Q4 2017 Earnings Call

Company Participants

- Edward D. Vallejo, Vice President, Investor Relations
- Linda G. Sullivan, Chief Financial Officer & Executive Vice President
- Susan N. Story, President, Chief Executive Officer & Director
- Walter Lynch, Executive Vice President and Chief Operating Officer

Other Participants

- Angie Storozynski, Analyst, Macquarie Capital (USA), Inc.
- Benjamin Joseph Kallo, Analyst, Robert W. Baird & Co., Inc.
- Jonathan Reeder, Analyst, Wells Fargo Securities LLC
- Julien Dumoulin-Smith, Analyst, Bank of America Merrill Lynch
- Michael Lapides, Analyst, Goldman Sachs & Co. LLC
- Richard A. Verdi, Analyst, Atwater Thornton LLC
- Ryan M. Connors, Analyst, Boenning & Scattergood, Inc.
- Shahriar Pourreza, Analyst, Guggenheim Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to American Water's 2017 Fourth Quarter and Year-End 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 February 28, 2018. U.S. callers may access the audio archive toll free by dialing 1-877-344-7529. International callers may listen by dialing 1-412-317-0088. The access code for replay is 10116315. The online webcast will be available at American Water's Investor Relations homepage at ir.amwater.com.

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

Edward D. Vallejo {BIO 16076814 <GO>}

Thank you, Anita, and good morning, everyone. 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 open the call for your questions.

Now, during the course of this conference call, both in our prepared remarks and in answers to your questions, we may make forward-looking statements that represent our expectations regarding our future performance or other future events. These statements are predictions based upon our current expectations, estimates, and assumptions. However, as these statements deal with future events, they are subject to numerous known and unknown risks, uncertainties, and other factors that may cause actual results to be materially different from the results indicated or implied by such statements.

Additional information regarding these risks, uncertainties, and factors as well as a more detailed analysis of our financials and other important information is provided in the earnings release in our December 31, 2017, Form 10-K, each as filed with the SEC. Reconciliations for non-GAAP financial information discussed on this conference call, including adjusted income, adjusted earnings per share, adjusted return on equity, 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 webpage. All statements in 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 N. Story {BIO 3335156 <GO>}

Thanks, Ed. Good morning, everyone, and thanks for joining us. After my opening comments today, our CFO, Linda Sullivan, will cover our fourth quarter and year-end 2017 results, tax reform impacts, and our 2018 guidance and long-term outlook. Our COO, Walter Lynch, will then give key updates on our Regulated operations.

While there continues to be volatility in the market, our fundamental story remains the same. The vast majority of our business is regulated, and our capital plan is critical to addressing ongoing infrastructure challenges. There are lots of national conversations about the urgent need to invest in water and wastewater in the U.S., a topic emphasized in the administration's recently released infrastructure plan. Every year, our country loses about 2 trillion gallons of treated water through more than 240,000 main breaks, with an economic cost in the billions of dollars. And about 900 billion gallons of untreated sewage is discharged into our rivers and streams every year, further stressing our environment, water quality, and communities.

Addressing these infrastructure issues is compounded by fragmented industry, with approximately 53,000 water and 17,000 wastewater systems, the majority of which are run by small to medium-sized municipalities with multiple competing critical needs for their investment dollars. American Water will invest $8 billion to $8.6 billion over the next five years, with more than $7.2 billion spent to improve our existing systems. Additionally, the lower federal tax rate, which Linda will cover in more detail, means we can make these capital investments without increasing customers' bills as much. We will always make needed investment to ensure safe and reliable water services, which are critical to human life and healthy communities. But we are constantly mindful of what our customers must pay for those services.

Our portfolio of market-based businesses provides strong growth by leveraging our core competencies, using little to no capital, and generating healthy cash flows. The successful execution of our strategies has enabled us to achieve a five-year total shareholder return of 275% with a 29% TSR in 2017. Today, we are affirming our 7% to 10% long-term EPS growth and our 2018 EPS guidance range of $3.22 to $3.32 per share, the same that we provided to you in December.

Our conservative financial approach has resulted in our current A credit rating and strong balance sheet, providing us optionality going forward under tax reform. We continue to pursue efficiencies in O&M and capital deployment to further ensure that our decades of investment needs are affordable for our customers.

From a capital project risk standpoint, we're different from most utilities, who focus on just a few large projects per year for the majority of their capital spend. Our annual capital is spent on around 500 discrete investment projects per year, along with 2,500 smaller and more routine capital efforts. In 2018, the spend is projected to be $1.4 billion to $1.5 billion. And these investment projects are planned for multiple years out, so if issues arise, which could cause delays, we simply move that project into a future year and pull forward other projects, which are already in the queue.

Given our size and scale as the nation's largest water utility, we benefit from our geographic diversity, reducing both regulatory and weather risks to earnings. And this is further enhanced by our small, but important portfolio of Market-Based Businesses. All of our efforts are driven by our commitment to our customers, communities, and those who invest in us.

For the fifth year in a row, our Board of Directors approved a quarterly dividend increase that is at the top end of our 7% to 10% EPS CAGR. But none of our results matter if we don't operate in the right way. For us, the hows are just as important as the whats. We know this matters to you, too, because companies do well by also doing good.

Our efforts in the environmental, social responsibility and governance arenas are recognized, most recently, by Barron's, which named us 36th out of their 100 most sustainable companies. Of course, none of our achievements would be possible without the 6,800 people, who are American Water. When sustained subzero temperatures in late December and early January resulted in over 1,000 main breaks in the Midwest and Northeast, our folks were working 24 hours a day to ensure that our customers had the precious resource of water at their faucets as well as critical fire protection and sanitation services.

We've been in business for 132 years, and we want to be in business for at least that many more years. We have succeeded through world wars, market ups and downs, company ownership changes, technology disruptions, and the full continuum of political and regulatory policy. Experience matters, history matters, and that's why we're confident in our business and growth for the future.

