increase incident in-home, not necessarily the others. We have been able to manage through that.

And in terms of offering it again, we have a robust, disciplined process before we ever bring on a new contract. We have a system of contractors, we have a master contractor who coordinates that.

We go out to ensure before we institute a contract that there's not pre-existing conditions. We also look for any indications that there could be, if a week later there is a problem.

So yes, we saw an increase in incident in one small part of the business. We have been able to manage it, but we have a robust process to ensure that when we do take on new contracts, that they are actuarially sound.

Q - Andrew Weisel {BIO 15194095 <GO>}

Great. Thank you, very much. That's all we have.

Operator

Heike Doerr, Robert W. Baird.

Q - Heike Doerr {BIO 15084832 <GO>}

Thank you. Good morning. Congrats on a solid quarter.

A - Jeff Sterba {BIO 1426511 <GO>}

Thanks, Heike.

Q - Heike Doerr {BIO 15084832 <GO>}

Wondering if we could talk about New Jersey, and if there is any update on pending CTA decision.

A - Jeff Sterba {BIO 1426511 <GO>}

It is still in process. I think New Jersey has had a number of other things occurring that may have taken a little bit of a focus off this.

We do continue to expect that it will occur, that we'll get some clarification out of the commission. We don't have control of the timeline, and again at this stage, Heike, we don't have a good sense. I would hope that it will be in the next three months.

Q - Heike Doerr {BIO 15084832 <GO>}

And assuming that we would get some kind of a favorable ruling that makes the way that the Commission treats this a little bit more fair, is that something that you would recognize in the next rate case cycle, or what would be the process once we have a decision?

A - Jeff Sterba {BIO 1426511 <GO>}

It would be recognized in the next rate case cycle, absolutely.

Q - Heike Doerr {BIO 15084832 <GO>}

Got it. Thanks for the clarity.

Operator

Jonathan Reeder, Wells Fargo.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Good morning. Susan, if I could, would you talk about some of those regulated O&M expenses, the drivers. It sounded like two of the increases, there was a lot of unsustainable components to it that we'll see probably drop off in 2014. But more importantly, the two accounts that dropped by a wider margin, the employee-related costs and the maintenance materials and supplies, how sustainable are those decreases going forward?

A - Susan Story {BIO 3335156 <GO>}

First of all, on the increases, you're right. The two big increase areas were the billing and the uncollectibles, and the majority of that was due to the implementation of the new system, which as of 2013 we stabilized ERP.

We see 2014 as the year to stabilize even further CIS and EAM. Also the other increase, as you noted, dealt with temporary labor that we used, and leveraging efficiencies of ERP.

In terms of the decreases, we continue to look at preventative maintenance. We continue, in terms of the implementation of automation, for example, across our system looking at the sets, the smart ESS [ph] technology, the communication protocol, of ensuring that we can commoditize the purchase of meters, we can tie it into reading pressure flows, et cetera. In terms of decreases, we're working on all of those.

Let me back up a little bit, though. Remember the goal, the chart we showed on Investor Day? It's to hold O&M as flat as we can, and in order to offset the increased depreciation and amortization, which was $26.2 million incrementally higher in 2013 than 2012, and because we are investing the capital significantly in 2014 will also increased, we're having to look at all of the O&M expenses. If I look at each category, there are certain things we can do in each category. But all of our employees and our teams have the goal of trying to keep O&M flat so that we can have experiences like I described at Indiana in their rate [inaudible] and we are [multiple speakers] --

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay, on the, sorry.

A - Susan Story {BIO 3335156 <GO>}

-- Jonathan, the implementation of CIS, EAM, we have not seen the efficiencies yet from that because the implementation was in 2013. This year in 2014 we will be looking to leverage those systems the way we are looking to leverage ERP, and start seeing some of those over the next one, two, three, four, and five years. So we're just at the beginning of that process.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. And so the overall goal is to just hold O&M flat, and grow the revenue side? And that's what's going to cause the decrease in the efficiency ratio?

A - Susan Story {BIO 3335156 <GO>}

Yes.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. And then just a point of clarity. The 7% to 10% growth rate, is that now off of the $2.25 weather-adjusted 2013?

A - Susan Story {BIO 3335156 <GO>}

No, the wedge starts at $1.99, and the wedge will start at $1.99 for the rest of this year also.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay.

