Q2 2018 Earnings Call

Company Participants

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

Other Participants

- Chris Morgan, Analyst, Macquarie
- Julien Dumoulin-Smith, Analyst, Bank of America Merrill Lynch
- Richard Verdi, Analyst, Atwater Thornton

Presentation

Operator

Good morning, and welcome to American Water's Second Quarter 2018 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 9th, 2018. US callers may access the audio archive toll-free by dialing 1-877-344-7529. International callers may listen by dialing 1-412-317-0088. The access code for replay is 10122331. The audio webcast will be available on American Water's Investor Relations homepage at ir.amwater.com.

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

Ed Vallejo {BIO 20515524 <GO>}

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

During the course of this conference call, both in our prepared remarks and to address 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 estimates 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 other factors as well as a more detailed analysis of our financials and other important information is provided in the earnings release and in our Form 10-Q filed with the SEC.

Reconciliations for non-GAAP financial information discussed on this conference call, including adjusted earnings per share and our adjusted regulated O&M efficiency ratio, can be found in our earnings release and in the appendix of the slide deck for this call. Also, this slide deck has been posted to our Investor Relations page of our website, and will remain available through September the 2nd, 2018. All statements made during this call related to earnings and earnings per share refer to diluted earnings and earnings per share.

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

Susan Story {BIO 3335156 <GO>}

Thanks, Ed. Good morning everyone and thanks for joining us. Today, our CFO, Linda Sullivan, will cover our second quarter financial results, and COO, Walter Lynch, will give key updates on our operations. The employees of American Water delivered strong results in the second quarter of 2018. We had a number of positive events this quarter, and I will highlight just a few of them.

First, we continue to deliver strong, consistent growth in financial performance. I'll discuss more details in just a moment. Our Regulated business continued to make critically needed investments in infrastructure for safety, reliability, and resiliency. We continue to provide water and wastewater solutions within our service areas through disciplined acquisitions. We also made progress in optimizing our portfolio of Market-Based Businesses. We completed the acquisition of Pivotal Home Solutions, which significantly grew and enhanced our home warranty business.

As we've noted before, Pivotal is a leading provider of home warranty protection products and services, and is highly complementary to our legacy Homeowner Services Group. On July the 5th, we announced the sale of the majority of our Contract Services business to Veolia North America for a purchase price of $27 million. Veolia and we have already closed on 17 of the 23 contracts sold, with the remainder to close by the end of the year. We will keep four separate contracts in Camden, North Brunswick and South Orange, all in New Jersey, as well as Godfrey, Illinois due to their proximity to our existing service areas. Six other contracts, not part of the Veolia transaction, are being sold to others or will terminate within the next 12 months.

Another highlight of the quarter is the selection of American Water to the inaugural NAACP Equity, Inclusion and Empowerment Index. This index was created in partnership with Impact Shares and Morningstar, and tracks and monitors indicators that assess racial equity and inclusion policies among US corporations with a $2 billion or higher market capitalization. We are a values-driven company, and our employees represent the communities we are privileged to serve. This is a real honor for us, as our people take pride in delivering the critical services of water, sanitation, and fire protection to about 14 million Americans in diverse communities throughout the nation.

Lastly, the global settlement related to the Freedom Industries chemical spill in West Virginia has obtained final court approval, and the appeals period has ended. We also settled the one outstanding claim with our last insurance carrier related to this matter. Linda will give you greater detail on the related financials in just a few minutes.

For the sake of our employees, and the communities and customers we're privileged to serve in West Virginia, we're pleased this matter has reached its conclusion. As always, we remain focused on giving all of our customers the best quality product and services possible. In fact, our West Virginia Kanawha Valley water plant won first place this year in the statewide Tap Water Taste Test competition. This is the plant that was affected by the Freedom Industries chemical spill in 2014.

Moving to our financial performance. Our adjusted earnings per share were up 13.7% compared to second quarter 2017. The foundation for our earnings growth continues to be the capital investments we make in our regulated operations. We invested $1.1 billion during the first half of the year with $713 million for our Regulated infrastructure, and $363 million for the purchase of Pivotal. We minimized the customer bill impacts of our infrastructure investments through a continued focus on controlling O&M costs, optimizing capital spend through value engineering and volume procurement, and through constructive regulatory mechanisms. Walter will discuss examples of these in just a few minutes.

