Q3 2016 Earnings Call

Company Participants

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

Other Participants

- Angie Storozynski, Analyst, Macquarie Capital (USA), Inc.
- Brian Chin, Analyst, Bank of America Merrill Lynch
- Jonathan G. Reeder, Analyst, Wells Fargo Securities LLC
- Michael Lapides, Analyst, Goldman Sachs & Co.
- Shahriar Pourreza, Analyst, Guggenheim Securities LLC
- Steve Fleishman, Analyst, Wolfe Research LLC
- Timothy Winter, Analyst, Gabelli & Co., Inc.

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to American Water's Third Quarter 2016 Earnings Conference Call. As a reminder, this call is being recorded and is also being webcast with an accompanying slide presentation through the company's Investor Relations website.

Following the earnings conference call, an audio archive of the call will be available through November 10, 2016 by dialing 412-317-0088 for U.S. and international callers. The access code for replay is 10094124. The online archive of the webcast will be available through December 3, 2016 by accessing the Investor Relations page of the company's website located at www.amwater.com.

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

Edward D. Vallejo {BIO 16076814 <GO>}

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

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

Additional information regarding these risks, uncertainties and factors is provided in the earnings release and in our Form 10-Q, each has filed with the SEC. I encourage you to read our Form 10-Q for a more detailed analysis of our financials and other important information.

Also, reconciliation tables for non-GAAP financial information discussed on this conference call, including adjusted earnings, both as historical performance and as earnings guidance, adjusted return on equity and our O&M efficiency ratio can be found in the appendix of the slide deck for this call. The slide presentation for this call can also be accessed through the Investor Relations page of our website.

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

And 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. With me today are Linda Sullivan, our CFO, who will go over the third quarter financial results; and Walter Lynch, our COO, who will give key updates on our operations.

But before we give you the summary of our third quarter results, I'd like to comment on the announcement we made on Monday. We have a binding global Settlement in principle approved by the federal court for all consolidated claims in both federal and state courts in West Virginia arising from the Freedom Industries chemical spill on the January 9, 2014. This Settlement is not an admission of any liability or fault on the part of our company or our employees. As a matter of record, Freedom Industries, as a company as well as six of their employees, including three officers, has plead guilty to criminal violations of the Clean Water Act as a result of the chemical spill.

In comparison, West Virginia American Water has not been found to have violated any laws or regulations in connection with the chemical spill. We firmly believe the suits brought against us are without merit and resulted, at least in part, due to the bankruptcy of Freedom Industries and their limited ability to pay claims. As noted in the recent report by the Chemical Safety and Hazard Investigation Board, the Freedom Industries chemical spill was preventable had Freedom followed proper procedures.

Additionally, the federal court dismissed all claims against American Water parent company and our service company in pre-trial decisions, nor is either a party to the class action litigation in state court. So, why did we decide to settle these cases? First, we believe, it is in the best interest of our customers, our company, and especially our West Virginia employees. They are the people who work hard to deliver the highest standard of customer service possible, regardless of the challenges they face.

Second, this resolution allows us to serve our customers without the distractions and potentially significant expenses of federal and state litigation over the next several years, which Linda will quantify in a few minutes. And third, these distractions and expenses are further compounded by a couple of facts. West Virginia is our only regulated state in American Water with severely limited protections against claims of damages arising from outages or interruptions of services. Even electric and gas utilities in the state are more protected as our municipalities.

Additionally, these trials would have occurred in a state that historically has been highly favorable to the plaintiffs' bar. While West Virginia passed meaningful tort reform measures in 2015, the lawsuits filed by plaintiffs in these cases were filed before the new measures took effect.

Now, let me turn the call over to Linda to comment on the financial elements of the proposed global Settlement.

Linda G. Sullivan {BIO 7300156 <GO>}

Thanks, Susan. Let me start with the earnings impact. The aggregate amount of the binding global agreement in principle is $126 million pre-tax. Our portion is $65 million with the remaining $61 million coming from some of our insurers. In the third quarter, we recorded our $65 million portion of the Settlement, net of committed insurance receivables as an after-tax charge of $39 million, or $0.22 per share, which was recorded on the books of West Virginia American Water.

I would like to point out that two of our insurers that we asked to participate in the Settlement have presently not agreed to participate in the Settlement. Their insurance coverage level is up to $50 million in the aggregate. We intend to actively pursue recovery from these two insurers and in fact, last Friday, West Virginia American Water filed suit against one of these insurers in West Virginia and we will pursue arbitration against the other. We firmly believe that these insurers have a responsibility to participate appropriately.

In terms of the structure of the Settlement, page six lays out the components of the structure for both our Settlement of $126 million as well as another $25 million funded under a separate Settlement agreement between the plaintiffs and Eastman Chemical Company. The structure establishes a two-tier approach to payments of claims made up of a guaranteed fund and claims-based payments. Let me discuss the guaranteed fund first.

In our Settlement, the guaranteed fund will be $76 million, of which our portion would be $51 million and an insurance carrier will contribute $25 million. The two insurers that I mentioned earlier who did not participate in the Settlement were asked to commit coverage to the guaranteed fund. Their insurance coverage level is up to $50 million in the aggregate. We have not recorded in accounts receivable from these two insurers, but we're actively pursuing recovery, as I mentioned earlier.