With that, I'll turn it over to Linda.

Linda G. Sullivan {BIO 7300156 <GO>}

Thank you, Susan, and good morning, everyone. Today, I will cover our fourth quarter and annual results, followed by a discussion of the impact of tax reform on 2017 and on our five-year plan, and conclude with 2018 and five-year earnings guidance.

Let me start with our fourth quarter and full-year 2017 results on slide 7. Excluding the impacts of tax reform, we had a very strong fourth quarter. We reported adjusted earnings of $0.69 per share, an increase of $0.12 or 21% over the fourth quarter of 2016. Our Regulated Businesses were up $0.11, our Market-Based businesses were up $0.01, and the parent was flat to prior year.

GAAP earnings, which were negative $0.01 per share, included a $0.70 charge from the re-measurement of deferred taxes to the new 21% tax rate under the Tax Cuts and Jobs Act. I will discuss the key elements of this charge in more detail in a moment.

For the full year, our adjusted earnings were $3.03 per share, which is at the midpoint of our narrowed earnings guidance range set forth in both December and January. And as you know, we had some challenges to overcome in 2017, including tax-related changes in several of our states and lower capital upgrades in our Military Services Group. Despite those challenges, our teams across the company delivered, and just like they have consistently done. For the year, GAAP earnings were $2.38 per share, which includes adjustments for the positive insurance settlement related to the Freedom Industries chemical spill, the early debt extinguishment charge at the parent, and the impact of tax reform.

Turning to slide 8, let me walk through our adjusted quarterly earnings by business. Our Regulated operations were up $0.11 per share in total. Revenue was up $0.06 from infrastructure investments and regulated acquisitions, net of lower demand or declining usage of about 1%. Weather negatively impacted the quarterly comparison by $0.01 per share, as fourth quarter 2016 had drought conditions in the northern part of New Jersey, resulting in higher bulk water sales.

Also, in the fourth quarter, we had favorable O&M expense of $0.02 per share mainly from higher O&M expenses in the fourth quarter of 2016 due to timing. Finally, higher depreciation and interest expense related to investment growth was more than offset by approval of a new depreciation study in Illinois, which reduced full-year 2017 depreciation by $16 million.

Turning to our Market-Based Businesses, we were up $0.01 compared to the same period last year. The majority of this increase was in Homeowner Services from customer growth and price increases, offset slightly by lower capital projects in the Military Services Group.

Turning to slide 9. Our full-year adjusted earnings were up $0.19 per share or a 6.7% increase over adjusted earnings in the same period last year. Our Regulated operations were up $0.23 in total, driven primarily by infrastructure investment, regulated acquisitions, and organic growth. Also, we had warmer and drier weather in 2016, which negatively impacted year-over-year earnings by $0.05 per share. Depreciation, interest, and taxes were higher by $0.06 per share from investment growth, partially offset by the new depreciation rates authorized in Illinois.

Our Market-Based Businesses were up $0.02, with AWE coming in $0.01 favorable to the prior year, as growth in Homeowner Services exceeded the impact from lower capital upgrades in our Military Services Group. And Keystone was favorable $0.01 to prior year as market conditions continue to improve. Parent and other were down $0.06, mainly from the two discrete tax adjustments associated with legislative changes in New York and Illinois, impacting state tax apportionment, as well as higher interest expense to support growth.

Let me now turn to the impact from tax reform on slide 10. As you all know, there are a lot of moving parts on tax reform, both with the numerous judgments and interpretations from the changes in law and how our different regulatory jurisdictions will handle the implications. We will continue to monitor the impact of additional interpretations or guidance on these judgments.

For American Water, the most important takeaway from tax reform is that over the next five years, our fundamental investment strategy does not change. We continue to see a 7% to 10% long-term compound annual growth rate in EPS, and our EPS CAGR with tax reform is accretive or even stronger than our plan before tax reform. We expect to continue to invest capital of $8 billion to $8.6 billion over the next five years, with the majority focused on the much-needed infrastructure investments for our customers.

We expect to continue to help make our Regulated customers' bills affordable by focusing on O&M and capital efficiency. We expect to continue to grow our complementary capital-light and cash-flow-positive Market-Based Businesses. We expect to maintain our guidance to grow our dividend at the high end of our long-term EPS compound annual growth rate of 7% to 10%. And we do not plan to issue additional equity under the normal operating conditions expected with this plan, so our fundamentals stay the same.

Now, what changes? There are two primary items. First, we expect our customer bills to benefit from the impact of tax reform, which for us helps make our much needed capital investments more affordable. Second, similar to other utilities, as we return the benefit of a lower tax rate back to our customers, we expect lower cash flow. And with the loss of bonus depreciation, we expect to become a cash tax payer sooner than in our prior plan, which is why Moody's put us, along with 23 other utilities, on negative outlook.

So, you may ask given the expectation of lower cash flow, why do we think we can execute on our five-year plan without impacting capital, dividends, or equity? And the answer is because we start from a position of strength. We have a very strong balance sheet. We are A-rated by S&P and A3 by Moody's which gives us optionality. And we continue to believe we will have a strong balance sheet under the plan, even though we expect our FFO to debt metrics to drift lower as we return the tax rate benefits to our customers and pay cash taxes sooner.

It's also important to note that we are working closely with our regulatory jurisdictions to determine the best approach for our customers, which I'll talk more about in a moment. So, all that said, the bottom line is that we are starting from a position of balance sheet strength, and net-net, we believe tax reform will be good for both our customers and our shareholders.

