Q2 2014 Earnings Call

Company Participants

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

Other Participants

- Dan L. Eggers, Credit Suisse Securities (USA) LLC (Broker)
- Jonathan G. Reeder, Wells Fargo Securities LLC
- Ryan M. Connors, Janney Montgomery Scott LLC
- Tim M. Winter, G.research, Inc.
- Walter S. Liptak, Global Hunter Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to American Water's Second Quarter 2014 Earnings Conference Call. As a reminder, this call is being recorded and is also being webcast with accompanying slide presentation through the company's website www.amwater.com.

Following the earnings conference call, an audio archive of the call will be available through August 15, 2014 by dialing 1-412-317-0088 for U.S. and international callers. The access code for replay is 1004-9534. The online archive of the webcast will be available through September 7, 2014, by accessing the Investor Relation's page of the company's website located at www.amwater.com. After today's presentation, there will be an opportunity to ask questions.

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

Edward D. Vallejo {BIO 16076814 <GO>}

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

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

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

Susan N. Story {BIO 3335156 <GO>}

Thanks, Ed. Good morning to everyone and thanks for joining us on this call. As you know, this is the first earnings call with our new leadership team in place. I'm joined today by Linda Sullivan, our Senior VP and CFO, who will be going over the second quarter financials, and Walter Lynch, our President and COO of Regulated Operations, who will give us updates on key matters in our regulated business.

We're very fortunate to have such a talented management team and I'm also glad to report that through the hard work of all of our employees at American Water, we've once again delivered a quarter of strong performance.

Before I go any further on our results for the quarter, I do want to touch on two recent events. It's not often that water makes national headlines, but it did twice last week. One event centered on the major water main break on the campus of UCLA. And the other event was an algae bloom that impacted the drinking water of over 400,000 people in Toledo, Ohio. While neither event impacted American Water directly, both of these events highlight the importance of water supply sources and infrastructure.

For many years, American Water and folks throughout our water industry have been raising the challenges that our country faces when it comes to our water systems and supply.

Later in the call, I'm going to mention several efforts that we've got underway at American Water so that we can find solutions to these challenges. It's our hope that in the near future, it will be the solutions that are making the headlines and not the problems. Last week's event, show the risks in our industry, but they also open the door to increased collaboration among all sectors to improve our nation's water future.

So, now on to our performance for the quarter. We achieved increases in revenues and EPS. We completed three acquisitions. We continued strategic growth on the market-based guide and importantly for our customers we found ways to be even more efficient and effective in our services.

As you can see from slide 5, our operating revenue increased about 5%. Adjusted diluted earnings per share, which excludes the second quarter impact of the West Virginia event was $0.63 per share, up approximately 9% from the weather-normalized $0.58 per share last year. This increase is due mainly to higher revenues in our regulated business through rate authorizations and infrastructure charges as well as additional revenues from acquisition. Our market-based revenues also increased, mostly from capital projects associated with our military contracts and growth in our service line protection programs.

We also reported an increase in cash flow from operating activities of approximately $65 million. Linda will give more detail on these financials shortly. Our adjusted ROE for the last 12 months ended June of 2014 increased 80 basis points to 8.65% compared with the same period last year.

Turning now to slide 6. Our mission is to provide clean, safe, affordable and reliable water and water services to highly satisfied customers. You can't do that without maintaining and improving the pumps, plant and pipes that deliver water and water services. This quarter, we invested about $213 million in needed improvement. Because our first quarter capital spending was hampered due to a very cold winter, our year-to-date spending is just a bit behind, but we are still planning to spend up to $1.1 billion by year's end.

And as we stated previously, we anticipate investing approximately $5.8 billion in our business in the next five years, including around $700 million for regulated acquisitions and strategic opportunities. As you all know, for 2014, one of our goals is to actively address regulatory lag and promote constructive regulatory frameworks. I'm happy to report that more than $9 million of additional authorized revenues became effective in the second quarter due to step increases, infrastructure charges and rate cases.

To address affordability for our customers, we continue to improve our O&M efficiency ratio, which when we adjust for the West Virginia event and weather is 37.7% for the 12 months ending June 30, 2014, compared to 40.7% for the same period last year. A key part of driving efficiency comes from our focus on developing and implementing innovative technology. I'll go into the detail on this towards the end of the call, but I do want to give you just a few examples right now.

In 2009, American Water launched its Innovation Development Process or IDP to assess and bring new innovations to our company and the water industry. Since then, more than 600 technologies have been examined through IDP and a number of these initiatives have been implemented.

One of these is NPXpress for which American Water has been awarded three patents. This technology reduces up to 50% of aeration electricity consumption, which is the biggest wastewater treatment energy user, and it reduces supplemental carbon additives by up to 100%. American Water has implemented this technology at seven of our plants, and we're in the process of installing it in additional locations. These are real savings for our customers.