As the chart shows, Eastman's $25 million is in the guaranteed fund. The total $101 million in the guaranteed fund must be exhausted before any claims-based payments are made. Now, let me cover the claims-based payments. In our Settlement, the claims-based payments would be up to $50 million, of which our portion would be up to $14 million and a number of our insurance carriers committed to contribute up to $36 million. I trust that this chart helps to explain the structure of the Settlement.

Let me now discuss a few other points. As part of the Settlement, West Virginia American Water agreed it will not seek rate recovery from the West Virginia Public Service Commission for the amounts included under this Settlement and for approximately $4 million in direct response costs expensed in 2014 relating to the chemical spill. In terms of cash flow, we intend to fund West Virginia Settlement payments through existing sources of liquidity. Funding is not expected to begin until the Settlement is final, estimated to occur in the first half of next year.

Let me also discuss legal fees. We estimate that future defense costs could easily have been $25 million or more over the next several years had we gone through all trials in the case, both federal and state. And these are only the estimated legal expenses and do not account for other expected impacts that results from significant litigations, such as management's time and attention, and an ongoing distraction to our employees in West Virginia, who are focused on delivering water service to our customers in that state.

I'll now turn it back to Susan.

Susan N. Story {BIO 3335156 <GO>}

Thanks, Linda. We believe strongly that these uncertainties, distractions and anticipated expenses warranted a global Settlement at this time, again, despite the fact that we believe the suits brought against West Virginia American Water are without merit. In terms of next steps, the terms of the Settlement must be finalized and approved by the court, notice of the terms of the Settlement must be provided to the Settlement class members, and then a final fairness hearing will be held before the final approval of the Settlement.

We anticipate this final hearing should occur in the first half of 2017. The Freedom Industries chemical spill was a challenging time for the West Virginia community, our customers, and our employees. We are looking forward. And as we have for our 130 years as a company, our focus is on serving our customers clean, safe, reliable, and affordable water. So, with that, let's discuss our third quarter performance, because outside of this week's news of the pending resolution of ligation, our employees continue to consistently deliver great results across our business with their outstanding dedication and commitment to our customers.

Excelling at fundamentals is critically important in any business. We get that. And this is why we continue to invest in our water and wastewater systems, while, at the same time, increasing our operating efficiencies to reduce cost impacts on our customers. We also continue to grow our Regulated Businesses based on our demonstrated core competencies in customer care. Our people are providing solutions and value to customers and communities across our footprint. And this is what drives our consistent results.

Slide seven highlights how we have executed our strategies. It starts with providing reliable service through capital investment in our regulated operations. During the first nine months of the year, we invested $905 million in capital, with a majority dedicated toward our regulated operations to improve water and wastewater systems. It also included $24 million for regulated acquisitions. We plan to invest between $1.4 billion and $1.5 billion this year, with about $1.2 billion of that amount in regulated infrastructure investments.

This level of investment is balanced by our continued focus on: first, controlling O&M costs; then spending every capital dollar efficiently; and finally, utilizing constructive regulatory mechanisms. We're extremely proud of our employees' efforts to improve efficiencies. And their commitment comes from a deeply ingrained culture at American Water to provide the best quality service to our customers at an affordable price. Walter will give you a little more background on some of these efforts in just a few minutes.

Having the reputation of doing what is right for our customers also contributes to our growth. This year, we've already welcomed 10,700 new customers just from acquisitions and a total of 10,000 more customers from organic growth. We also have signed agreements representing another 67,800 customers, pending regulatory approvals. As we discussed in the first two quarterly calls this year, we faced headwinds in our Market-Based Businesses in 2016. We continue to see reductions in capital upgrade projects in our Military Services Group compared to previous years.

This is due to decreases in base infrastructure budgets as well as the completion earlier this year of a very large multi-year capital upgrade project we had in one of our military bases. We see improving conditions in natural gas drilling plants in Appalachian Basin and our Keystone Clearwater subsidiary continues to increase its market share from about 20% when we bought the company in July of 2015 to about 35% today. However, due to the timing of ramp ups and work completion schedules, at this time, we still view Keystone as being EPS neutral for this year.

Our Homeowner Services business continues to grow, especially through municipal partnerships and expansion of services we offer. To date, we have about 1.7 million customer contracts, which serve 833,000 customers in 43 states and Washington, D.C. This business is seeing a very active national market with several municipal RFPs in process. We believe that our Market-Based Businesses remain strong long-term play, and they leverage our core competencies in water and wastewater treatment and management. We strategically limit their impact to our overall risk profile. These businesses are also very capital-light, with a vast majority of our investments made in our Regulated Business.

Moving on to slide eight. Adjusted earnings were $1.05 per share for the third quarter, excluding the Freedom Industries Settlement, a 9.4% increase above third quarter 2015. For the first nine months in 2016, EPS increased 8.6%. Our continued strong results enable us to revise our adjusted earnings guidance to the upper end of our prior range plus $0.01. So, from $2.75 per share to $2.85 per share to $2.81 per share to $2.86 per share, again excluding the Freedom

Industries Settlement. We also continue our progress toward achieving our long-term goal of 7% to 10% EPS growth through 2020.

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

Walter J. Lynch {BIO 6064780 <GO>}

Thanks, Susan, and good morning, everyone. During the third quarter and year-to-date, our employees continued to demonstrate their expertise and skill in delivering reliable and safe water services to our customers. Once again, we've made smart investments, achieved growth through the solutions we offered to communities, and we continue to maximize efficiencies that help keep costs down.