Now, let me dig into the details a bit. I'll start with how tax reform impacted our 2017 income statement and balance sheet on slide 11. As I mentioned earlier, on the income statement, we had a $0.70 or $125 million charge in 2017 related to tax reform. This one-time noncash charge was the result of re-measuring our deferred taxes from the 35% federal rate to the new 21% rate. This re-measurement was required to be recorded when the new tax law was enacted, therefore, it impacted 2017 earnings. The largest portion of this adjustment was from federal net operating losses recorded at the parent company, as well as adjustments to deferred taxes for items currently not recoverable through regulated customer rates.

For the balance sheet, our Regulated Businesses are required to normalize the impact of the change in the federal tax rate, or said another way, they're required to return that benefit to customers over the average remaining life of our assets, which is currently estimated at approximately 50 years, 5-0, which is specific to the longer life of water and wastewater assets in our industry. The re-measurement resulted in a $1.5 billion net reduction to deferred taxes on the balance sheet.

Looking forward, the impact of tax reform on our business is summarized on slide 12. There are three major technical areas that impact us, and we have shown directionally how they are expected to affect earnings and cash flow. And as you can see, overall, tax reform is expected to be positive to earnings over time and negative to cash flow.

Let me walk briefly through each area. First, the change in the tax rate from 35% to 21%. We expect the change in tax rates to be accretive to long-term earnings and negative to cash flow. For earnings, the lower tax rate will benefit our customers, so that impact is expected to be earnings neutral. However, we do expect rate base in our Regulated Businesses to increase over time as a result of having lower deferred tax liabilities, which offset rate base.

There are three primary drivers of lower deferred tax liabilities. First, we will have a lower federal tax rate on new investments. Second, we will normalize or give back to customers the re-measured deferred taxes over the remaining life of the assets. And third, we are no longer eligible for bonus depreciation going forward.

For our Market-Based Businesses, the lower tax rate is expected to increase earnings. However, we do expect the majority of our Military Service contracts to true-up over time. Partially offsetting these increases is the impact of a lower tax shield on parent company interest expense and higher debt levels due to the lower cash flow from operations through 2022.

From a cash perspective, the lower tax rates will result in lower Regulated revenue under cost of service ratemaking. Although this lower revenue will be earnings neutral, it will negatively impact cash flow as we currently have a net operating loss for federal tax purposes. We will see a cash benefit from lower taxes at the Market-Based Businesses, but this is offset by the lower tax shield on interest expense at the parent company.

Next, interest expense deductions and bonus depreciation. Utilities received a carve out that allowed us to preserve the ability to deduct interest in exchange for foregoing bonus depreciation. At the parent, we expect the majority of the interest expense to be allocable to our Regulated operations and fully deductible for tax purposes. And with our Market-Based Businesses being capital-light, the allocated interest is expected to be well below the 30% limitation. And that is why we show the interest deduction as neutral to both earnings and cash flow. As I mentioned earlier, the loss of bonus depreciation will increase rate base and earnings over time, but will decrease cash flow and is expected to accelerate when we become a full cash taxpayer from 2021 to 2020.

Now, let me quantify some of the major impacts I directionally discussed. Let me start with the impact on earnings on the left side of slide 13. For the Regulated Businesses, rate base is expected to increase 1 full percentage point over our prior plan to a compound annual growth rate in the range of 7.5% to 8.5% post tax reform. Because the earnings from our Market-Based Businesses are at about the same level as the interest expense of the parent company, the increase from the lower tax rate in our Market-Based Businesses is expected to offset the loss in the tax shield on interest at the parent. However, lower cash flow will result in an additional debt and interest expense drag at the parent. In total, over time, the earnings benefit at the Regulated and Market-Based Businesses are expected to largely outpace the additional drag at the parent company.

On the cash flow side, we expect lower cash flow of about $500 million over the next five years compared to our pre-tax-reform plan. You can see that the estimated impact is larger in the beginning years especially in 2020, when we become a full cash taxpayer, but that impact declines over time as we grow rate base. Now, the actual impact will be largely dependent upon the outcome of our regulatory proceedings regarding tax reform. With this lower cash flow, we expect about $500 million of additional debt at the parent to support our growth over the next five years, which could increase our long-term debt-to-cap level to a range of about 61.5% to 62.5% in 2022 after tax reform.

Moving to slide 14. The forecast we are providing you today are based on the expectations of reasonable regulatory outcomes and customer impacts, which will be determined by the various regulatory proceedings. And all of our State Commissions have opened formal proceedings or dockets related to changes in the tax law, or we have open rate cases. And we have begun to work with regulators to determine how best to provide the tax savings to our customers.

We are currently considering several options with our various Commissions that will moderate rate and cash flow impacts. Some of the discussions with regulators include consolidation of customer rate impacts with general rate case proceedings; offsetting of capital investment needs and regulatory assets to address customer rate impact; deferral of rate proceeding; rate reduction; or a combination of these items.

The outcome of these proceedings will likely take some time, and we have to keep in mind that each state will look at the infrastructure needs and customer bills in a different way. And we are glad our regulators are trying to find a win-win in conversations with us. And this is so important for our customers and the local communities we serve, as we continue to invest in our infrastructure and create jobs in our local communities.

Turning to slide 15 and looking forward to 2018, we are today affirming our 2018 earnings guidance range of $3.22 to $3.32 per share. In terms of the tax reform impact on 2018, in our Regulated Businesses, we do not expect significant near-term changes in earnings, as the decrease in the tax rate is expected to flow back to customers and is earnings neutral. However, in our Market-Based Businesses, we do expect a positive impact from the lower tax rate that will be offset by the lower tax shield in interest expense of the parent. The major variables included in our guidance range are consistent with what we've shown you before with plus or minus $0.07 of weather, or what we consider to be normal weather variability, being the most significant. Events or variations outside of these ranges could cause our results to differ.

Turning to slide 16. In our long-term financial plan, as I mentioned earlier, we do not expect our fundamental investment strategy to change. We are affirming our 7% to 10% long-term compound annual growth rate in EPS, while investing capital in the range of $8 billion to $8.6 billion, mainly for our customers. Our strong balance sheet provides flexibility to overcome challenges of tax reform, and we do not see a need to issue additional equity under normal operating conditions.

