Q2 2016 Earnings Call

Company Participants

- Gregory S. Panagos
- Linda G. Sullivan
- Susan N. Story
- Walter J. Lynch

Other Participants

- Jonathan G. Reeder, Wells Fargo Securities LLC
- Richard A. Verdi, Ladenburg Thalmann & Co., Inc. (Broker)
- Ryan Michael Connors, Boenning & Scattergood, Inc. (Broker)
- Shahriar Pourreza, Guggenheim Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to American Water's Second Quarter 2016 Earnings Conference Call. As a reminder, this call is being recorded and is also being webcast with an 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 August 11, 2016 by dialing 412-317-0088 for U.S. and international callers. The access code for replay is 10089150. The online archive of the webcast will be available through September 6, 2016 by accessing the Investor Relations page of the company's website located at www.amwater.com.

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

Gregory S. Panagos {BIO 17562275 <GO>}

Thank you, Bianca. Good morning, everyone, and thank you for joining us for today's call. We will keep the call to about an hour. At the end of our prepared remarks, we will open the call up for your questions.

During the course of this conference call, both in our prepared remarks and in answer 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 is provided in the earnings release and in our Form 10-Q, each is filed with the SEC. I encourage you to read our Form 10-Q for a more detailed analysis of our financials and other important information.

Also, reconciliation tables for non-GAAP financial information discussed on this conference call, including adjusted return on equity and our O&M efficiency ratio, can be found in the appendix of the slide deck for this call, which is located at the Investor Relations page of the company website.

We'll be happy to answer any questions or provide further clarification if needed during our question-and-answer session. All statements in this call related to earnings and earnings per share refer to diluted earnings and earnings per share.

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

Susan N. Story {BIO 3335156 <GO>}

Thanks, Greg. Good morning, everyone, and thanks for joining us. With me today are Linda Sullivan, our CFO, who will go over second quarter financial results; and Walter Lynch, our COO, who will give key update on our operations.

Once again, American Water employees delivered strong results during the second quarter of 2016. We executed on fundamentals by investing in our water and wastewater system to ensure safe and reliable service. We operated efficiently to reduce cost impacts on customers' bill. We continue to grow our business based on our reputation and core competencies, and we work to provide excellent service to all of our customers.

As you can see on slide 6, we reported second quarter operating revenues of $827 million, a 5.8% increase above second quarter 2015. Earnings were $0.77 per share, a 13.2% increase above second quarter 2015. Our results reflect some timing benefits, partially offset by some one-time expenses. For the first six months in 2016, EPS increased 8.8% and revenues were up 6.1%.

Slide 7 highlights how we are executing on our strategy. Our foundation remains capital investment in our regulated operations. During the first half of the year, we've invested $552 million in capital, including $24 million for regulated acquisition. The majority of the remaining $528 million was in regulated operation, primarily to improve water and wastewater system improvement for the benefit of our customers.

We plan to invest $1.4 billion to $1.5 billion for the full year, mostly for regulated infrastructure investment. That level of investment is balanced by our continued focus on controlling O&M cost as well as utilizing constructive regulatory mechanisms.

Walter will cover this in greater detail, but we never lose sight of our customers and what they have to pay. This quarter was no exception, and our employees continued to improve efficiency. We had excellent growth during the first half of 2016. We've added approximately 7,600 new customers from closed acquisitions and 5,300 customers from organic growth.

We have agreements in place, pending regulatory approval, which would add 47,800 more customers. That includes both the previously announced Scranton Sewer Authority, which will add 31,000 wastewater customers, as well as our recently announced acquisition of Shorelands Water Company, adding more than 11,000 water customers in New Jersey.

I also want to mention acquisition activity that exemplifies my earlier comment about growing our business based on our reputation and core competencies. On Tuesday, the citizens of Blue Grass, Iowa, voted an overwhelming 86% majority to join the Iowa American family. Subject to a final agreement in regulatory approval, these 720 customer connections in Blue Grass will join the 730 new customers in YES! Communities, Iowa, which closed earlier this year.

These two additions result in a 2.3% growth from acquisitions over the 63,000 customers we had in Iowa at the end of 2015. We're all very proud of the dedication, reputation, and customer commitment of our folks in Iowa, as well as in all of our other states that we're privileged to serve.

In the market-based businesses in the second quarter, we launched a municipal partnership through Homeowner Services in Georgetown, South Carolina. Our Contract Services group signed a 10-year O&M agreement in July with the township of South Orange Village, New Jersey, which has 4,700 customers. Our Military Services group began service to our military and their families at Vandenberg Air Force Base on June 1.

As we noted in the first quarter earnings call, we continue to see headwinds in AWE for the remainder of the year, primarily due to lower fixed capital upgrades on our existing military installations compared to previous years. Linda will discuss this a bit more in her comments.

