Q4 2012 Earnings Call

Company Participants

- Ed Vallejo, VP
- Ellen Wolf, CFO
- Jeff Sterba, Pres & CEO
- Walter Lynch, Pres & CEO

Other Participants

- Andrew Weisel, Analyst, Macquarie Capital Securities
- Gerry Sweeney, Analyst, Boenning & Scattergood Inc.
- Jonathan Reeder, Analyst, Wells Fargo Securities, LLC
- Kevin Cole, Analyst, Credit Suisse
- Leslie Rich, Analyst, JPMorgan Securities Inc.
- Michael Lapides, Analyst, Goldman Sachs

Presentation

Operator

Good morning. Welcome to American Water's year-end 2012 earnings conference call. As a reminder this call is being recorded and also being webcast with the Company's slide presentation through the Company's website, www.amwater.com. Following the earnings call, an audio archive of the call will be available through March 6, 2013, by dialing 303-590-3030 for US and international callers. The access code for the replay is 459-3380. The online archive of the webcast will be available through April 17, 2013, by accessing the Investor Relations page of the Company's website located at www.amwater.com.

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

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

Ed Vallejo {BIO 20515524 <GO>}

Good morning, everyone. Welcome to American Water's 2012 year-end conference call. As usual we will keep our call to about an hour and at the end of our prepared remarks, we will have time for questions.

But 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 our future performance and our statements represent our most reasonable estimates. However, since these estimates statements deal with future events, they are subject to numerous risks, uncertainties and other factors that may cause the actual performance of American Water to be materially different from the performance indicated or implied by such statements. Such risk factors are set forth in the Company's SEC 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 thank you for joining us today. I will be joined in the presentation by Ellen Wolf, our Chief Financial Officer, and in addition, Walter Lynch, who heads our regulated operations is here to help with your good questions that I am sure you'll have.

Before delving into the results of 2012, let me just make an opening comment. As you know, Ellen announced her retirement from our Company in January and I just want to take this opportunity to thank her for her tremendous dedication, expertise and leadership during the 12 years that she has served our Company. On a personal basis it has been a true pleasure to work with you and to really see the caliber and commitment that she has brought. Her direction of our financial objectives and obligations has helped us deliver strong results year over year. And she is about as red as the shirt that she is wearing right now. .

I also want to thank her for helping to ensure a smooth transition. As you know, Susan Story will join us on April 1 as our new CFO. I believe a number of you know her and, personally, I am thrilled to bring someone with her diverse background to our Company. Her experience and breadth of skills make her an excellent fit for this position and for American Water, and we look forward to introducing her to those of you who may not have had a chance to get to know her in the past at our next earnings call in May.

So, today, we are pleased to present the very strong results that we achieved in 2012, really, the outcome of sound execution of our business plan on any fronts.

So if you go to slide 5, for 2012 we reported an 8% increase in revenue, an 18% improvement in cash flow from operations, a 22% increase in net income and a 20% increase in diluted earnings per share from continuing ops. Our return on equity adjusted for the abnormally hot and dry summer improved about 49 basis points over 2011. And remember that we have got about $1.2 billion of debt at the parent and, given the cost of that when you take that into account, that means that our regulated operations earned a return on equity of just about 9% last year. And in the midst of this strong year performance our Board authorized an 8.7% increase in the dividend in 2000 -- or for the dividend in 2012.

So as a Company to challenge we laid out for ourselves in 2010, to build a culture of continuous improvement and excellence, is firmly taking root and providing a pathway to sustainable and profitable growth.

Now let's turn to slide six and let me talk about the other goals that we accomplished in 2012 that led to strong -- that lead to the strong prospects that I believe we have for the future. 2012 was the year of optimizing and enhancing our business portfolio to ensure that we are operating in areas that maximize value to our customers and shareholders. We acquired a total of 16 water and wastewater systems through accretive transactions adding more than 55,000 customers to our base. We also closed on the sale of our regulated operations in New Mexico, Arizona, and Ohio, which generated over $560 million in cash proceeds. That cash is now being more effectively deployed in our other regulated operations.

We also saw growth through agreements with shale gas developers to build pipelines to support drilling operations in the Marcellus Shale area which also enable us to provide the public with much-needed clean, treated water service. In 2012, we doubled the revenue from hydraulic fracturing contracts to about $3 million with a 74% increase in sales in excess of 430 million gallons.