We've been a top leader in dividend growth for five consecutive years. We've had dividend growth at or above 10%, and we expect to grow our dividend over the next five years at the top of our 7% to 10% EPS growth range, subject to board approval. Also, we continue to target a dividend payout ratio of 50% to 60% of earnings.

With that, I'll turn the call over to Walter to talk about the Regulated Businesses.

Walter Lynch {BIO 6064780 <GO>}

Thanks, Linda. Good morning, everyone. Our Regulated Businesses had a strong year all around, with historic capital investment and record levels in employee safety, strategic acquisitions, and continued O&M efficiency gains that benefit our customers.

Let's walk through some of the regulatory highlights, starting with Pennsylvania. The Pennsylvania Public Utility Commission unanimously approved the rate settlement in December, with new rates going into effect on January 1. The settlement resulted in an increase of approximately $62 million in annual revenue, driven by approximately $1.3 billion of investments made since our last rate case in 2013. Our calculated ROE for this black box settlement is 10%.

This constructive settlement balances our customers' interest with much-needed investments, including the replacement of nearly 450 miles of aging pipe, valves, service lines, and hydrants. This substantial investment, balanced by our commitment to cost management, means the average family pays about $2 for a day's worth of cooking, bathing, cleaning, and drinking water.

In New Jersey, we filed a rate case last September, seeking recovery of $868 million in infrastructure upgrades, made in less than three years since our last rate adjustment in 2015. This includes the replacement of more than 200 miles of aging water mains, which is in compliance with the new replacement rate criteria of New Jersey's recently approved Water Quality Accountability Act. In fact, New Jersey American Water has had a better replacement rate than required by the new law for several years.

In Missouri, we filed a rate case last June, requesting an increase of $84 million in annual revenue, driven by more than $490 million in investment our systems. Settlement discussions have begun with evidentiary hearings to begin next week. A decision could come late April or early May.

In California, we filed our cost of capital application last April. It was submitted for consideration in the fall, with a proposed decision issued earlier this month. The proposed decision must be on record for 30 days before the Commission considers it. At that time, they may support, reject, or modify.

We've reviewed the decision and intend to file comments next week. We're concerned that the proposed decisions, recommendation in ROE does not reflect current market conditions, like interest rates, inflation and tax reform. It also makes an assumption that ROE is guaranteed by the water revenue adjustment mechanism, which is not accurate. This will be reflected in our comments, and we'll keep you updated as the process moves forward. Finally, as Linda mentioned, our states are currently assessing the impact of tax reform. We're working closely with our local commissions as each of our states have different circumstances and needs. We want to ensure we get to the right outcome for everyone.

Moving to growth, we had another great year. We added 15,000 customers through organic growth in our existing service areas, the highest organic growth in many years. Through pending and closed acquisitions, we'll add approximately 63,000 customers in our Regulated Businesses. You can see here that we have 16 pending acquisitions in multiple states. This growth across our footprint really speaks to the local solutions we're able to offer in neighboring communities.

In 2017, we closed 19 acquisitions in nine states adding about 40,000 customers. This includes our newest wastewater customers in McKeesport, Pennsylvania. We completed an acquisition last December, and we're pleased to welcome 22,000 new customers, as well as the new employees, who joined our Pennsylvania American Water team. This acquisition has been highlighted in several venues as a model of public and private sectors working together to address wastewater challenges.

Turning to slide 20, doing right by our customers is key to our ability to grow. This means smart investments balanced by efficient operations and capital deployment. We invested more total capital in 2017 than in any other year, with $1.4 billion going into our Regulated operations. This is critical to reliable service, but it's also about affordable service.

As you know, we measure our operating efficiency using the O&M efficiency ratio. With tax reform, we expect that metric to increase to 34.9% in 2018 due to reduced operating revenues. For comparison purposes, we've included pre-tax-reform and post-tax-reform numbers. As you can see, we've made great progress since 2010 due to our continued commitment to our customers and our culture of continuous improvement, which is why we expect to meet our 32% O&M efficiency target by 2022.

Let me give you two examples of the many initiatives we have at American Water to improve operating efficiency. We have a highly trained asset reliability team that conducts assessments at critical facilities across our footprint. Using specialized instruments, these teams predict and correct minor issues, preventing major issues from occurring. Just last year, through their assessments, they identified and corrected about 200 minor issues, resulting in $400,000 of avoided repair costs.

In New Jersey, our operations team is using acoustic monitoring to find and fix leaks before they lead to main breaks. This water-saving technology uses sound waves to locate leaks and has already provided savings up to $1.9 million in the first two years and an estimated 1.7 million gallons of water per day. Remember, every $1 we save in expenses, we can invest $8 in capital, with no impact to customer bills. That's what drives our commitment to our O&M target.

Additionally, we reinforce our operational efficiency efforts by also focusing on capital efficiency, leveraging technology and using our scale and size to achieve savings to our supply chain. We understand that driving capital efficiency allows us to do more with the same amount of money. In summary, it was a great year of growth, smart investment, and engaged employees, driving efficiencies and quality results, all to benefit our customers.

With that, I'll now turn the call back over to Susan.

Susan N. Story {BIO 3335156 <GO>}

Thank you, Walter. Before I turn the call over for questions, I do want to speak just a couple of minutes about the administration's infrastructure proposal, which was recently released. We're encouraged that the administration and Congress are working to address the pressing need to upgrade our nation's infrastructure, including the systems that provide critical water and wastewater services. Companies like American Water play an important role working together with the public sector as the needs are too great for any one sector to tackle alone. We're very pleased that the proposal seeks to level the playing field for private and public providers of these critical services.