We continue to grow our Regulated business. Today, we have welcomed 10,300 new customer connections through closed acquisitions and organic growth. Just as a reminder, we say customer connections because it's more accurate to measure additions by customer meters rather than try to estimate the number of people who live in every house. Typically, and it varies location by location, but on average there are about three or more customers per residential meter. When we at American Water refer to customer additions, we are talking in terms of metered connections. We have an additional 57,000 customer connections under agreement for acquisition. This includes two recently announced additions; one in New Jersey, where we will welcome 3,900 new water customers, and one in Pennsylvania, where we will add another 9,000 new wastewater customers.

We've had two quarters of strong performance in 2018, and are affirming today our 2018 adjusted guidance of $3.22 to $3.32 per share, which excludes the $0.08 insurance settlement benefit related to Freedom Industries. As most of you are aware, it has been our practice for the past several years to narrow or change our annual EPS earnings range following our third quarter results, and we will do so again this year.

American Water will invest $8.4 billion to $9 billion over the next five years with more than $7.2 billion spent to improve our existing infrastructure. We see line of sight to our 32% target O&M efficiency ratio by 2022. Our Regulated operations will continue to be our core business. Under this plan, and normal operating conditions, no new equity will be needed. With this strong performance and our continued execution of strategies, we affirm our long-term EPS CAGR to be in the top half of our 7% to 10% range through 2022.

Walter will now give you his update on our Regulated business.

Walter Lynch {BIO 6064780 <GO>}

Thanks, Susan. Good morning, everyone. As Susan mentioned, our Regulated Businesses had a strong first half of the year, making capital investments to ensure a clean, safe, and reliable water service, while continuing to improve our operating efficiencies to benefit our customers. We also had tremendous growth driven by acquisitions.

Let me start on slide nine with an update on our New Jersey rate case. We filed this case last September, seeking recovery of more than $868 million in infrastructure upgrades statewide since our last rate adjustment in 2015. We concluded evidentiary hearings on June 25th, and are now in the briefing phase of the proceeding. We expect a final decision in the first quarter of 2019. Also effective April 1st of this year, New Jersey American Water customers received a rate decrease of almost 6% as a result of the lower federal tax rates under the Tax Cuts and Jobs Act.

Moving to California, we now expect both a proposed and final decision later this year on our general rate case for 2018 to 2020. If approved, this case will support approximately $230 million of capital investments in our systems. We also expect the California Public Utility Commission to approve, in September, the Certificate of Public Convenience and Necessity for our water supply project in Monterey. This action, as we discussed in the first quarter, will give us the authority to move forward with this critical water supply project.

In June, Maryland American Water filed a petition with the Maryland Public Service Commission seeking recovery of approximately $18 million in capital investments since our last rate adjustment in 2015. The driver of this case is a new reservoir and intake that will secure the water supply for our customers in Bel Air and parts of Harford County. The reservoir, which cost approximately $15.4 million, is $6.3 million less than originally planned due to our value engineering approach, and the tremendous team working on this water supply solution.

On the legislative front, two bills were recently signed in Missouri that benefit communities and water and wastewater customers. The first bill allows the state's Public Service Commission to approve a Revenue Stabilization Mechanism or RSM for water utilities. An RSM aligns the conservation goals of the state, customers, and water providers, while helping to ensure the water utilities achieve their authorized revenue requirement as established by the Public Service Commission.

The second bill changes the public vote requirement for the sale of a municipal water or wastewater system to a simple majority for towns with populations of less than 3,000. Historically in Missouri, smaller communities need a two-third majority. This new legislation increases the options for small towns, and we stand ready to assist. Also during the quarter, in Iowa, legislation passed that allows private water utilities to use a future test year approach in rate cases. This will decrease potential regulatory lag and help spread out the time between rate cases.

We've also made constructive progress in our other regulatory jurisdictions on the Tax Cuts and Jobs Act. We've had four states revise their state income tax rates. Linda will talk about these in more detail in a few minutes.

Recently in New York, we're working through a self-reported issue concerning a property tax error, which resulted in an overpayment to local taxing authorities, and ultimately affected about 4,500 customer bills. We're working with the Public Service Commission leaders and staff as well as other stakeholders to ensure that the issue is resolved constructively to the benefit of everyone involved.

