

Q3 2017 Earnings Call

Company Participants

- Ed Vallejo, Vice President Investor Relations
- Linda Sullivan, Chief Financial Officer
- Susan Story, President and Chief Executive Officer
- Walter Lynch, Executive Vice President and Chief Operating Officer

Other Participants

- Angie Storzynski, Analyst, Macquarie Research
- Jonathan Reeder, Analyst, Wells Fargo
- Richard Verdi, Analyst, Atwater Thornton
- Stuart Alan, Analyst, Bank of America Merrill Lynch

Presentation

Operator

Good morning, and welcome to the American Water's Third Quarter 2017 Earnings Conference Call. As a reminder, this call is being recorded and is also being webcast with accompanying slide presentation through the company's Investor Relations website.

Following the earnings conference call, an audio archive of the call will be available through November 9, 2017. U.S. callers may access the audio archive toll free by dialing 1-877-344-7529. International callers may listen by dialing 1-412-317-0088. The access code for replay is 10113687. The online webcast will be available at American Water's, Investor Relations homepage at ir.amwater.com.

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

Ed Vallejo {BIO 20515524 <GO>}

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

Now during the course of this conference call, both in our prepared remarks and in answers to your questions, we may make forward-looking statements that represent our expectations regarding our future performance or other future events. These statements are predictions based upon our current expectations, estimates and assumptions. However, since these

statements deal with future events, they are subject to numerous known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from the results indicated or implied by such statements.

Additional information regarding these risks, uncertainties and factors, as well as a more detailed analysis of our financials and other important information is provided in the earnings release and in our September 30th, 2017 Form 10-Q each has filed with the SEC.

Reconciliations for our non-GAAP financial information discussed on this conference call including adjusted income, adjusted earnings per share both as historical financial information and as earnings guidance, adjusted return on equity and our adjusted regulated O&M efficiency ratio can be found in the appendix of the slide deck for this call. Also this slide that has been posted to our Investor Relations page of our website. All statements in this call can -- are related to earnings and earnings per share referred to diluted earnings and earnings per share.

And with that I will turn the call over to American Water's President and CEO, Susan Story.

Susan Story {BIO 3335156 <GO>}

Thanks, Ed. Good morning everyone and thanks for joining us. Today our CFO, Linda Sullivan will cover our third quarter financial results and COO, Walter Lynch, will give key updates on our operations.

Moving to slide five, our employees delivered solid financial performance and continued to execute on our strategies in the third quarter. These strategies include, prioritizing employee and customer safety, building constructive regulatory relationships through transparency and credibility, providing excellent service to our customers, growing our business and becoming even more efficient in our operations to keep bills affordable for our customers.

Our third quarter adjusted earnings were a \$1.08 per share, an increase of \$0.03 per share or 2.9% over the same period in 2016. This 2017 third quarter adjusted number excludes a positive \$0.07 related to an insurance settlement from the Freedom Industries chemical spill, which you may remember was a negative \$0.22 in last year's third quarter.

This quarter's adjusted number also excludes \$0.02 of an early debt refinancing charge at the parent. Linda will discuss this in more detail in her comments. With the solid results we've seen year-to-date and projected through the year-end, we've narrowed our adjusted earnings guidance to \$3 to \$3.06 per share.

Our foundation for growth continues to be providing safe and reliable service by investing wisely and effectively in our regulated operations. We've made more than \$1 billion in capital investments in the first nine months and we're on track to invest about \$1.65 billion for the full-year, with the vast majority dedicated to water and wastewater system replacements and improvements.

We remained focused on controlling our O&M expenses to ensure that every dollar we spend on infrastructure replacement has minimal impact on our customers' bill. We're extremely proud of our employees' efforts to improve efficiencies and their commitment comes from a deeply ingrained culture at American Water to provide the best quality water and water services to our customers at an affordable price. Our folks live in the communities we serve and all of our employees are keenly aware of the importance of keeping customer bills affordable. This commitment to customer care contributes to our growth.

This year we have welcomed about 16,000 new customers from acquisitions and 10,400 customers from organic growth in our service areas. We also have signed agreements representing another 45,000 customers pending regulatory approvals. We also saw growth this quarter in our market-based businesses, mainly driven by our Homeowner Services Group. HOS currently has 1.7 million customer contracts that serve more than 825,000 customers in 43 states in Washington DC.

Keystone Clearwater remained relatively flat quarter-over-quarter, but is still projected to be accretive this year, due to increased activity and work during the latter part of the year.