Many of you know that drilling activity is picking up in the Marcellus and Utica formations, where our Keystone Clearwater subsidiary provides water services. As noted on the slide, as of today, we continue to see Keystone as being EPS-neutral for the year. However, we will continue to evaluate the market and services demand and provide any updates on our third quarter call. As noted on the slide, our market share continues to increase and is now around 35% of the water services market in the Appalachian Basin.

As Linda will discuss in more detail, we experienced an increase in our medical cost during the second quarter, some of which we expect to impact us through the second half of the year. I'll address some of the more innovative ways we are looking to manage these costs in the future in my closing remarks.

As you can see on slide 8, based on the results during the first half of the year, we remain on track, and we are affirming our 2016 guidance of $2.75 to $2.85 per share. We also continue our progress toward achieving our long-term goal of 7% to 10% EPS growth through 2020.

And with that, Walter will now give you his update on our operations.

Walter J. Lynch {BIO 6064780 <GO>}

Thanks, Susan. Good morning, everyone. We're really proud of the results our employees have delivered this year. We've had strong growth, we've made smart investments, we meet or surpass all standards as shown in our Annual Water Quality Report, and we continue to realize efficiencies across the business.

Through June 30, we've invested more than $535 million in our regulated business. Of that total, we've invested $511 million to maintain and improve the service we provide and another $24 million for regulated acquisitions. As Susan said, this investment is balanced by our focus on cost management, constructive regulatory mechanism and legislation that enables us to assist communities with challenged water and wastewater systems.

Our commitment to invest in our infrastructure while focusing on customer affordability is clear in the rate cases filed and closed this year. In Missouri, our rate case settlement was adopted, and we received an order for $4.5 million of additional annualized revenues. As part of the rate order, the PSC further consolidated water and sewer rates into geographic regions, going from 19 water rate regions to three, and 13 wastewater regions to two. This creates economies of scale by spreading costs over a larger group of customers, reduces company administrative costs, and mitigates the volatility of our customer bills.

During the second quarter, Iowa and New York requested an additional $13.6 million in combined annualized revenue, and lowered operating expenses by $3.6 million collectively. In California, on July 1, we filed an application to set new rates in each of our service areas for 2018 through 2020. This application seeks a revenue increase state-wide of $51 million over the three-year period.

Also, the State Water Resources Control Board approved a five-year time extension for California American Water to comply with the 2009 order to significantly reduce withdrawals of water from the Carmel River. This action by the Board recognizes our significant progress in building cooperative alliances among California American, local governments and communities, and environmental organizations. With these alliances, we're pursuing projects in water recycling and reuse that augment our water needs both before and after completion of our planned desalination facility.

On slide 11, you can see the success we've had in working with state governments and our commissions, either on legislation or policy that enables water solutions to water and wastewater challenges. For example, the Pennsylvania Legislature eliminated a consolidated tax adjustment in setting utility rates. The new law now requires a calculation of the public utility's federal income tax expense on a standalone basis, separate from any gains or losses of unregulated affiliates. Prior to this law, Pennsylvania was one of a few states that had a consolidated tax adjustment.

In Illinois, over the last several months, Illinois American Water has worked to find solutions that help our customers have a more reliable water system more quickly. The Illinois Commerce Commission adopted new rules in June, which removes the 5% cap between rate cases and instead permits rates that can increase an average of 2.5% a year, with no year to increase more than 3.5%. This will be a big help in a state with big infrastructure challenges.

Finally, in Kentucky, the Governor signed House Bill 309 into law. This law establishes a framework for public-private partnerships in Kentucky. For the first time ever, the state and local governments can leverage private investment to complete necessary infrastructure projects to better serve the public. This law has been referenced as the most comprehensive P3 legislation to-date in the nation.

As you can see in slide 12, during the first half of the year, in addition to our organic growth, we welcomed about 7,600 new water and wastewater customer connections, which is about 20,000 people. We have pending acquisitions, which represent another 47,800 new customers. This includes the Shorelands acquisition, which is more than 11,000 water customers. This is another example of how we're able to provide solutions.

Shorelands service area is in a part of the state that is designated by the New Jersey Department of Environmental Protection as a critical area in terms of water supply. Once the purchase is approved and closed, we'll welcome our new employees and our new customers.

We're also working to close our acquisition of the Scranton Sewer Authority by September 30. Here, we will welcome 31,000 new wastewater customers, who will benefit from our operational and engineering expertise and our commitment to make necessary capital investments.

You can also see in this slide how legislative efforts are helping us provide water and wastewater solutions for people across our footprint. Out of the nine states where we have pending or closed acquisitions, five have fair market value legislation. The importance of this legislation is evident when you look at the numbers. Nearly 97% of the customers we have closed or are pending in one of these fair market value states.