Our homeowner services business expanded into 10 more states and has partnered with New York City to provide service line protection programs to its 650,000 eligible homeowners. This program, which was just launched last month, has seen a very strong response rate already in excess of 7%.

Now in recognition of the investments we make in infrastructure in our regulated operations to ensure our quality service to customers, during 2012 we resolved 10 rate cases, bringing in annualized revenue increases of over $120 million and we also filed for rate requests.

An important regulatory tool, the DSIC mechanism was approved in New Jersey. We responded by putting forward a plan to incrementally invest $220 million over the next three years in New Jersey and that is in addition to the base level of about $20 million a year or $60 million for that three-year period. With the inclusion of DSIC in New Jersey, we now have six states with such a infrastructure recovery mechanism and that includes all of our five largest states enabling the timely recovery of about 30% of our total CAPEX spend. The Regulated Business continued to increase efficiency and manage costs resulting in an O&M efficiency ratio adjusted for the midpoint of the estimated weather impact of 40.7% for 2012. So even adjusting for the weather, we drove 170 basis point improvement in this ratio, approximately the same reduction we saw in 2011 from 2010.

The investments we make into our infrastructure and systems which have amounted to over $1.8 billion in the last two years is key to our commitment to provide safe and reliable service. If you think back about 2012, extreme weather highlighted the importance of long-term planning and appropriate investment to ensure sustainability and resiliency of our operations. During the summer drought, for example, we saw the benefit of our water supply investment in our Southern and Midwestern service areas. And when Hurricane Sandy slammed into the East Coast, our dedicated employees, the preparation that they had done and our system enhancements kept the water flowing even through widespread and sustained power outages.

It is also worth noting that as we build resiliency into our systems to help with bad weather volatility, one of the key tools that we use is the leveraging of technology and innovation.

Let me just give you an example. As you know, most utilities use GIS systems to locate on maps their facilities, relative to other pieces of infrastructure -- roads, curbs, gutters, those kinds of things. So you have a sense of where your equipment is relative to other equipment that may exist in the right-of-way.

We have expanded beyond that to, in some of our areas we are starting to use GPS facility mapping which means that we have the ability to locate it just through GPS coordinates in the satellite and let me tell you how handy that came in.

When Hurricane Sandy hit and the New Jersey Barrier Island was in the midst of devastation and you had 2 to 4 feet of sand and piles of debris and moved houses, some moved as many as seven blocks and boats littered everyplace, you couldn't find traditional landmarks. You couldn't find a curb. You couldn't even find the street.

And so with our GPS coordinates we are able to locate every one of our facilities, our valves, be able to control our valves, so we could bring water back safely and we were also able to help communities find their equipment that they could not find like roads. So when they are trying to clear a road they don't know where to have the plows go. So we were able to -- based on finding our equipment -- then be able to map for them what the boundaries for those roads were. This will help -- this is the kind of tool that will help us with resiliency as we move forward.

In 2012, we also took phase 1 of our conversion to SAP and this was included the financial and human resource modules. We took it live. And while there are always struggles in implementing these complex systems, as I am sure you have talked to many companies that have been through this, an independent review we had done concluded that this was an above average implementation compared to more than 100 similar projects. And at this stage, we are on the schedule and budget that was established almost four years ago for this project.

While we did incur some higher O&M costs at the end of last year with implementation, these costs were relatively small compared to the overall $320 million project cost and that number includes AFUDC, you may recall.

Turning to slide 7, our long-term EPS growth target has been and continues to be 7% to 10%. And our history over the last three years demonstrates our capacity to achieve that long-term target. Given our past performance and the strategy we are implementing for the future, we are confident we will continue to meet that long-term goal.

For 2013 we announced our guidance range of $2.15 to $2.25 per share which puts our annual growth from a weather-adjusted 2012 between 8% and 13%. Interestingly, our EPS in 2008 was $1.10 per share. So at the midpoint of our guidance range for 2013 of $2.20 per share and a five-year period through 2013 we will have doubled earnings.

And with that, I will now turn the call over to Ellen who will provide details on our financial performance.

Ellen Wolf {BIO 1854557 <GO>}

Thank you, very much, Jeff. Good morning to those of you who are listening to our earnings conference call. Let me take a few moments now to describe the underlying factors that drove our 2012 results. More details will be available when our 10-K is filed.