There are several positive proposals in the plan, including the removal of caps on tax-exempt private activity bonds, as well as making Clean Water State Revolving Fund loans available to private wastewater utilities. The plan encourages partnerships between private and public providers with incentives for smarter ways of investing in critical upgrade. And while this infrastructure plan is just a proposal, the fact is that the Tax Cuts and Job Reform Act (sic) [Tax Cuts and Jobs Act] is actually an infrastructure package for us. It doesn't change our strategy or operating plan, but we'll be able to invest more with less impact to our bills. And that's good news for our customers and our regulators. American Water looks forward to continuing to be part of the infrastructure conversation and working with the administration and Congress as they address the nation's infrastructure challenges.

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

Q&A

Operator

We will now begin the question-and-answer session. The first question today comes from Shahr Pourreza with Guggenheim Partners. Please go ahead.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Good morning, guys.

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

Good morning, Shahr.

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

Good morning.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

So, just two questions. First, there's obviously been a lot of analysis on tax reform. And so, much of the focus is centered on cash flow metrics, like FFO to debt. In light of you guys not needing any equity and looking at debt to sort of offset the near-term cash drag from tax reform, can we talk a little bit about what other metrics the agencies could be looking at, especially, as we think about the water industry? I mean, I have to imagine that looking at cash flow metrics in isolation sort of misses the bigger picture especially in this industry.

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

Yeah. Shahr, this is Linda. And you're right, there has been a real heavy focus on FFO to debt metrics for utilities due to the lower cash flow from the loss of bonus depreciation, the passing back of the tax benefits to customers, and especially for those that are in a federal net operating loss position like us.

And you're right, FFO to debt is an important element of our rating. It represents 12.5% of our rating under Moody's methodology. But it is also important to note that the largest component of our rating is based on our business risk profile, which generally represents about half of our rating. And the business risk profile is based on a more qualitative risk specific to the water industry and to the unique size and scale of American water.

So, for example, the types of things that are looked at there are items such as the absolute essential service of providing water; the smooth deployment of our small capital projects, like Susan talked about earlier; and the regulatory environment across our diverse 14 jurisdictions that really support our ability to grow, to invest, and to generate cash flow going forward. So, this strong business risk profile is not changing with tax reform.

The other thing that's really important to note is that the business risk profile of the water industry and American Water is unique to us. So, our FFO to debt metrics generally will fall in a broader range than what you see with other utilities. So, a strict comparison of the numbers of FFO to debt with other utilities is really not a good comparison.

So, Shahr, all of that said, as I mentioned in my comments, with tax reform, we do expect our FFO to debt metrics to drift lower. And we very carefully evaluated the right mix of capital investment needed for our customers, dividends for our shareholders, and that we believe we'll be able to carry the tax reform impacts without issuing additional equity. So, the trade-off is a lower FFO to debt ratio. And our starting point, as I mentioned, is a very strong balance sheet that provided us with that optionality as we work through the appropriate mix.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Got it. That's super helpful. And then just want to touch a little bit on your growth rate. You have no dilution, obviously, from incremental equity. You have very minimal regulatory or structural lag, and what seems to be fairly perpetual growth opportunities and a very healthy step-up in rate base. So, how are you sort of thinking about where growth should fall kind of within this range, especially, as the benefit of tax reform sort of lands within your outlook, so mainly focused on your 5% to 7% regulated growth outlook?

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

So, in our growth triangle, we continue to see the bottom part of the triangle as 5% to 7% for rate-based growth. We also see 1% to 2% for regulated acquisitions. And both of those together really kind of translate to what we showed on our rate-based growth chart.

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

And, Shahr, this is Susan. We tend not to be a company that gets too far ahead ourselves and speculate what we want to see as let's give time for everything to settle in before we start looking at changing anything. We want to feel confident and comfortable that our plan, which we have presented at the 7% to 10%, is still the best guess we have in terms of the best estimates and projections we have for the next five years.

So, what you won't see is us going back and forth based on any type of trends or initial analysis, but the points you brought up are good. We will continue to evaluate all market trends. We'll continue to evaluate our balance sheet and our growth opportunities to determine the best projections for our five-year plan.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Understood. Congrats, guys, and terrific results.

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

Thanks, Shahr.

Operator

The next question comes from Julien Dumoulin-Smith with Bank of America Merrill Lynch. Please go ahead.

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

Hey. Good morning. Congratulations.

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

Thanks, Julien.

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

Hey. So, wanted to follow a little bit up on Shahr's questions. Two-fold on the tax reform question. First, on the regulatory front, what are you embedding in the context of your slide, you showed some CFO impacts? And can you touch on some of the regulatory efforts in the key states, say, Pennsylvania, New Jersey, Missouri, for instance, just on what the game plan is there, vis-à-vis returning the funds to customers, or otherwise seeking accelerated investment to depreciation?

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

Yeah. And we are working – as you know, we have 14 regulatory jurisdictions. We're working through with those regulators in terms of how to best pass the benefits back to customers and continue to invest in a much needed infrastructure. And so, as you know, we have currently three open rate case proceedings in New Jersey, California, and Missouri. So, we're having discussions in those proceedings. We're also working across our jurisdictions, where everyone has really opened some type of a tax proceeding. And so, we're working to determine what is the best approach. And I went through some of those strategies on the call.

I don't know, Walter, if you want to add a little bit more to the specific states?

A - Walter Lynch {BIO 6064780 <GO>}

Yeah, again, as Linda said, we're in rate proceedings obviously in New Jersey, and California, and Missouri, and we're incorporating these discussions in those rate case proceedings. It's a great discussion. We're open with the committee. We're very happy that the commissions are open to discussing these issues as part of the rate filings. And then, as Linda said, in the other proceedings, we're working through with the commissions to say, we want to mitigate the impact on customers, give back what we can. But then as we invest, we want to make sure that it's smoothing out. So, with that, I think we're having good discussions across our footprint.