Moving to slide 13. We continued to improve our O&M efficiency ratio, achieving 35.2% for the last 12 months. We remain on track to meet our O&M efficiency target of 34% by 2020. It's a great effort by our employees across our business and it's all about bringing value to our customers.

As I did last quarter, let me provide you with a couple of examples on what we're doing to drive these results. The first example is in our customer service centers where we recently introduced new features to our customers' self-service site. These changes improved the customer experience by using easy to understand language for reoccurring payments and enabling our customers to change the bank account they use to pay their bills without the need to contact us.

For the month of July, more than 17,000 customers signed up for paperless billing, and that's more than three times the amount of customers that signed up in the month of June. These changes are a true win-win to make it easier for our customers to do business with us and they enabled us to drive down costs.

In New Jersey, an energy deregulated state, we've taken advantage of reverse auctions to reduce our electricity costs. We first did this in 2011 and completed another auction this past fall. Through this process, New Jersey American Water will save a total of $9 million for the next three years in energy costs, benefiting our customers. When we reduce $1 in operations and maintenance expense, we can invest $6 in capital. The $9 million cost reduction will translate into an additional $54 million in capital improvements without impacting our customers' rates.

Finally, we thank our employees in West Virginia for the way they responded to the devastating flood there this past June. Once again, our team rose to the challenge, working safely and getting our service restored as quickly as possible.

Additionally, they assisted state-wide emergency response efforts. For example, we loaned two water tankers to the West Virginia Department of Homeland Security and Emergency Management to provide potable water for flood-devastated communities outside our service area. We also provided three large generators to run critical facilities and neighboring communities without power. We saw great effort by our employees there and we're very, very proud of them.

And now, I'll turn the call over to Linda for more detail on our second quarter financial results.

Linda G. Sullivan {BIO 7300156 <GO>}

Thank you, Walter, and good morning, everyone. In the second quarter of 2016, American Water delivered strong financial results, and year-to-date, we remain on track.

Slide 16 shows the earnings per share contribution from each of our businesses. We reported earnings of $0.77 per share in the second quarter, up $0.09 or 13.2% over the same quarter last year. Year-to-date, we reported earnings per share of $1.23, up $0.10 or 8.8% over the same period last year. For the quarter, the regulated businesses were up $0.08, and the market-based businesses were up $0.01. Parent, which is primarily interest expense on parent debt, was flat compared to the same period last year.

Turning to slide 17, let me walk through the components of our quarter-over-quarter increase in earnings per share. The primary driver for earnings growth was in our regulated business, which was up $0.08. Regulated revenue was up $0.10 from authorized rate increases, infrastructure surcharges and new revenue from completed acquisitions and organic growth.

O&M expense was down $0.01 per share. This represents continued improved O&M efficiency that Walter discussed and some timing impacts, including a one-time $0.02 benefit from settlement of the Missouri rate case that will be offset during the remainder of the year.

Largely offsetting these positive items were higher medical and prescription drug insurance costs of about $5 million pre-tax that are managed through our deed of trust. These higher costs are the result of three items. First, we have been managing down the over-funded status of our deed of trust. And this year, the funded status went from being over-funded to being fully funded. Second, we are seeing an increase in claims cost. And third, we trued-up our liability based on our claims experience.

As I mentioned, the second quarter impact was about $5 million pre-tax or $0.02 per share. For the remainder of the year, we estimate increasing claims will add another $3 million pre-tax, putting the full-year increase at about $8 million pre-tax or $0.03 per share.

American Water, like other employers, is challenged by rising healthcare costs. And later, Susan will discuss actions we are taking to manage these costs going forward. Next, interest expense was up $0.01 and depreciation expense was up about $0.02, both driven by growth associated with our regulated system investments.

Moving to our market-based businesses. Quarterly net income was up $0.01 per share, primarily from a favorable contract dispute settlement of about $3 million pre-tax, which we had expected to receive later this year. Absent this favorable settlement, the market-based businesses were relatively flat. Increases in Homeowner Services as well as the acquisition of Keystone last July were largely offset by lower capital upgrades in our Military Services group.

As noted in our first quarter call, we expect lower capital upgrades in 2016 from reduced federal budgets and because these capital upgrades can be lumpy year-over-year. One of the biggest reasons capital upgrades were lower in the second quarter was the wind down of an $85 million three-year project at Fort Polk.

Let me now cover the regulatory highlights on slide 18. We currently have six general rate cases and one infrastructure surcharge request in process for a combined annualized rate request of $113 million. For rates effective from July 1, 2015 through today, we received a total of $102 million in additional annualized revenues from general rate cases, infrastructure charges and step increases.

As you can see on this slide, our requested ROE in our outstanding general rate cases is generally 10.75% to 10.8%, with recent authorizations at 9.75% in several of our states. Overall, our weighted company-wide authorized ROE was 9.9% at the end of this quarter.