Our commitment to invest in our infrastructure while focusing on efficiency of operations to balance customer costs is front and center in the regulatory request we made this year. In Kentucky, our rate case Settlement was approved and we received an order for $6.5 million of additional annualized revenues. As part of the rate order, the PSC eliminated the former 45% equity ratio cap, this allows for some flexibility in how we finance our investments in that state.

In California, we filed a general rate case on July 1, seeking $51 million in annualized revenues over three years. We also received approval to begin construction of our new pipeline associated with Monterey Peninsula Water Supply Project, which is due to start this month. This marks another significant milestone in a multi-year approach to solving the water supply issues for residences and businesses in that area. And in Pennsylvania, the Public Utility Commission last month approved our proposed acquisition of the wastewater assets of the Scranton Sewer Authority, which I'll discuss in a moment.

Turning to slide 11, in the third quarter, record warmth and lower rainfall swept through many of our largest service areas, especially in Pennsylvania and New Jersey. While some areas we serve are wetter than usual, mainly in Missouri and Illinois, the overall effect was higher weather impacted water sales. We estimate the impact to our net revenues to be approximately $6 million.

Also of note, on October 21, the New Jersey DEP issued a drought warning in four of the six designated drought regions. While we do have production facilities in these designated drought areas, we have the ability and capacity to transfer water to the impacted regions as authorized by the DEP. Currently, we're in discussions with the DEP and we stand ready to help.

On slide 12, you can see the success we've had in executing our growth strategy by providing solutions to water and wastewater challenges across our footprint. As Susan said, our pending and closed agreements represent about 78,500 customers. In New Jersey, we filed with the Board of Public Utilities on October 28 for approval of the Shorelands acquisition, which is 11,000 water customers. We anticipate approval in the first half of 2017.

In Pennsylvania, we have our two largest pending acquisitions this year. The wastewater assets of the Scranton Sewer Authority as well as the Municipal Authority of the City of McKeesport, together these systems represent more than 50,000 customers. Regarding Scranton, the

Pennsylvania Public Utility Commission in October approved our application authorizing the acquisition. The Commission's approval is an important positive step forward in the regulatory review process and it reflects the hard work by our Pennsylvania team and partnership with the Sewer Authority to secure the necessary approvals.

We remain confident that we'll receive all the necessary remaining approvals, close the acquisition, and begin providing quality wastewater service to Scranton and Dunmore before the end of 2016. Finally this week, we closed on our acquisition of the Borough of New Cumberland Wastewater System adding 3,100 customers to our Pennsylvania footprint.

Moving to slide 13. Once again, we continued to improve our O&M efficiency ratio, achieving 34.9% for the last 12 months. We remain on track to meet our O&M efficiency target of 34% by 2020. This tremendous effort by our employees is centered on bringing value to our customers. Once again, let me provide you with a couple of examples of what we're doing to drive these results.

In Indiana, we completed a local project to digitize customer requests to locate underground assets, so that customers can excavate on their own property. Known internally as E. Locate (21:03) this project which uses our GIS data has improved our response time, reduced labor, and improved accuracy and customer satisfaction on these customer requests. E. Locate (21:12) has been replicated now across six states and has provided over $1 million in annualized cost savings and efficiencies.

Another example is our investment in enterprise software and meter data management, which is beginning to pay off in efficiency gains, which continue to improve our performance, closing in on near 100% in actual meter reach for billing. We've seen cost savings of over $1 million as we reduced the time spent handling exceptions. And again, every $1 we save in O&M costs; we can invest $7 in capital with no impact on our customers' bills.

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

Linda G. Sullivan {BIO 7300156 <GO>}

Thank you, Walter. In the third quarter of 2016, American Water reported earnings of

$0.83 per share, including the $0.22 charge for the Freedom Industries Settlement. Excluding this charge, adjusted earnings per share were $1.05, 9.4% higher than the third quarter of last year.

As shown on slide 15, our Regulated segment was up $0.10 per share, our Market-Based Businesses were down $0.03, and the Parent was favorable $0.02. For the nine months ended September 30, our adjusted earnings per share were $2.27, up $0.18, or 8.6% compared to the prior year. As with the quarter, these results were driven by our Regulated segment, which was up $0.22, and both our Market-Based Businesses and Parent were each down $0.02 per share.

Turning to slide 16 let me discuss the quarterly results by business segment. For the third quarter, adjusted earnings for our Regulated Businesses increased $0.10 per share. The largest driver of growth was Regulated revenue which was up $0.15 per share. Of that $0.15, approximately $0.14 was from additional revenue authorized through rate cases and infrastructure mechanisms to support investment growth, as well as some fluctuations in balancing accounts and $0.01 was from acquisitions and organic growth.

As Walter mentioned, we experienced hot-dry weather throughout much of our service area this quarter, especially in New Jersey, which increased revenue by more than $12 million. This was partially offset by wet conditions in Missouri and Illinois, which decreased revenue by about $6 million. Net-net, we had a pickup in revenue of about $6 million this quarter compared to normal weather conditions, although, the year-over-year third quarter weather impact was zero.