Turning now to slide 9, as Jeff indicated, 2012 was another year of solid financial results with continued increases in revenues, net income and cash flow. For 2012, we reported operating revenues of approximately $2.9 billion, a $211 million increase over the revenue reported for 2011. Net income from continuing operations for 2012 was approximately $374 million or $2.11 per common share, an approximate 23% growth rate over the prior year. This is driven mainly by higher revenues in our Regulated Businesses of around $196 million and our continued focus on expense control.

As we have mentioned previously, we believe the estimated impact of the hot, dry weather in the summer of 2012 was around $0.13 to $0.16 per share for the year. Net cash provided by operating activities for 2012 was around $956 million compared to approximately $808 million for 2011, primarily driven by increase in our operating revenues, changes in working capital, lower pension and post retirement healthcare contribution, and long-term cap planning.

Now I would like to discuss briefly the various components of our income from continuing operations starting, of course, with revenues.

Turning to slide 10. Overall, revenues increased approximately $211 million with the regulated business increasing around $196 million or 8.3% from 2011. The increase in revenues was primarily driven by rate authorizations related to the needed maintenance and updating of our water systems and higher customer demand in our Midwest and Eastern states over the prior year.

For 2012, the impact of these rate authorizations including investment surcharges was approximately $129 million. The increase in revenues associated with higher demand over the prior year amounted to approximately $39 million. Also in 2012, revenue increases from acquisitions was approximately $27 million, primarily driven by the acquisition of systems in New York in the Second Quarter.

For our market-based businesses, revenues increased approximately $3 million with continued growth in homeowner services and our military contracts.

Turning to slide 11. As you know, our ability to invest in our infrastructure is driven by our ability to earn an appropriate rate of return on our investments. The extent to which requested rate increases are granted by the applicable regulatory authorities varies. This slide shows rate cases that have been filed and we are awaiting final orders on as well as rate cases and infrastructure charges that have been recently granted.

Annualized revenues from general rate cases affected in 2012 were $120.5 million. After year-end, an additional $4.9 million in step increases authorized in previous rate cases became effective.

For 2013, through February 26, we were granted $24.9 million or about $25 million of annualized revenues related to infrastructure surcharges. We are currently awaiting final orders for general rate cases in two states where we are requesting around $37 million in total additional annual revenues. And as Jeff mentioned, in 2012 our New Jersey subsidiaries submitted and had approved a foundational filing for our distribution systems improvement charge. The benefit of this filing for our customers and our shareholders is not expected until later in 2013 as we ramp up our infrastructure investment spend in New Jersey.

Turning our attention now to water sales volumes, total sales volumes increased 4.1% for 2012. As you can see, this increase in water sales volume was mainly driven by our residential customer class which is up 5% from 2011, mainly as a result of warmer drier weather in our Eastern states through July and Midwestern states into September. And also our customers -- or commercial customer class which is up 4.1% for the year.

Also contributing to the increased sales volume was our increase in customers mainly from our New York acquisition.

Turning now to slide 13. Total operating expenses for 2012 increased approximately $89 million from 2011, driven by our increased consumption, acquisitions, and a $7 million donation to the American Water Charitable Foundation.

Let me take a minute and discuss the main categories on this chart. Production costs in the regulated business increased $12.2 million, driven mainly by an increase in purchase water costs, particularly in California and Illinois, which was a result of higher consumption. Our employee-related costs decreased almost $18 million, primarily due to higher capitalization and reduced headcount as a result of vacancies. Conversely, operating supplies and services did increase around $23.7 million for the year primarily due to incremental contractor costs related to backfilling the vacancies that I just mentioned and incremental costs related to the stabilization of our ERP conversion.

Additionally, in 2012 there were also costs involving projects to improve processes and operating efficiencies over the long term. As we've discussed previously for 2013, our business transformation projects will be rolling out the enterprise asset management system, which will manage an asset's lifecycle and our customer information system to better serve our customers. We will continue to keep you posted on our progress in these areas.

Maintenance materials and services, which includes emergency repairs as well as costs for preventative maintenance, increased $8 million. This is mainly attributable to increased preventative maintenance expenses throughout our regulated subsidiaries including painting, meter testing, pump, paint and well maintenance and paving costs.

Operating expenses for our market-based business decreased slightly in 2012. This combined with their revenue growth produced an over 16% increase in our market-based pretax income from continuing operations.