Turning to slide 10, we had a 5,600 new customer connections to date, and have another 57,000 customer connections through signed agreements in addition to the 4,700 we added through organic growth. Most recently in July, New Jersey American Water announced an agreement to acquire the Roxbury Water Company that provides water service to nearly 3,900 customer connections in Morris County, New Jersey. Following regulatory approval, we expect to close this acquisition in early 2019.

In June, Pennsylvania American Water signed an agreement to acquire the wastewater assets of Exeter Township in Berks County, which serves approximately 9,000 wastewater customer connections. We provide water service to about 70% of the township's residents, and we're excited to be the future provider of wastewater service for the entire town. We expect to close this transaction by the end of the first quarter of 2019 pending regulatory approvals. These agreements represent our continued focus on a regional approach to water and wastewater service, which expands our customer base, increases operational efficiency, and economies of scale, while keeping rates affordable for our customers.

Moving on to slide 11, doing right by our customers is key to our ability to grow. This means smart investments balanced by efficient operations and capital deployment. In the first six months, we invested $713 million in our Regulated operations. This investment is critical to ensure reliable service, but for us, it's also about affordable service. We continue to make progress towards our long-term O&M efficiency goal of 32% by 2022. And to put this into perspective, our adjusted O&M expenses are less today than they were in 2012. And during that same period, we invested more than $7.2 billion in our infrastructure, and added more than 150,000 customer connections.

Let me give you two examples of how our employees are driving these results. Starting in 2017, we expanded the use of drones to perform visual inspections of our above-ground water tanks. This is a safer and faster way to visually inspect tanks while providing more detailed information. We can now perform about 150 visual inspections of above-ground water tanks in six months, when it once took us four years to complete this work. We've also developed software that uses artificial intelligence to analyze thousands of images and millions of data points per day to detect deteriorating tank coating. This allows us to manage our tank maintenance program more proactively and efficiently, and again, it's a much safer way to conduct this work.

Our technology and innovation group is also developing a series of physical and digital solutions to detect and respond to water quality events in surface water supplies. The advanced systems include an artificial intelligence smart sensor network that can detect a range of contaminants. We'll complete this program in phases, and eventually these sensors will tie into our operations and initiate treatment protocol. We're very excited about this project and what it can mean for our entire industry.

Lastly, the chemicals PFOS and PFOA have made a lot of headlines of late when it comes to water quality. New Jersey has set the nation's toughest PFOA limit to date. I'm pleased to say that we've proactively addressed this contaminant and are in compliance. I also want to commend New Jersey's leaders for their commitment to addressing this water quality concern.

As a final point, we're pleased to announce that we reached a national benefits agreement with our 3,200 employees who are a part of 17 national unions and represent 69 contracts. Every five years, we negotiate national benefits with our represented employees. These negotiations were marked by collaboration, professionalism, and respect. Some of the highlights include making all of our employees eligible for our annual performance plan and providing our employees more options to decide what benefit plans make best sense for them and their families. We look forward to our continued partnership in doing what's best for our employees.

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

Linda Sullivan {BIO 7300156 <GO>}

Thank you, Walter, and good morning everyone . Before I jump into the numbers, I would like to provide a few key updates that occurred during the second quarter, on slide 14. First, I am pleased to announce that S&P affirmed our A credit rating with a stable outlook, which is a reflection of our strong commitment to maintaining a predominantly regulated risk profile. Second, we closed the Pivotal acquisition for $363 million on June 4th, and we fully settled our equity forward agreement issuing 2.32 million shares for $183 million or approximately 50% of the purchase price. And lastly, as Susan mentioned, we received final approval by the US District Court of the Freedom Industries related settlement. We also settled this quarter with the final outstanding insurer for a $20 million pre-tax benefit that was reflected as a non-GAAP adjustment consistent with all other elements of the settlement. In total, West Virginia American Water's final share of the $126 million Freedom Industries related settlement net of insurance recoveries was $23 million pre-tax.

As reflected on slide 15, we had a strong second quarter of 2018. GAAP earnings were $0.91 per share, an increase of $0.18 compared to the same period last year. Excluding the insurance settlement, adjusted earnings were $0.83 per share, an increase of $0.10 or 13.7% over the same period in 2017. The Regulated segment was up $0.08 per share and the Market-Based Businesses were up $0.02.