Next, adjusted O&M expense increased $0.03 per share this quarter. There were lots of pluses and minuses here, but among the drivers were higher production and employee-related costs, partially offset by lower insurance costs. We are also experiencing some O&M timing this year, as more than $10 million of regulated O&M is now expected to be complete in the last quarter of the year. This includes tank painting expenses, certain maintenance and repairs, as well as some project delays.

Next, depreciation expense increased $0.02 per share from regulated investment growth. In the Market-Based Businesses, our third quarter results were $0.03 lower than last year's, due mainly to lower capital upgrades at our military bases. The year-over-year reduction in capital upgrades is driven by two factors. The first is a reduction in military base infrastructure budgets and the second is the completion of an $85 million capital upgrade project at Fort Polk that contributed revenue in 2015 and which was substantially completed in the second quarter of this year. Also, I'd like to clarify that what we call military capital upgrades represent working capital only. These military projects are not capitalized on our balance sheet; rather we recover these investments through scheduled or milestone payments as we complete them.

Finally, while we are seeing a year-over-year decrease in military capital upgrade projects, the pipeline of new bases looking to privatize remain strong. In the final section of the waterfall chart, you'll note that Parent is positive $0.02 per share for the quarter, primarily due to certain expenses recorded in the third quarter of last year, partially offset by higher interest on parent debt. And finally, we show the $0.22 impact of the Settlement, bringing our GAAP earnings to $0.83 per share for the quarter.

Turning to slide 17, we have five rate cases and two outstanding infrastructure surcharge requests awaiting final orders for a total revenue request of $109.7 million. We also have a total of $90.5 million in annualized rates effective since October 1, 2015, including the resolution of our Kentucky rate case for $6.5 million in late-August, and $9 million in annualized infrastructure surcharges in our Pennsylvania subsidiary.

Slide 18 highlights our ongoing, strong financial performance and some key cash flow and investing metrics for our business. Our capital investments year-to-date were $905 million. This is $65 million lower than the same period last year, which included the third quarter purchase of Keystone Clearwater for $133 million. We expect to spend between $1.4 billion and $1.5 billion this year, including capital for the Scranton acquisition which we're working to close in the fourth quarter.

Our cash flow from operations grew 8.1% to $925 million for the first nine months of the year. The majority of this growth was driven by increased net income and depreciation, both of which are the results of infrastructure investment for our customers. Our adjusted return on equity improved to 9.57%. This is testament to the ongoing efforts of our employees to work efficiently and to limit regulatory lag through timely filings and innovative regulatory mechanisms.

We also continue to provide top-quartile dividend growth compared to the Dow Jones Utility Average and our water peers. On October 28, we declared a dividend of $0.375 per share payable on December 1, 2016, to shareholders of record as of November 9, 2016.

Finally, I would like to discuss our earnings guidance. Throughout the year, we have shared with you the headwinds we faced in our Market-Based Businesses. For example, we have discussed the impact of lower capital upgrades in our Military Services division, as well as our Keystone team's efforts to manage their business to be earnings neutral, despite a very challenging natural gas market.

Despite these headwinds, the employees in our businesses have delivered extraordinary results. Even with the additional fourth quarter O&M expense, we are revising our adjusted earnings guidance to the upper end of our prior range, plus $0.01 or to $2.81 per share to $2.86 per share, which excludes the Freedom Industries' Settlement.

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

Susan N. Story {BIO 3335156 <GO>}

Thanks, Walter and Linda. You heard us describe in some detail the excellent results of our business through the third quarter of the year. And with the announcement of our preliminary Settlement of the Freedom Industries chemical spill-related lawsuit, we will remove future risks and uncertainties related to legal costs and other expenses and distractions inherent in multiple ongoing multi-year litigations.

Our year-to-date financial performance reflects the successful execution of our strategies: investing in our systems; operating efficiently; growing our business; and remaining steadfast in our commitment to the highest standards of customer service. We have 6,700 amazing people that we all get the privilege of working with every day. They are great in what they do.

They make life better for about 15 million people across the United States every day with the services they provide. They are the first ones to volunteer when communities are in need or natural disasters hit. I'm proud of not just what they do, but as the people that they are. And as investors, you can be proud of their record of service as well.

Before we go to questions, as a reminder, we will have our 2016 Investor Conference at the New York Stock Exchange beginning with lunch on Thursday, December 15. At that time, we will share with you our projections for our lines of businesses in 2017, as well as share our capital plans for 2017 and beyond. As the slide indicates, we will need you to RSVP to make sure that you can get into the Exchange. We hope you will be there.

With that, we're happy to take any questions that you might have at this time.

Q&A

Operator

We will now begin the question-and-answer session. Our first question comes from Steve Fleishman of Wolfe Research. Please go ahead.

Q - Steve Fleishman {BIO 1512318 <GO>}

Hey, Susan. How are you?

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

Hi, Steve. Good. How are you doing today?

Q - Steve Fleishman {BIO 1512318 <GO>}

Doing great. So, just one question, this just maybe a technicality, but I didn't see your kind of 7% to 10% growth slide that you normally have in the slide deck. So, just wanted to clarify. Is the 7% to 10% growth still the growth rate through 2020?

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

Yes. 7% to 10%, 2020 and our long-term growth at 7% to 10%, and on December 15, we'll rollout what we're looking at over the next five years.