Another example is our partnership with ENBALA Power Networks by connecting our plant assets to the electric grid through ENBALA. We've been able to generate a new revenue stream to mitigate our electricity costs. Our program at our Pennsylvania Shire Oaks pumping station has offset 2% to 3% of that site's total energy bill. And remember that labor, power and chemicals are our largest expenses. As we drive efficiency in our operations, we can use those resources to fund more needed investment in aging water infrastructure without putting undue burden on the water bills of our customers.

So moving on to growth, from April 1 through June 30, we completed three acquisitions, adding approximately 700 metered customers to our regulated footprint. On the market base side, homeowner services has expanded its service offerings into eight new states since the beginning of the year. We expanded into four of those eight in the second quarter as well as we launched our exclusive partnership with Metro Water Services in Nashville in April. Homeowner services currently has nearly 700,000 customers and more than 1.3 million customer contracts and operates in 43 states and Washington D.C.

Moving to slide 7, which illustrates our commitment to shareholder value. On July 30, 2014, we announced that our board of directors declared a quarterly cash dividend payment of $0.31 per common share, payable on September 2, 2014 to all shareholders of record as of August 11, 2014. This 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.

And finally, we are reaffirming our annual earnings guidance to be $2.35 to $2.45 per share, excluding the impact of the Freedom Industries chemical spill in West Virginia. While we are reaffirming this guidance, we do see our performance trending toward the upper end of the range assuming normal weather patterns for August and through the remainder of the year. Given that our third quarter is normally our largest for revenue and net income, we will continue to monitor and provide any changes, which might be appropriate on our third quarter call.

As Walter and Linda will discuss in just a few minutes, the impact of the Freedom Industries chemical spill was $0.02 in the second quarter and year-to-date through June 30, it is approximately $0.04 per share. We estimate that this number will stay relatively stable through the rest of the year unless there are additional legislative changes requiring immediate actions or if a civil trial were to begin earlier than expected.

Based on our performance, we remain confident in our ability to deliver on our long-term EPS growth goal of 7% to 10% through execution of our growth strategy and continued operational efficiency gain.

Walter will now give an update on our regulated business.

Walter J. Lynch {BIO 6064780 <GO>}

Thanks, Susan. You mentioned weather so we'll start there. We've mentioned in the past our geographic diversity mitigates the impact of regional weather. We saw that clearly in the second quarter. The map on slide 10 provides a precipitation for the second quarter in the states where we operate with our service areas indicated here as well. You'll note that this map does not include the West Coast, which is making the news with record drought. I'll get to that in a moment, but for now, I want to focus on the weather in the Northeast and Central States.

As you know, Pennsylvania and New Jersey are our two largest states and you can see while Pennsylvania had above-normal precipitation for the quarter, a good part of New Jersey had normal precipitation as well as parts of Missouri, which is also one of our larger states. This geographic diversity contributed to the second quarter not having a significant weather impact in our operations. Having said that, we've seen some cool and wet weather in July, specifically in our New Jersey service areas. We'll update you on any weather effects in the third quarter earnings call.

On the next slide, let me start with an update on California. As we moved into summer and drought conditions continued across the state, California American issued a call for a 20% reduction in usage in accordance with the governor's emergency drought declaration. In June, we were able to report that our Sacramento district reduced usage by 23% compared to 2012 and 2013 levels. We thank our customers there for successfully conserving water. Also, I want to mention here that thanks to constructive regulatory treatment during this drought, we've been able to maintain revenue stability during a period of decreasing sales through the various regulatory mechanisms that are in place.

Of course, part of addressing water challenges in California is our efforts related to our desalination facility, known as Monterey Peninsula Water Supply Project. In July, we announced that data gathered from boreholes drilled along California's Central Coast showed that an alternative way of collecting seawater for desalination may be feasible.

Without getting into too much detail, California American Water has proposed subsurface intake wells or slant wells that would collect sufficient ocean water to produce nearly 10 million gallons of potable water a day to supply to the Monterey Peninsula. Subsurface intakes have become the preferred technology for desalination plants amongst state regulators and environmental groups because unlike an open pipeline to the ocean, they don't trap and harm marine life.

There've been some concerns about the quantity and quality of ocean water these produced wells will produce and as I've said the data gathered and collected so far looks very promising. The basis of design report for the desalination facility is now complete and under review. Design is scheduled for 60% completion by September, and again, we'll keep you updated on our progress.

Also in California, as in all of our regulated states, we continue our work on receiving a reasonable return on vital infrastructure investments we make. So I'm happy to report in California, we've signed a proposed settlement agreement with the Office of Ratepayer Advocates and other interveners in our general rate case in the amount of $13.6 million for the first year of a three-year step increase. The proposed settlement is scheduled to be voted on by the California Public Utility Commission later this year.

In New Jersey on June 18, the Board of Public Utility staff proposed modifications to the consolidated tax adjustment when determining utilities tax expense for rate-making purposes. Under the BPU proposal, it limits the look back to five years from beginning of the test period. In addition, 75% of the savings would now go to the company and 25% to utilities customers.