Looking at the change in ROE over the past three years, since 2013, the company's average authorized ROE has only moved about 10 basis points from a prior average of 10%. And during the same time period, our weighted authorized equity ratio increased about 20 basis points. So, even with sustained low interest rates over this period, changes in ROE have tended to be slow and gradual.

Slide 19 highlights our continued strong financial performance. We made total capital investments of $316 million during the second quarter of 2016 and $552 million year-to-date, primarily for regulated system investments, mainly for the replacement and renewal of transmission and distribution infrastructure.

We expect total capital expenditures to be in the $1.4 billion to $1.5 billion range in 2016. Our capital expenditure range was updated to include our pending acquisitions.

I would also like to point out that the Shorelands acquisition announced yesterday is a stock-for-stock transaction, and the maximum number of shares to be exchanged at closing will be less than 500,000 shares, with the final number of shares based upon American Water's stock price. We expect to close the transaction in the first quarter of 2017.

For the second quarter of 2016, cash flow from operations increased $51 million or about 23% to $271 million, mainly due to focused efforts on improving the aging of our accounts receivable, as well as the timing of accounts payable and accrued liabilities.

Our adjusted return on equity for the past 12 months was 9.55%, an increase of 57 basis points compared to last year from continued execution on our strategies. We also announced in July a $0.375 common stock cash dividend payable on September 1, 2016 to stockholders of record as of August 8, 2016.

Turning to slide 20. We are affirming our 2016 earnings guidance. I would like to point out a few items. First, weather impacts in July are expected to be minimal, as the hot temperatures across many of our states were also accompanied by rainfall. Second, our year-to-date earnings were strong across the business.

However, as I've noted, they also include some timing-related items, including the favorable contract dispute settlement at AWE, which we had expected later in the year, and the $0.02 benefit from settlement of the Missouri rate case that will be offset during the remainder of the year.

Third, looking forward, despite the expected increase in group insurance cost and the headwinds we previously discussed at our Military Services group in Keystone, we affirm our earnings guidance range of $2.75 to $2.85 per share.

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

Susan N. Story {BIO 3335156 <GO>}

Thanks, Linda. Before we move on to Q&A, I would like to take a couple of minutes to talk about healthcare costs. Like other companies, our healthcare costs are going up. This is especially true in utilities where we have an even more pronounced aging workforce.

We're currently partnering with our healthcare and pharmacy providers for better pricing, while strongly promoting a healthy and safe culture for our employees. We continue to promote wellness and health management programs, preventive care screening and education for employees on being thoughtful consumers of healthcare.

But we're going a step further. Earlier this year, American Water was a founding member with 20 national companies, which you see on the chart, to form the Health Transformation Alliance or HTA. Since the initiative was kicked off in February, an additional 13 companies have joined the alliance, with the now 33 companies representing more than 5.5 million people across the country. We're proud to be part of this cutting-edge effort.

The overall goal of the HTA is to create higher quality care by, first, partnering with facilities and physicians that have better outcomes, while also aggregating the purchasing power of all the member companies to keep costs down. Additionally, HTA companies will pool our data without identifying individual information for better treatment options, better health outcomes, and more reasonable and efficient pricing.

The HTA is following a similar process for pharmaceutical purchasing and contracting systems. The HTA's efforts have been highlighted recently in several media publications, including the Wall Street Journal, Barron's and The Boston Globe.

This is just the start of an exciting collaborative effort. We will keep you updated as we work with leading companies throughout the United States to improve the quality of healthcare and slow the rising costs for our company, employees and their families.

So, in summary, our year-to-date financial performance reflects the successful execution of our strategies, investing in our system, operating efficiently, growing our business, and remaining steadfast in our commitment to the highest standards of customer service and water quality.

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

Q&A

Operator

We will now begin the question-and-answer session. The first question comes from Ryan Connors with Boenning & Scattergood. Please go ahead.

Q - Ryan Michael Connors {BIO 21817016 <GO>}

Great. Thanks for taking my question. I wanted to talk a little bit about the infrastructure surcharge and the new rates coming on to the P&L. And if I read the slides correctly, you've got more than $40 million worth of DSIC and other surcharges that are coming on to the P&L in the first half, which puts that DSIC revenue, if my calculations are right, upwards somewhere around 1.5% of total consolidated sales, which is a pretty high number relative to the historical average.

So can you just talk a little bit about transitioning those rates across your system from DSIC and surcharges over to base rates? And whether that's – as this becomes a bigger and bigger part of the business, DSIC and surcharges, is that a seamless process, or will that create complications that were not there in the traditional setup of a regular general rate case cycle?

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

Ryan, this is Linda. Thank you for the question. Great question. This is actually a pretty smooth transition from the DSIC mechanisms to the general rate cases. Because, generally, these types of mechanisms are really set up for the purpose that we will be able to continue to make these investments in an ongoing basis in our much needed infrastructure upgrades. And so, that's really the purpose of it, and then they roll into the general rate cases.

