Q3 2019 Earnings Call

Company Participants

- Brian X. Tierney, Executive Vice President and Chief Financial Officer
- Darcy Reese, Director, Director, Investor Relations
- Nicholas K. Akins, Chairman, President and Chief Executive Officer

Other Participants

- Ali Agha, Analyst, SunTrust Robinson Humphrey
- Angie Storozynski, Analyst, Macquarie
- Christopher Turner, Analyst, JPMorgan
- Greg Gordon, Analyst, Evercore ISI
- Gregg Orrill, Analyst, UBS
- Julien Dumoulin-Smith, Analyst, Bank of America Merrill Lynch
- Michael Lapides, Analyst, Goldman Sachs
- Steve Fleishman, Analyst, Wolfe Research

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the American Electric Power Third Quarter 2019 Earnings Release Conference Call. At this point, all the participant lines are in a listen-only mode. There will be an opportunity for your questions, and instructions will be given at that time. (Operator Instructions) As a reminder, today's call is being recorded.

I'll turn the call now over to Ms. Darcy Reese. Please go ahead.

Darcy Reese {BIO 20391516 <GO>}

Thank you, John. Good morning, everyone, and welcome to the 3rd Quarter 2019 Earnings Call for American Electric Power. Thank you for taking the time to join us today. Our earnings release presentation slides and related financial information are available on our website at aep.com. Today we will be making forward-looking statements during the call. There are many factors that may cause future results to differ materially from these statements. Please refer to our SEC filings for a discussion of these factors.

Our presentation also includes references to non-GAAP financial information. Please refer to the reconciliation of the applicable GAAP measures provided in the Appendix of today's presentation. Joining me this morning for opening remarks are Nick Aiken's, our Chairman, President and Chief Executive Officer; and Brian Tierney, our Chief Financial Officer. We will take your questions following their remarks. I will now turn the call over to Nick.

Nicholas K. Akins {BIO 15090780 <GO>}

Okay. Thanks, Darcy, and welcome to the call. You're first-time on the call. And moving to Bette Jo Rosa is still listening, even though she is in retirement, but thanks for everyone for joining Apes 3rd Quarter Earnings Call. Brian will update you on the financial for the quarter and year-to-date a little later, but I'll summarize my view of the quarter as we go forward.

First, we had a great quarter supported by warm weather through September, previous positive regulatory outcomes that are now being reflected in our financial results, continued success and management or O&M expenses. And I have to say load is making a comeback. After the lower load last quarter, it is good to see some improvement that generally remains flat to last year, but still positive from the second quarter.

We're watching this trend closely during the 4th quarter and into next year. Given all of that, we are raising and narrowing our operating earnings guidance range for 2019 from $4 to $4.20 per share to $4.14 to $4.24 per share with a new midpoint of $4.19 per share. We're also reaffirming our 5% to 7% growth rate based upon our original guidance.

Additionally, the AEP Board earlier this week authorized an increase of $0.03 per share from $0.67 to $0.70 a share, a 4.5% increase. This increase keeps us firmly in the middle of our targeted 60% to 70% payout range, and along with last year's increase of 8.1% averages to a 6.3% increase for the last two years, commensurate with our 5% to 7% earnings growth rate. We continue to expect the dividend to grow in line with our earnings and firmly within our targeted payout ratio.

So let's step into a few highlight areas for the quarter. Regarding our North Central Wind projects, as you recall, we had made filings for state approvals in Oklahoma, Louisiana, Arkansas and Texas on July 15, and during 3rd quarter, we requested FERC approval of the transaction as well. Also we would acquire three wind farms, currently under development by Inv energy within service dates in 2020 and 2021, based upon requirements consistent with the integrated resource plans of both PSO and SWEPCO in the various jurisdictions. Finalized procedural schedules have been determined in all of the state jurisdictions at this point, The Oklahoma Corporation Commission has set the PSO scheduled for hearings in January of 2020. The Louisiana Public Service Commission has set the SWEPCO Louisiana hearings for March 2020, The Arkansas Public Service Commission has also set it's scheduled for March 2020, and The Public Utility Commission of Texas has set the schedule for hearings in February of 2020. So we're currently working with the discovery process in each jurisdiction, and we're on track to receive final decisions by the summer of 2020. I'll remind everyone once again that these projects are not in our capital plan.

Regarding regulated solar, HB6 has cleared the path for credits to be applied to our existing solar request before the Ohio Commission. With this change, we have filed a temporary delay to provide additional clarity concerning project benefits to our customers and we await a decision from the PECO.

While on the subject of Ohio, we are continuing our focus on HB247 with hearings progressing well, this bill is important in regards to further grid modernization, technology deployment and behind the meter customer investment opportunities to improve the customer experience. There is no doubt our business is changing at the distribution level in regards to technology, grid modernization, distributed generation and further grid and customer-related optimization efficiency opportunities, HB247 modifies Ohio's electric retail service to allow the company to include these provisions in electric security plans, followed with the PECO. This allows us to provide that continued obligation for our customers to improve the customer experience and be able to provide universal access to the benefits of the clean energy economy.

Our contracted renewable, which have benefited from the recently acquired wind facilities, development opportunities and resources, continues to perform well. The projects are performing toward the upper end of acquisition assumptions, and the development portfolio is making good progress as well. We have one project that we expect to place in service in 2020 using all of the PTC's safe harbor equipment and expect to release an announcement of a project backed by a long-term contract with an investment grade counter party by the end of the year. And there are others in the pipeline that look really good as well.

Our regulated utilities continued to perform very well. I just want to take a moment to congratulate our employees of the Cook nuclear plant, that once again, received an INPO excellence rating. We are very pleased with that outcome, and this exemplifies our belief that operational excellence is the foundation for anything else that AEP wishes to achieve from a strategic perspective.