While we're pleased with the progress that is being made by the BPU to address a consolidated tax adjustment issue, we still believe the adjustment should be eliminated entirely as it has been in most other jurisdictions. And comments to the BPU are due August 18.

Lastly, let's move to an update on the Freedom Industries chemical spill in West Virginia. On the cost side, as Susan mentioned earlier, we've incurred $0.04 on an EPS basis during the first half of the year. Since our last call, our filter changes complete and to further demonstrate our commitment to our customers we took the additional step of testing water samples across the 1900 mile Kanawha Valley water distribution system. We're pleased to report that there are no traces of MCHM detected in any samples taken from the replaced filters.

As we've said since day one, we're extremely proud of our team there and what they've accomplished. It's one thing to hear it from us, but it's also been reported from external parties as well. In fact the head of the U.S. EPA's Office of Ground Water and Drinking Water recently said that West Virginia American Water "did what they absolutely had to in that circumstance, by not cutting off the intake to ensure that there was water available for fire suppression and other emergencies." We agree.

On slide 12, continuing our commitment to be more transparent, let me give you a brief update on our Shale activity as it relates to regulated operations. Our sales for the last 12 months ended June 2014 was 7% higher than in 2013. And gallons sold have increased close to 60% over the last two and a half years, again this is on our regulated side. We continue to evaluate other opportunities as we've said in the past such as water treatment and disposal on the non-regulated side.

So now I'm going to turn the call over to Linda for a more detailed review of our financial performance.

Linda G. Sullivan {BIO 7300156 <GO>}

Thank you, Walter, and good morning, everyone. I'm excited to be here and I look forward to working with all of you. Let me now walk through the second quarter financial results in more detail. Turning to slide 14, second quarter 2014 was yet another quarter of strong financial results with increasing revenues and continued progress on improving operating efficiency.

For the three months ending June 30, 2014, we reported operating revenues of $759.2 million, which is a $35 million or about a 5% higher than the second quarter of last year. Operating income rose to $253.8 million or about $12 million higher than the same period last year. We reported second quarter net income of $109.3 million or diluted earnings per share of $0.61. This compares to net income of $101.3 million or diluted EPS of $0.57 for second quarter of 2013.

As Susan mentioned previously, included in the $0.61 is a $0.02 charge for the quarter related to the Freedom Industries chemical spill in West Virginia. Excluding this impact, our adjusted EPS for second quarter 2014 was $0.63 per share. We also paid a dividend of $0.31 per share during the quarter, which represents an approximate 11% increase over the $0.28 per share payment in the second quarter of 2013.

For the three months ended June 30, 2014, we reported cash flow from operating activities of $205.7 million compared to $140.6 million in 2013 or a $65.1 million increase. This increase in cash flow from operations was primarily due to three things. First, stronger cash flow from core growth in the business; second, a decrease in pension and post-retirement benefit contribution;

and third, changes in working capital, driven by higher cash collections this quarter as earlier this year we largely caught up on the delayed billings that resulted from implementation of our customer information system.

Turning now to slide 15, I want to highlight the key items impacting earnings this quarter compared to the same period last year. And I will cover more details on the revenue and expense breakdown slide.

On the left side of the page, our starting point is second quarter 2013 recorded earnings per share of $0.57. Last year was cooler and wetter than normal, so we have adjusted up $0.01 for weather, which gets us to what we consider a normalized earnings starting point for the second quarter of 2013 or $0.58 per share.

Next, we outline the various earnings per share drivers contributing to the $0.05 per share increase in our second quarter 2014 EPS of $0.63 after adjusting for the impact of the Freedom Industries spill in West Virginia. The key items contributing to the $0.05 increase in adjusted EPS this quarter include higher revenue in our regulated business of $0.09 per share, partially offset by higher depreciation of $0.03 per share driven by regulated growth and higher O&M of $0.01 per share.

The O&M increase includes several offsetting items and I'll discuss each of these items in more detail on the revenue and expense breakdown slide. On a GAAP basis, diluted earnings per share were $0.61 for the three months ended June 30, 2014, and as I mentioned earlier, we've added back the West Virginia event impact of $0.02 to bring our adjusted earnings per share to $0.63. With regard to the cost associated with the West Virginia event, we indicated last quarter that we expected these costs to be in the $0.03 to $0.04 per share range for the year. We have now recorded $0.04 per share and expect these costs will remain relatively stable for the remainder of the year.

Also included in this estimate are costs associated with the general investigation by the PSC, which were not included in our original estimate. In the second quarter of 2014, we recorded approximately $5.9 million associated with the spill, bringing the total for the year to $10.9 million, which includes operating related costs that have largely returned to pre-event level and the estimated cost for the year related to the civil lawsuits filed to date based on known facts and current circumstances. These costs are subject to change and as Susan mentioned do not include incremental costs associated with potential legislative changes or civil trial costs.