It also allows us to spread out the time between general rate cases and smoothe the impact of our capital investments on our customer rates.

Q - Ryan Michael Connors {BIO 21817016 <GO>}

Okay. And then, I know that most of these DSIC-type mechanisms actually have a return on equity component to them. Is that typically equal to what you expect to receive in a given state when you move from a surcharge over to a base rate?

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

Typically, it is. I mean, every state is a little bit different, but typically it's the same.

Q - Ryan Michael Connors {BIO 21817016 <GO>}

Okay. And then my other question was a little bigger picture in terms of the new fair value legislation. Obviously, you have the Act 12 in Pennsylvania, and Walter, you mentioned five different states now.

I'm just wondering whether this is really catching on more broadly. I know we've just had the NARUC Summer Meetings. I believe, Walter, you were there. And curious whether that's something that's getting a lot of play in the hallways and whatnot, and whether we might see other states move in a similar direction or whether this will maintain – stay pretty niche-oriented?

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

Yeah. Ryan, thanks for that question. We are seeing us catching on in many of the states, and you can see that by each of the states adopting it. And what it really does is providing a center for municipalities to look to monetize their assets to be able to provide a fair market through the systems.

And before this, we could pretty much only pay original cost minus depreciation. And then anything above that, we got a risk for us getting in rate base. So this just works for everybody. And it is getting a lot of traction in each of the states where we operate. And you can see that from the slide that we had up there, five of our big states have fair market legislation.

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

And, Ryan, so the driver for this, just like Walter and Linda said, the reason that this is for water is because there is a recognition that, with ever-increasing infrastructure need, ever-increasing retirement, smaller systems increasing water quality standards, there's a general concern, do we have the ability to meet the need of water and wastewater systems? And Public Service Commission also are residents of the states they're in. So, even if in many states municipalities aren't regulated by the PSC, the recognition of water and wastewater challenges is shared by everyone.

So we do find that, in many of our states, the Commission are concerned about water quality, water issues, along with their governmental entities. And the whole point here is to offer optionality to municipalities, so that whatever works for them and their citizens, they have the options to do. And fair market legislation just helps out that whole situation.

Q - Ryan Michael Connors {BIO 21817016 <GO>}

That's very helpful color. Thank you. And then one just last quick one is, Walter, you mentioned the Scranton acquisition. You wanted to close by the end of September. Is that pretty much buttoned up now or are there any lingering issues that could actually complicate that regulatory approval?

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

Well, Ryan, we're working towards closing by September 30. And we'll continue to work with the city on that.

Q - Ryan Michael Connors {BIO 21817016 <GO>}

Okay. Thanks for your time.

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

Thanks, Ryan.

Operator

Our next question is from Shar Pourreza with Guggenheim Partners. Please go ahead.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Good morning.

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

Hi, Shar.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Apologize if this was asked already. I only kind of got to hop on a little bit late. So, on the fair value legislation, Susan, is there sort of any other states you're thinking about where we could see some sort of passage? And I'm thinking more like Illinois or New York? Is there any opportunities there?

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

Well, actually, Illinois was the first. When you look at the fair market legislation, at least in our service area, it started with Illinois legislation. They were among the first to do that. The general question, though, is I think that as you continue to see water and wastewater systems under distress across the country, this is a very viable solution that enables municipalities to benefit from water utilities like us and others to benefit. And the main thing is to solve the problem for the citizens out there who are depending on the best water quality.

But also, you have communities around the country who are doing an amazing job, first of all, but they have all of these different priorities, they have to provide for schools and for roads and for parks. And the responsibilities that these municipalities have is so long.

And as we know, a lot of the federal funds aren't there anymore that were there during the 1970s and 1980s and even 1990s. And so they are trying the very best they can to serve the citizens of their communities. So, where it makes sense, and this is an option for them when they choose to put their systems up for sale, having this type of legislation takes an obstacle away from that.

In the past, we've had situations where a municipality or governmental entity willing to sell its system, we wanted to buy it. But because of the way things worked between the book value and what we were able to put in a rate base that wasn't considered premium, it stopped a lot of deals before they ever took place.

So, I think, this is an effort by states to have a win-win situation. But at the end of the day, the people in those communities need to be better off and the municipalities are able then to provide the critical services that they're responsible for.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Got it. That's helpful. And then just around – obviously, there hasn't been any issues growing and you've got organic opportunities, you've got acquisition opportunities. But when you think about the next leg of growth, is there sort of – where are we at with stormwater? And is that something we can as a potential driver of that growth maybe next year or the year after?

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

I think that is a big open question right now, Shar. I think one of the things we know is that on some of the military installations where we serve water and wastewater, a question has come up about stormwater so that we provide services for the whole water cycle. So, that's really the immediate issue that we're looking at and clarifying in Washington in terms of the role of stormwater in the privatization legislation, which by the way is actually there.