Q - Steve Fleishman {BIO 1512318 <GO>}

Okay. Great. And I'm just curious, the upcoming election kind of from the water sector standpoint. Is there any real difference in your view in terms of policy on who wins in the election and anything that we should be kind of watching?

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

Steve, really not. Both candidates have expressed support for infrastructure investment. I think both candidates have expressed support for public-private partnership. So, specifically in the water industry where there are a number of governmental entities. I, co-chaired with Doug Peterson, the CEO of S&P Global, earlier in the year for the Bipartisan Policy Center, a template. And we had an advisory council of political figures, former mayors and political figures, Democrats and Republicans, who are all advocating for public-private partnerships, because there simply won't be enough federal monies to do the infrastructure investment we need in this country for water and wastewater transportation.

The Clinton's campaign has come out and talked about a water innovation center. The Trump campaign has talked about infrastructure investment. So, we believe that whoever wins the election, the focus will remain on infrastructure and the role of private industry to be part of that renaissance of infrastructure investment for the country.

Q - Steve Fleishman {BIO 1512318 <GO>}

And then just finally, in all your kind of key states, is there any kind of election or kind of issues or proposals or things like that, that we should be watching?

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

No. Actually, the opposite. In our states, we have states with lots of representation from Democrats, Republicans, and we have – they're all great states. So, what we are – when we look actually, and Walter can comment on this, what we're actually seeing are positive legislative efforts, given the attention that's given to infrastructure investment. We're actually seeing the opposite. We're really seeing support from both sides of the aisle on solutions that can help us solve some of the water and wastewater infrastructures issues.

Walter, do you want to comment?

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

Yes, Susan. All across our footprint, we're seeing positive legislation from Indiana and Illinois to New Jersey and Pennsylvania. But really all the states are encouraging us to invest in our infrastructure and making sure that we have enablers to acquire systems as well. So, we're seeing very positive movement in each of our states.

Q - Steve Fleishman {BIO 1512318 <GO>}

Okay. Great. Thank you.

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

Thanks, Steve.

Operator

Our next question comes from Angie Storozynski of Macquarie. Please go ahead.

Q - Angie Storozynski {BIO 15115714 <GO>}

Thank you. So, I wanted to ask about the municipal acquisitions that you have announced. Is there any rule of thumb about the earnings in fact, per se the 1,000 accounts acquired, and also how does it track versus your prior expectations on an annual basis, how many accounts you're adding? Because it feels to us like you've more than doubled the prior goals in additions of customer accounts.

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

So, Angie, let me start – this is Linda. Let me start, the way that this works is that once we acquire a system, it goes through regulatory approvals by the PSC in that state. Once that approval is obtained, then we would include the acquisition in our next rate case. And so, there is a bit of regulatory lag from the time that we get the approval to the time that it's included in a rate case proceeding. That rate case proceeding then will determine the amount of rate base that we are authorized to earn a return on. And so, that's really the process that it goes through.

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

And Angie, it's Walter, speaking to the acquisition pipeline and some of the deals we've announced, what we're doing is providing solutions for communities. And when communities have issues and they're looking for somebody to come in and buy their systems, we are the natural acquirer. I think the legislation in each of the states are key enablers for us to do this, and we're seeing that play out across our footprint. But particularly in Pennsylvania as I noted, with two large acquisitions, Scranton Sewer Authority and then the Authority of McKeesport, we're providing solutions for these communities and they're turning to us, because we have the expertise and the financial wherewithal to be able to buy the systems and operate them properly and make sure they're protected for years going forward.

Q - Angie Storozynski {BIO 15115714 <GO>}

But do you feel like it's the beginning of a real consolidation of the water sector that we've been waiting for many number of decades now?

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

Well, I think you've seen a pretty big increase in the number of deals that we've announced and we're – I mean, we're in discussions with the number of communities as we've said, and we're here to provide solutions and we're confident that we can do that.

Q - Angie Storozynski {BIO 15115714 <GO>}

But is this, I mean – okay. I'm sorry. Go ahead.

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

Angie, this is Susan. I thank your question. So, to your point, we've been talking about this – people have been talking about this for years, and that's one reason, I know we can get questions about, is this – the 1% to 2% still good on the triangle, those types of things. We're going to watch and see. We've had an extraordinary year, we think the pipeline looks very healthy, and we want to look and see what happens and we monitor it very carefully in all of our states. We are seeing more interest than we've seen, but whether that translates into X-percent more growth, that's what we're looking at and really putting our pencil to the paper to see what we'll see. I think when we see what happens in 2017 that will inform us more, is this suddenly the floodgate starting to have a little more flow. Hopefully it is, the indications are positive, but we'll just have to see.

Q - Angie Storozynski {BIO 15115714 <GO>}

And is it just – I mean, it sounds like most of the acquisitions are happening in the Pennsylvania, and then this one in New Jersey. Is this trend for now limited to these two states?

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

No. Not limited to the two, New Jersey and Pennsylvania. We are in discussions with others in other states, but these are just the ones that we've been able to announce here recently. But our teams are working in each of the states, looking for solutions to provide for these municipalities. And again...

Q - Angie Storozynski {BIO 15115714 <GO>}

I'm sorry. But you are staying only – but you're only seeking municipal acquisitions in the states where you already operate, right? So, there is no venturing into other states?