A real highlight of the quarter was our Military Services Group win of Wright-Patterson Air Force Base in Ohio. We consider it an honor and a privilege to serve the military men and women who defend our country and our liberty. This base is the 13th installation to partner with American Water. We're fully committed to providing industry-leading water and waste water services to Wright-Patterson for the next 50 years.

We also had three other significant accomplishments, I'd like to highlight for the quarter. First, we completed a \$1.35 billion debt financing, which is the largest since our IPO in 2008. These interest savings will provide significant long-term benefits primarily for our regulated customers. Linda will discuss this financing in more detail. Second, you may remember that in the third quarter of last year, we entered into a global binding agreement in principle related to the Freedom Industries chemical spill in West Virginia. Two of our insurance carriers providing coverage of up to \$25 million each chose not to participate in that settlement agreement at that time. We have now settled with one of those carriers and this \$22 million settlement reduces West Virginia American Water's total pre-tax costs from 65 million to 43 million. We continue in arbitration with the remaining insurance carrier.

And third, Walter will discuss in a moment, our filing of a proposed black-box settlement agreement among intervenors in our Pennsylvania rate case, which remains subject to approvals. So all said, we're on track to meet our long-term 7% to 10% long-term EPS guidance. Walter will now give you his update on our regulated business.

Walter Lynch {BIO 6064780 <GO>}

Thanks, Susan. Good morning, everyone. As Susan mentioned our regulated businesses continue to show strength through growth, increased investment in infrastructure, improve customer service and progress made to manage our expenses.

Let's walk through some of the highlights of the quarter. We currently have active rate cases in our three largest states, Pennsylvania, New Jersey and Missouri. In Pennsylvania, we entered into

a proposed settlement agreement in October 16th, that will provide additional annualized water and wastewater revenues of \$62 million. As you may recall this case was driven by \$1.3 billion in capital investments to ensure reliable service. The proposed settlement agreement is under review by the presiding administrative law judges and will then go before the Pennsylvania Public Utility Commission for approval. We anticipate the decision before year-end and are hopeful we can discuss the settlement further on our December 11th guidance call.

Moving to New Jersey, we filed a general rate case in September 15th seeking \$129 million in annualized revenue over three years. Since our last rate adjustment in 2015, we invested more than \$868 million in infrastructure upgrades. These investments included replacing more than 200 miles of water main and a flood protection project at our Raritan-Millstone Water treatment facility.

Susan will talk about our efforts to mitigate extreme weather impacts later. But this project will ensure the sustainability of the water supply for more than \$1 million people in seven counties in Central New Jersey. That level of investment also had a positive impact in New Jersey's economy creating approximately 14,000 jobs across the state.

As we mentioned in the last call, we filed a rate case in Missouri requesting an increase of \$84 million in annual revenue, driven by more than \$490 million in investment in our systems. This case marks the first future test year filing by Missouri American Water and we appreciate the commission's openness to consider or choose in this case.

Moving to California, the fires that occurred last month in Sonoma and Napa counties have been devastating to the communities there, including one of our service areas Larkfield. We're still assessing the damage, but we estimate that about a quarter of our service district, about 600 homes have been destroyed. We're working with our impacted customers during this difficult time. While the recovery work is still underway to replace damage equipment. We were pleased that we maintained water service for firefighting during the event, and restored full potable water services for the vast majority of residents there within a matter of days. We're also very pleased to announce that California American Water and the American Water Charitable Foundation provided a grant of \$100,000 to the North Bay Fire Relief for individuals and families impacted by the wildfires. I want to thank our team in California for responding quickly to our customers during this crisis, and most importantly for staying safe.

Turning to slide nine, let me touch briefly on weather for the quarter. As you know, we had a \$0.02 benefit from hot, dry weather in the third quarter of 2016. In the third quarter of 2017, we experienced warmer weather in several states through July. However, during the remainder of the quarter, we saw more rain and cooler temperatures in the Northeast.

We've spoken in the past about how our geographic diversity allows us to manage through weather fluctuations and limit their impact. As a result, weather did not positively or negatively impact our revenues for the third quarter of 2017. Linda will cover the quarter-over-quarter and year-to-date earnings impact.

Turning to slide 10. We added about 16,000 new customers to-date through completed acquisitions and more than 10,000 through organic growth. In October, we also received an

approval from the Pennsylvania Public Utility Commission of our McKeesport Pennsylvania wastewater acquisition. This is great progress and we expect this acquisition will close later this year. We're excited to add these 22,000 new customers and welcome our new employees. As Susan mentioned, we have pending agreements to welcome 45,000 more customers, which includes the McKeesport acquisition. We're pleased that this represents a 11,000 more pending customers than we had last quarter.