Now, let me walk through the adjusted quarterly results by each business. Regulated operations were up $0.08 per share in total. Net revenue was down $0.01 with three primary drivers. First, we had a $0.14 increase from additional authorized revenue and surcharges to support infrastructure investments, acquisitions, and organic growth. Second, we had warmer weather resulting in a benefit of $0.01 per share, and these positives were more than offset by the $0.16 impact of the lower federal tax rate expected to benefit customers. Next, O&M expense increased $0.05 and depreciation increased $0.02, mainly to support regulated acquisition and investment growth. Also, our income tax expense was favorable $0.16 mainly from the lower federal tax rate.

Turning to the Market-Based Businesses, the $0.02 increase was mainly from our Homeowner Services Group due to operational efficiencies from improved cost management, customer growth, and the favorable impact of the lower federal tax rate. This part -- the partial month of Pivotal's earnings were offset by expected integration costs. So a strong quarter for our Homeowner Services Group.

Turning to slide 16, our first half adjusted earnings through June 30th, 2018 were $1.42 per share or a 12.7% increase over the same period last year. Our Regulated operations increased $0.13 per share from investment and acquisition growth. Our Market-Based Businesses increased $0.05 primarily from Homeowner Services. Our Military Services Group was flat as operational improvements offset the impact from lower capital upgrades awarded by the Department of Defense in the first half of this year, and Keystone's first half results were accretive, aided by strong revenues from an active market, especially in water transfer. And then finally, the parent decreased $0.02, mainly from the lower tax shield on interest expense.

Turning to slide 17, let me provide an update on tax-related matters. We are making steady progress in our 14 regulatory jurisdictions on the best approach to return tax reform benefits back to our customers. The top part of this slide updates the status by state for both the tax rate change and amortization of the remeasured accumulated deferred income taxes.

Turning to state tax changes, on the bottom half of this page, we had three states pass legislation during the second quarter that reduced future state income tax rate. For each state, we expect the impact of the lower state income tax rate to benefit our regulated customers, as calculated on a standalone basis. Any difference between the amount determined on a standalone basis in each state and the actual tax expense based on state tax apportionment factors are recorded at the parent company. And during the second quarter, we recorded a $3 million cumulative non-cash charge to earnings at the parent for state tax apportionment.

In addition, New Jersey passed legislation increasing the corporate business tax rates in the third quarter, and we are in the process of determining the impact of this change on both our New Jersey subsidiary and the parent company, and expect to have an update in the third quarter.

Turning to slide 18, let me provide an update on our regulatory filings. We have $110 million in annualized new revenues effective since January 1st of this year. This includes $95 million from the Pennsylvania and Missouri rate case settlements, and $15 million from infrastructure mechanisms. We have also filed requests and are awaiting final orders on four rate cases and one infrastructure surcharge for a total annualized revenue request of $169 million.

Turning to slide 19. Today, we are affirming our 2018 earnings guidance to an adjusted range of $3.22 to $3.32 per share. This excludes the $0.08 insurance benefit for the Freedom Industries related settlement.

We had a strong first half this year, and looking forward, we have several items outstanding that we expect to firm up during the third quarter. First, as I mentioned, we are in the process of quantifying the impact from the increase in the corporate business tax rate in New Jersey. We also performed a preliminary assessment of our purchase price allocation for Pivotal, and are working through the appropriate amortization of intangible assets, which we now expect to be a bit more front-end loaded in 2018 than originally anticipated. And while we have one year to complete the purchase price accounting, we expect to be substantially complete in the third quarter. Also, we expect a lease termination cost of up to $5 million as we move into our new headquarters building in Camden later this year from four separate office locations.

And lastly, as you know, the third quarter is typically our largest net income quarter and is the quarter with the largest potential earnings variability from weather. And as a reminder, we consider plus or minus $0.07 of weather to be normal annual weather variability that is included in our guidance range. So a lot of puts and takes expected in the last half of the year, and we are confident in our adjusted guidance range and will update as appropriate in the third quarter as we typically do.