We're in the midst of four major rate cases that I'll update you on. In Arkansas, we filed a settlement of that case that included all the parties that contains a net $18 million increase, a 9.45% ROE with the formula-based rate process for 5 years. Because we have not filed a rate case in Arkansas and approximately 10 years, it's important to note this order included no disallowances on $1.2 billion of investments made on generation and environmental retrofits. The company had requested a $34 million net increase, so all in all, a decent settlement to move forward with the new formula-based rate mechanism. The settlement awaits Arkansas Public Service Commission approval with the rates assume to go into effect in January 2020.

In Indiana, we filed a case in May of 2019 for a net increase of $94 million and a 10.5% ROE with the 2020 forecast and test year. The rate case includes our "Innovate Indiana" program that supports the continued operation of Cook nuclear plant, new smart grid technologies, AMI meters, expansion of electric vehicle charging and support for renewable energy. Testimonies by I&M and interveners have already been filed, and Indiana staff does not filed testimony. We filed a rebuttal testimony in September and hearings are currently ongoing. We expect an order and rates to go into effect by March 2020.

In Michigan, I&M filed a base rate case in June requesting a net increase of $52 million, and a 10.5% ROE with also a 2020 forecasted test year. The Michigan plan also included support for the continued operation of Cook nuclear plant and a commitment to distribution reliability through equipment upgrades, tree trimming and AMI meters. Staff and intervener testimony has been filed with staff recommending a 9.75% ROE with a $38 million revenue increase. We'll file a rebuttal testimony in November with hearings also being in November and expect to commission order in April of 2020.

And lastly, regarding the AEP Texas rate case we filed in May, a base rate case review that included a net increase of $35 million and a requested ROE of 10.5% with the 2018 test year. The rate request includes increased charges to retail like to providers, REPs for use of AEP Texas T&D lines along with refunds and credits associated with the Tax Cuts and Jobs Act of 2017.

The PUCT staff in August filed testimony with reductions in both the transmission and distribution revenue requirements based upon 9.35% ROE removing various incentive comp and SERP expenses, incremental distribution forestry expenses and other tax and depreciation related adjustments. The hearings concluded in August. The case has been fully briefed, and we await a PFT from the ALJs in mid-November. We will then file exceptions and expect a ruling from the commission in first quarter of 2020. Summaries of all of these cases are included in the earnings slide presentation.

Now moving to the economy, this quarter is indicated some bright spots to consider. Many have talked about this economy being driven forward by the consumer because of low unemployment and higher wages. We are seeing that as well in our service territory. While industrial, overall, is still down, but improved from last quarter, residential and commercial are both that more than expected.

We have the lowest unemployment on record in our territory going back to 1990 and wages are growing faster than inflation. And even in the industrial sectors, which have improved overall from last quarter, the oil and gas sector growth was the strongest we've seen since 2016. As you know, our margins are higher on residential and commercial than industrial, so overall financial results are positive. So all-in-all, I would say, it's time for a return of optimism regarding the economy.

So now moving to the equalizer graph, the overall regulated operations ROE is currently 10.1%, it was 9.7% last quarter. We generally project the ROE for our regulated segments to be combined to be 9.5% to 10% range. We have a long track record of delivering these results and we expect that to continue. The reason for the increase in third quarter 2019 versus second quarter includes the effect of favorable weather this September.

I'll also note for you the size of the bubbles in the chart. It's interesting to note that AEP Transmission Holdco is now the second largest operating utility behind Appalachian Power. So that's interesting to note, and you have several of them that are approximately the same size companies as well that follow-on to that. So we're continuing to make quite a bit of progress, and it is interesting to note.

Moving onto the graph at sale on AEP Ohio, the ROE for AEP Ohio at the end of the third quarter was 11.3%, and we expect to end 2019 near 11% as the legacy fuel and capacity carrying charges, the PER and the RSR, as they recalled roll-off, and we continue to invest in the distribution smart grid.

Epic, the ROE for Epic at the end of third quarter 2019 was 9%. Epic has change in ROE for the second quarter '19 is primarily attributable to favorable weather and rate proceedings when comparing third quarter 2019 with third quarter '18, partially offset by lower normalized usage in third quarter '19 versus third quarter '18. West Virginia, as you recall, West Virginia implemented new base rates in March 2019, which was a $44 million base rate increase based on 9.75% ROE. Virginia's first triennial review is in 2020, and we'll cover the 2017 to '19 periods, and ROE of 9.42% will be used for triennial period review with 70 basis points bandwidth ranging from 8.72 to 10.12, so that will be coming out.

As far as Kentucky Power is concerned, the ROE for Kentucky Power at the end of third quarter was 7.8%. Kentucky's change in ROE from second quarter is primarily due to a slightly favorable normalized usage weather and transmission revenues. We're working on optimizing revenue and scrutinizing the O&M and capital to improve ROE by the end of the year.

With I&M, I&M at the end of third quarter was 11.6%. I&M's positive performance through the third quarter '19 is primarily driven by timing of expenses, favorable financing of long-term debt, supportive regulatory environments and some one-time adjustments. I&M expects to end the year with an ROE around 10.5%, which is higher than authorized ROE in Indiana, Michigan, primarily due to one-time adjustments. I&M continues to successfully execute its capital programs in generation, transmission and distribution, and recently filed future test year rate cases in Indiana, Michigan, just to seek timely recovery of ongoing capital costs.

Regarding PSO, ended the quarter with an ROE at 11.3%. Pisa's increase in ROE was due primarily to summer weather and normalized usage. PSO received an order on its base case settlement in March 2019, as you recall, approving a $46 million increase in 9.4% ROE. So we've seen a great turnaround in Oklahoma. And in fact, Oklahoma is a bright spot from the economic process as well. Oklahoma continues to operate on all (inaudible) and continue to increase in terms of load.

SWEPCo, SWEPCo at the end of third quarter 2019 was 6.7%, the most recent 12-month ROE increased primarily due to favorable weather and favorable normalized load. We did, as that I mentioned, filed an Arkansas base rate case and the settlements that are pending there, an ROE of 9.45% and cap structure of 52.1 there 47.9 (inaudible) equity. SWEPCo's ROE continues to be affected by the Arkansas share of the Turk plant that is not in retail rates.