Moving on to slide 11. Doing right by our customers is key to our ability to grow. This means smart investments, balance by efficient operations and capital deployment. During the first nine months of the year, we invested \$963 million of which the majority was dedicated to regulated operations to keep our services reliable. We also continue to keep our service affordable, by working more efficiently throughout our business. Our O&M efficiency ratio decreased from 34.9% to 34.2% for the last 12 months ending September 30th, 2017. We're on track to achieve our long-term goal of 32.5% by 2021. Thanks again to our employees and their commitment to our customers.

Technology is also playing a critical role. Let me give you a couple examples of this. In Illinois, we're using technology to make the operation of our Bradley Avenue treatment plant in Champaign more cost efficient through automation. During the nine-month period this year, we've already saved more than \$200,000 while effectively managing our plant. We expect to achieve savings of about \$300,000 annually.

In Pennsylvania, our operations team is using Cellular Leak detection instruments to find and fix leaks before they lead to main breaks. This technology provides remote alarming and automatic data uploads from any location where self-service is available. Through this technology, we're saving a 11 million gallons of water per day. Additionally as estimated, that it's about 10 times cheaper to fix a leak before the water main breaks. The technology in operational efficiency are core to our strategies. And these examples demonstrate how our company is using innovation to better serve our customers.

With that, I'll turn the call over to Linda for more detail on our financial performance.

Linda Sullivan {BIO 7300156 <GO>}

Thank you Walter, and good morning everyone. Let me start with our third quarter 2017 results on slide 13. GAAP earnings were \$1.13 per share, an increase of \$0.30 compared to the same period last year. We had a few non-GAAP adjustments in both periods, so let me start with those. First, we adjusted GAAP earnings for the Freedom Industries chemical spill settlement activity. In 2016, we entered into a binding global agreement in principle to settle all claims associated with this matter of which West Virginia American Water's share, net of insurance recovery was a pretax charge of \$65 million or \$0.22 per share. At that time, two of our insurers providing coverage of up to 25 million each did not agree to participate in the settlement and we initiated legal actions to pursue recovery.

In the third quarter of 2017, we reached the settlement with one of those insurers to recover 22 million pretax or a \$0.7 per share benefit. With this insurance settlement, West Virginia American Water's share of its 126 million Freedom Industries settlement was reduced from 65 million to

\$43 million pretax. Consistent with prior year treatment of this settlement, this benefit was reflected as a non-GAAP adjustment.

Also in August, we completed a 1.35 billion financing, which I will discuss in greater details in a few slides. A portion of the proceeds was used to refinance certain higher cost debt before their original maturity dates in 2018 and 2021. This resulted in early debt extinguishment charges of \$34 million in total. The majority of this amount of \$28 million is expected to be recovered through customer rates and was recorded as a regulatory assets and did not impact earnings. However, 6 million or \$0.02 per share was associated with parent company debt and recorded as a charge to earnings. We have reflected this item as a non-GAAP adjustment consistent with prior year treatment of similar charges.

Excluding these items, adjusted earnings were \$1.08 per share, an increase of \$0.03 or 2.9% over the same period in 2016 with the regulated segment up \$0.05, the market based businesses up \$0.03 and the parent was unfavorable \$0.05.

Turning to slide 14, let me walk through our adjusted quarterly results by each business. Our regulated operations were up \$0.05 in total, revenue was up \$0.08 from authorized rate cases and infrastructure mechanisms to support growth and acquisitions and this is net of lower demand or declining usage of about 1%. Also in the third quarter of 2016, we had warmer weather as Walter discussed, which negatively impacted the quarterly comparison by \$0.02 per share.

Next, we had higher net depreciation interest and general taxes of \$0.03 driven by investment growth. And then finally, all other items resulted in the benefit of \$0.02 mainly from our continuous focus on cost management.

Turning to our market-based businesses, we were up \$0.03 compared to the same period last year. The majority of this increase was from Homeowner Services, from customer growth and price increases. Although, we continue to experience lower capital projects in the Military Services Group, we are excited to announce the agreement with Wright-Patterson Air Force Base in Ohio, which represents partnership with our 13th military base. This contract will add \$490 million in revenue over the 50-year contract term. And with the addition of this base, our backlog of revenue associated with our military contracts is over 3.5 billion over the remaining contract terms.

