Pinnacle West Capital's (PNW) CEO Don Brandt on Q3 2019 Results - Earnings Call Transcript

Nov. 7, 2019 5:21 PM ET
by: SA Transcripts

Earning Call Audio

Pinnacle West Capital Corporation (NYSE:PNW) Q3 2019 Earnings Conference Call
November 7, 2019 11:00 AM ET

Company Participants

Stefanie Layton – Director-Investor Relations

Don Brandt – Chairman and Chief Executive Officer

Jim Hatfield – Chief Financial Officer

Jeff Guldner – President-APS

Conference Call Participants

Michael Weinstein – Credit Suisse

Insoo Kim – Goldman Sachs

Julien Dumoulin-Smith – Bank of America Merrill Lynch

Greg Gordon – Evercore ISI

Ali Agha – SunTrust Robinson Humphrey

Charles Fishman – Morningstar

Operator

Greetings, and welcome to the Pinnacle West Capital Corporation Third Quarter 2019 Earnings Conference Call. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Stefanie Layton, Director of Investor Relations. Thank you. You may begin.

Stefanie Layton

Thank you, Christine. I would like to thank everyone for participating in this conference call and webcast to review our third quarter earnings, recent developments and operating performance. Our speakers today will be our Chairman and CEO, Don Brandt; and our CFO, Jim Hatfield. Jeff Guldner, APS' President; and Daniel Froetscher, APS' Executive Vice President of Operations are also here with us.

First, I need to cover a few details with you. The slides that we will be using are available on our Investor Relations website. Along with our earnings release and related information. Note that the slides contain reconciliations of certain non-GAAP financial information. Today's comments and our slides contain forward-looking statements based on our current expectations, and the company assumes no obligation to update these statements. Because actual results may differ materially from expectations, we caution you not to place undue reliance on these statements.

Our third quarter 2019 Form 10-Q was filed this morning, please refer to that document for forward-looking statements, cautionary language as well as the risk factors and MD&A sections, which identify risks and uncertainties that could cause actual results to differ materially from those contained in our disclosures. A replay of this call will be available shortly on our website for the next 30 days. It will also be available by telephone through November 14.

I will now turn the call over to Don.

Don Brandt

Thank you, Stefanie, and thank you all for joining us today. Our operating performance and financial management remain in line with our expectations for the year. As you know, weather provided significantly below average revenue in the second quarter and was mild in the third quarter. Before Jim discusses the impacts of weather on our expectations for 2019 and details of our third quarter results, I'll provide a few updates on current regulatory and operational developments.

The 2019 summer season was successfully completed by focusing on our core priorities, delivering safe, clean, reliable and affordable energy. June began with relatively mild temperatures, which for resource planning meant heavy imports from California renewables and watching for over generation during the midday hours, while July and August had 23 days over 110 degrees. It was the driest summer in the last 20 years, with less than one inch of rain between June and the end of September.

The lack of humidity can impact peak demand, which was 7,270 megawatts in 2019, following 200 megawatts short of the 2018 peak. Our evaluation of the McMicken substation battery storage facility equipment failure is ongoing. The fire occurred on one rack containing 14 battery modules. The rack that experienced the fire has been disassembled and was shipped to a forensic lab in Michigan where it's undergoing a series of tests. While we remain committed to our investments in energy storage, it's imperative that we move forward safely. We expect that more specifics on what a safer path forward looks like shouldn't be available by the end of this year or early 2020.

Turning to our regulatory updates. We filed a rate case on October 31, 2019. Key components of the filing include a 10.15% return on equity, a 1% return on the fair value increment, 54.7% equity layer and 12 months of posttest year plant. We've requested an increase in annual revenue of $184 million. This includes $73 million for the four corners selective catalytic reduction project that is the subject of a separate ACC proceeding. We proposed that new rates go into effect on December 1, 2020. The rate case filing highlights technology-driven programs, we're already pursuing on behalf of our customers, including our participation in the western energy imbalance market. Our participation in this market not only provides greater ability to manage our grid and the intermittent resources in our service territory, it also provides access to the increasing availability of negative-priced energy.