So I think it's one of those that, as the entire country looks at water supply changes and we look at the entire water cycle, it's not – in the past, we tend to say it's the drinking water, it's stormwater, it's sewer water. Where you have drought situations, where you have the need and we need to promote water recycling reuse, you're going to start everyone looking at the whole cycle.

So I think it's very early in the stage to do that, but it's something, because it's part of the water cycle, that we have to look at.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Got it. That's helpful. And then, just lastly, on Keystone, obviously you reiterated the earnings neutral, and I think I would assume cash flow positive up until the second quarter. But, obviously, you highlighted that drilling activities picked up a little bit and you sounded a little bit more constructive. So, if we kind of continue with the fundamentals we're seeing right now on drilling activity, is it something that – is there an opportunity to look at that earnings profile this year? Or are we too late in the year to revisit that neutral status?

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

Well, Shar, what we know – so we like to base our guidance on what we know. So market conditions have stabilized. We know that. And they've got bigger and slightly improved. So we've seen some increases in rig count, commodity pricing, as you all know. Some customers have resumed completion and drilling activities. But we're looking at capital spending, how much of it we'll hit at the end of this year versus 2017.

So I think it's really a timing issue that we're looking at. So what we want to do is look over the next few months to look at how that has stabilized, what that means for 2016 versus 2017. But the good news, as you said, is that we are starting to see activity. It is widespread. We're starting to see our growth in market share. The last we had shared with you before this call was about 30%. We're now seeing about 35% as some of the smaller players have fallen by the waste side during the really tough times.

So, our customers are steady. We're not seeing any further deferrals of completion activities. We're picking up some new customers. But we just need to monitor over the next few months and see what we've got.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Excellent. Thanks. Congrats.

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

Thanks.

Operator

Our next question comes from Richard Verdi with Ladenburg. Please go ahead.

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

Hi. Good morning, everyone. Congrats on another nice quarter, and thank you for taking my call.

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

Thanks, Rich.

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

Thanks, Susan. My first question kind of is a follow-up on Ryan's question about the DSIC. I'd asked this to Aqua on their Q1 call. And so, in early Q2, I had a conversation with one of the more prominent members in the (37:24). He told me that the consumer advocates are basically looking conveniently to push back on the DSIC and similar surcharges in other states, because the group kind of feels that DSIC is being abused with one filing after the next.

And so, I'm wondering if American Waters is hearing this, expecting it, and if so, I'm wondering how it could impact the company's strategy?

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

Well, Rich, I'm not going to comment on this because they need to speak for themselves. But I will tell you from our standpoint, the fact – here's what we know. There is a recognition by the EPA throughout the country about the infrastructure needs that we have in the United States.

Our plans are very open in our state in our DSIC. In any of our infrastructure surcharge, we present plans. We also go in when we have either quarterly, sometimes semi-annually filing where there is a close monitoring of the projects we're working on, what we're spending, in addition to our O&M efficiency at least for American Water.

We also have several efforts in terms of capital efficiency. What do we do not only to spend every O&M dollar, but what are we doing to show that we're actually even improving how we spend every capital dollar? Because for us, at this situation, we are faced with years of investment. We want to be as efficient with every dollar as we can possibly be, because that means we can put more in the ground, not impact the customer bills, and to be able to get the infrastructure replaced more quickly, which still is a decade-long issue. So, that's one thing we know.

I will also tell you, with the recent, I'll say, attention to water quality issues in a time when you have infrastructure but you also have emerging water quality issues, and we've seen what happened in different parts of the country when you don't invest in infrastructure, I'm not sure that that is a risk that we are willing to take.

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

Great. Thank you, Susan. That's perfect. And then, another question I have, I want to focus most of my questions on the non-reg segment. This kind of follows up also on the last caller's inquiry.

I mean, you kind of laid it out to him. I just kind of wanted to get some clarity, though, about the call it cautiously optimistic Q3 and Q4 for Keystone.

I mean, oil is expected to pull back because of seasonality in late Q3 and into Q4. I mean, a lot of these guys go on vacation because of weather around Thanksgiving time and drilling activity drives up. So I'm assuming you're optimistic because Q2 was probably strong and Q3 probably followed that strength. But what keeps you cautious? Is that seasonality potential for an oil pullback keeping you cautious or are you now seeing customer indications where they're keeping you cautious on Q3? I'm just looking for a little more clarity in there.

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

Sure. Sure. So, first of all, understand that our Keystone executives and management spend a lot of time with our customers. We do have a lot of – we share with them and they share with us some of their drilling plans. So the cautiousness is not really related to timing of holidays or vacations. It's more of you're talking about an E&P industry that's extremely cautious because of what they've gone through the past 18 months.