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

Well, what we have always said, Angie, is that we're very interested in our states growing, we are constantly looking at the landscape, and we have three hurdles when we look at whether we would enter a new state; the first one is, what is the regulatory climate; the second one is, what is the business climate and are they open to private water; and the third is, do we see a line of sight to get to at least 50,00 customers within five years. So, those are our gates and we're constantly looking across the country. We write every state based on those three. So, we would not disclose if we had any activity until there was signed agreements, but we are always looking beyond our states. But right now, our focus – we're seeing a lot of opportunity.

To your point about, it only seems – it seems mostly in Pennsylvania and New Jersey. Pennsylvania is where we have the most mature laws that are favorable for this. Act 11, which was passed the 2012, maybe 2013, and then of course Act 12, which we are seeing more on the fair value legislation across the country. But I think you're seeing a state that has been more mature in some of the enabling legislative efforts that have been translated into regulatory policies. And so, we are looking towards seeing more activity in other states as their legislation, enabling legislation becomes more mature.

Q - Angie Storozynski {BIO 15115714 <GO>}

Perfect. Thank you.

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

Thanks, Angie.

Operator

Our next question comes from Brian Chin of Bank of America. Please go ahead.

Q - Brian Chin {BIO 6608875 <GO>}

Hi. Good morning.

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

Hi, Brian.

Q - Brian Chin {BIO 6608875 <GO>}

Just a question on the acquisitions again. On slide 12 you broke out agreements reached, approvals granted and acquisitions closed. Given that Scranton was reached – an agreement was reached last year, could you just define a little bit more clearly, when we say 30,000 customers to 60,000 customers, is that agreements reached, is that approvals granted, is that acquisitions – because the three categories can startle over a year. So, can you just be a little bit more specific in terms of what you're including in that 30,000 customers to 60,000 customers?

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

Right. That 30,000 customers to 60,000 customers translates into the approximate customer amount to reach our 1% to 2% earnings per share growth in that regulated acquisition portion of our growth triangle. So, what that means is, as I mentioned earlier, there is a process that we go through with the acquisition which starts with the regulatory approval and other types of environmental approvals, if necessary. We then go through the regulatory rate case process to include this in our earnings, and it's really when it gets to the 1% to 2% of earnings that it would count.

Q - Brian Chin {BIO 6608875 <GO>}

So -

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

So Brian, I think how are we classifying these. So, a city or a municipality does an RFP. Okay. We're the successful bidder. We don't put it into that pending at that point, only after we've negotiated, done our due diligence, negotiated an agreement from the time we get a signed agreement is when we put it into that pending. Then, once we sign the agreement, you get regulatory approval, and then typically you close. Sometimes like Scranton, there is another step, because they were under a consent decree from the EPA, additionally we're having to get a couple of environmental permit. So, the quick answer is, when we put something in the pending, it's because we have a signed agreement. We've gone through the RFP, we've done due diligence, we've signed to the terms. There, all we're waiting on typically from that point on is regulatory approval which can typically take six months. Does that help?

Q - Brian Chin {BIO 6608875 <GO>}

Okay. So, if I think about it properly, what you're basically saying is, don't focus necessarily on which transaction gets included in which year by customer count. It's just that the loose 30,000 customers to 60,000 customers should translate to roughly 1% to 2% customer growth, even if the definition of agreements reached or approvals granted or acquisitions closed might be a little bit in flux from year-to-year. Is that the right way to think about that?

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

That's exactly right. And again, that's why we do five years with a triangle. The 1% to 2%, you need to average it. But again, we want it, we're trying to be more clear, which is why we put this slide in here, so you could see what exactly does this mean. What is really closed, what you're waiting on, what is it mean when you put in that bucket. We don't want to included as pending until we have pretty strong assurance it's going to go through, which is why we don't include anything until we have a signed agreement on the terms with the municipality.

Q - Brian Chin {BIO 6608875 <GO>}

Great. And then one last question. I know you touched on this a little bit earlier, but in terms of just your confidence with regards to the acquisition and overall regulated growth outlook, I know we're going to get more detail at the conference coming up, but do you feel more confident in terms of the possibilities that are out there versus, say, a year ago when you did the last analyst conference?

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

Yes. I mean, it all ties back as we're talking here, the 1% to 2%, we're confident that we're going to be able to deliver 1% to 2% customer growth through acquisitions.

Q - Brian Chin {BIO 6608875 <GO>}

Thank you very much.

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

Thanks, Brian.

Operator

Our next question comes from Michael Lapides of Goldman Sachs. Please go ahead.

Q - Michael Lapides {BIO 6317499 <GO>}

Hey, guys. Thank you for taking my question. Real quickly on the Market-Based segments. This has been a tough year in terms of growth. Can you talk about whether that business you think still is able to fit the growth target overall or do you see the utility business is growing at faster than 7% to 10%, but the Market-Based Businesses maybe grows a little bit slower than 7% to 10%?

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

Michael, you always ask such good questions. The answer is, we are – as I said talking earlier, we're very committed to the Market-Based Businesses that we're in. Specifically for American Water Enterprises, predominantly you have Homeowner Services and you have the Military. The capital upgrades business that Linda talked about is a big part of that. But the big difference is that in Military, while some of those infrastructure budgets may continue to be under some pressure, the pipeline for new bases that are issuing RFPs or who have RFPs out there, they're significant. We have seen army pretty much, pretty active in the past several years. The Air Force over the past couple of three years has gotten even more active. So, there is a robust pipeline in the Military for new bases to win. So, that's why we remain bullish on the Military Services.