As far as Texas is concerned, the ROE for AEP Texas at the end of the third quarter was 8.8%. The main driver for the increase in ROE is primarily due to favorable summer weather. We expect the ROE to decline by year end due to lag associated with the timing of annual filings in the base rate review filed with the PUCT in May. Favorable regulatory treatment has allowed us to file annual DCRF and biennial TCOS filings and recover our cost on distribution and transmission related capital investments, but during a rate review year, there is a lag associated with these filings. In addition, continued high levels of investment and timing of our planned comprehensive rate review, we'll continue to have an impact on ROE in AEP Texas in 2019.

And then the ROE for AEP Transmission Holdco at the end of the third quarter was 11.4%. AEP's Transmission Holdco ROE is higher than second quarter '19, driven by the prior year radial impact adjustment falling off, and by higher revenues due to differences between actual and forecasted revenues in third quarter. Transmission is forecasting a higher ROE than authorized at the end of fiscal 2019, as a result of higher revenues and a prior year favorable true-up.

So, as we look forward to EEI, you can expect AEP to give further updates regarding continued affirmation of our 5% to 7% growth rate, details of capital plans, additional focus on O&M related initiatives, and any further updates on renewables, rate cases and other matters. There is no question AEP continues to fire on all cylinders as we continue our promise of being a premium regulated utility with the consistency in quality of earnings and dividends that our shareholders expect. We reiterate our intention of achieving the higher end of our 5% to 7% growth rate would be disappointed not to achieve it. We believe the foundation is there to achieve just that. As the Doobie Brothers, one of the latest nominees, and it's about time they were a nominee for the Rock Hall of Fame this year, said we got to let the music play what the people need is a way to make them smile. Well, that's what we want for our investors and we intend on letting a great AEP to in play, so listen to the music. Brian?

Brian X. Tierney {BIO 15917272 <GO>}

Thank you, Nick, and good morning, everyone. I will take us through the third quarter and year-to-date financial results, provide some update on load in the economy, review our balance sheet and liquidity, and finish with a preview of what we will present at the EEI conference.

Let's start briefly on Slide 6, which shows the comparison of GAAP to operating earnings for the quarter and year-to-date periods. GAAP earnings for the third quarter were $1.49 per share compared to $1.17 per share in 2018. GAAP earnings through September were $3.58 per share compared to $3.17 per share in 2008. There is a reconciliation of GAAP to operating earnings in the release.

Let's get into the detail on Slide 7, and look at the drivers of quarterly operating earnings by segment. Operating earnings for the third quarter were $1.46 per share or $722 million compared to $1.26 per share or $619 million in 2018. Operating earnings for Vertically Integrated Utilities were $0.89 per share, up $0.18, primarily driven by rate changes, which were favorable by $0.07. Weather was also favorable this quarter, up $0.04 from last year. Smaller impacts for this segment are listed on the slide.

The Transmission and Distribution Utilities segment earned $0.27 per share, down $0.03 from last year. Earnings in this segment declined due to the roll off of legacy riders in Ohio and higher O&M, depreciation and property taxes. These items were partially offset by recovery of the increased transmission investment in ERCOT, weather and rate changes.

The AEP Transmission Holdco segment continued to grow contributing $0.25 per share, an improvement of $0.10 over the last year. This growth reflected the return on incremental rate base as well as the impact of a nonrecurring prior year accounting adjustment. Net plant increased by $1.4 billion, or 18%, since September of last year.

Generation & Marketing earned $0.16 per share, up $0.08 from last year, primarily driven by favorable taxes that will levelize over the year. This segment reflects the growth in the renewables business and favorable wholesale margins.

Corporate and Other was down $0.13, primarily due to tax items that will levelize over the year, as well as higher O&M and interest expense.

Let's turn to Slide 8, and review our year-to-date results. Operating earnings through September were $3.65 per share, or $1.8 billion, compared to $3.23 per share, or $1.6 billion, in 2018. Looking at the earnings drivers by segment, operating earnings for Vertically Integrated Utilities were $1.90 per share, up $0.16, with rate changes being a largest driver in the segment. Other positive items included lower O&M and taxes, as well as higher AFUDC. While weather was favorable compared to normal, it was unfavorable compared to last year subtracting $0.12. Normalized load was also down for the year and depreciation increased due to incremental investment.

Through September the Transmission and Distribution Utilities segment earned $0.85 per share, up $0.07 from last year, influenced by the reversal of the regulatory provision in Ohio. Other favorable drivers included higher rate relief and ERCOT transmission revenue as well as favorable carrying charges in Texas. Partially offsetting these favorable items were the roll off of legacy riders in Ohio, unfavorable weather, higher depreciation of property taxes and O&M. The AEP Transmission Holdco segment contributed $0.82 per share, up $0.25 from last year. This growth in earnings reflected a return on incremental rate base, a favorable annual true-up in FERC settlement, higher AFUDC, and the nonrecurring prior year accounting adjustment. Generation & Marketing produced $0.30 per share. The renewable business grew with the repowering of Trent Mesa and Desert Sky as well as the acquisition of multiple renewable assets. Increases in retail and wholesale margins were partially offset by lower generation sales due to lower energy prices, plant retirements and outages.

Finally, Corporate and Other was down $0.15, driven by higher tax expense, primarily from consolidating tax items that will reverse by year-end with $0.01 relating to prior period tax adjustments. Interest expense was also higher. Overall, we are pleased with our financial results, and are confident in raising and narrowing our annual operating earnings guidance to $4.14 per share to $4.24.