So you don't have people that have gone from being so far down to saying, we're going to pull out all the stops and ramp everything up immediately. They have a cautiousness, so we have a cautiousness. And it is a testing of the waters. The foundations are becoming stronger. We're seeing natural gas prices. I think NYMEX closed yesterday at $2.84. For example, just in April, it was $1.90 per million Btus. You're starting to see better pricing as the supply is being drawn down because of the heat across the country this summer. We're starting to see some activities where people had not been doing drilling, and now they are. We're starting to see some more drilling rigs come up.

So our cautiousness is the timing. It is the spacing. It is how quickly will we see this come up? How quickly will we see the supply that basically is being drawn down and being replenished? What are the forecasts for the winter months? How cold will the winter be? So we try to base looking at objective third-party data like price projections, like drilling projections. We look at all of that, then we also look at our internal discussions we have with our customers and what their drilling plans are.

So the cautiousness is – what you don't want is for people to flip back and forth and say, it's not good, it's great, it's not – we just want to be very cautious as we look at the ramp-up and the continuing strength of the natural gas drilling market and make sure that we're very careful in how we look at that emergence.

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

Great. That's excellent color. Thank you, Susan. And then, staying on the Keystone here, it's in the Appalachian footprint, it's in the Marcellus, and it's in the Utica. So, I'm curious, given the market shares that you – the 35% market share you shared, which I'm very thankful for, what basin did they focus on more over the other, is it the Marcellus or is it the Utica?

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

Really, it's both. And let me – so they're so close. I mean, basically, it's three states: it's Pennsylvania, it's Ohio, and it's West Virginia. And of course, the formations are beside each other. And also, importantly, as we mentioned on the first quarter call, Shell has announced that they're going to build the cracker plant there, south of Pittsburgh, which is right in the heart of where the Marcellus and Utica and some of the formations are very close together.

So we're very excited about that because what that will do is, if they start construction, as they have said, in 2018 and finish in 2020, you're talking about even more valuable natural gas drilling where you can get the NGLs along with the natural gas. So we just see that area and the intersection between Utica and Marcellus being very rich in terms of – the fact is we know that it is the cheapest to drill for the drillers, and it also requires a good bit of water because of the depth of the formation.

So we think that's the right place to be, and we've been asking it. Also, at this point, we're not interested in going into other formations because we think that the Utica and Marcellus is where we have the most key areas for production growth in the future.

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

Okay. Okay. That actually helped answer my next question then. And then, of that 35%, does Keystone work with Antero Resources?

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

We do – we work with a lot – we have right now, I believe, in this somewhere between 22 and 27 different customers.

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

Okay. Okay. That's helpful. And, I guess, the last question is this. I mean, when I think of the Marcellus, there are 10 rigs there. Six of them are Antero Resources, which then means that their midstream arm who has a water business – that water business is going to the midstream arm. And so, then there is the four other guys there. And then the Utica, there's only one Antero Resource rig there. And of the 13 remaining, they're all other players. And so, of these other players – I understand that oil prices are supposed to decline because of seasonality, but they're also expected to decline following that.

And in addition to that, if you look any upstream players, they're all touting about how they're expecting to use – I think they were using something like 1,500 pounds of sand per lateral or somewhere around there, and it's expected to go to 2,000 pounds. And so, I'm wondering if there's a potential to expand and capture more business in the Utica because it's kind of open there.

And then, two, that increased sand means increased needs for water there. So are you guys factoring that into your figures? And if so, are you expecting – how much of a positive impact, because a year ago that was 1,000 pounds, and now we're talking doubling that. So, I mean, that could be really meaningful for American Water.

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

Well, a couple of things. So, Rich, in recent weeks the drill count's been about 36 in Appalachian Basin and...

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

Okay.

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

And we're all natural gas, by the way. So we do very little to no support for oil. Actually for us, it's mostly natural gas. So, that's one.

Second thing, you're exactly right. What we are finding is that, in order to more efficiently utilize wells that have already been drilled, they are looking at higher pressure more sand, which does require more water, you're exactly right. But those changes in the market and the efficiency are things that our folks at Keystone work closely with customers in terms of estimates of how much water we need.

So, you're right, there's changes. That's one of the reasons that the wells have become so much more efficient is they're doing the second and third frac, and they're also putting a lot more sand and lot more pressure with the sand when they go to those second and third fracs. So, you're exactly right.

I'd tell you there's a couple of other things we're involved in, and one of them is we're working with a couple of customers on some automated pumping that really is not pretty standard right now. So we consistently look at working with the E&Ps on how to make the production more efficient, how to get the most they can out of each individual well, and to make sure that we are a solutions provider on everything around water and water services.

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

Fantastic. Thank you for that, Susan. That's great color. And then, the very last question and then I'll jump out. I'm taking up a lot of time. Last quarter I had asked, Susan, and I think this is a great move on American Water's part, I had asked if American Water with your smart metering initiative, you were trying to team up with the electric companies to use your infrastructure. And you'd given some great color. I was just wondering if there is any sort of update on that, if there's been any more progress, what have you? Just some color to see if there's an update.