Now, let's discuss the different components of our EPS growth starting with revenues on slide 16. I encourage you to read our 10-Q on file with the SEC for a more detailed analysis of both revenues and expenses. Overall, operating revenues increased $34.9 million or 4.8% with revenues from our regulated business, increasing by $30.2 million or 4.7% compared to second quarter 2013.

Regulated revenues were higher, primarily due to the first four items you see on the slide. First, authorized rate increases for a number of our operating companies was $20.8 million; second, a $3.5 million increase due to acquisitions with the most significant being Dale Service Corporation in Virginia in fourth quarter of 2013; third, increased surcharge and amortization of balancing accounts of $3.1 million; and fourth, a $2.1 million benefit due to higher consumption and other items compared to last year.

Continuing with our market-based business, revenues for the second quarter of 2014 increased by $4.6 million. Half of that increase was from an increase in contract operations revenue, primarily due to capital project activities associated with our military contracts, partially offset by price re-determinations of $2.3 million recorded in the second quarter of last year and a reduction in revenues from terminated municipal and industrial O&M contracts as part of our portfolio optimization efforts.

Homeowner services revenue increased by $3.8 million in the second quarter as a result of contract growth, mainly with our New York City contracts as well as expansion in other geographic areas.

On slide 17, total operating expenses for the three months ended June 30, 2014, increased by about $23 million compared to the same period in 2013. Operations and maintenance expense in the regulated business increased $11.8 million or 4.3%, which is included in the regulated box on this page. Within the regulated O&M expense category, production expenses were the single biggest contributor and increased by $9 million or 13.8% for the quarter.

This increase is a result of purchased water cost, principally from price increases in our California subsidiary, which are recovered through various regulatory mechanisms. We incurred approximately $5.9 million for the Freedom Industries chemical spill, as I discussed earlier. Customer billing and accounting expenses increased $4.1 million or 33.8% from higher uncollectible expenses associated with an increase in the aging of our accounts receivable due to slower than normal collection pattern.

With the implementation of our customer information system in 2013, we made temporary changes in our collection process, which resulted in an increase in our receivables aging. We are focused on returning our collection process to pre-implementation levels, and we're making steady progress. However, we expect it to take a bit more time than originally anticipated, and as a result we expect to continue to experience higher uncollectible expense this year, and we have factored that into our reaffirmed earnings guidance range.

Maintenance, materials and supplies, which include emergency repairs as well as cost for preventive maintenance, increased $3.6 million for the quarter, mainly due to increased tank painting in New Jersey and higher paving and backfilling expenses.

Employee-related costs, which includes salaries and wages, group insurance and pension expense, decreased $7.7 million for the second due to decreased pension and post-retirement benefit costs, mainly from the change in the discount rate. Also partially offsetting this decrease were severance costs as we continued to drive efficiency in the business.

The operating supplies and services in other category decreased $3.1 million. This decrease was primarily due to lower contracted services as 2013 included additional costs from backfilling positions using contractors on certain projects and incremental costs attributed to the continued maturity of our enterprise resource planning system implementation.

Moving to the market base business. O&M expense increased for the quarter $6.3 million, mainly due to the increase in construction project activity for our military contracts, which corresponds with the increase in revenue. In second quarter 2014, we also reported higher consolidated depreciation, amortization and other expense of $4.9 million. This increase was principally from placing additional utility plant in service including phase 2 of our SAP project that was placed into service in two waves during 2013.

On slide 18, this shows our O&M efficiency ratio. Despite higher uncollectible expense and severance costs recorded this year, we continued to see progress in this metric. For the 12 months ending June 30, 2014, we achieved a 37.7% ratio, which is a considerable improvement from the 40.7% ratio we had for the same period last year. This ratio is adjusted for weather and excludes the West Virginia expenses related to the Freedom Industries chemical spill.

As we have shared with many of you previously, our long-term stretch goal is to achieve a 35% O&M efficiency ratio by 2018. There is a full calculation of this ratio in the appendix section of this earnings call slide deck.

Now let's look at recent regulatory highlights on slide 19, which shows formal rate increases awaiting final order as well as step increases and DSIC filing, which impacted the quarter or are still pending. In terms of pending rate cases, as of August 6, 2014, we are awaiting orders for the general rate cases in two states, including California, where we now have a settlement with the Office of Ratepayer Advocates and other interveners as Walter mentioned, as well as a step increase.

For rates that became effective in 2014, we had a $1.2 million in step increases from a prior rate case in New York effective April 1, 2014. Infrastructure charges awarded to be effective in the first and second quarters of 2014 totaled $18.2 million annually. And in addition, effective July 1, 2014, we received approval of $7.4 million in annualized DSIC revenue in New Jersey, for a total of $25.6 million. These infrastructure mechanisms represent the ability to more timely recover capital when we invest to improve our infrastructure and customer service. Additionally, we implemented new rates effective January 1, 2014, in Pennsylvania and effective April 18, 2014, in Iowa for a combined annualized total of $29.8 million.