Now let's turn to Slide 9 to provide an update on our system load. Starting in the lower right chart, normalized retail sales were essentially flat for the quarter compared to 2018. This represents a marked improvement from our last quarterly update. Third quarter sales were up at the Transmission and Distribution Utilities and public service company of Oklahoma, while the remaining vertically integrated utilities experienced the decline. For the year-to-date comparison, AEP's normalized retail sales were down 0.6% [ph] from last year. Through September, the growth in residential sales was being offset by the decline in commercial and industrial sales. You will notice that our latest year-end estimate is projecting normalized retail sales will finish the year down 0.5% from 2018. The mix of sales -- of sales growth combined with rate design nuances give us confidence in our 2019 guidance in light of our load outlook. I will cover rate design later in the presentation

Moving to the upper left chart, normalized residential sales increased by 0.7% for the quarter. Customer count growth was responsible for three tenths of a percent increase, while the remaining four tenths was due to improved normalized usage. Third quarter residential sales were up at several of our operating companies with the exceptions of Appalachian Power, I&M and SWEPCO. Year-to-date normalized residential sales increased by 0.2% which was mostly driven by an increase in residential customer count. The uptick in residential sales this year is consistent with recent macroeconomic drivers. Unemployment rates across the AEP service territory are at record lows. Tight labor market has created upward pressure on wages. This has allowed personal incomes to grow faster than inflation through most of 2019. As incomes rise, customers tend to purchase more electricity consuming products.

Moving to the upper right chart normalized commercial sales increased by 0.4% for the quarter. The results varied by operating company, but were strongest in the Transmission and Distribution Utilities segment. Seven of our top 10 commercial sectors posted growth this quarter with the strongest growth coming from the utilities, hospitals and accommodation sectors. Through September, normalized commercial sales were down 0.7% from last year, not surprising the sector that posted the biggest drop in commercial sales was traditional retail. As you can see on this chart, there has been a consistent improvement over the last 12 months in commercial sales growth.

Finally, in the lower left chart, industrial sales decreased by 1.1% for the quarter, which brought the year-to-date comparison to 1.4% below last year. For both periods, industrial sales were down at most operating companies with the exception of PSO, which has experienced double-digit growth from oil and gas activity. We are fortunate to have these sectors in our industrial mix. The impact of the General Motors strike on our load was negligible.

Turning to Slide 10, I'll provide a brief update with respect to industrial sales growth by sector. This chart shows the distinction growth between the oil and gas sectors and all other industrial sectors. Industrial sales to oil and gas industry has increased by 7.8%, which was the strongest growth in these sectors since the first quarter of 2016. This was largely driven by the 16.3% growth in the pipeline transportation sector. Most of the growth in the quarter was a result of a number of anticipated expansions that will address congestion issues coming out of the major shale regions and our service territory. There are still additional oil and gas related expansions in the development pipeline that will provide more growth over the next 18 months. Focusing your attention on the green bars, the non-oil and gas industrial were down for the quarter, but less so than last quarter. For the AEP System, chemicals manufacturing and transportation equipment manufacturing accounted for most of this impact.

Now let's turn to Slide 11 and review the status of our regional economies. As shown in the left chart GDP growth in AEP service territory was 2.4% for the quarter, which is 0.3% above the US. The strongest growth for the quarter came from our Oklahoma service territory. All of our service territories experienced GDP growth for the quarter.

Moving to the right chart, you see that employment growth for the AEP service territory improved this quarter to 0.8% above last year, while US growth moderated slightly in the third quarter. Throughout the AEP footprint nearly 16,000 jobs were added in the third quarter with 42% of those coming from the education and healthcare sector.

Turning to Slide 12, I want to explain a nuance related to customer class rate design. Since 72% of industrial rates across our system are fixed rather than variable, a 1% decline in industrial load is much less impactful than a 1% decline in residential load where 82% of the rate is variable. For your reference, a 1% change in industrial sales is worth about $0.02 per share.

Now let's move on to Slide 13 and review the Company's capitalization and liquidity. Our debt-to-total capital ratio improved slightly during the quarter to 58.7%, our FFO-to-debt ratio was solidly in the BAA1 range at 15.2%, and our net liquidity stood at about $2.6 billion, supported by our revolving credit facility. Our qualified pension funding decreased approximately 2% to 94%, a drop in interest rates increased the pension liability here. OPEB funding decreased approximately 7% to 123%. This was a result of lower interest rates and a new OPEB liability experienced study, both of which increased the OPEB liability.

Let's try and wrap this up on Slide 14 and get to your questions. The strong results we have delivered year-to-date and our confidence in our plan for the remainder of the year allow us to raise and narrow the operating earnings guidance range to $4.14 per share to $4.24. Our message at EEI will be that we are the premium regulated utility delivering 5% to 7% earnings growth with dividends growing in line with earnings. Our plan has line of sight transparency to growth and has greatly reduced execution risk. We will provide detailed drivers for 2020 earnings by segment, an update to our capital expenditure and financing plans.

One final item, we have historically released fourth quarter and full year earnings in January of the subsequent year. In 2020 we will release 2019 full year and fourth quarter earnings in late February, more coincident with the filing of the 2019 10-K. We look forward to seeing many of you in Orland in a couple of weeks. And with that, I will turn the call over to the operator for your questions.

Questions And Answers

Operator

Thank you. (Operator Instructions) And first go to the line of Julian Dumoulin-Smith with Bank of America Merrill Lynch. Please go ahead.

Q - Julien Dumoulin-Smith {BIO 15955666 <GO>}

Hey, good morning and congratulations, guys. So perhaps, if I can go back to some of the commentary from the last call in brief, certainly some variations across the service territory on your sales trends, would be curious how does this position you relative to your broad plans and thought process against the 5% to 7%? Just want to be exceptionally clear as you think about having posted some good results here in the third quarter, and again reaffirming the higher end.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah, there is no change in our thought process. We're still tracking 5% to 7%. We'd be disappointed if we weren't in the upper range of that because, obviously, when you look at the components of load here from a financial perspective, it's not having much impact on our plans. And by the way, we adjust all the time for weather, for all kinds of things, and we have a big opportunity to do that. And I think there is a real opportunity for us to continue to advance, particularly with the renewables play and everything else what's going on. So even without that, though, I think, we're in great shape. So it hasn't changed anything. I think, probably, last quarter, we probably talked almost too much about the load and the industrial side of things. And really, it was nothing compared to what we experienced back in 2009, and we did pretty well weathering that storm. So -- but in this case, I think you're seeing some resiliency there from a industrial and manufacturing standpoint and you're seeing it start to pick up. And from the -- and as we said, it's also interesting to note it's great to have diversity in load because we've got the oil and gas activity that's going gangbusters with the transportation sector and then also you think of what's going on just the consumer side. And everyone is talking about this being a consumer-driven economy and there's no question that people have more money in their pockets and more people have jobs and you're seeing that reflected in the numbers that we see. So, we stand committed to what we've always said before and we fully expect to be in the upper range of that 5% to 7%.