A - Susan Story {BIO 3335156 <GO>}

And next year, and in 2016.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Got you. Anticipating future questions, I like it. And then lastly, congrats on getting that military base contract. Do you know what the timing might be on the next determination from the military? Is there a few more decisions that we might see in 2014, or do you have any clarity there?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, the last question really said it clearly. Do we have any clarity? The answer is no. We never really know when they're going to go forward.

We know what are typical schedules, and they seem to be moving forward on the more typical schedule now, and -- because we've said we have about six or so bids that are currently outstanding. We would hope to see one or two of those come out as decisions this year.

On Fort Hill, it's an eight-month transition, which is a pretty quick transition, and it has already started. So we'll start to see the revenues from that transaction this year. And we would hope to see a couple more decisions this year, but I can't tell you that we have intelligence that that's going to occur.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay, thanks. That's all I had.

Operator

Steven Fleischman, Wolfe Research.

Q - Steven Fleishman {BIO 1512318 <GO>}

Great. Thank you. Hi, Jeff.

A - Jeff Sterba {BIO 1426511 <GO>}

Hello, Steve.

Q - Steven Fleishman {BIO 1512318 <GO>}

Just on the West Virginia, could you give us a sense of, do you expect to see additional costs throughout this year from that, or are you just not sure?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, Steve, I think as Susan said, the lion's share of our system-related costs are a First Quarter occurrence, and a lot of that I think has already been incurred in January and February in terms of chemicals, overtime, bottled water, tankers, all the things that go along with -- plus the revenue credits that we're providing customers. I think beyond that, beyond the First Quarter, frankly, it'll largely be legal costs associated with working through the suits that have been filed that name us, working with our customers, because we're going to aggressively work to have them not just understand but get comfortable with the water.

One of the learnings out of this is, and it's different than a lot of other chemicals. In this instance, it isn't how much can someone drink without putting themselves at risk, it really is, can they smell it.

And so what we're finding is there is so much lower concentration that someone can smell, way below 200, 300 times below, what's been determined as the acceptable level by the CDC, and that's a different challenge. And that's both in people's homes as well as within our system.

We're continuing to do flushing, and yet, that costs because we're pushing treated water through systems. I would say the lion's share of the operating cost impacts, the one-time operating cost impacts, will really just be in the First Quarter.

Q - Steven Fleishman {BIO 1512318 <GO>}

Okay. And just any bigger picture thought in terms of highlighting more the -- obviously, this is not directly related to something with a water system, but just, does this refocus on the story you've pushed about needing to replace and upgrade the system that we have overall?

A - Jeff Sterba {BIO 1426511 <GO>}

I think it absolutely does. One of the challenges that we had in West Virginia, Steve, when it occurred is, if you will remember, this was right after the Polar Vortex. So we'd had that enormously cold period, and then warmth. And when that happens, you get line breaks.

We had a lot of line breaks in our West Virginia system, which is an old system that is under a lot of duress because of the elevation changes within the system. And so what we find is that pipes in West Virginia, frankly, don't last as long as they do elsewhere because of the stress that is placed on them.

At the same time, our West Virginia customers have higher bills than most of our other systems because of density of population, which is very low, and the costs associated with operating such a complex system. That is probably the most -- well, it is -- the most complex system we have anywhere in our 30 states, regulated and unregulated.

So I think one of the things it does speak to is the costs that can be incurred with aged infrastructure. On the water plant side, our folks have done a great job operating that plant. We're going to continue to look at ways to help improve that plant.

One of the issues that has been raised is whether there should be a second intake off another water source. If we look about that across our systems, some 20%, 25% of our water treatment systems only have a single intake. That is something that has to be looked at in the context of what is the cost.

So I think what it does is this opens the door for good conversation with all of our regulators about the trade-off between cost and the greater levels of investment, how can we manage that so that we don't push rates up too high but we recognize that these systems are old? That is really separate from the issue of how do we protect against, hopefully not bad actors like I think we had in this situation, but potential contaminants dumped into a river or other water body.

Q - Steven Fleishman {BIO 1512318 <GO>}

Great. Thank you, very much.

A - Jeff Sterba {BIO 1426511 <GO>}

Thank you, Steve.

Operator

There are no further questions. I would now like to hand back to the management team. Thank you.

A - Jeff Sterba {BIO 1426511 <GO>}

Let me thank you all for joining us today, and we look forward to talking with you at our next quarterly call. We welcome Durgesh into these quarterly calls, and we look forward to talking to you all down the road. Bye-bye.