And then lastly, the parent was down \$0.05 per share in the quarter. \$0.02 was due to the cumulative tax adjustment I discussed last quarter related to the July 1st increase in our state income tax rate in Illinois. This change required us to remeasure our deferred tax balances at the new rates in the third quarter. The cumulative adjustment totaled \$7 million. The portion calculated on a standalone basis for Illinois is expected to be recovered through future customer rates and was recorded as a regulatory asset. The remaining portion was allocated to the parent through our state tax apportionment factors and reduced 2017 earnings by \$0.02 per share. The remaining \$0.03 of the parent was from higher interest expense to support growth of \$0.01 and an overlap of interest expense related to our August financing of about \$0.01. The overlap was because we had 428 million of parent debt that didn't actually mature until

October of this year, but was part of the refinancing in August. And lastly, we had a \$0.01 tax benefit recognized last year.

Turning to slide 15, our year-to-date adjusted earnings were \$2.34 per share or a 3% increase over adjusted earnings in the same period last year. Our regulated operations were up \$0.12 per share in total, which includes the \$0.04 negative year-over-year impact from weather, as Walter discussed.

Our market based businesses were up \$0.01 with the favorable third quarter results in our Homeowner Services Group exceeding the impact from lower capital projects in our Military Services Group.

Parent and other were down \$0.06 mainly due to the two discrete tax adjustments associated with legislative changes in New York and Illinois impacting state tax apportionment.

Now let me discuss in more detail the August 1.35 billion financing on slide 16. This was the largest financing at American Water since our IPO in 2008, and our team did an extraordinary job executing this transaction. Overall, the transaction reduced our long-term embedded cost of debt by 48 basis points, mainly for the benefit of our regulated customers. It reduced our five-year debt maturities by 876 million and it increased the average tenor of our debt from about 13 years to almost 16 years. Those are the highlights, now let me discuss the deal.

We financed 1.35 billion or 750 million of 30-year debt at a 3.75% interest rate and 600 million of 10-year debt at a 2.95% interest rate. The funds will be used for three primary purposes. New debt to support growth of 440 million, refinancing of debt maturing in 2017 of 557 million and 353 million for early refinancing of debt maturing in 2018 and 2021 including the make whole. These transactions were designed to take advantage of lower interest rates for our customers.

Turning to slide 17, let me provide an update on our regulatory filings. We have 66 million in annualized new revenues effective since January 1st of this year from general rate cases and infrastructure mechanisms. We have also filed requests and are awaiting final orders on rate cases, infrastructure surcharges and proposed settlement, for a total annualized revenue request of 321 million. This includes the Pennsylvania rate case proposed settlement of 62 million that Walter discussed.

Turning to slide 18, our cash flow from operations grew about 4.3% to 986 million for the first nine months of 2017. This increase was primarily driven by net income growth in our regulated and market-based businesses. Turning to dividends, on October 31st, our Board of Directors approved our quarterly cash dividend of \$41.5 per share to shareholders of record on November 10th and payable on December 1st of this year. And as a reminder, for five years straight, we have grown our dividend at or above the top of our long-term 7% to 10% EPS growth range.

Turning to slide 19, today, we are narrowing our 2017 adjusted earnings guidance range to \$3 to \$3.06 per share. As you know, we traditionally do not make many non-GAAP adjustments. And when we do, we want to be consistent and transparent. This year we have had two items excluded from our adjusted earnings guidance range. The \$0.07 per share benefit from the

insurance settlement related to the Freedom Industries chemical spill and the \$0.02 per share charge from early debt extinguishment at the parent company. These are reported as non-GAAP adjustments consistent with our treatment in prior years.

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

Susan Story {BIO 3335156 <GO>}

Thank you, Walter and Linda. Before taking your questions, I'd like to mention the extraordinary weather and fire events that we've experienced in our country and our American Water Service areas over the past few months. Given our geographic diversity, we are oftentimes located within natural disaster areas or close enough to offer help to other communities. With every event we face, safety comes first. We prepare, we leverage national resources, and we look to help impacted communities.

In August, Hurricane Harvey hit our operations in Fort Polk, Louisiana dumping about 20 inches of rain on the bay. The storm also had a lesser effect on our Fort Hood, Texas operation. Our employees who work there and those who came to help, worked tirelessly during and after the storm to maintain service to both military communities.

In September, Hurricane Irma made landfall in the Florida Keys as the category four storm. By the time the storm moved up the coast to the desalination facility we operate in Tampa, our Contract Services Group had enacted this emergency plan and the facility made it through the storm with little to no damage and no flooding. The plant and our people were there to help the community during the recovery.

And just last month, as Walter shared, our team in California responded to the tragic fires in Sonoma and Napa counties, maintaining water service for firefighting during the event and restoring full potable water service for the vast majority of our residents there within a matter of a few days. Whether it's hurricanes, tornadoes, flooding, ice storms or wildfires, our response to all of these events highlight our commitment to resiliency of water and sanitation services for our customers.