Homeowner Services is doing well. There are more municipalities who are interested in partnership opportunities for these home warranties that we offer. So, we feel really good about it. And then on the Keystone Clearwater, everybody – and gosh, Goldman, you guys are really doing a great job of monitoring the natural gas and oil markets. So, you know that things are picking up. We're very proud that through the worst of it that our organization, our business was able to stay EPS neutral. That is a huge deal and it shows a lot about how they kept going in some of the services they were able to provide during the downturn. So, yes, the Market-Based Businesses we're in, we are committed to.

Now, we have always said that at our core, we are a regulated utility, period. We will stay that way. Currently, anywhere from 9% to 10% of our revenue, net income comes from Market-Based, little less this year. So, we will not see that grow beyond 15% to 20% and probably closer to the – up to 15%, unless there is something extremely regulated-like, if we win every new military base, for example, and that helps us and it's more regulated-like. But right now, we are committed that the Market-Based Businesses have a limited role in the overall growth of our company and the majority of our growth will always come from our capital investment in our Regulated Business as well as regulated acquisition that then turns into more capital investment into our business.

Q - Michael Lapides {BIO 6317499 <GO>}

Susan, that was super helpful. I want to make sure I can summarize that back.

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

Okay. Go.

Q - Michael Lapides {BIO 6317499 <GO>}

It was a lot. I'm just trying to digest. I'm going back to the transcript, if it were out already. Market-Based Business grows faster than the overall total EPS growth rate for the company, albeit, maybe not as fast as what you've seen prior to this year.

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

I think that's a nice summary. Wow. I could have saved a lot of time, if I have just said that, right?

Q - Michael Lapides {BIO 6317499 <GO>}

One follow-up. How are you thinking? Company has gotten bigger. Your regulated rate base, your regulated earnings power has improved significantly with rate increases, cost management, et cetera. How are you thinking about dividend and dividend policy, especially, if you remain in that kind of $1.4 billion to $1.6 billion a year in capital deployed? It would imply that with higher earnings, you'd have kind of a little better cash flow, both with similar CapEx levels. Are you thinking there is potential for dividend growth, maybe do exceed earnings growth or for an upgrade or uptick in the dividend payout ratio policy?

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

Well, I'll start and then let Linda contribute. So, on the positive side, we're already really high in the top-quartile of dividend growers in utility space. We have said that we have a 50% to 60% payout ratio target and we remain at the lower end of that. So, we have room within our current payout ratio target to grow, the answer to your last question that you asked.

We look at every dollar and the best way to use that dollar. Reinvesting in our capital programs for the benefit of our customers will always be first and dividends, of course, are right up there. So, we also look at other investments. Are there other ways to grow? Do we look at things like – I mean, the very bottom of our list by the way is buybacks. We think that we should have plenty of opportunities to invest in our business.

We look at dividends. We look at refinancing debt. All of those things we think have far more value to our shareholders than the latter. So, we right now see ourselves continuing to have our dividend growth commensurate with our EPS growth. However, we also are very happy that over the past four years, we've had double-digit dividend increase and still remain at the bottom of our payout range.

Q - Michael Lapides {BIO 6317499 <GO>}

Got it.

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

And, Michael, I would add to that that we continue to look at our cash flow from operations, which is strong and which in our five-year plan is expected to exceed our capital expenditures in 2018.

Q - Michael Lapides {BIO 6317499 <GO>}

Got it. Thank you. Much appreciate it, guys.

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

Thanks, Michael.

Operator

Our next question comes from David Carter (49:12) of Baird. Please go ahead.

Hi, guys. Thanks for taking the question. I was wondering if you could provide a little commentary on what you're seeing in terms of fair value legislation. Do you see a catching on more broadly across your service area and – yeah, what are your expectations there?

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

Yeah. This is Walter. We have that fair market legislation, fair value legislation in six of our states now. And we do see a catching on, because it's just another enabler for us to go out and acquire systems and pay the fair market value which gives the mayors, the communities' options if they're looking to monetize assets. So, we do think it's got momentum and you can see just in the last couple of years, how it's expanded across United States and so many of our acquisitions are tied to that fair market legislation. So, it is working as well.

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

Yeah. And one thing too – this is Susan, David. (50:05). This is really a differentiator for the water utility sector compared to other utilities, because these fair market legislation initiatives really only cover water and wastewater and they tend to be also for distressed water systems, which is back to the whole infrastructure issue nationally that we have with municipalities.

Q - Operator

Excellent. Thank you guys very much.

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

Thanks.

Operator

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

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

Hey. Good morning, everyone. Congrats, Susan. Auburn is surprising a little bit this year. So, I'm sure you're happy there.

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

Jonathan, I won't talk about Notre Dame.

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

Yeah. Please don't. At least, a lot of those fans are Cubs fans too, so they have a little solace there. But I wanted to follow just a bit on Angie's – your response to Angie's question. So, for the Scranton and the McKeesport deal, from a modeling perspective, we shouldn't really be expecting any earnings impact until the next Pennsylvania rate case. Is that the way to kind of think about that?