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

And with those discussions, Julien, we put forward on slide 13 the cash flow impacts that are expected using reasonable judgments. And so, we looked at what do we think are the reasonable judgments from a regulatory perspective; what are some of the cash flow strategies that we can deploy across the company? And we wanted to be very transparent to put it there by year.

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

And, Julien, interestingly, each of our states are in a little bit different situation. I mean, for example, I mentioned, we actually had about 1,400 main breaks in the frigid temperatures in late-December and January. So, that goes into our investment planning. Where we've had flooding, where you have natural disasters, we're putting a lot of focus on our critical assets and resiliency plans.

When you look at Indiana, for example, in Gary, Indiana, there are a lot of lower-income customer-owned lead service lines. So, each state has some similarities, but each state also has its own issue in terms of investment needs as well as the ability to be able to continue to have these affordable rates, while we increase our investment. So, each state President, as Walter said, we're very much a local company, and each state President and each state staff is working very closely to determine what that specific state's needs are and finding a way forward that works for everybody.

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

Got it. Excellent. And then, just coming back to the FFO to debt question, I know that there's been a lot of focus on it. Can you just give us a little bit more of a quantification of where you stand relative to where the agencies want to see you, just, again, just broad brush where you kind of end up through the plan?

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

Yeah, Julien. So, our cash flow from operations remains robust. Moody's just issued their report and published an FFO the debt metric of 17%, covering 12 months ended in September. And we believe the FFO to debt metric continues to remain strong throughout the remainder of 2017.

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

Through the remainder of 2017, you said?

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

Yeah. Yeah.

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

Got it. All right. Excellent. Thank you.

Operator

The next question comes from Ben Kallo with Baird. Please go ahead.

Q - Benjamin Joseph Kallo

Hey, you all. Thanks for taking my question. Can we just comes back on California, the cost capital proposal, and then maybe draw on what we saw with other types of utilities and their cost of capital in California? What do you think that means going forward to water utilities in California? And then, do you think that there's a spillover, or this is a precedent in other jurisdictions? And then, I'll have a follow-up question, please.

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

Yeah. Absolutely. So, the decision was an administrative law judge proposed decision, so not a final decision, as Walter mentioned, we have 30 days before the Commission considers it, and we they can support, reject, or modify it. We will be filing comments next week. We are concerned that the ROE does not reflect the current market conditions like interest rates, company's risk profile, et cetera. And we will include those items in our comments back to the Commission. And I think reasonable jurisdictions across the country were not seeing anywhere near those proposals. And I think there is an understanding of the need to have – attract capital to invest in the much-needed water and wastewater infrastructure across the nation.

Q - Benjamin Joseph Kallo

And I guess on that point is my second question. You guys mentioned infrastructure plan, and it comes up in conversations, but could you just talk about maybe one or two things – and I know it's early and you all change a lot, but one or two things that actually have (00:44:32) for the water utility industry.

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

Yeah. So this is Susan, Ben. So, we were actually a little bit surprised at just how much focus there actually was on water and wastewater, and a few things. So, PricewaterhouseCoopers actually came out with a report about six months ago that said that $60 billion to $80 billion of additional private investment could be leased if a few things happened.

Interestingly, there were five things they listed. Two of those five I mentioned in my comments, which is one thing people may not understand is state revolving funds that tend to have the least expensive financing cost. We're able to take advantage of those in several of our states, but only for drinking water. The Clean Water Drinking Act state revolving fund which is wastewater, it would not allow private. This particular proposal now would allow us to be able to access the state revolving funds, which have a lower financing cost. That's one. The WIFIA which is the Water Infrastructure and Finance Act (sic) [Water Infrastructure Finance and Innovation Act], it basically also allows for privates to be able to pay in financing debts tied to the Treasury yield without an upcharge, so that would expand the ability to do that.

A couple of things, too, that we're seeing that will be part of this is half of the $200 billion that the administration says is going to leverage the $1.5 trillion, over half of that is for projects, and only 20% of the project costs can come from federal. So, local areas, private companies or municipalities will have to find funding for the other 80% of that. We think that's very positive. As well as the fact that the issue of workforce development and looking at things like permitting reform to allow projects to go forward more quickly, we think those are all positive things that will benefit, not just the entire industry, but specifically, American Water.

Q - Benjamin Joseph Kallo

Got it. Thank you, Susan.

Operator

The next question comes from Ryan Connors with Boenning & Scattergood. Please go ahead.

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

Great. Thank you. Good morning.

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

Good morning, Ryan.

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

I wanted to – it's understandable, because the tax reform is such an important issue, but it definitely does seem there's less focus this quarter on the acquisition, M&A -municipal M&A pipeline. So, I just wanted to get more of an update there on the pipeline, especially in key states like Pennsylvania, where you've had so much success the last couple of years, and now with the Act 12 in. And just want to kind of get a little more detailed update on the deal environment and the cadence of the inquiry activity and that sort of thing.

A - Walter Lynch {BIO 6064780 <GO>}

Yeah, Ryan. This is Walter. I'll take that question. The opportunities are robust throughout our pipeline. We've spent a lot of time working on legislation to enable the acquisitions. Our teams are focused on it. The municipal sector, many of them were having a lot of issues that monetizing the assets would really solve their situation, so we're in discussions.

We have, as I said before, about 330,000 customer opportunities in our pipeline across our footprint, and that's up from 145,000 this time last year. So, we have a robust pipeline, we're working through in each of our states. And I can't comment at any one deal that's not public yet, but we are working very hard to meet the 1% to 2% growth of 30,000 to 60,000 customers. And I feel confident we're going to get there.

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

Okay. And in terms of – I know you can't comment on specific deals. But in terms of the general themes that are coming up on those discussions, I mean, are there certain recurring themes that are preventing things from moving ahead in a number of cases, or is it just kind of a real case-by-case aspect? I mean, any comment threads you can let us in on in terms of how those discussions move ahead or don't move ahead?