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

Susan Story {BIO 3335156 <GO>}

Thanks, Linda. American Water's stated purpose is to keep life flowing, and that means for our customers, our communities, and our planet. We also have five values that we measure ourselves by, and those are safety, trust, environmental leadership, teamwork, and high performance. Living by these values actually constitutes a full 50% of our employee performance plan and individual employee ratings.

These values match up nicely with the goals of our investors interested in ESG principles and measures. We agree that the hows are just as important as the whats. While we have always focused on ESG principles as the way we should run our business, we have not done a good job communicating our efforts as well as we should have. You told us you wanted to hear more. So you will. Following the third quarter, we will share quarterly updates on ESG metrics that are important to our company and our investors. We look forward to your feedback on these.

We know that being a good corporate citizen, an environmental leader, and a role model for sustainability, is more than metrics or a communication campaign. It's ensuring that we leave our children and grandchildren a healthy planet and the natural resources that we enjoy today. It means developing solutions to issues before they become problems. It means keeping our employees and our customers safe from harm. It's providing a workplace where every employee is respected and developed to his or her fullest potential. It means building strong communities where we serve, and meeting and exceeding the expectations of our customers. So we close with a snapshot of just some of the things that others outside of our company are saying about our efforts.

With that, we're happy to take your questions.

Questions And Answers

Operator

We will now begin the question-and-answer session. (Operator Instructions) Our first question comes from Julien Dumoulin-Smith with BoA Merrill Lynch. Please go ahead.

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

Hey, good morning, everyone.

A - Susan Story {BIO 3335156 <GO>}

Good morning.

A - Linda Sullivan {BIO 7300156 <GO>}

Good morning.

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

Hey. So a couple of quick follow-ups, if we can. Just to start off on New Jersey, I'm curious on the state income tax for -- on the corporate side. Why would it not flow back to Regulated customers, just given especially the commentary in the other jurisdictions that you have in the slides here?

A - Linda Sullivan {BIO 7300156 <GO>}

So we are working through that right now in terms of how that will affect our New Jersey subsidiary and the parent company allocation. And so as you are aware, we are currently in a general rate case in New Jersey, and so we're working through how that increase in the corporate business tax rate would impact our customers.

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

Right. Completely understood, but broadly speaking, you should think about this principally as a parent level impact?

A - Linda Sullivan {BIO 7300156 <GO>}

Right, and we also have a corporate headquarters that is located in New Jersey, which will impact that calculation as well. And so we're going through all of the detailed calculations from a state tax apportionment perspective. We're also working through some clarifications either through administratively or through legislation to make sure that we understand the complexity of how this will apply to water utilities.

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

Understood. Excellent. Turning back to the Market-Based side of the business, if you can, just curious how is the sort of the Keystone water side of the business going year-to-date just given some of the trends there. And then separately, can you just talk to a little bit more of the sales side of the equation, the Veolia deal in the context of sort of pruning the business? Is the thought process here that this is more opportunistic or should we expect more as you think about the aggregate size of the Market-Based Business and kind of bumping up against that 15% pro forma?

A - Susan Story {BIO 3335156 <GO>}

Julien, that's a great question. So I will take Keystone first and then talk about the sale of the ESG, and then more broadly our views and philosophy around the Market-Based Businesses. So in the Keystone in the Appalachian Basin, we are continuing to see a firm market, a strong year for revenues. As Linda said, through the first half of the year, it is accretive. For example, our two biggest businesses in Keystone water transfer, we have steady work continuing, we're continuing to try to hire more employees. Rig count has slightly decreased for the past few months, and so we're looking at that, but we're still seeing robust activity there. And in the oil and gas construction for pipelines, we're seeing consistent bid opportunities, increased infrastructure planning for 2018 and 2019. So in terms of the business there, as you know, there are a lot of takeaway pipeline capacities that are still under construction that will be very helpful for the Appalachian Basin compared to Henry Hub, as you are very aware of. So Keystone continues to be in a good market, and we continue to monitor the market there, and look at our main businesses and how we optimize those businesses.