And lastly we also experienced higher depreciation of around $30 million compared to the same period last year. This is due to our continued investment in needed infrastructure for our utilities.

Finally, based on these strong results for the year and attention to cost control, our regulated O&M efficiency ratio continues to improve. For 2012, stripping out the weather impact the ratio stands at 40.7% compared to 42.7% for 2011. This is due to the great efforts of the employees throughout all of American Water.

And with that. I would like to turn the call back to Jeff for any closing comments before we open it up for your questions.

Jeff Sterba {BIO 1426511 <GO>}

Thanks, Ellen. Going to slide 15, so besides EPS of $2.15 to $2.25 per share what can you expect from us in this next year?

First and foremost, we will maintain the same customer-centric dedication to providing safe, reliable water and wastewater services. We will also continues to stay very active on the public policy and regulatory front, promoting constructive regulatory frameworks and continuing to address regulatory lag that impacts our return on investment.

We plan to resolve three rate cases in the course of the year and file up to four general rate cases as well as infrastructure surcharge filings.

We will also continue our focus on operational efficiency and bolstering a culture of continuous improvement, effectively managing costs and leveraging processes and technology to create value. So the implementation of the SAP platform is an example that is going to provide us greater transparency into our cost drivers and the impact of the best practices that we will be able to study and understand that we have in one state and be able to transfer that to the rest of our operations.

This will help us approve our regulated O&M efficiency ratio and meet our five-year goal of having it below 40% in 2015 1 or two years early. You can expect that we will also continue to invest approximately $900 million to upgrade our systems with the goal always being to balance these needed investments to ensure reliability with our concomitant rate impacts.

Realizing savings and efficiencies from our supply-chain initiatives will help us achieve greater efficiency of capital spend, so we generate more dollar for each -- more value for each dollar invested. And there's just a fascinating array of examples that we have on the supply-chain side of where we are finding opportunities.

On our market-based businesses, we are focused on new offerings in existing markets and product in market line extensions. For example, we have now successfully piloted a program to provide gas and electric line protection programs and will be rolling these out to existing customers of our water and service line production products. We have also expanded homeowner services into more states and expect to have operations in 39 states by the end of the year. And we have a growing pipeline of additional military bases slated for privatization, though we recognize that this is not a fast process as it usually takes 18 to 20 months for any one to go from bids to contracting stage.

Finally, we also anticipate additional extensions in our regionalization strategy to help serve shale gas development in the Marcellus area.

We will also continue to leverage technology and innovation through our innovation development process which we have talked about in the past and we look to commercialize these offerings. Recall that this innovation development process effectively creates a test bed where we can look at taking emerging technologies, allow them to be demonstrated in the hands-on environment of an operating utility. In return for doing that and, obviously, we control it through its process, we will have the opportunity to take an interest in that business and also to help ensure that we can deploy that technology effectively through our regulated and market-based operation.

So in 2012, we did a lot of work leveraging the interdependency between water and energy. Earlier this year, we signed a joint development arrangement with a company that developed the standardized communications platform that creates interoperability among any meter manufacturers. In addition to seamlessly integrating different types of meters, this platform is able to receive many kinds of data from the water distribution network including pressure, water quality, lead detection and flow and not just meter data. This creates a powerful tool for meter reading and billing, but also for the collection of real time system data so that we can better manage and operate the distribution network, detect leaks and the like.

And this is just an example of the prospects we see coming from the innovation development process.

We will also continue to offer the scale, scope, and efficiency of American Water's operational water resource, environmental, supply chain, and capital management expertise to other utilities through tuck-ins and acquisitions as well, as well-structured long-term market-based arrangements. All of our 2013 targets will anchor our long-term EPS growth range goal of 7% to 10%.

We are pleased with the performance that we achieved in 2012 coming on the heels of also another great year in 2011, and we look to continue that momentum in 2013.

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

Questions And Answers

Operator

[Operator Instructions] Kevin Cole, Credit Suisse.

Q - Kevin Cole {BIO 18674088 <GO>}

Good morning. Ellen, congrats on your retirement and finding a worthy successor.

A - Ellen Wolf {BIO 1854557 <GO>}

Thank you.

Q - Kevin Cole {BIO 18674088 <GO>}

I guess, Jeff, just on this process given your whole co structure you obviously had an abundance of qualified internal candidates. So what new skill set do you believe that Susan will bring to the organization and how do you expect her to evolve the CFO position?