We use a systematic approach to assess the vulnerability of all of our assets and we continually prioritize our critical infrastructure investments. Our engineering and operations team, examine every facility we own and our regional water supplies to develop a capital plan to determine how much and what kind of investment is needed to ensure ongoing safe and reliable service to our customers both during and after these disasters.

We evaluate historic conditions combined with future predictions and we consider factors like a 100-year flood, which now seems to be occurring every 20 years and other impacts of climate variability. These engineering planning studies drive our capital needs assessment, business planning and our financial forecasting.

During a significant weather event, a water utility's level of preparedness can literally mean the difference between a temporary inconvenience or a serious health or environmental consequence for our customers. We know that and we prepare for it. It's our job, and we do it

well. I'm extremely proud of our people and their commitment to doing what's right for our customers and our communities every day. Our thoughts and prayers continue to be with the people who are recovering from these natural disasters.

And with that, we're happy to take your questions.

Questions And Answers

Operator

We will now begin the question-and-answer session. (Operator Instructions) The first question comes from Angie Storozyński from Macquarie Research. Please go ahead.

Q - Angie Storozyński {BIO 15115714 <GO>}

Thank you. I have two questions. First one about M&A, municipal M&A. So two things, one is could you discuss any reaction you're seeing on the municipal front to the New Jersey bill that was recently passed. And secondly in Pennsylvania, the fair value legislation being somewhat questions in a pending asset sale case and how you think about the independent assessments of assets as you go forward and contemplate acquisitions in Pennsylvania. Thank you.

A - Susan Story {BIO 3335156 <GO>}

Sure, Angie, thank you. This is Susan. I will start on your last question and then turn it over to Walter and let him add anything to that and then address the issue of the water quality accountability act in New Jersey.

So with the fair market value in Pennsylvania, we think it's important to have an appraisal process that's fairly valued the systems we're acquiring and also sets a fair and sustainable base rate for our customers. We don't want a high appraisal value just to get a higher base rate and we don't -- we want the right base rate for us and our customers for the long-term.

We don't think system should be undervalued or overvalued, because we think either one hurts the process long-term in the spirit of the law. Pennsylvania's fair market value legislation requires appraisals to meet a uniform standard that the professional appraisal sector has and there have been some questions about, so what is the Pennsylvania PUC, what's their role, what's it not.

In our look and we have gotten an approval for McKeesport under that. We think that the Pennsylvania PUC can review the appraisals and determine if they comply. If appraisals don't comply, adjustments should be made, complying with standards as a check and balance that we think clearly the Public Utility Commission has authority for.

So in our recent PUC application for the McKeesport acquisition, we sat down with the parties, we sat down with PUC staff, we sat down with consumer's advocate, we listened to their issues and we tried to find a way forward that we could all live with and we are very pleased that this

was approved -- the settlement that we reached with the staff, with the consumers' advocate were all approved by the Public Commission last week.

So, Walter do you want to add anything to that.

A - Walter Lynch {BIO 6064780 <GO>}

Yes, Susan. I'd like to emphasize, just the point of how we work cooperatively with the commissions and all the parties to get to a settlement that's fair for everybody. And I think the Scranton and sewer acquisition is an example of that. It's the first acquisition in the state where we're dealing with the issue of combining sewer and storm water.

Currently Pennsylvania American Water doesn't have a combined tariff for wastewater. We have a number of different tariffs, because we've done so many acquisitions over the years. So working through the first issue that I said, the combined sewer and storm water, and also working through not having a combined tariff on the sewer side, it takes a lot of cooperation and a lot of dialog with the number of parties including the officer consumer advocate and commission staff to get to the right place.

But I think we've done that, I'm confident we've done that, the team has done a great job in working with all the parties. I think it's another example of how we're working to make sure that we get a fair settlement for all and the Scranton Sewer Authority again is a perfect example of that.

A - Susan Story {BIO 3335156 <GO>}

And on the New Jersey Water Quality Accountability Act, it's been interesting because the legislation was passed this year and there hasn't -- it hasn't really gone through the regulatory whether it's the DEP Agency, what does that look like in terms of regulations? What does that look like in terms of the reporting and I think our best guess, Walter, is that we think maybe those defining regulations maybe put out as early as the first quarter of next year, the first half of next year?

A - Walter Lynch {BIO 6064780 <GO>}

Yeah, that's right Susan. There is a requirement to have cybersecurity program in place by the first quarter and then the asset management plan by January of 2019, but the DEP's working with all the other agencies to really come up with a really good detailed implementation plan.

A - Susan Story {BIO 3335156 <GO>}

So, I think until then, Angie it's a little bit early to say are we seeing an effect. I think people are waiting to see what does this actually mean, what are the regs that I'm going to have to be in compliance with. So we're watching that carefully.