Our customers have realized gross savings of over $120 million during the three years, EPS a member of EIM. In further support of our customers, our filing contains three proposals to benefit the most vulnerable. We propose increasing funding for our Crisis Bill Assistance program from $1.25 million to $2.5 million annually, expanding the ways in which customers may enroll in our limited income, bill discount program and deferring costs for our bill discount program, allowing for expanded program growth.

We're also responding to customers by proposing a flat bill pilot program. This subscription rate will offer customers an option to be billed the same amount each month similar to an unlimited use cell phone plan. Programs like this demonstrate our commitment to increase customer choice and provide options that fit our customers' lifestyles.

In addition, we have heard the commission's request for transparency in our financial status on a more frequent basis. In response, we have proposed an alternative formula rate concept for the commission's consideration. The benefits of a formula rate in addition to the annual transparency and accountability include annual earnings calibration, annual ACC approval, a reduction in the need for adjustor mechanisms and rate gradualism for customers. The commission has a number of other open dockets, including final disconnection, rules and retail choice. We anticipate another retail competition workshop may be scheduled in December or in early 2020 to continue evaluating the complexities of retail choice.

In the disconnection rules docket, commission staff has proposed draft rules for the commissioners to consider. We do not know the timing or next steps in this docket. On October 29, the commission approved our third tax expense adjustor mechanism filing, refunding, another $103 million to customers. Including this third filing refunds to our retail customers from Federal Tax Reform will total $547 million by the end of 2020, allowing us to continue investing in the system, while keeping bills affordable.

Earlier this year, I announced my retirement date of November 15. While I look forward to what's ahead, I can't say enough about the immense pride I have in the performance of this company over my tenure. The strength of our team and the dedication of our people drive our success, and I have no doubt that success will continue under Jeff's leadership.

I wish you all the best, and I'll now turn the call over to Jim.

Jim Hatfield

Thank you, Don, and thank you again, everyone, for joining us today. This morning, we reported our financial results for the third quarter of 2019. We earned $3.77 per share in the third quarter of 2019 compared to $2.80 per share in the third quarter of 2018. A reconciliation of the earnings drivers can be found on Slide 3 of the materials. Given the impact year-to-date from below normal weather, we would not expect to hit the lower end of the $4.75 to $4.95, 2019 guidance range.

As illustrated on Slide 26, through the end of the third quarter of 2019, weather decreased gross margin, a total of $24 million or $0.16 per share. October sales are also below expectations due, in part, to another month of mild weather. For the full year 2019, we expect a negative weather impact will be partially offset by lower O&M and the approval of the TEAM 3 refund.

As we look ahead to 2020, we will continue to enhance our customer and shareholder value through our cost management discipline. We have a long track record of managing our costs and continuous improvement. The customer affordability effort challenges our employees to find ways to work better and more efficiently challenged bureaucracy and eliminate unnecessary work in our daily operations, all of which are based on lean principles.

Just working harder will not get us there. We must find different general rates to get the job done and cost savings will result. Although we are in the early stages of the customer affordability initiative, we have identified $20 million of potential O&M savings that will serve as a positive driver in 2020. We are introducing 2020 guidance of $4.75 to $4.95 per share. Given the rate case outcome is unlikely to materially impact 2020 earnings. There are no assumptions regarding a rate case outcome incorporated into the guidance range.

Positive drivers for 2020 include lower O&M, sales growth, higher transmission revenue and the Ocotillo deferral. We expect our O&M will decrease approximately $25 million from 2019 to 2020. The main drivers for lower O&M include the closure of the Navajo Generating Station, reductions from our customer affordability initiative and lower planned outage expense. We expect these drivers will be partially offset by an increase in expense associated with revised disconnect policies, higher depreciation and amortization, higher property taxes, higher interest expense and lower AFUDC.