A - Walter Lynch {BIO 6064780 <GO>}

Yeah. No overall themes, it's really in a case-by-case basis. And again, we feel very good about our pipeline, about the size of the deals. Our focus again has been 3,000 to 30,000 customers, and we feel like we're going to execute on that very favorably over the next five years.

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

And, Ryan, this is an area where our geographical diversity also helps. I mean, you mentioned about Pennsylvania, but the fact is we've got numerous states where we have opportunities and that's part of this significant pipeline we have, which is we're in 16 states, we have 14 regulatory jurisdictions, much easier to grow from a grassroots where we're in the communities, we live there. So, what we're seeing is more states that we see more activity in. So, we think that's a very big positive.

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

Got it. Okay. And then just to revisit this. I don't want to beat the dead horse, so to speak, but on the tax impact, and then the various PUCs looking at how to address that issue and opening discussions on that. Just to be clear, from a modeling standpoint, obviously, the earnings impact is neutral to positive. But from a revenue standpoint, I mean, just to be clear, logically, we're talking about a potential revenue requirement reduction, at least in some cases. I mean, is that logically – that's the way to think about it, correct?

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

Yes, it is. That's correct.

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

Okay. Okay. Okay, great. Thanks for your time.

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

Thank you.

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

Thanks.

Operator

The next question comes Angie Storozynski with Macquarie. Please go ahead.

Q - Angie Storozynski {BIO 15115714 <GO>}

Thank you. I'm sorry to go back to the tax question. So, when you show us the projections of the likely degradation of the operating cash flow, I mean, how does it compare to what the credit agencies saw back in January when they put you on the negative credit watch? Because at least, versus our expectations, it seems like the reduction and the FFO was a bit lower. I mean, basically, the hit is lower than we had expected.

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

Yeah. And when Moody's put us on the negative outlook – as you know, they put us on with 23 other companies. And so, didn't really do a deep dive into our financials. It was really more about us being in a net operating loss position. And so, we are having meetings with our rating agencies. We're continuing to work through this, but they were not kind of reviewing all of these details as part of that particular analysis.

So, we'll continue to work with them. And what we wanted to do here is really be transparent that from our prior plan to this plan with tax reform, this is our estimate of the potential tax impact on cash flow over that five-year period, with the key being that you can see it's kind of higher in the earlier years, and then as rate base continues to grow, it lessens.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. And given that the earnings mix plays such a role in your credit ratings, I mean, are you having, for instance, any second thoughts about the growth in the Market-Based operations in light of this – with this tax reform, just mostly, just to attempt to manage some of the duration and the FFO to debt through maybe some change in the earnings mix?

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

Yeah. So, when we look at the earnings mix going forward, remember that under tax reform, the Regulated Business is growing and the Market-Based Business is growing. That's being offset somewhat by the additional drag at the parent company. But the earnings mix is still roughly 90/10.

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

Yeah, and Angie, we have no plans, at this point, to change strategically our outlook for Regulated versus Market-Based.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. And my last question. So, the infrastructure plan, as you, Susan, pointed out yourself, it actually did cover quite a bit of water-related investments. And so, are the municipalities, basically, even more hopeful that they will get some help from the federal government, and as such, that could further delay any municipal M&A?

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

Well, one thing that was missing from the infrastructure proposal, there are not large pots of federal money, free federal money. Basically, it's $200 billion to leverage $1.5 trillion, and except for about $50 billion that's set aside for rural infrastructure block grants which also was expanded to include broadband, really the amount of money – half of that $200 billion, $100 billion, is basically 20% of a project, and the municipality has to find a way to finance 80%.

Then you've got some of the block grants that have to include broadband, transportation, and water for $50 billion. Then you've got expanding the federal loan programs that we all have access to. But then again, a municipality has to ensure it has bonding capacity that it's able to do. And then beyond that, you've got about 10% – 7% to 10% that was dedicated for what the administration refers to as transformative projects, like Elon Musk's Hyperloop on transportation. So, what you don't see here are huge amounts of free federal funding that people can access.

Q - Angie Storozynski {BIO 15115714 <GO>}

Okay. Thank you.

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

Thanks, Angie.

Operator

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

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

Hi. Good morning, everyone, and thank you for taking my call, and super all-around quarter here.

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

Thank you, Rich.

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

I have a quick question regarding Keystone. On the last call, it sounded like American was guiding to rather flat earnings growth there in 2018. However, on the last call, I had mentioned that if you sift through the filings since American acquired Keystone, the customer base has more than doubled; rig count is up, let's call it, 10 rigs in the past 10 months; and all of the energy companies that I used to follow were sifting through their transcripts, listening to their calls, are citing that the Marcellus, it's heating up.

I mean just yesterday Hi-Crush said that they're expecting a meaningful increase in shipments to the Marcellus, which means you're going to see much more frac sand there, which means you're going to see much higher water needs. You're going to need to clean it, deliver it, et cetera. So, I'm wondering if you could give us an update on Keystone for 2018, because in my eyes, right now, it looks like that's going to be much stronger than what American guided to just a few months ago.

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

Well, Rich, one of the things we did cover is that year-over-year Keystone was $0.01 up from 2016, so we were very encouraged to see that. And it didn't show up in the fourth quarter, because the market started picking up in the fourth quarter of 2016. However, you're correct, we currently have about 300 employees. We're looking to hire another 100. The margins are a little less than they were before the market went down, but we're still continuing to grow our percent of the market. There's a lot of big projects underway this year, and we feel very good about the business this year. We think it is going to be a strong business this year.

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

Okay. Great. Thank you. And then, just one other question and it pertain to the Military Group and the idea that the contracts will true-up on tax reform. I understand under the price re-determination, I can understand how this might be the case. But with economic price adjustments, I mean, the concept there is contractual. And very simply put, the idea is if the water utility spent too much, then they would have to eat it.