Q - Julien Dumoulin-Smith {BIO 15955666 <GO>}

So, thanks for the clarity there. And then perhaps if I can jump in real quickly, how you are trending on energy supply as you think about it? And you said you might be updating this with respect to EEI. But can you elaborate at least initially on how you're trending on the energy supply side of the business? Obviously there's a number of different moving factors within that segment of the business. Renewables increasing, sort of the legacy stuff declining still. How is that trending altogether, if you can give us a little bit of a sense here, especially again relative to that longer-term 5% to 7%?

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yes. It's going to be up versus what we talked about last year at EEI. But the fact of the matter is as we've sold off some of the competitive generation in the retiring plants, we're replacing some of those earnings with the renewable business that we have. So, it's not declining the way you might expect from the sale of the competitive assets and the retirements, but we filled in some of that gap with the renewables but we don't expect that to be a huge growing business for us going forward.

A - Brian X. Tierney {BIO 15917272 <GO>}

And by the way on the contracted renewable, we continue to do very well in that business. Obviously it's measured with the $2.2 billion of capital that we've allocated to it. The organization there is doing a wonderful job of being judicious about that. Obviously the acquisition that we made was very positive, the development opportunities are significant there and we have some other opportunities that we continue to work on. So, that pipeline can continue as long as we want it to continue and to what extent we want it to continue. But we're able to make that kind of decision regarding that business because we also have a huge transmission business and a growing distribution business. It's huge already, but there's all kinds of opportunities there. So, really our big issue is continuing to manage around a strong and robust balance sheet and continue to deploy the capital.

Q - Julien Dumoulin-Smith {BIO 15955666 <GO>}

Great. I'll leave it there. See you guys soon. Cheers.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Thanks.

Operator

Next we'll go to the line of Steve Fleishman with Wolfe Research. Please go ahead.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Good morning, Steve.

Q - Steve Fleishman {BIO 1512318 <GO>}

Hey, good morning. I'm -- just a -- first a curious question on the growth at FPSO particularly on energy because from an energy standpoint, you would have thought that's been the area where the rig count has come down the most. So, is there a way to kind of make sense of that?

A - Nicholas K. Akins {BIO 15090780 <GO>}

Well, there has been some industrials that -- in place down there and some expansions. And so Oklahoma has a governor down there that is really focused on economic development and I think it's having an impact on the state. We're very happy to see that. There is certainly low rates there and the ability to put these industrials in place. But it's probably a more balanced economy as well.

A - Brian X. Tierney {BIO 15917272 <GO>}

Steve, even what you're seeing with rig count, a lot of the growth that we've seen has been in mid and downstream and a lot of that specifically in pipeline transportation uncongesting a lot of the shale region congestion that's happened over the last several years and it's moving the products and commodities out of those regions.

Q - Steve Fleishman {BIO 1512318 <GO>}

Okay. That makes sense. Thanks. And just I think you kind of answered this, but just the renewables acquisition that you made, can you just give us kind of a flavor of how well that's gone versus pro forma and just how much are you seeing the ability to potentially expand not utility renewables?

A - Brian X. Tierney {BIO 15917272 <GO>}

Yes. So, we're particularly pleased with the performance of that particular acquisition and really in concert with the other development opportunities that we're focused on. But when you think about the acquisition of not only the projects and really the economics was based on the active projects that were ongoing, the developmental opportunities we've hardly placed any value on because we didn't know they would happen. But in fact those have continued to progress quite nicely. So, it really has been an opportunity for us to continue the expansion of that effort. And then you also have to include Santa Rita in that where we've continued to expand from that perspective. So, I think that business is moving along quite well. We're very disciplined in the way we approach it and I think it's paid off.

Q - Steve Fleishman {BIO 1512318 <GO>}

Okay, great. Thank you.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yes.

Operator

Our next question is from Christopher Turner with JPMorgan. Please go ahead.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Good morning.

Q - Christopher Turner {BIO 17669645 <GO>}

Good morning, guys. My first question is just on forward-looking guidance. I guess, one, it sounds like you would not put out a 2021 range at EEI for EPS. And then, two, related to that, can you remind us of the current drivers underlying your 2020 range?

A - Brian X. Tierney {BIO 15917272 <GO>}

Yes. So, we're likely just to focus on 2020 at EEI and reaffirm our 5% to 7% earnings growth rate. Remember that our guidance for 2020 is $4.25 to $4.45 and we're likely to say that that's what it will be again for 2020. And the key drivers are the things that you would think about for a traditional premium regulated utility. It's rate outcomes, ability to invest in our organic regulated businesses, our ability to continue to invest in contracted renewables, and then of course things like weather and load will impact the earnings outlook as well. So, not to forget of course our ability to constrain as we have over many years O&M spending and we're particularly going to be focused on that in 2020.

A - Nicholas K. Akins {BIO 15090780 <GO>}

You're going to hear more about our achieving excellence program that really is focused on a forward view of where our business needs to go and our employees are all energized around it because we have to redefine our sales going forward. And the outcome of that obviously is to be able to deploy more capital, but also to reduce O&M because you are able to deploy capital and be able to optimize and drive efficiencies through automation digitization and all those kinds of things. And so for us it's really a focus on changing that business. And the fact that we're coming out with our guidance for 2020 and then the 5% to 7% growth rate. I think we are comfortable with just doing that because that element consistency is there and we don't expect it to change. I mean you can sort of do your own math. And typically what we've done is when we gone out of the year, we just did the math for you. So, just think of it from that perspective. Now the one thing that could change that is the regulated renewables that are not included in the capital plan. So, you could have a step change and then continue at 5% to 7%. So, that's the kind of thing we're looking at right now.