A - Jeff Sterba {BIO 1426511 <GO>}

Yes. Very good question. What Susan brings to the table is one, senior roles in a much larger company that has strong multistate experience and her breadth of experience goes from everything from all of the fundamental services that have financial impacts like the supply-chain and IT, et cetera, to the running of a business and the reporting of a CFO to her through that process, to being part of that management team and the financial acumen that she developed both through her school, her schooling as well as through the roles that she had which included oversight over a number of different functions, everything from the marketing and the derivative issues associated with that to rates.

And one of the things you will find with Susan is that she is a very well known commodity in the regulatory community with exceptionally high marks. And so it is that breadth that she brings. And I'll say that that breadth we are able to utilize because of the strength of the financial team that we have inside the Company.

Bill Rogers and Mark Chestlett highlight, really, our two key folks bring enormous capacity and capability in the controllers function and Mark is moving to be the Principal Accounting Officer. And in Bill's case, not just capital markets, but also because that's second nature to him because of his background, but he also brings a strategic acumen.

So I don't think about finance as a functional narrow silo. I think about finance as a resource that enables the business to be the best that it can be. And the broader base of the experience of the people that are in that area, the better able they are able -- they can provide that value while we also make sure that we have got the necessary and appropriate controls, accounting mechanisms and visibility transparency into the financials of the Company.

Q - Kevin Cole {BIO 18674088 <GO>}

That is actually a very good answer. Thank you. And should I almost view this as a CFO position today, but likely evolving into maybe succession plans for you as well? [multiple speakers] -- successor, sorry.

A - Jeff Sterba {BIO 1426511 <GO>}

My succession plans are not even my subject. That is the Board's.

So, my objective is to ensure that when we have the opportunities to expand our skill sets, strengthen our bench, that we exercise those opportunities because they don't come around very often. And I think through a number of the hirings that we have done in the last year and a half, two years, probably with the exception of maybe them deciding to hire me, we have had great success. From Bill Rogers coming in as Treasurer to a person that we hired brought in recently to head supply change who has got a wealth of experience as VP of supply-chain in many companies from pharma to telecom to the individual we have got running our continuous improvement and process excellence, lean Six Sigma to a new head of HR.

In each of these cases we have, I believe, enhanced our bench strength that gives us the ability to look at succession in a different way for a lot of positions. So I had the luxury of never being able to hold a job for about more than 18 months because I just kept getting moved to different things. And the result was I learned a lot about a lot of different pieces. That makes an executive much more effective, I think, particularly at the senior level.

So to have people that have that broad-based experience, for Walter to have operated in the competitive world and now operate in the regulated world, that gives great exposure and experience to both of those markets which are different. So any time we have the opportunity to enhance and strengthen our bench, I am all for it.

Q - Kevin Cole {BIO 18674088 <GO>}

Great. Thank you. And again, Ellen, good luck.

A - Ellen Wolf {BIO 1854557 <GO>}

Thank you, very much.

Operator

Andrew Weisel, Macquarie Capital.

Q - Andrew Weisel {BIO 15194095 <GO>}

Good morning. Just one question on behalf of Angie Storozynski. Regarding the flow-through tax accounting for repair costs in Pennsylvania, why haven't you changed your tax accounting for that?

A - Ellen Wolf {BIO 1854557 <GO>}

Let me -- if I could just step back and give a little history on this. Let me start with the fact that we adopted this in 2008 on a system wide, total Company wide basis. So we have had and will continue to have the cash benefit of this since 2008.

A - Jeff Sterba {BIO 1426511 <GO>}

And really that goes back to 2005, right?

A - Ellen Wolf {BIO 1854557 <GO>}

Right. The extent that we could then apply any of those generated losses to prior years we were able to do that. We have created out of this plus other things that have happened over the years such as bonus depreciation. We have an NOL on our books of about $1 billion. And our goal is around maximizing cash.

So what we wanted to do and why we are under the normalization is really match when the benefit is given to our customer with when we actually received the benefit on our taxes. And because we have NOL and most of that benefit will be in the future and that is when we are matching it with when we give the benefit to our customer.

Q - Andrew Weisel {BIO 15194095 <GO>}

Great. Thank you.