We currently estimate that the disconnection moratorium and revised policies could result in a decrease of approximately $20 million to $30 million of pretax income in 2020, depending upon certain assumptions, including customer behavior. The estimated effective tax rate of 14% for 2020 reflects benefits associated with the amortization of $45 million in excess deferred taxes associated with the TEAM 2 and TEAM 3 filings. These effective tax rate benefits are substantially offset by the refunds provided to customers as part of the team filings.

Going forward, we will need a modest amount of equity to support the growth in clean energy investments our customers want, while supporting our strong equity layer. We will continue to evaluate our equity needs, including the form and timing of any issuance as our capital expenditure plans progress. We expect to issue $300 million of long-term debt at APS during the remainder of 2019. This may include a portion of our funding needs for the refinancing of the APS $250 million, 2.2% senior notes, which mature in January 2020.

We also expect to issue up to $1 billion of term debt at APS and $450 million at Pinnacle West during 2020. Overall, liquidity remains strong. A complete list of factors and assumptions underlying our 2019 and 2020 guidance can be found on Slides 5 through 7. In addition to our cost management, we stand to benefit from organic growth in our service territory as a result of economic development. According to the Arizona Technology Council's quarterly impact report, Arizona's tech sector is growing at a rate 40% faster than the U.S. overall. The Metro Phoenix area continues to show strong job growth and has consistently been above the national average.

Through August of 2019, employment in Metro Phoenix increased 3% as compared to 1.6% for the entire U.S. Construction employment in Metro Phoenix increased by 10.8% and manufacturing employment increased by 5%. The Metro Phoenix residential real estate market has also continued its upward trend. In 2019, we expect a total of 13,000 housing permits, an increase of about 2,900 compared to 2018, driven by single-family permits. Reflecting the steady improvement in economic conditions, APS' retail customer base grew 2.1% in the third quarter of 2019. So we expect that this growth rate will continue to accelerate in response to the economic trends I just discussed.

In closing, our long-term rate base growth outlook remains at 6% to 7%, and we expect to achieve a weather-normalized annual consolidated earned return on average common equity of more than 9.5% through 2020. As illustrated on Slide 8, our earnings are not linear and will fluctuate from year-to-year. When we reach the end of our rate case cycle as we will in 2020 , regulatory lag can slow our earnings growth. However, over the long term, the opportunity to partner with stakeholders across Arizona to build a cleaner energy future positions us well to continue our track record of success.

And this concludes our prepared remarks. I'll turn the call back over to the operator for questions.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Our first question comes from the line of Michael Weinstein with Credit Suisse. Please proceed with your question.

Michael Weinstein

Good morning.

Don Brandt

Good morning, Michael.

Michael Weinstein

When I look at the slides on – I'll continue on the Four Corners SCRs, and I think there's a slide in here that shows about $0.07 of EPS reduction full year 2019 impact from Four Corners. It looks like perhaps the two of those things combined in 2020 would be probably about a $0.15 hit. Is that – would it be fair to say that, that $0.15 would be restored once the rate case is finished in 2021.

Jim Hatfield

That would be the math of the combined two. We can't predict the optimal rate case, obviously, but those are the two big components of our rate ask.

Michael Weinstein

Got you. And do you have kind of any thoughts right now on what kinds of equity issuances you might do for the modest equity that you said you might need going forward? And what the timing of that might be? Is it a 2020 issue or a 2021 issue?

Jim Hatfield

I don’t have any thoughts currently, Michael.

Michael Weinstein

All right. Thank you very much.

Operator

Our next question comes from the line of Insoo Kim with Goldman Sachs. Please proceed with your question.