But at the same time, when the water utility get the benefit and eat a benefit of tax reform, I guess, everything I'm hearing is pointing to American's going to keep that. And you guys are – seem to be the only ones – and I don't know if it's a conservative approach, but I'm kind of having a hard time understanding how you guys see that passing through.

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

Sure. So Rich, when you understand price redetermination, so on the positive side, and this helps make it regulated-like, there are three instances that the Department of Defense says that they will true-up your original bid. And you're right, if you make a bad O&M bid, and it doesn't fall into these categories, you live with the results. And one of those is do you have a law change.

For example, if there is a change that requires more environmental monitoring, then we actually can get more money for that. We also look at inflation and the O&M contracts get adjusted for inflation. And the third component is if we put another capital project. For example, if we build another wastewater facility and operation costs go up or down, it gets trued up. So, understanding that's the definition of price redetermination.

So what you have now is that the DLA and the DoD has not come in and said, where they see the tax reform falling into. So, yes, we are very conservative. One way you can review and you can interpret what that price re-determination definition is, is that tax reform was the law, and thus, we would basically give back that money over a period of time, just like we would gain if there was a law passed that increased our cost.

So, that's been our position. I know that not everyone shares that. We're not sure what – they have not basically given – they, the DoD, has not given guidance. But the way we're modeling it is in the most conservative nature. So, if they come back and say, gee, we are going to let you keep a portion of this, then it would just be upside for us. But we feel more comfortable modeling the way we have it based on our interpretation of the caveats under price redetermination.

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

Understood. Got it. Okay. Hey, I appreciate the time. Thank you very much, guys. And congrats, again, on the great all around quarter.

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

Thanks, Rich.

Operator

The next question comes from Michael Lapides with Goldman Sachs. Please go ahead.

Q - Michael Lapides {BIO 6317499 <GO>}

Hey, Susan.

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

Hey, Mike.

Q - Michael Lapides {BIO 6317499 <GO>}

Big picture question, just curious how you're thinking about larger scale M&A in a world where tax reform maybe impacts you less than some of your peers, in a world where you're trading at a mid-20s PE multiple, and at a time when you've got one of the best balance sheets in the business?

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

Well, thank you, Michael. Wow, I wish we had used some of your words on our call. But in terms of how we look at it, when we look at our growth triangle, we don't assume any large acquisitions, we just don't. That 1% to 2% of acquisitions are these – the tuck-ins or the ones in our state, they're very ground up, grassroots up, happen in the local communities.

However, we also do have a corporate strategy group, and we are always looking at the landscape. We are always looking at other water companies. We are always looking at large municipalities. We have mentioned to our investors before, as we look at whether we grow in our existing states or a new state. If we look at going into new state, we look at three factors. We look at the business climate, the regulatory climate, and do we see a way to get to 50,000 customers in five years, because otherwise, our efficiency model doesn't work, and we can't ensure that we have affordable value-added rates for our customers, and that we can leverage our size, scope and scale.

So, the answer is, we're always looking. However, we are also very disciplined in how we look. And we don't believe that you get too in love with any type of deal or that you chase a deal that could be to the detriment of the overall long-term performance of the company. So, we'll continue to look, monitor, and where we see opportunities, we'll pursue them.

Q - Michael Lapides {BIO 6317499 <GO>}

And do you see the opportunity set as being changed at all via tax reform?

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

That's a really interesting question. I think that the water space is so limited, and that you look at that – and I'm not sure, I don't think any of us understand now how all of this is going to shake out in the next one, two, three years. In terms of municipalities, I don't think it makes a difference. I think the bigger difference are things like the age of water systems, wastewater systems, the amount of investment needed, growing pension, unfunded pension liabilities, the amount of roads that need paving, the amount of schools. So, for us, really, I think it's more in a municipal market. It is left to be seen what happens with the entire water/wastewater infrastructure in this country and how we approach that because it is getting at a critical stage. And in the next few years, decisions are going to have to be made, because these systems can't hold up forever if they're not being invested in.

And even more importantly, one thing we really like about the administration's plan, in the past, sometimes you had pools of money, and it only went to a capital project, but there was no requirement for nourishment of those systems ongoing. The interesting thing about this administration is the 50% of the $200 billion that funds the 20%, not only are they looking at investing 20% of those funds into projects that have funding for the upfront capital investment, but they are also requiring a revenue stream that is predictable that will help with operations maintenance and upkeep. We've not seen that before. So, the recognition of lifecycle cost for this infrastructure investment is something that I think is a real positive that you have to step back and look at what are you going to do for the next 50 years.

As Linda mentioned, in the water industry, our assets, we're looking at 50 years. We're not looking at 20, 30 years. They're 50, sometimes 70-year assets. So, we think that, that, based on what happened to this proposal and the overall philosophy about overall infrastructure investment could have more opportunities than any type of impact from tax reform on individual private companies.

Q - Michael Lapides {BIO 6317499 <GO>}

Got it. Thank you, Susan. Much appreciated.

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

Thanks. And I think we've got time for one more question.

Operator

The final question today comes from Jonathan Reeder with Wells Fargo. Please go ahead.

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

Hi, Jonathan.

Q - Jonathan Reeder {BIO 18909775 <GO>}

Hey, Susan. In the interest of time, I'm okay. So, thanks. I appreciate you taking it, though.

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

It's great talking to you, though.

So, we thank all of you for participating on our call today. We value you as our investor owners and as the financial analysts, who research our company for the benefit of your clients and their financial futures. We'll always be open and transparent in all of 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 some of the questions or you think about something later, please call Ed or Ralph, and they'll be happy to help you. We look forward to talking to you at our 2018 first quarter earnings call on May 3 and our annual shareholders' meeting will take place on Friday, May 11.

Thanks again, and we hope you all have a great week.

Operator

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