These are the highlights of these cases and we advise you to review the footnote for a fuller understanding of particular cases. While we can't predict how any new case will be determined, we hope that this will help you understand our current rate environment. And in the appendix, you will also find an updated version of our largest 10 states with their authorized rate base and allowed ROE.

Going to slide 20, on June 2, 2014, Standard & Poor's Ratings Services revised American Water's outlook to positive from stable. This highlights our commitment to managing the overall financial strength of the company and we are really proud of that. Lastly, as Susan mentioned, we are reaffirming our annual earnings guidance to be in the $2.35 to $2.45 per share range. While we are reaffirming this guidance, we see our performance trending toward the upper portion of the range assuming normal weather patterns for August and through the remainder of the year. This guidance excludes the impact of the Freedom Industries chemical spill in West Virginia.

And with that, I'll turn it back over to Susan.

Susan N. Story {BIO 3335156 <GO>}

Thanks, Linda. I would like to conclude each of our earnings calls going forward by giving you expanded color on some of our initiatives and efforts outside of what we might typically cover in an earnings call. It's our hope that you'll find this information useful in understanding how we are moving forward as a company, just let us know if you think it's helpful. This quarter, I want to speak very briefly on the topic of water, energy, and innovation. I spoke a little bit about innovation earlier.

In the past, we briefly discussed the critical dependency between water and energy. In recent months, we've seen the level of national discussion on this topic increase dramatically and we're excited about it. Why are we excited? Well first, we see it as a way to improve efficiencies in both water and energy usage, and address key water challenges and energy production. Second, it plays to one of the strengths of our management team, which reflects a mix of seasoned water professionals, and experienced professionals from the electricity and energy industry.

The Department of Energy issued a report last month on the water-energy nexus. As we all know, water is essential for human survival, prosperity and whether that's for drinking, sanitation, industrial use, irrigation or power generation. For example, for every gallon of gasoline that you put in your car, it took 13 gallons of water to produce it.

Each shale well requires from 3 million to 7 million gallons of water in the hydraulic fracturing process. Thermoelectric plants require substantial water for cooling, although the majority can be returned to its source. And in turn, electricity plays a critical role in producing, treating, and delivering clean water.

For example, about 4% of the electricity consumed in the United States is used for collecting, treating, and moving water and waste water. That number's much higher in California. So, the future of water and energy is fundamentally intertwined.

This DOE report frames the integrated challenges and opportunities surrounding water and energy. And specifically, it lays out six pillars to address this constructive way forward for the nexus. These pillars include, energy efficiency in water treatment and distribution, resiliency and reliability of water and energy systems, using non-traditional water sources in a sustainable and productive way, and linking synergies among water and energy. As the first U.S. water and wastewater utility to join the EPA's Climate Leaders Program, American Water is discussing with U.S. Energy Secretary, Ernest Moniz; and DOE staff, the multiple efforts we have underway that address the DOE's six pillars.

American Water's efforts range from developing and implementing new technology to reduce energy use during treatment, to connecting a smart water grid with a smart electric grid, to using renewable power in water treatment. And the use of recycled water and new water supply sources such as desalination. The DOE paper discusses RDD&D, research, development, demonstration, and deployment.

We at American Water are involved in all four stages in different water and wastewater technologies. We know that through our expertise and research capabilities, our customers will benefit through increased reliability, water quality and increased cost efficiencies, while we also bring valuable new technologies to the rest of the water industry.

As new challenges in the water industry arise, so will the opportunity to increase collaboration with the energy industry. And think about it from a regulator's point of view. If water and energy companies work together to increases efficiencies, that have a positive impact on customers, that's a win-win for all of us.

Together, we have the potential to bring about smart solutions that are resilient, sustainable and affordable. We put our specific efforts on each DOE pillar in a new document that can be found on our website. I invite you to go and check out all the innovations that we have here at American Water. As I said, this is an exciting time to be in our industry and especially at American Water.

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

Q&A

Operator

The first question will come from Ryan Connors of Janney Montgomery Scott. Please go ahead.

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

Hi, Ryan.

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

Great. Hello. Thanks for taking my question. I wanted to talk about kind of rate strategy a little bit. I mean, obviously, we've seen a pretty big shift in where the top line gains are coming from, from base rates over to kind of DSIC and otherwise, and especially I guess that looks particularly acute in New Jersey.

So I wonder if you could talk about your CapEx and rate strategy in New Jersey, in particular, given that obviously the recent peer rate cases suggests we're looking at lower returns on equity there going forward, you're leveraging DSIC to the extent you can, but that only goes so far. Can you just give us your thoughts on how you managed through the challenge of capital allocation going forward in New Jersey, given that the environment seems to have shifted in terms of ROEs?

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

Ryan, it's Walter. Thanks for the question. What we're doing in New Jersey as in the other states, we're maximizing the use of DSIC and other mechanisms. So that we continue to invest and we address the infrastructure challenges and we get recovery in the shortest period of time without having gone through a rate case.