A - Brian X. Tierney {BIO 15917272 <GO>}

A positive step change.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yes, positive step change.

Q - Christopher Turner {BIO 17669645 <GO>}

Okay. That's good to hear. So it sounds like some of them positive things over the past year that have changed underlying 2020 are potentially curtailed a little bit maybe by load or other factors, but net-net you're pretty much compared to the same place?

A - Brian X. Tierney {BIO 15917272 <GO>}

Oh no, we're not say anything zeal [ph] back in 2020 because, obviously our transmission business continues to do well and other components of our business does well and then the load itself, there is components of that load that's doing really well. And from a financial perspective, load will have not that much of an impact on the earnings of the Company. So, we're not saying that at all. I mean 2020 is supposed to be ahead and then '21 we'll obviously see the outcome of the regulated renewable piece of it and go from there.

Q - Christopher Turner {BIO 17669645 <GO>}

Okay, excellent. And then just given one of your peers in Texas and some of the back and forth in their rate case proceeding. Can you give us an update on kind of the latest in the rate case process and dialog and any thoughts to the overall Texas environment changing?

A - Nicholas K. Akins {BIO 15090780 <GO>}

Well, certainly, Texas is Texas. I mean, there is all kinds of opinions and interveners obviously have their opinions. But when it comes down, too, it's AEP Texas is the transmission and distribution utility. And it's very difficult to disallow costs that are spent from a transmission and a distribution perspective. So that's going to be up to the Texas Commission. And certainly, we have a different pattern than the other one that you referred to. And, every case is different, every company is different, the kind of investments are different. So we feel good about our position in AEP Texas. That's why we continue to invest the way we do. So obviously, we are looking for a positive outcome as a signal to continue investing.

Q - Christopher Turner {BIO 17669645 <GO>}

Okay. Thanks, Nick.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah.

Operator

Next, we are going to Greg Gordon with Evercore ISI. Please go ahead.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Hi, Greg.

Q - Greg Gordon {BIO 1506687 <GO>}

Hey, how are you? Good morning. Great quarter, congrats.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah, thanks.

Q - Greg Gordon {BIO 1506687 <GO>}

What is the fascination down in Texas with the idea of ring-fencing? I know that it's been proposed in both the -- one of your competitor's pending cases as well as staff position is proposing (inaudible). And I'm just wondering what your perspective on that is, and where do you think they're coming from?

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah. It's probably better question for the Commission than for us, but, obviously, during the Oncor proceedings that's where sort of all of this started. And obviously, a company like Oncor, they want to make sure that there were some local type of control. And we are already operating in the state and have been for 100 years. And I think the Commission, obviously, is interested in how much control was placed within Texas around the assets that they feel like that benefit the state of Texas. So I suspect you may see some remnants of that showing up in various cases, but we have been and are operating in Texas for a long time, and that's not going to change.

A - Brian X. Tierney {BIO 15917272 <GO>}

Greg, the thing that's ironic, particularly, given our situation in Texas is that, we are a net investor in Texas, meaning, we are putting debt and equity capital to work in Texas, rather than taking it out. So for us, I think, they wanted to see us continue doing what we've been doing now for years, which is investing that capital in Texas, rather than taking it out, and that's what we are intend to continue doing.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Texas is one of the fastest growing territories that we have, and we're not going to, I mean, we're not going to fall back on our ability to invest and produce benefits for our customers. And East Texas, obviously, it's -- we have direct contact with the customers in the ERCOT portion, it's the T&D. But, certainly, I think that this line is getting more blurred all the time, and that's probably a future that needs to be discussed in Texas about how to deal with that. But nevertheless, that's gone for the strategy part of it in the future.

Q - Greg Gordon {BIO 1506687 <GO>}

Thank you. And one more, I know, it's early days, but what is the sort of -- has there been any public response from intervener groups with regard to the North Central Wind proposal? And do we see a more sort of accepting initial response than we did in your Wind Catcher proposal or is it too early to say?

A - Nicholas K. Akins {BIO 15090780 <GO>}

I'd say it's too early to say at this point. There's nothing public that has been out there. But I will say that, we purposely file this to where it had a lot of variability, a lot of optionally to it, and certainly consistent with the ongoing and existing processes of the integrated resource planning of each one of the areas. And I would say just that fact alone, we've had a more -- at least a more positive reception of how to deal with it. And so I would have to say, things are going reasonably well at this point.

And certainly, the parties involved, no one understands it, because after going through Wind Catcher, this one, you can really talk about what the differences are and the beneficial differences. If they were concerned about transmission, don't be concerned about it. If you are concerned about a large area, just one area of -- don't be concerned about that either. And if you're concerned about dependency on one area versus another, don't worry about that either. So I think our processes and with the procedural schedules already defined in every jurisdiction, we're rolling along to a summer of getting the approvals and moving ahead.

Q - Greg Gordon {BIO 1506687 <GO>}

Fantastic. Thank you, guys.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah. Thanks, Greg.

Operator

And next from the line of Gregg Orrill with UBS. Please go ahead.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Good morning.

Q - Gregg Orrill {BIO 1532939 <GO>}

Yeah. Thank you. Good morning. I was wondering if it's possible to get a preview of the CapEx update at EEI, maybe just -- maybe the drivers and I assume that the backlog would increase?

A - Nicholas K. Akins {BIO 15090780 <GO>}

So I really want to say the detail of that for EEI. But if you've looked at the trends for how we've been spending dollars over the last decade or so, the preponderance of it going to regulated properties and the preponderance of that going to the wire-side of the business. So that trend that you've seen in the past is going to continue in the detail that we're going to release at EEI.

Q - Gregg Orrill {BIO 1532939 <GO>}

Okay, thank you. Look forward to it.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Thanks.

Operator

Next we move to Michael Lapides with Goldman Sachs. Please go ahead.