Q - Angie Storzynski {BIO 15115714 <GO>}

Okay, and the last -- my last question, I haven't heard anything about Keystone Clearwater, I might have missed it actually. But I would have expected it to be mentioned as an earnings driver on the market based side, given the pickup in drilling. So could you tell us a little bit more about it?

A - Susan Story {BIO 3335156 <GO>}

Sure, sure. So I mentioned very briefly my remarks, quarter-over-quarter, it's basically neutral. We are still projecting it to be accretive by the year-end because of the backlog of work that we have in the latter part of year -- of the year. We are seeing increased activity. We're actually seeing players that are picking up what they're doing. We're seeing more interest actually, it's interesting, our Keystone got out of the transportation, meaning the moving water by truck, and so we're seeing an uptick in the amount of the drillers who are now wanting to actually put pipe -- a lot of pipe above ground temporary piping. So we are seeing a pick up there. We believe that the latter half of the year that we're going to see a pickup in that and that will be accretive for the year.

Q - Angie Storozynski {BIO 15115714 <GO>}

Thank you.

A - Susan Story {BIO 3335156 <GO>}

Thanks Angie.

Operator

The next question comes from Richard Verdi of Atwater Thornton. Please go ahead.

Q - Richard Verdi {BIO 15139674 <GO>}

Hi. Good morning guys and thank you very much for taking my call here.

A - Susan Story {BIO 3335156 <GO>}

Thank you, Rich and congratulations.

Q - Richard Verdi {BIO 15139674 <GO>}

Thank you very much. I have a -- just a few quick questions here, and congrats on the quarter too, I thought it was great. Congrats on this Wright-Patterson Air Force Base win. On a very high level, can you please give us a sense of the timeframe for when price redeterminations from this contract would potentially positive -- positively impact the P&L?

A - Susan Story {BIO 3335156 <GO>}

Yeah. The price redetermination typically take place two to three years. They happen every two or three years in the contract. So the fact that we just won we've put in the bid for what we believe the upfront work needs to be done, to do some immediate projects, but we also look at the O&M. So you probably won't see a price redetermination for Wright-Patterson for another two to three years, because we just put in a bid, that in that bid, we look at the first two to three years and what we think it will take to do some of the capital upgrades on the project.

Q - Richard Verdi {BIO 15139674 <GO>}

Okay. Great. Okay, thanks for that.

A - Susan Story {BIO 3335156 <GO>}

And what the initial O&M cost will be.

Q - Richard Verdi {BIO 15139674 <GO>}

Okay. Thank you for that. And then I have a question pertaining to the acquisition strategy. Looking back at 2013 to 2016, versus the years of 2008 to 2012, I mean the number of acquisitions jumped there the past three years, but I'm wondering where the strategy comes in and kind of shifts and goes to, we're going to move away from the actual number of deals and just focus on the customer -- the number of customers moving forward, how many customers we pick up per transaction?

I'm wondering if you could kind of give us a sense of how we should balance thinking about in the model, the number of transactions per year versus the number of customers we pick up. Are we going to go more towards less transactions, more customers or vice versa?

A - Walter Lynch {BIO 6064780 <GO>}

Rich, Walter. Thanks for the question. We've said that's a 1% to 2% EPS growth from customer -- acquisitions is about 30,000 or 60,000 customers across our entire system. Our focus has been on growing our business through acquisitions, adjacent to where we operate, and also looking at our sweet spot as we define from 5,000 the 30,000 customers.

We've also had a renewed focus on waste water. And over the last three to four years, we focused on buying wastewater systems in areas where we serve water customers. So we're going to continue to do some of the smaller ones where it makes sense in around our footprint. Our real focus is on the larger 3,000, 4,000, 5,000 to 30,000 customers to make sure that these acquisitions are more of sizable, they move the needle, and they represent I think opportunities for us to improve the systems that we buy.

Many of these systems need significant investment and the systems of 5,000 to 30,000 seem to need more investment than some of the others. So that's really our focus.

Q - Richard Verdi {BIO 15139674 <GO>}

Okay.

A - Susan Story {BIO 3335156 <GO>}

And if I can add to that Rich, one of the other things that we've been working on with this increase in acquisitions over the last few years is how do we integrate them effectively, whether or not it's a smaller system or a larger system, and so we've really been working to enhance our process so that it is seamless, irregardless -- regardless of the size of the customer additions.