In terms of how -- the CSG sale, we've mentioned in the past that our Contract Services Group -- and to remind everyone, this is where we run systems for other people where municipalities or industrials actually maintain the assets, we run the business. It's a much more competitive business. There are a lot more players in the market like Veolia, Suez, different people. And as we look at our Market-Based segment and started looking at buying Pivotal, the growth of Homeowner Services, how well Homeowner is doing, and your earlier point about ensuring that Market-Based is predominantly 15% or less of our portfolio through 2022, we've mentioned before that it could get up to 20%, but we were very clear that would have to be very Regulated like, and currently about the only business in Market-Based that we see that would fit that profile is more -- is the Military Services Group.

So, as we looked at the business and the focus on that business, and the time and effort to run it, we thought that Veolia could actually run that business better than we could, and we reached an agreement with them to buy the majority of the contracts. We -- there are 10 that they did not buy; four of them we're keeping because they're in proximity to our service areas, and there is very strong community relationships there. The others -- four of the others, there are other buyers who had first rights in many cases, and two of them will terminate in the next 12 months. So this is an effort to, as you say, prune the Market-Based Businesses.

And I've kind of alluded to then the general philosophy, which is at our core, we are a regulated utility. When we tell you and tell the Street that we want to keep that part of the business at 15% or less, and we grow parts of the business, we of course will always look and say, so what are the parts that we think further leverage the core competencies that we have as a water and wastewater company.

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

Got it. Excellent. And then lastly, can I turn quickly to Missouri? You obviously alluded to legislation there in your prepared remarks. How does that change the strategy? I mean, obviously you've had some success of late in the settlement there. Does that require any kind of enabling subsequent rate case here or how do we see that actualize the latest legislation?

A - Walter Lynch {BIO 6064780 <GO>}

Yes. As far as the RSM goes, that would be applicable on the next rate case, and as far as the growth -- the legislation that deals with the vote of half -- simple majority instead of two-thirds, it's really just allowing us to have more discussions with municipalities throughout Missouri, and particularly some of the smaller municipalities that had a really high threshold as far as the vote count. So we just think it's more in keeping with the rest of Missouri and the rest of the country, and it enables us to have many more discussions with some of the smaller municipalities.

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

All right. Excellent I'll leave it there. Thank you all very much.

A - Susan Story {BIO 3335156 <GO>}

Thanks, Julien.

Operator

Our next question comes from Chris Morgan with Macquarie. Please go ahead.

Q - Chris Morgan {BIO 20451303 <GO>}

Hi, everyone. Thank you. My questions have been asked and answered. Appreciate it.

A - Susan Story {BIO 3335156 <GO>}

Thank you, Chris.

Operator

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

Q - Richard Verdi {BIO 15139674 <GO>}

Hi, good morning everyone, and thank you for taking my call, and also a great quarter too. Great on the report and on the other news delivered.

A - Susan Story {BIO 3335156 <GO>}

Thanks, Rich.

Q - Richard Verdi {BIO 15139674 <GO>}

I just have two quick questions regarding the acquisition front. Obviously American is the most operationally diverse water utility, and it helps -- won against unfavorable weather conditions or regulatory impact, but despite that operational diversity, I was wondering if there are any states outside of that current American Water footprint that the company maybe consider entering to the acquisitions?

A - Susan Story {BIO 3335156 <GO>}

So Rich, that's a great question. As a company, of course, our growth projections we give, the five year based on growth within our service area, we do have a corporate business development group. We are always looking across the country, at other states, opportunities, but as I think we have mentioned before, we have three kind of gates before we would look at going into a new state. The first one is looking at the regulatory environment, the second one is the business environment or business climate, and the third one tends to be the one that is the most difficult, which is, do we see a line of sight to get to at least 50,000 customers within five years.

Why that's important to us, you hear Walter and Linda talk all the time about the O&M efficiency. We're very proud of the chart we put up that showed that our O&M costs, the adjusted that's used in the calculation for O&M efficiency, and we have a reconciliation table in the appendix, but that calculation, our O&M costs are less today than they were in 2012. Our reputation, being able to do investment that's desperately needed in systems, is dependent on being able to also help offset a portion of those impacts to customer bills by reducing O&M costs.

What we find is if we don't have enough customers to get a critical mass, then we're not able to make the investments, we're not able to get some of the economies of scale. So we find that that third element of ensuring that we can grow to about 50,000 customers in five years tends to be the one that is our biggest hurdle. So with that said, we are always looking at every state in the nation, we are always looking at opportunities, and we're always looking at a chance to grow and to provide our expertise to as many people across the country as we can.