Q - Michael Lapides {BIO 6317499 <GO>}

Good morning, guys. Congrats on a good quarter.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah. Big game coming up.

Q - Michael Lapides {BIO 6317499 <GO>}

We've got to get a quarterback healthy before we play LSU, (inaudible) Couple of things, one, interest rates, obviously, are way down, especially the long end of the curve. Just curious how you're thinking about what this means for not just pension expenses that flow through the income statement, but also pension contributions.

A - Brian X. Tierney {BIO 15917272 <GO>}

So that's a great question. We plan every year as we go into the year to pay, to contribute through the pensions about equal to our annual service cost. For the last two years, both '19 and '18, we sort of had a funding holiday, and the decrease in interest rates has pushed down our funding a little bit really into the mid '90s for pensions, and still very well over-funded at the

OPEBs, but rates can only go down so much more, I think. And so I think we don't have much downside on the pension fund. Again, we'll be watching every year what our funding is going to be. For next year, we plan on putting in about $100 million with annual service cost. And we still expect the expense side of that equation to be about zero to maybe a slight positive credit.

A - Nicholas K. Akins {BIO 15090780 <GO>}

That's a good thing about being well funded on our pension and OPEB. It gives us a lot of flexibility and really no surprises.

Q - Michael Lapides {BIO 6317499 <GO>}

Got it. And then one follow-up. When you think about the dockets, especially, obviously, PSO in the different SWEPCo states for the North Central Winds process, how do you think this is different than what you went through with Wind Catcher?

A - Nicholas K. Akins {BIO 15090780 <GO>}

I think, Wind Catcher was a unique situation. I mean, we obviously looked at it and thought that it was a great opportunity for all of these jurisdictions. But at the end of the day, there was -- it was a large project in one area with a large generation, interconnect, transmission, whatever you want to call it, and you got to hung up on the risk associated with that, particularly with all the customer savings and trying to figure that out and making sure that everyone was comfortable with that kind of project. I still stand by it, it was a great project. There is no question about it. But we learned from that.

And I think the more you stick with the regular processes of the commissions have had longstanding, I mean, we've had other renewable projects that we've done the same exact process with that have gone through with no problem, we want to refashion this thing to make sure it was what everybody expected to see. And when you look at these projects, there is three different wind farms that are involved with that with the law flexibility on who is in and who is out. And it gives us the ability to not only do that, but also not depend upon additional transmission. So you don't have to focus on that piece of it. And then also for us to be able to look at the project benefits themselves, those benefits are still substantial. So I would say that -- and, of course, the way it worked out in the bidding itself, I can talk about this, but we chose those three projects because they were much better than the others that they were bid from a pricing perspective, but also all three of them happen to be with a party that we have continually done business with on a regular basis. So we're very comfortable with the deliverability of those projects. And we feel confident that the savings that we've presented in the various commission filings are secure, and we're very happy about that.

And then also, part we got hung up a little bit on our own natural gas forecast versus standard natural gas forecast out there. So even though we thought our forecast was a good one, we said, okay, we're going to just use a -- those standard forecasts for the evaluations so that everybody knew that it was coming from an independent party and we wouldn't get into the conversation of your forecast is showing more benefits than another standard forecast. So we did it from that perspective as well.

I think the other big difference too, we did have a lot of outreach to the individual staff and so forth at various commission levels with Wind Catcher to try to explain what it was about. Well, it's sort of a natural progression for us to be able to move to the outreach programs that we have because we've already had substantial discussions of the benefits of wind power in general. Now, it's a matter of, okay, this is what the RFP process says, this is what the wind power that's available, the attractiveness of the wind power, and we're going through the regular process to do it. And that communication has been positive, and we've also communicated with other parties in the process too to let them know what's going on. So I would say that all-in-all, it's been a much better and probably a much more pleasant experience than before.

Q - Michael Lapides {BIO 6317499 <GO>}

Got it. Thank you, Nick. One last thing, tax rates, how should we think about what the consolidated tax rate for income statement reporting purposes is going to be in 2019? What are you assuming in guidance?

A - Brian X. Tierney {BIO 15917272 <GO>}

So for GAAP taxes, we're anticipating about a 2.6% to 3% effective tax rate for the year, obviously driven down by the amortization of the deferred protected and unprotected taxes. But for 2019, there's also an AMT credit carry-forward from prior periods. So that 2.6% to 3% is going to be lower than what we anticipate going forward, where we anticipate a rate after the amortization of the deferred taxes to be about 10% going forward.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Meaning, if I think about 2020 tax rate, in 2021, you're using about 10% for guidance for those years?

A - Brian X. Tierney {BIO 15917272 <GO>}

We are, but, and let me be clear about that. That's what we're using for guidance. That's what's in our numbers. That's what we figure to be around that 10%. If we were to have incremental income because we're maxing to the 75% allowed for the deferred taxes, if we were -- I'm sorry, for the production tax credits. If you were to have incremental income and you were trying to model that in, you should use a 24% rate. Does that make sense?

Q - Michael Lapides {BIO 6317499 <GO>}

I think so, but I can follow-up offline, guys.

A - Brian X. Tierney {BIO 15917272 <GO>}

So let me just try to be clear. What's in our 4.25 to 4.45 guidance for 2020 assumes an effective tax rate of about 10%. If you were to layer in incremental, you would need to use a 24% rate.

Q - Michael Lapides {BIO 6317499 <GO>}

Got it. Understood. So you'd have to -- it has to be a lot of incremental to move the needle on the weighted average?

A - Brian X. Tierney {BIO 15917272 <GO>}

Yes, sir.

Q - Michael Lapides {BIO 6317499 <GO>}

Cool. Thank you, Brian. Much appreciate it guys.

A - Brian X. Tierney {BIO 15917272 <GO>}

Thanks Michael.

Operator

Next we'll go to Angie Storozynski with Macquarie. Please go ahead.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Morning, Angie.