A - Jeff Sterba {BIO 1426511 <GO>}

Let me add one thing. If you think about and the way I look at it, obviously I wasn't around when they had the foresight to take this action as early as they did, so we picked up the benefit of this for our customers for now really going back to 2005. So eight years. If you think about it when you flow through something, yes, it flows through your income statement, but it also flows through the ratemaking treatment for that year. When you normalize it, it goes over time to the shareholder and to the customer. So it links the two.

For us, given that NOL position, if we flowed through, yes, you may get a bump in earnings in one year, but then you are going to reduce in the following year when you have the rate case occur. And for us, we operate in 16 states, having a process -- policy that works across all states has worked well.

We will always take a look at new approaches, but what doesn't sound very attractive to me is to give the cash back to customers when we can't get the cash from the IRS for another 10 years, because we have got the NOL carryforwards that are already keeping us from being a cash taxpayer except for AMD. So for me that is the real issue.

If we were in a different tax position and didn't have the benefit of that NOL position, we may have a different approach to it.

A - Ellen Wolf {BIO 1854557 <GO>}

And also as you can see the benefit of our doing the repairs and maintenance in our cash flow, it continues to grow stronger every year. And that is important to us as a company. It is important to our customers because it allows us to invest more in the infrastructure. It is important to our shareholders and customers in the sense of it is very low-cost financing.

A - Jeff Sterba {BIO 1426511 <GO>}

Well, that is what keeps us from having to issue other instruments that would be dilutive to your earnings.

A - Ellen Wolf {BIO 1854557 <GO>}

That's correct.

Q - Andrew Weisel {BIO 15194095 <GO>}

Added. Thank you.

Operator

Leslie Rich, JPMorgan.

Q - Leslie Rich {BIO 2186455 <GO>}

I wondered if you could go into a bit more detail on the New Jersey DSIC spending. I think you said it was $220 million of spending and I am just wondering over what period of time and how that actually rolled through the -- your rates in terms of [multiple speakers].

A - Jeff Sterba {BIO 1426511 <GO>}

Yes, let me ask Walter to --

Q - Leslie Rich {BIO 2186455 <GO>}

-- the timing of the true-up and things.

A - Walter Lynch {BIO 6064780 <GO>}

Yes. We, in our foundational filing, we said we would spend up to $220 million. That gets us to the 5% of revenue cap that we have and that is over and above the $20 million each year of base spending. So that $220 million [inaudible] every six months we will do a filing and then the Commission will have 60 days to look at it and then allow us to put it on the bills. [multiple speakers].

A - Jeff Sterba {BIO 1426511 <GO>}

And that's over three years, that's [multiple speakers].

Q - Leslie Rich {BIO 2186455 <GO>}

Okay.

A - Jeff Sterba {BIO 1426511 <GO>}

Now we will tell you we are looking at whether some of that is -- should be advanced into a tighter period, but it will be $220 million over no more than three years.

Q - Leslie Rich {BIO 2186455 <GO>}

And then, you -- I am sorry. Could you go through the timing of how that actually rolls through rates?

A - Ellen Wolf {BIO 1854557 <GO>}

Sure. Well, what happens is you file a filing with the Commission so similar to New Jersey to Pennsylvania where you have a surcharge on the bill. You would have a surcharge on the bill for every six months for your filing and what you are authorized to spend and approve to spend and then when you file your rate case that surcharge rolls up into the normal rate.

Q - Leslie Rich {BIO 2186455 <GO>}

Got you. Thank you.

Operator

Michael Lapides, Goldman Sachs.

Q - Michael Lapides {BIO 6317499 <GO>}

Subbing in for Neil a little bit right now. Real quick, just question on the dividend. How are you thinking --? I know you kind of talked about the dividend increase, but how are you thinking about long-term dividend payout ratio policies and can you put that in conjunction with your view on credit metrics, target credit ratings and how you are thinking about managing capital overall over a multiyear period?

A - Jeff Sterba {BIO 1426511 <GO>}

Let me address the dividends and have Ellen address that relative to the credit metrics. From the dividend side, our philosophy and belief is that because it is always a trade-off between what do you -- how you can invest that cash and how you can return that cash and the balance between the two is we have targeted the payout ratio in the 50% to 60% range and to have the dividend grow at something close to what our rate of increase in earnings per share is.

If you look at the early years after the Company came back into the public markets, the dividend probably lagged a little bit and so we took a step of an additional increase last year. We are now, frankly, a little below the 50% payout ratio and the yield has gone down as our stock has been bid up. We view that positively, but we also will look at that long-term philosophy of paying 50% to 60% relative to how we go about dividend decisions in 2013 and forward.