And as you know, our focus on cost, we've been able to keep our costs flat over a number of years. So the real focus for us is where do we invest and the timing of our investment and we just think that the DSIC mechanisms are the perfect mechanisms in each of the states, particularly New Jersey to invest in our infrastructure.

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

And Ryan, if I could add to that. This is Linda. So when we look at the DSIC mechanisms, they really provide us additional flexibility in terms of the – the timing of filing our rate cases. And in New Jersey, in particular, we're also looking at from the lower ROE issue, the impact of the consolidated tax adjustment. So if that were to be final, there would be somewhat of an offset from that as well.

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

So one thing to kind of overall with what Walter and Linda said, Ryan, I think it's a great for any utility in today's market, where we have interest rates continue to be pretty much artificially held low, is that through all of the alternative mechanisms we've worked so hard to get in the past few years. It provides us more flexibility and optionality and ensures that when we do go in for rate cases, we don't have the bigger rate increases or rate shocks.

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

Okay. And then I guess – I guess boiling that all down to kind of the target growth rate, so I guess you don't believe that having to achieve growth through alternative methods like DSIC will have a negative impact on your ability to meet the 7% to 10% kind of target range over the long-term – over the intermediate term, let's say.

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

No. In fact, our growth triangle, we shared last year, we looked at the CapEx investment and again, as Walter mentioned earlier, we look in all of our states, we look at where we need to invest, we look at the ROEs. We always provide a level of funding to ensure that we're able to provide the clean, safe, affordable and reliable service. And then we look at other capital that's a little more discretionary and where that goes. But also, when we look at that on top of the CapEx, you have the regulated acquisitions, you've got the market base. So, we have a diversified portfolio for growth just as Walter said, we benefit from the geographic diversity we have with our state.

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

Okay. That makes sense. Thanks for your time.

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

Thanks, Ryan.

Operator

The next question will come from Dan Eggers of Credit Suisse. Please go ahead.

Q - Dan L. Eggers {BIO 3764121 <GO>}

Good morning.

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

Hey, Dan?

Q - Dan L. Eggers {BIO 3764121 <GO>}

Hey, good morning. Listen, good job again on the improvement in the operating efficiency ratios. Can you just maybe give your thoughts on what your trajectory of improvement looks like from here to 2018 to get to your 35% goal? And are you now, as you've succeeded in moving O&M pretty fast, you're reevaluating, maybe where you could ultimately get to?

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

Well, Dan. If you look at the O&M efficiency ratio, as a straight line for improvement, that might be the case. But we've gone from 44.2% in 2010 to the 37.7% in the last 12 months, but really the O&M efficiency ratio is more like an exponential curve as opposed to a linear line and the further along that curve you get, the harder it is to make even smaller increments of change. So, I don't think you can look into a straight line rate and think that that's going to hold. We've been very successful. We have other opportunities, especially through automation and technology, but we stand to our stretch goal in 2018 of 35%.

Q - Dan L. Eggers {BIO 3764121 <GO>}

Well, I did try at least. Okay.

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

And that was a nice try also.

Q - Dan L. Eggers {BIO 3764121 <GO>}

How much – if you flip around the other way, how much of the improvement in earned ROEs this year versus last is a function of efficiency gains relative to, maybe kind of the regulatory relief and mechanisms helping to put some revenues back in the business?

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

The calculation is basically O&M over revenues. And you can look at our revenue growth and you can look at our expenses and know that we've made significant improvement on expense management. You all ask us frequently, well, do you think there is more to get and the fact is that as Linda mentioned earlier, we're just now stabilizing our SAP system, the implementation from last year, we see opportunities there. And the innovation and technology that I talk about, we think will provide us even more opportunities in the future. So we've done a lot of things. What we do in the future, maybe a little bit more of that, but also some new areas.

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

And I can say that our drive for efficiency throughout our business is really taking hold. We've got, as I said in on prior calls, we have a number of Yellow Belts that are looking at improving processes and eliminating errors. We have a supply chain that's so engaged with the business and looking to reduce the materials that we purchase. And our entire team is really focused on driving our cost down because they understand the why. The why is so we can continue to invest in our infrastructure and do so with minimizing our customer impact. So we've made great progress, and as Susan said we're going to continue to make progress to get below the 35%.

Q - Dan L. Eggers {BIO 3764121 <GO>}

And I guess just kind of one last question, just to put in context, kind of some weather expectation for the rest of this year. What conditions would you like to see in August and September to help you shore up the upper end of guidance range and what is the risk as you look at the forecast today of seemingly mild temperatures at most places?

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

Well, what we'd like is hot and dry weather, but our business is based on normal weather. So as long as we have with – and it's hard to determine what normal weather is. But as long as we have normal weather, that's what we're looking for.

Q - Dan L. Eggers {BIO 3764121 <GO>}

So a little more heat and a little less wet from here would be good?

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

Through at least December.

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

Through at least.

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

Through at least December.

Q - Dan L. Eggers {BIO 3764121 <GO>}

Okay. Thank you guys.

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

Thanks, Dan.