Q - Angie Storozynski {BIO 15115714 <GO>}

Good morning. So two questions. First going back to the oil and gas related sales, so you mentioned pipeline investments, but we're actually hearing that drillers are switching pumps from diesel to electric and that could be a meaningful driver of sales growth for electric companies that serve companies in the shale regions. Are you seeing this?

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah, that's been going on for a while, actually, the conversion to electric. And then also when you look at the transportation fees, there is a lot of activity around ability to get out of the shale gas fields and to get gas out of the shale gas field. So there's a lot of optimization on the transmission side. Brian?

A - Brian X. Tierney {BIO 15917272 <GO>}

Yeah, it's a lot of -- rather than just on the pumping side and pipeline transportation, we're seeing a lot of electric compression.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. And then, to that point, you were showing us that the sensitivity of earnings to changes in industrial sales is actually very low. So O&M, the plan that you get some efficiencies on the

O&M side that you plan to unveil at the EEI, that would be actually a more meaningful earnings driver, is that fair?

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah, I think, one of the key areas we look at is, if we need to deploy capital and reduce O&M, because if you think about load in general -- I think this is for many Utilities, but load in general, you can't have the expectation of ever-increasing energy demand. You got to really think about efficiency, what it means and what it means to the economy. And also, if you assume that, then the way that you continue to grow from a 5% to 7%, which we've confirmed, is not only to deploy capital but to reduce O&M. So it's a -- and that's why we say bending the O&M curve or doing those kinds of activities is going to be a key component in the future, I would say not for us, but -- not just for us, but for just about every utility.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. And lastly, so I understand that the rate-based renewables are not currently embedded in either your CapEx plan or funding needs. Assuming that come mid of next year, you get a green light, at least on that portion of this incremental CapEx, you would probably have incremental equity needs to fund this spending. Would you consider some sort of an optimization of your current portfolio as a way to pay for this CapEx?

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yes, we would. And I think, one of the big process as we have going forward will be around optimization of our balance sheet and capital rotation and capital management, and asset management goes with that. Obviously, it'd be a great opportunity to get the wind power resources, and we will be looking at all kinds of methods to be able to fund that investment.

Q - Angie Storozynski {BIO 15115714 <GO>}

Very good. Thank you.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah. Thank you.

A - Darcy Reese {BIO 20391516 <GO>}

Hey, John, we have time for one more call.

Operator

And that will be from Ali Agha with SunTrust Robinson Humphrey. Please go ahead.

Q - Ali Agha {BIO 1509168 <GO>}

Thank you. Good morning. First question, Brian or Nick, I just wanted to understand the philosophy behind the annual dividend changes. As you mentioned, last year, you moved it up 8%, and I believe that was to get you to the midpoint of your payout ratio. This year, it's gone up 4.5%, perhaps brings you little below that midpoint. So just thinking the lumpiness there, how should we think about the philosophy behind that?

A - Brian X. Tierney {BIO 15917272 <GO>}

Yeah, we're trying to keep it right in the middle of the payout range, and that's what we do this year. You put last year and this year together, it's above the midpoint of our long-term growth rate for earnings. And I think the Board is trying to reward investors by keeping it right in the midpoint of that 60% to 70% stated payout ratio.

A - Nicholas K. Akins {BIO 15090780 <GO>}

It's just unfortunate that we have quarters and years around the annual calendar and stuff like that, but a lot times, you're looking at these -- the dividend side of things, and of course, it's going to move generally in that 5% to 7%. And it's no secret that it's tagged around the 6% range. And we are committed to stay in -- firmly in the middle of that 60% to 70% payout range, but there's a lot of things to consider. We got the same questions when we did it at 8.1% last year. What does that mean? So we're reiterating that it will be in line with our 5% to 7% growth rate, but year-to-year, you see just things that around off on pennies and that kind of thing. There should not be any interpretation that our Board feels any differently about the prospects of growth of this company in the future. And so, we debated that quite a bit because we did want to reaffirm this 5% to 7% growth rate. So don't read anything into it.

Q - Ali Agha {BIO 1509168 <GO>}

Got you. And then last question. With regards to the 2020 range 4.25 to 4.45, I mean that was put out a long time back, I think, last EEI, if I recall, and large has happened. You've got some very good rate case outcomes, Oklahoma, etc. So any thought on that? I mean, and especially, how '19 is turning out that maybe you could move that up, or maybe the upper half or the brand is more comfortable as we sit here today? Any thoughts around that?

A - Brian X. Tierney {BIO 15917272 <GO>}

We're just -- we're going to refresh that at EEI, Ali, but, Nick always says we we'd be disappointed if we weren't in the upper end of the range, and I think that's going to be true. For 2019 and 2020 and ...

A - Nicholas K. Akins {BIO 15090780 <GO>}

Ali, some of these things just sort of have to approve themselves out over time. And we went to 5% to 7% after we sold the unregulated generation, we were at 4% to 6% at that point, because we felt like that 5% to 7% was something that we saw going forward for the long term, and it is a long-term growth rate. So we'll have to see, obviously, we're seeing some positive outcomes, and we continue to see that. The question is, okay, how sustainable is that on a long-term basis going forward based on what we see today. And we're comparable with the 5% to 7%, we're getting more comfortable with the upper ranges of 5% to 7%. But -- before you change to 6% to

8%, or you've asked about 10%, It's -- you have to be able to credibly see that for the long term, and that's something you have to sort of warm over to over time.

Q - Ali Agha {BIO 1509168 <GO>}

Understood. Thank you.

A - Nicholas K. Akins {BIO 15090780 <GO>}

Yeah.

A - Darcy Reese {BIO 20391516 <GO>}

Thank you. Thank you for joining us on today's call. As always, the IR team will be available to answer any additional questions you may have. John, would you please give the replay information.

Operator

Definitely. Ladies and gentlemen, the replay starts today in 11.15 A.M. Eastern. It will last until October 31 at midnight. You may access the replay at any time by dialing 800-475-6701 or 320-365-3844. The access code is 472043. Those numbers again 1800-475-6701 or 320-365-3844. The access code 472043.