A - Walter Lynch {BIO 6064780 <GO>}

And Rich to your point, Walter again. You can look at how we're executing on our strategy, buying wastewater systems in area where we're serving water system. And I think Scranton and McKeesport are two perfect examples of that where we've been serving the water customers for decades, and the opportunities came up to buy the wastewater systems because we can add value to the communities. And that was the case that we made and the communities agreed and we purchased -- we have purchased or will purchase real soon, McKeesport on that basis.

Q - Richard Verdi {BIO 15139674 <GO>}

Okay, great, thank you guys. It's great color. And then couple more questions here. Thank you again for taking the call. For the nonregulated segment as a whole, looking at a few of the investor decks this year, American was citing that the nonregulated segment, the market based businesses, could potentially be 15% of earnings by 2021. Is that somewhat back half of the next five years loaded or could we expect to model that in where it's a straight line layer in growth over the next five years?

A - Linda Sullivan {BIO 7300156 <GO>}

So Rich, at this point, that is the guidance we've given as you probably know when we've promoted during this call and we'll continue what was December 12 is now December 11. We will update our five-year plan on December 11th on our guidance call, and give further color to that and answer that question.

Q - Richard Verdi {BIO 15139674 <GO>}

But the guidance, it is still your guidance though?

A - Linda Sullivan {BIO 7300156 <GO>}

That is still our guidance at this point.

Q - Richard Verdi {BIO 15139674 <GO>}

Great. Okay. Perfect.

A - Linda Sullivan {BIO 7300156 <GO>}

And its calculated as a --

Q - Richard Verdi {BIO 15139674 <GO>}

Thank you. And then --

A - Linda Sullivan {BIO 7300156 <GO>}

-- annual growth rate.

Q - Richard Verdi {BIO 15139674 <GO>}

I'm sorry, what was that Linda?

A - Linda Sullivan {BIO 7300156 <GO>}

It's calculated as the compound annual growth rate.

Q - Richard Verdi {BIO 15139674 <GO>}

Yeah. Okay, great. Thank you. And then just the last one. I mean it's not a secret here the American has been greater cutting in costs. I mean the target rate continuously goes down, the stretch target at what point though, I mean at some point, it's got a kind of stop right? And so where does that come in, is that -- could that be 20 years away, 15 years away, or could we maybe expect over the next couple of years, one of the investor days, Susan you announced, we're going to bring down this O&M expense again over the next five years even lower?

A - Susan Story {BIO 3335156 <GO>}

So we believe we can continually improve our business Rich. We believe that the water industry in general, is a little behind the electric and gas from the technology standpoint. We have really ramped up our technology integration and we've got some very exciting projects going on. And at this point we see a lot of opportunity to continue the efficiency gains that we've also seen in the last few years.

Walter you want to add anything?

A - Walter Lynch {BIO 6064780 <GO>}

Yeah. Rich, the improvements will never stop and we have a continuous improvement mindset. We're focused on every cost in this business, and through the uses of technology and best practices we're going to continue to drive cost down for our customers. So that's why I spotlight, some of the things we're doing the business every quarter, just to show you this is a continuous improvement mindset.

Q - Richard Verdi {BIO 15139674 <GO>}

That's great. Thank you very much for the time guys. I really appreciate it.

A - Susan Story {BIO 3335156 <GO>}

Thank you, Rich.

Operator

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

Q - Jonathan Reeder {BIO 18909775 <GO>}

Hey good morning, everybody.

A - Susan Story {BIO 3335156 <GO>}

Hi, Jonathan.

Q - Jonathan Reeder {BIO 18909775 <GO>}

How are you doing?

A - Susan Story {BIO 3335156 <GO>}

Good. How are you?

Q - Jonathan Reeder {BIO 18909775 <GO>}

Not too bad. So far it is going well, so happy there.

A - Susan Story {BIO 3335156 <GO>}

I think the (inaudible) community loved [ph] him some another [ph] day, don't they?

Q - Jonathan Reeder {BIO 18909775 <GO>}

I know, how about it? Frantic [ph] schedule I guess. It's amazing what a defensive coordinator change can do sometimes. What was the settled rate base now in McKeesport approval. I recall you agreed to buy the system for 156 million?

A - Walter Lynch {BIO 6064780 <GO>}

Yeah, Jonathan, Walter. The rate base is 158 million.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay, so I mean, pretty much what you ask for them.

A - Walter Lynch {BIO 6064780 <GO>}

That's right. And our purchase price is 159 million.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. Great job there.

A - Walter Lynch {BIO 6064780 <GO>}

Thanks.

Q - Jonathan Reeder {BIO 18909775 <GO>}

When Walter, do you think you might get clarity in Missouri regarding the request featured test here. Do you have to wait until the final order or kind of where you get the thumbs-up or down at some point earlier in the procedural schedule.