Operator

The next question will come from Walter Liptak of Global Hunter. Please go ahead.

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

Hi, Walter.

Q - Walter S. Liptak {BIO 1541340 <GO>}

Hi, thanks. I wanted to ask about the O&M expenses and I understand that it's not going to be linear and all that, but I wonder if, as you work with your ERP system and on projects, if you can better pinpoint the timing of any step change in expenses?

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

So let me start there. So as you implement an ERP system, it takes a little bit of time to go through stabilization and then optimizing the system and then being able to really drive the improvements and get the efficiency out of the system. We are seeing this year, we implemented our ERP system in 2012. We're seeing that efficiency coming through this year. We implemented in two phases, the customer information system as well as our work management system in 2013. So we would expect to move through those same stages through time and begin to continuously drive improvements and optimization.

Q - Walter S. Liptak {BIO 1541340 <GO>}

Okay. Well, sounds like you've got some projects that are going to start bearing some fruit as we get into next year?

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

Yes. I mean, the SAP and also as I mentioned the NPXpress, again labor and power and chemicals are our largest cost drivers. So the more we can find ways to save on the power costs, which by the way, just three years ago, our power costs were $110 million last year, for 2013, they were $94 million. So we're finding ways to reduce those large cost drivers including the NPXpress also reduces the need for chemicals, with up to 100% of the carbon additive.

So – and as Walter mentioned, the SAP system is allowing us much more visibility into inventory. For example, where we at one time could not see between states when we had in inventory, now we can do more inventory sharing, which is making us much more cost effective. Now those things, as Linda mentioned, don't happen overnight, but we see a steady building of the ability to do this. Some will be over the next year, some the next two years or three years, but we see a path forward for continual improvement.

Q - Walter S. Liptak {BIO 1541340 <GO>}

Okay, great. Sounds good. I wanted to ask an unrelated question, going back to the DSIC. If you could help us review just on which states have that mechanism in place and where we are with DSIC for some of the other states that you operate in?

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

Yeah. We have DSIC in a number of states, but our top five states, New Jersey, Pennsylvania, Missouri, Illinois and Indiana all have DSIC. So again, a significant amount of our investment moves through those mechanisms to get recovery in the quickest amount of time.

Q - Walter S. Liptak {BIO 1541340 <GO>}

Okay. And what does the pipeline look like for the rest of the states?

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

Well, we're always – we look at several alternative mechanisms. We look at DSIC, we look at future test year, we're looking at mechanisms to address declining usage. So for all of our states, we're constantly evaluating the regulatory construct in which variations of these type of mechanisms could work best in every state. So we're always looking at all of our states and ways to address these issues.

Q - Walter S. Liptak {BIO 1541340 <GO>}

Okay, great. And I may have missed this. Did you publish CapEx for this year?

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

We did. We said that we would spend around $1.1 billion.

Q - Walter S. Liptak {BIO 1541340 <GO>}

Okay, great. Okay. Thanks for taking my questions.

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

Thank you.

Operator

The next question will come from Jonathan Reeder of Wells Fargo. Please go ahead.

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

Hi Jonathan.

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

Good morning, everyone. Good morning Susan. Just building on Ryan's first question. Is there a specific timeline for the BPU to finalize the CTA issue? And how does that impact the timing of your next New Jersey rate filing or more specifically when do you expect to file next in the state?

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

Well, as I said in my prepared remarks, the comments are due back on August 18 and then there's no published timeline, but we'd expect something maybe – by the end of the year. No guarantee but that's what we'd expect.

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

And Jonathan, to the second part of your question, we're constantly evaluating all of our stake, the appropriate timing for any rate cases.

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

Okay. I mean, do you need – I guess a BPU to finalize that before you can file the case and actually get the implementation of the new CTA treatment?

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

Once the BPU makes the decision then it would be effective in your next rate case filing.

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

Okay. And are you at liberty to say how much that would increase New Jersey's underlying rate base value if the staff proposal is adopted?

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

We're not. We had – our last rate case was a black box settlement and so each of those components are confidential.

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

Okay. Moving on to the O&M, is the run rate of 37.7%, is that indicative of where you think the full year will come in?

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

We believe that we will continue to make progress on the O&M efficiency ratio from now through 2018 and then to the stretch goal of 35%.

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

Okay. I'll leave that one alone. So I think Q2 basically you're saying that, weather was normal when you balance your universe of regulatory jurisdictions, is that correct?

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

Yeah, that's correct.

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

Okay. So the trend towards the upper end of guidance range is no way weather driven.

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

You know, when we look at a range there is some degree of weather variability that we build in there, but that does not account for any extreme weather variability, which is why just in water, just as you see in electrics, the third quarter has such a big impact on our year that we just like to see what happens in the third quarter before we're able to address the range again.

And I will tell you that again, we expect some weather variability that's why you have a range in the first place, that's one of the component. But we need to look and see what happens. We're getting preliminary numbers for July, but that's not final, we've got to look at August and September to kind of see where we end up.