Insoo Kim

Thank you. Maybe starting with the economic data that you guys were pointing out, it seems like there is – continues to be a lot of growth in various industries in the commercial/industrial side. Despite that, you – now you’re forecasting the weather-normalized load growth for 2021 to be about 50 basis points lower than your prior forecast? Could you just talk a little bit about the usage trends that you’re seeing in the various customer classes?

Jim Hatfield

Yes. So if I look at the – residential continues to be strong. The economy is doing very well overall, virtually all sectors. For stronger growth in the C&I customer base is being dominated by warehousing and logistics. Currently, retail stores and malls still appear to be weak, which is in line with national trends. So from an energy-use perspective, the rapid growth in warehousing and logistics sector appears to be reducing average use per customer in the C&I area, still showing growth but a little weaker than we expected.

Insoo Kim

Understood. And then maybe switching to the rate case. I think in the past couple of months, there's been conversations about the treatment of the fair value increment of the rate base. And I just – I'm not as familiar with that in terms of – is that a PSC statute, is that a legislative item? Or is that just something that the ACC has discretion on whether to approve an increment or not?

Jeff Guldner

Hey, Insoo, it's Jeff. That's actually part of the Arizona constitution and so the state is adopted in the constitution in 1912, a fair value requirement. So it's somewhat unique to Arizona. And over the years, it's been addressed in a variety of different rate cases, not all of them, ours. And it really started to have more of a role, probably five or six years ago, a lot of rate case context. And so the commission has been applying it and discussing how to apply the fair value standard since that time. This was a workshop on it a few weeks ago. And so there's some moving parts on it. I don't know exactly how that's going to play out.

Insoo Kim

Okay. But the constitution would state that the PSC would apply some sort of fair value increment to rates?

Jeff Guldner

Yes.

Insoo Kim

Okay. Thank you very much.

Operator

Our next question comes from the line of Julien Dumoulin-Smith with Bank of America Merrill Lynch. Please proceed with your question.

Julien Dumoulin-Smith

Hey, good morning, team. So obviously, continue to cut costs in the 2020 versus 2019. Can you talk a little bit about how you think about earned returns and narrowing the gap versus authorized? And I'm really trying to get at how you think about sort of a post rate case outcome, and continuing to focus on narrowing that gap, especially in the eventuality of any change in authorized returns here. And then maybe if I could follow-up on Insoo's question just in brief. How do you think about the delta in ask here on the fair value piece just given some of the commentary in other cases between staff?

Jim Hatfield

So Julien, I think in terms of narrow on the regulatory lag, we have some mechanisms now that work well from a rate gradualism perspective. Obviously, as an alternative in the case, we proposed formula rates would just be an annual filing, much like we do at FERC, which we would need adjusters. And those will be the sort of two things we'd look at in terms of getting faster recovery in terms of the fair value.

Don Brandt

Yes. Obviously, on the fair value, Julian, each case is a little bit different. So if you watch right now in the Tucson Electric case, they had requested a 1.25% fair value increment and the staff testimony at fall was a little less than 0.5% increment. There've been other cases before where the company – water company didn't get a fair value increment. But again, that's going to be in the context of that specific case. And so it is an area that's – the policy is evolving or at least being discussed. But it's just a part of the Arizona regulatory framework.

Julien Dumoulin-Smith

All right. Fair enough. But with respect to earned returns, I mean, obviously, O&M coming down. I mean the broad framework, I think you guys have historically talked about is about a 9.5% earned return or better. I suppose, still broadly, even in going to the future, sticking to that mantra, is there no ability to kind of narrow that range?

Jim Hatfield

Well, I mean based on where we are now, obviously, beyond the right case outcome, we can't really focus or really say what that is because we don't – we can't predict the outcome.

Jeff Guldner

But we do try to get the delta between – you're always going to have some structural disallowances, right? And so you do try to narrow the delta between the earned and the authorized return. And so that obviously will continue to be a focus for us.