A - Ellen Wolf {BIO 1854557 <GO>}

A couple of things to note. Our cash flow continues to get much stronger. That has helped contribute to covering our capital and also our dividends. Our shareholder base looks at a combination of both growth in the stock and growth in the dividend and we will continue to look at dividend growth in terms of the right balance for our shareholder, as well as for the Company so that we can reinvest that money back into the business.

I would also like to add that because of the strong cash flow that we have had and our known dividend policy, both rating agencies have put us on positive outlook. So we continue to see the benefit of our focus around this area.

A - Jeff Sterba {BIO 1426511 <GO>}

And just to reinforce what Ellen said, our focus there is on cash. Not cap structure. It is not that we don't look at cap structure, we do. But it used to be that you had to really focus on cap structure and think about getting to a 50-50 or what have you to be at the BBB plus or to move up into the A category.

I think the rating agencies in one sense are more focused and smarter about what they really ought to be looking at is the cash flow and the security of that cash flow, while you have boundaries around the cap structure that probably aren't as tight as they were before. So we are not focused on thickening the equity ratio for the sole purpose of getting an increase in rating. It is just that there's just not value there. But all the things we are doing to drive cash flow improvement, those will have the same impact, we believe, with the rating agencies.

A - Ellen Wolf {BIO 1854557 <GO>}

And if I could also add to, our equity ratio continues to strengthen based upon the strength of our earnings. So as of year end we are a little bit above 44% equity where we started much lower three years ago.

A - Jeff Sterba {BIO 1426511 <GO>}

Yes. I think there used to be some analysts who were always nervous that, well, we are going to issue equity to thicken [ph] the equity ratio and that's just not we see no need to do that.

Q - Michael Lapides {BIO 6317499 <GO>}

Got it. Thanks. Much appreciated.

Operator

[Operator Instructions] Gerry Sweeney, Boenning.

Q - Gerry Sweeney {BIO 15217227 <GO>}

-- on the retirement. Quick question for you, Jeff. Obviously with the hiring of Susan Story she has got a lot of services experience and you have talked about in the past always looking for some regulated-like programs. Are we going to see a little bit more additional focus in coming years on this and maybe to rephrase it or to put it a different way, what is your vision and strategy for this, the market-based opportunities? How is that going to develop and I sense there's stuff percolating under the surface, but I wanted to see what your thoughts were.

A - Jeff Sterba {BIO 1426511 <GO>}

Relative to our market-based businesses it is a small but important and growing part of our business. We demonstrated 16% increase year over year to '12 and I think it was higher than that in '11 to '12. Let me adjust that. '10 to '11. So it is an important part of the business, but it is not going to grow to be 30% of the business. It would have to grow exceptionally rapidly to just double its impact on our bottom line.

We are focused on reg-like kinds of things so certainly the businesses that we are in which include the military services, the homeowner services, a revamped Contract Services group because we have talked about how we are not going to participate in the old traditional kinds of short-term-based Contract Services groups. Plus doing more frankly on the waste management side. As we expand in wastewater we see more opportunities in solid waste management -- and I don't mean trash, I mean the solid waste, the solids that come from wastewater as well as reuse. Which is effectively using the liquids that come from wastewater. So those we view, I think about it in terms of logical business line extensions.

At the same time, one of the things that we went out and said very early on was we are going to make sure that we get very good inside before we ever try to take anything outside. Because, otherwise, it is a great recipe to get bad bigger -- bigger bad and not get better. And so as we increase, for example, our supply chain capabilities, is that something that we could also bring to the benefit of customers that are utilities, municipal utilities that don't have access to the things we do. Does it open other doors for us?

Those are things that we will explore, but I wouldn't -- I don't expect there to be dramatic change in our risk profile in the way that we think about the balance of our regulated business versus our competitive business. But do expect that that focus on excellence will give us -- will open doors for what I'll call business line extensions where you have adjacent opportunities rather than completely new opportunities.

Q - Gerry Sweeney {BIO 15217227 <GO>}

And any comments on the revamped contract business? Obviously there is always talk about the 50,000 plus water systems in the US. There's pension issues, there's healthcare issues in terms of payment of liabilities.

Another thing that is sort of percolating under the surface, you see it now in TAM [ph]. Thoughts on how that is developing.