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

So what happens is, once we receive regulatory approval and we close on the deals, then we begin collecting the existing rates under this system. And so, we look at that for the interim period, and generally what we do in the interim period before a rate case is we will finance that acquisition with shorter-term debt. Then we will go through the regulatory process and that will determine the amount that gets on rate – gets into rate base upon which we would earn our return or have the opportunity to earn our return.

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

Okay. So, maybe you're not earning the same ROE as the rest of the business, but you are earning a return and you kind of help enhance that a little bit by doing the short-term financing in the meantime. Is that accurate?

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

Yeah. And John, part of – that's right. And part of what we go through is we look at specific metrics that each of these acquisitions need to meet those financial hurdles and generally accretion is one of those metrics.

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

Okay. And then, can you remind us what would be the timing of the next Pennsylvania rate case?

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

So, we do not make that public.

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

When was your last, I guess, rate case filed, how about that, for Pennsylvania? I don't think, it's been in the last 12 months.

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

Yeah. It's been two years.

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

It's been two years, so kind of coming out and – I mean, is it fair to say, getting those two large systems into rate base might be a catalyst as well?

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

So, we look at a multitude of factors to determine the timing of our rate cases, and we take all of that into consideration when we look at timing, Jonathan. But you are an excellent questioner, Jonathan.

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

All right. Thanks for that. And then, the other question I had just – the $10 million of O&M expense for Q4 is – did you say that's being pulled forward from 2017?

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

No. That's actually timing differences between primarily the third quarter, but also first quarter and second quarter, and has moved into the fourth quarter.

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

Okay. All right. Thanks for the clarity. I appreciate it.

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

Absolutely.

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

Thanks, Jonathan.

Operator

Our next question comes from Shar Pourreza of Guggenheim Partners. Please go ahead.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Good morning, everyone.

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

Hi, Shar.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

So, just one question. Can you remind us if the regulated acquisition, the trajectory of 1% to 2%, includes any stormwater? And if not, is that sort of an opportunity that can move the needle and where is that opportunity set?

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

Shar, no, it doesn't. First of all, the stormwater is an interesting area nationally that's been looked at, and really for us, the first place we're looking at that is on military bases. We've had a couple of our bases where we serve water and wastewater, who have indicated an interest. So, we're working through the Department of Defense as to whether that can fall under the preview that they got to their privatization language and legislation, which we believe it does, the senate and – the senators and the congressmen believe it does, but I think they're going through the lawyers and the Department of Defense to get comfortable with it.

So I think what you would find is, stormwater is part of the water cycle. We are looking at how that would look. So, for us, we're continuing to look at stormwater, but our foray into that would most probably come through our military bases, and it's our ability to take that part over along with water and wastewater.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Okay. Got it. So little bit ways off?

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

Yes.

Q - Shahriar Pourreza {BIO 15145095 <GO>}

Excellent. Thanks. That was it.

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

Wow. Thank you, Shar.

Operator

Our next question comes from Tim Winter of Gabelli & Company. Please go ahead.

Q - Timothy Winter {BIO 1518628 <GO>}

Good morning and congratulations on the quarter and year-to-date results.

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

Thanks, Tim.

Q - Timothy Winter {BIO 1518628 <GO>}

I wanted to follow up on the fair value legislation and the process. At what point does the fair value assessment take place and is that made public?

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

Every state is a little bit different, Tim, but typically after an asset purchase agreement is signed and then there are appraisers that are hired by the city and by us, and then there is an – typically an averaging of those appraisals, and it is public at some point. Yes, but that's typically the process, the average of a couple of appraisals.

Q - Timothy Winter {BIO 1518628 <GO>}

So, in the instance of McKeesport, when will that take place or has it?

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

We're actually hiring our appraisers now. So, we're doing it and then the city is doing it as well. That's where we are in the process.

Q - Timothy Winter {BIO 1518628 <GO>}

Okay. And as we consider the accretion process for these acquisitions, I mean, how would you characterize the level of synergies that you can achieve as you go into the next Pennsylvania rate case?

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

Lot of factors involved, and it's all based on local operations and the synergies that we can get from those, but there obviously are synergies, particularly when we're buying wastewater systems in areas where we serve water systems. And that's really key to our strategy is to be able to take advantages of those synergies to benefit our customers.

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

And Tim, I'd add to that. As we look at the way that we're structured overall from the American Water perspective, we really leverage the size and scale of our company to be able to provide synergies across the business in terms of back office support, finance, HR, legal, as well as our supply chain.

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

We see that as a big differentiator of supply chain and the purchasing power that we have. And I'd like to highlight the examples on these calls and in individuals meetings, but it's a huge advantage that we have I think in this business.

Q - Timothy Winter {BIO 1518628 <GO>}

Okay.

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 N. Story {BIO 3335156 <GO>}

Thank you. First of all, thank you all for participating today and your excellent questions. This was a great discussion. If you have any further questions, please call Ed or Melissa, and they'll be happy to help you. We really hope to see all of you on December 15 at our Investor Conference. We will – as you all know, we have a new Head of Keystone, Dan Dalton, who has been the President and COO for several years. We also have a new Head of our Market-Based Business, Deb Degillio. You'll get to meet them.

So I think – and of course, what's old is new again, which is Ed Vallejo back in his role as VP of Investor Relations as well as Financial Planning and Analysis. So, we look forward to seeing all of you and we appreciate all your support. And if there is anything we can do to help you understand our story better, please let us know. Thank you.

Operator

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