Q - Richard Verdi {BIO 15139674 <GO>}

That's great color. Thank you for that, Susan. And for the second question, I was just wondering if the company is seeing any municipal acquisition competition from the electric utilities. And if so, how that might be impacting the acquisition effort?

A - Susan Story {BIO 3335156 <GO>}

That's a great question, Rich. So again, for water investor-owned utilities, I think that of course the answer is yes. And predominantly Eversource, with their acquisition of Aquarion, and I'm sure that all of you were keeping up with what's going on with the merger between San Jose, Connecticut Water, and then Eversource's bid for Connecticut Water and Cal Water's bid for San Jose. So I think that's the main thing that we're seeing.

And again, outside of that, as we look at our strategy of buying municipalities that are between 3,000, 5,000 and 30,000, those are relatively small for someone to break into an industry. They also typically are in areas contiguous to where we're already located. We have named brands in those areas, we have people and communities. So for that area, we don't see as much because, first of all, these acquisitions of distressed municipalities take, as Walter showed in his slides, years to cultivate relationships because when municipalities are buying, yes, price is a big deal, but they also want to make sure that their citizens have the best service possible and are taken care of, and that they don't have to worry about emerging contaminants, and that they have professionals running the system. So what we find is for that particular market that we focus on, it's more difficult for someone who is not in our industry to break into that.

Q - Richard Verdi {BIO 15139674 <GO>}

Okay, great. Thank you, Susan. And actually I have one other question too, and it pertains to the military front. By our estimates, that's a pretty large opportunity and the majority of those contracts should be awarded between kind of next year and maybe 2025. And so I was just wondering if you could give us an update on the military basin that's -- on the military-based contract ops in the sense of, is that more focused on pursuing new opportunities or is it -- are you guys more focused on kind of pruning and improving the bases you have under the umbrella right now? I mean, are you guys going out and actively looking for new bases to bring underneath the American umbrella?

A - Susan Story {BIO 3335156 <GO>}

That's a great question, Rich. And the answer is, yes, we are. And so to back up for those that may not be quite as familiar, when you buy a base, there is typically work that goes on. It's mostly -- it's working capital predominantly. Then we have an operating -- once you win a base, you have a 50-year contract to operate on that base water and wastewater. Then, as you mentioned, it is buying new bases or doing capital upgrades on the bases.

The reason that we've seen the Military Group, for us, over the past two, three years be a little soft is because of that third category. When the Department of Defense went through three or four years of sequestration, their budget decreased significantly. They didn't have as much money for fixed capital upgrades for infrastructure. The money they did have, they put in more of the war fighter training and those areas. With sequestration lifted a year or so ago, we're starting to see a little more flow. It will take a bit of time for that to kind of trickle down to providing money for the infrastructure once they've met the other needs.

But you're exactly right that we have, I think, eight RFPs outstanding for bases. There is a chance that three will actually be awarded this year, and we see the rest of them being awarded over the next three to four years. As you said, we also -- there are two to three that we're looking at putting in RFPs. And to remind you, we typically only focus on the medium to larger-sized bases. Those are the ones that are worth more of our effort with our size, and that tends to be $250 million or higher for a 50-year contract value. So yes, we do see opportunity specifically in the Army and the Air Force. And we actually, last November, hired a new president of our Military Services Group, General David Turner, who had recently retired as a General from the Army. And so we're very bullish on that part of our business. We like that it is regulated like, and we do, as you mentioned, see opportunity down the road for that.

Q - Richard Verdi {BIO 15139674 <GO>}

That's excellent color. Thank you very much, Susan. I appreciate it. Great quarter again. I appreciate the time. Thank you.

A - Susan Story {BIO 3335156 <GO>}

Thanks, Rich.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Susan Story for any closing remarks.

A - Susan Story {BIO 3335156 <GO>}

Thank you, Brandon. And thank you all for participating in our call today. Again, please note we value you as our Investor owners and as the financial analysts who research our company for the benefit of your clients and their futures. We always want to be open and transparent in our discussions and dealings with you, so you can have confidence in your decisions around our company and your investments in our stock. If we've not been able to address your questions or you think of something later, please call Ed and Ralph and they will be happy to help. Thanks again for listening.

Operator

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