A - Walter Lynch {BIO 6064780 <GO>}

I think we'll have indications through our negotiations, but again, it won't be final until we get the final order. So when that case is settled later in the next year.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. But, so I mean it might be in like the settlement phase or so?

A - Walter Lynch {BIO 6064780 <GO>}

It could be, but then, we open the comment on it, that's the question. So, I will look to when we receive the order.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. Okay, thanks.

A - Walter Lynch {BIO 6064780 <GO>}

And back to McKeesport, just I want to make one point on that. If you look at the direct and indirect customers that we're bringing in as part of the acquisition, it represents about \$7,000 per customer. We think that's important because, we think that's a fair settlement for us and the customers through our Pennsylvania American Water.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. And then lastly, congrats, Linda on the debt refinancing deal. Just curious if there is any earnings benefit in the near term from the interest savings prior to the lower debt cost flowing through to -- in here a bit?

A - Linda Sullivan {BIO 7300156 <GO>}

Yeah. In 2017, in addition to the one-time charge that we had for the make whole of the parent of \$0.02 per share. I mentioned earlier we had a negative impact of about \$0.01 from the overlap of interest expense in the third quarter. Now, we do expect that we will see some benefits in the fourth quarter that will slightly exceed that negative carry that we had in the third quarter, but it's less than \$0.01. And then going forward, when we put forward our 2018 guidance, it will be included in there.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay. But I mean there is perhaps some timing benefits before it kind of flows. I guess, all through to rate payers through the rate case process. I guess?

A - Linda Sullivan {BIO 7300156 <GO>}

Right. And remember, the majority of this will be for the benefit of our customers and then as we go through our rate cases that will true up. And keep in mind, we talk about the fact that for every dollar of O&M, we say, we can put \$7 of capital in the ground. This is great, because this means that with this decades long need we have for investment, this is more investment we can make that doesn't impact the customer bill. So that's the way we look at this.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Right, right. And then is there a portion that does flow through to the parent that's kind of an ongoing benefit from this deal?

A - Linda Sullivan {BIO 7300156 <GO>}

Yes. There will be. We've refinanced 428 million of debt that matured in October that was related to the parent. And we will continue to see the benefits of that lower cost going forward.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Okay, great. Thank you for the details.

A - Linda Sullivan {BIO 7300156 <GO>}

Thank you, Jonathan.

Operator

The next question comes from Stuart Alan of Bank of America Merrill Lynch. Please go ahead.

Q - Stuart Alan {BIO 18896484 <GO>}

Hey guys. Great quarter.

A - Susan Story {BIO 3335156 <GO>}

Thanks Stuart.

Q - Stuart Alan {BIO 18896484 <GO>}

A quick question on military services, has there been any update on the DoD budgeting process. I know there's been some movement on the federal budget. I'm wondering if there's any movement on that front?

A - Susan Story {BIO 3335156 <GO>}

Yes, there has been. The sequestration was formally discontinued and so the commanding officers at the bases are hoping to have larger budgets, effective October 1st. They are getting more money. We think it will be more of a gradual increase in capital for infrastructure, because what's happened in the three, four years of the sequestration their budgets were significantly reduced and it wasn't just infrastructure projects like ours that got put on the back burner. They had several other training, warfighter training different things that now are in the queue.

So we are hearing, there is a pickup it will eventually become -- there will be more infrastructure projects like the type we do on the bases. But the initial increase in funding will go toward more of their mission critical items that they have for the military, men and women there. So, yes the sequestration was discontinued. They are seeing higher not quite up to what it was before the sequestration. We do think it will benefit us, but it will be gradual as they put those additional funds to use.

Q - Stuart Alan {BIO 18896484 <GO>}

Okay that makes sense. Thank you.

A - Susan Story {BIO 3335156 <GO>}

Thank you.

Operator

At this time, there are no further questions.

A - Susan Story {BIO 3335156 <GO>}

Thank you, operator. So I'd like to thank everybody for participating in our call today. We really value very much as investor owners and as a financial analysts who research our company for

the benefit of your clients and their financial futures.

We always want to be open and transparent in all of our discussions and dealings with you. And we always want you have confidence in your decisions around our company and your investments in our stock.

If you've not had your question answered or you think of something else please call Ed or Ralph, and they will be happy to help. And as we've mentioned earlier, we look forward to talking with all of you in our upcoming 2018 guidance call, which will be on Monday, December 11 from 9:00 until 10:30. At that time we will not just be talking about 2018, we will talk about some of our strategies, our five-year plan, so please be on the call, and we think that you will find it very interesting. Thanks again.

Operator

The conference is now concluded. Thank you for attending. You may now disconnect.

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