A - Jeff Sterba {BIO 1426511 <GO>}

You know, I think from day one, at least when I came I kind of expressed the sentiment that a number of my senior level cohorts here had which is, this is a slow market to develop. It reminded me of the old fuel cell issue that fuel cells will be here in five years, but it is always another five years. But I do believe that it has changed some because of the persistency, the persistence of the financial issue. And whether it is driven by pension, whether it is just remember the lack of revolving fund access from the Federal government, the shrinking of that pod, the almost complete dearth of grants from the Federal government and states being in the same situation, I think communities are having to face a different set of challenges.

And if they are interested in having someone like us operate their systems and be a part of their community, we are going to be very interested in doing that. Whether we do that under an acquisition which is generally a preference on our side because it fits with what we do well or it is done under a longer-term contract, we are willing to look at that.

So I think there are more cracks [ph]. I mean we even in last year we acquired some municipal systems. I expect that that will happen this year. And so I think we will see more instead of the private tuck-ins we will see a little more on the municipal side, but it is just -- it is still not going to be, barn gates get opened.

Q - Gerry Sweeney {BIO 15217227 <GO>}

Sure, I mean, from my perspective I would look it as an incremental growth avenue one [multiple speakers] in a good year, something like that.

A - Jeff Sterba {BIO 1426511 <GO>}

Absolutely.

Q - Gerry Sweeney {BIO 15217227 <GO>}

All right. Thank you, very much.

Operator

Jonathan Reeder, Wells Fargo.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Good morning. Hey, Ellen, congrats on the upcoming retirement. I am truly jealous, but you have done some great work and it is bringing native EK [ph] back to the public market in 2008. So it is well-deserved.

A - Ellen Wolf {BIO 1854557 <GO>}

Well, thank you and I also want to thank you and everyone on the phone for their continued support for American Water. It's a great company.

A - Jeff Sterba {BIO 1426511 <GO>}

And, Jonathan, I want to understand if you actually wore what you're supposed to wear the week about a week ago after the football game.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Yes I am still paying off that bet unfortunately. Most of my questions have been asked already this morning, but Jeff, are you targeting any sort of improvement in the O&M ratio in 2013? I know you have the 2015 goal that you said you may even hit two years early which would be by the end of this year, but you have any sort of internal target that we might want to build into the model?

A - Jeff Sterba {BIO 1426511 <GO>}

Well, there's -- until you said the last phrase it was a one word answer. So there's two. The answer is yes, but, no, I am not going to tell you. .

I don't mean to be funny or flip about it, but we do have obviously have a number of targets that we focus on internally they're not -- they have caveats and they have got ties and so it gets too complicated to try to explain all of those to the external market. So, but rest assured, we do have targets and I feel good about the progress we will continue to make on that front and that we will beat the 40% by the end of 2015 by one or two years.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay and then I don't know if you can talk about the usage that you saw in 2012 absent the weather. Was it similar to what you're forecasting going into the year which I think was a client of 7 -- or 0.7% to 0.8% on the residential side?

A - Ellen Wolf {BIO 1854557 <GO>}

Historically what we have seen in terms of decline is about 1.5% to 2.5%. It is difficult to pull that out in any time frame, but in the off months we do continue to see some decline.

A - Jeff Sterba {BIO 1426511 <GO>}

Although it is less -- it does -- we may see some leveling of that.

Q - Jonathan Reeder {BIO 18909775 <GO>}

So your expectation for 2013 --

A - Jeff Sterba {BIO 1426511 <GO>}

It builds into [multiple speakers].

A - Ellen Wolf {BIO 1854557 <GO>}

It builds into the 2013 number.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. All right, thank you very much.

Operator

I show no further questions in the queue at this time. I would like to turn it back to management for any closing remarks.

A - Jeff Sterba {BIO 1426511 <GO>}

Let me just thank you all for joining us today. I want to thank Ellen again for everything that she has done for the Company and I am going to give her the last word.

A - Ellen Wolf {BIO 1854557 <GO>}

All right. With that, this is a first. I just, again, I want to thank each and every one of you for listening to this call, for your continued support of American Water, for your in-depth questions. They have kept us on our toes and you are continuing to push us and as we become each year a better and better company. So thank you.

Operator

Ladies and gentlemen. this concludes the American Water Fourth Quarter 2012 results conference call. We would like to thank you for your participation and you may now disconnect.