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

Yeah. Well, we actually have an AMI team that we're working throughout the company to come up with a rollout. Unlike electric, the water bills are so much less expensive. Of course, we're looking at the ability to be able to justify them economically. One of the good things is we're seeing a lot better technology with the meters that will allow us to actually put in AMR meters that we can then do software upgrades to actually make them AMI meters, which is good.

We continue to work with some electric utilities on utilizing some of the same backhaul infrastructures, so that our customers don't have to double the cost of those investments. We're working with Commonwealth Edison, ComEd, in Chicago area, as well as there's a couple of other utilities that have expressed an interest, and we're very excited about that because it really is a win-win for our customers where we put in a water meter.

But the one reason that does push us to do AMI is, interestingly, still a lot of water meters across our footprint are in people's homes. So, the ability to put in AMI that we don't have to actually send people out to people's homes instead of times to go into their homes, is the real not just efficiency improvement but also a customer satisfaction improvement.

So we're taking all of those factors. We've got a plan in place to roll out AMI over the next few years. And where we can partner with electric utilities to offset some of that cost for our customers, we're all for it.

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

That's great. Thank you, Susan, and congrats again on the success this quarter and moving forward. I appreciate the time. It's great color.

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

Thanks, Rich.

Operator

Our next question comes from Jonathan Reeder with Wells Fargo. Please go ahead.

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

Hey. Good morning, you all. I'll try to be quick since this call's been extended a little bit recently. Could you give us an update on the military base RFP process? Obviously, your main competitor was awarded a pretty large base here recently. And if you could just kind of say maybe what happened there on your end, and do you get the sense that any new bases are on the verge of being awarded?

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

Okay. That's a great question, Jonathan. Thanks. As we look at the military bases, there are several RFPs that are outstanding. From the time we do an initial bid, it can be anywhere from three years to five years before bases are awarded. And we do have several outstanding bids. Again, we only bid on those bases that the 50-year contract value is from $250 million and above, because for us the smaller bases with the cost of bidding and all that.

So you are correct. The last one that was awarded was Eglin, and we did bid on it. And American States Water did win that one. And we are taking our lessons learned and seeing what we could do better next time. We do think that – we know that there are others in the process of several we've already bid on, others that we think will come out for bid. It's an ongoing process. And so we are just looking to get better every time we make a bid.

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

Okay. So, no anticipation necessarily of any announcements in the second half of the year at this point?

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

We don't foresee any announcement in the second half of the year. With that said, however, one never knows. So, when you've got a bid out there that's been out there for a couple years or three years, depending on the particular installation and where the Department of Defense is, so it's very difficult to predict. But at this point, we don't foresee any further award this year, but we could be wrong.

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

Okay. Great. And then, Walter, did you say the Illinois infrastructure surcharge changes removes, like, the total cap in terms of how much revenues can increase under the program between rate cases?

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

Yeah. That's right. It removes the cap of 5% between rate cases and allows us to increase rate no more than 3.5% a year.

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

Okay. So...

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

And it also a number of other things that we can invest in and get recovery, not just pipes. So, it was very favorable for the industry.

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

Okay. So, 3.5% annual cap. How does that impact the frequency of rate cases in the state for you now?

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

Well, we're just going to...

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

You'll kind of stretch it out a couple more years, given the broader application and the 3.5% annual cap?

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

It could lead to that. I mean we're going to continue work on our capital program to invest wisely within our systems. And if that extends the rate cases, that's great. But we're going to continue to invest per our capital management program.

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

Okay. Do you think it expands kind of the overall CapEx budget in the state where it'd kind of move the needle at all on the consolidated budget going forward, or too soon to say?

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

Yeah. It's really too soon to say. But it is favorable for us to continue to invest to get a timely recovery. So we'll consider that as we're working through our capital plan for the next five years.

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

Okay. And then, last question, and I think I already know the answer, but I guess, year-to-date, weather hasn't really had a meaningful impact, is that correct?

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

Jonathan, that is correct. We've looked at the weather impacts through July across all of our states. And although we did see more heat in those states and hot weather, it was offset by also having rainfall in those areas as well.

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

Okay. Great. Thanks so much for the time this morning.

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

Thanks, Jonathan.

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

Thanks.

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

Thank you.

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

Operator, I think that concludes our question-and-answer session for this morning.

Operator

Yes. I would like to turn the call back over to Susan Story for any closing remarks.

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

Well, thanks, everybody for participating in our call today. And as always, if you have any questions, please give Greg or Melissa a call. They'll be happy to help. We want to thank everybody for participating, look forward to seeing you in November and thank goodness, in one month, football season starts.

So, everybody, have a great day.

Operator

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