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

Okay. So I guess just continuing with the weather theme a little bit and looking at your consumption numbers, it looks like I guess the residential and commercial maybe down a little more than I would expect, specifically if Q2 last year was slightly negative due to weather. Is there anything you're seeing there, that's exacerbating the decline from just the normal, I guess 1% to 1.5%, we've seen annually over the years in the industry?

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

There's really nothing there. You have to remember to what we put out is billed and unbilled revenue and then billed sales volume. So what we're looking at is the billed sales volume piece of it, but we're seeing what would be expected from usage decline.

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

Yeah, Jonathan. We're still seeing the 1% to 2% decline as we have over the last several years, nothing out of the ordinary there.

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

Okay. And then last question on the military base side. One of your competitors recently has indicated a desire to perhaps pursue contracts on the electric side of bases, not just the water and wastewater. Is that something that you're interested in as well?

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

The 10 bases that we serve, we are partners with those bases and we know our business is water and wastewater, but we also, as I mentioned earlier, have a lot of opportunities in projects at our plants that do look at the whole water energy connection. So we are not claiming that specifically for any base, but we are open to options in the future based on what we think we can deliver in a cost effective and superior performance standpoint to our partners.

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

Okay, great. Thanks so much.

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

Thanks Jonathan.

Operator

The next question will come from Tim Winter of Gabelli. Please go ahead.

Q - Tim M. Winter {BIO 1518628 <GO>}

Good morning.

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

Hi, Tim.

Q - Tim M. Winter {BIO 1518628 <GO>}

I was wondering if you could talk a little bit more about the $700 million placeholder for acquisitions and development. Maybe are there any specific opportunities out there or is there a particular region you're focused on? Is the environment for municipal acquisitions improving? And why $700 million, just any color there would be helpful?

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

When we setup the capital budget for this year, for the first time we wanted to say here is the amount that we want to look at regulated CapEx investment in our plants, pipes. And the other part was we said, for regulated acquisitions, we want to make sure that we plan for a budget and then we had the strategic initiatives for those opportunities that might arise, so that we didn't have to then scramble if something came up.

So, for example, for this year, as we look at regulated acquisitions and as we've talked in the past before, Tim, they're very spiky and they don't happen overnight and they are in the pipeline and things come up, referendums, different things that may change the timing of some things.

So for us, it's a placeholder. And then we've got the strategic initiatives, as we've said before, there are things that we look at. Walter mentioned all of our work in the shale play, for example, is all regulated, but we continue to have discussions if we can find a non-regulated shale play that will not require us to take a risk or change our risk profile because we're not going to take a risk on invested capital in the ground. We want to have a return of, at a minimum, for any of those ventures.

So it was a placeholder. But what we also have the ability to do is as we go into a year, we have the ability to shift some of those funds from one place to the other. For example, if we see one area we may not spend as much, we have the opportunity, if we have a need, for example, in a state for additional investment, we can shift it over there.

So that's why Walter mentioned and I and Linda all we still see a path to the $1.1 billion this year. At the end of the year, it may not be quite in the buckets that we talked about at the first of the year.

Q - Tim M. Winter {BIO 1518628 <GO>}

Okay. And then are – say the drought conditions in the west are – if the economic conditions leaning to an easier environment for acquisitions or are things sort of status quo?

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

Well, we do discuss with municipalities and others on California, the opportunity to become part of American Water. We'll continue to do that. I think that would probably play into it long-term.

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

You know one of the benefits that we've got, Tim, to that point is we have the ability to raise capital. We are, as Linda mentioned, we have a strong credit rating. We have a strong balance sheet. So where regardless of the state, there are opportunities for systems that have huge demands on their resources and choose to not deploy them in water or wastewater, we provide an option for those folks.

Q - Tim M. Winter {BIO 1518628 <GO>}

Okay, thank you.

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

Thanks and hey, that was a good clip you did on CNBC.

Q - Tim M. Winter {BIO 1518628 <GO>}

Thank you, Susan.

Operator

And ladies and gentlemen, this will conclude our question-and-answer session. I would like to turn the conference back over to American Water's President and CEO, Susan Story, for closing remarks.

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

Well, thank you all so much. You know I have to tell you, this is an interesting call as you heard different voices on here. It is – I don't think there's ever been a more exciting time to be part of American Water.

We have an amazing team of people. We've got 6600 employees that every day their focus is on making sure that we deliver water and wastewater in all of our services in a way that's clean, safe, affordable and reliable. And we understand what our business is, we're going to stay true to our business with the risk profile you know, but also find ways to grow.

So thank you for being part of this and I just want to say that I'm just thrilled to death with the team we've got. Our new CFO is just doing a terrific job, much better than her predecessor. And again, Walter and the continuity we have, with the tremendous expertise we have throughout our state and in our market-base business, I'm just proud to be part of this team and we appreciate you all as investors and analysts.

Operator

Ladies and gentlemen, the conference has now concluded. We thank you for attending today's presentation. You may now disconnect your lines.