Julien Dumoulin-Smith

Got it. Excellent. And then CapEx wise. I know it's a small bump in 2020. But how do you think about any potential to shift that around, obviously, I suppose it was earlier here, you made a more meaningful shift. Given the pendency of the case, we shouldn't be expecting anything more meaningful until the termination of that case, right? Or resolution, rather?

Jim Hatfield

Yes, I think as we're now almost on 2020, that's – we have a good plan for 2020 and 2021, and I wouldn't expect any big changes currently.

Julien Dumoulin-Smith

All right. Fair enough, guys. I leave it there. Thank you.

Operator

Our next question comes from the line of Greg Gordon with Evercore ISI. Please proceed with your question.

Greg Gordon

Thanks, First, hey Don, congratulations on the retirement. You've served the customers of your utility in Arizona very, very well over your tenure and also put up good returns for shareholders, so well deserved.

Don Brandt

Thanks, Greg. I appreciate it, especially coming from you.

Greg Gordon

The – I've been multitasking here. So I appreciate and apologize if I missed this, but when looking at the adjusted gross margin targets for 2019 and 2020, obviously, they came down a lot for 2019 and the 2020 adjusted gross margin target is actually below where you thought you were initially going to come in, in 2019. Your expectations for weather-normalized retail electric sales volume are lower for this year, but the same for next year. Can you just go through what you've recalibrated there? And whether it's just a 2019 issue or there's also some uncertainty around where you think you'll end in 2020 versus initial expectations in 2019?

Jim Hatfield

Well, in a response to an earlier question, we talked about how in the C&I sector due to the customer mix that we're – we have now versus historically, we're seeing less huge per customer, that's really around warehousing logistics. And going forward, we have a slide with some of the other data centers and other things, which are highly uncertain in terms of timing and exact amounts. So I think we're just recalibrating to what we're seeing actually in the marketplace.

Greg Gordon

Okay. And then back on Michael Weinstein's question. You did – thank you for putting a slide in the appendix on the impact this year of not getting the step increase. I think you annualized that at $0.07. Is it – will it annualize at a larger number in 2020 before it all gets worked out in the rate case, is that right?

Jim Hatfield

No, that's really the delta between – you're having it in as rates and earning an equity return versus just a debt return. And that project will continue to be deferred. There's a – they're concurrent ALJ rule out there for that, and that's not going to change. The impact will be – it's a non-cash return. So you're always – you're not getting your cash return, but it's fairly minimal over a one-year time frame.

Greg Gordon

Okay. Thank you, guys. Have a great afternoon.

Operator

Our next question comes from the line of Ali Agha with SunTrust Robinson Humphrey. Please proceed with your question.

Ali Agha

Thank you, good morning. First question, just to clarify, I think you mentioned that you're going to be below the low end of your guidance for this year, can you give us some calibration of how much lower we should be thinking about just as we think about finishing this year off?

Jim Hatfield

We'll be below $475 million. That's about as a finest point I can put on at the moment.

Ali Agha

Okay, Jim. I mean can you – I know you manage all your target towards the 9.5% or higher earned return. Any range or numbers we should think about for 2019, when the dust settles?

Jim Hatfield

No.

Ali Agha

Okay. Then my second question, I think in your comments, you mentioned in 2020, these revised disconnect policies will hurt you by about $20 million to $30 million. One, I wanted to confirm I heard that right? And two, does that impact continue in future years as well?

Jim Hatfield

Well, you heard it correctly, the impact based on various assumptions. The reality is we don’t have a policy at this point going forward. So anything beyond the assumption of the number would be a pure guess at this point. And at some point in the future, those will ultimately be reflected in rates whenever we end up.

Ali Agha

I see. So there is some truing up that will happen in this rate case that’s currently pending?

Jim Hatfield

We did do a couple of pro formas in the case to try to increase our uncollectible expense based on the increase we’re seeing now.

Jeff Guldner

Ali, longer term, it’ll depend on what the final rules are. So they’re in a rule-making process now on the disconnect policy, and we’re participating in that. And ultimately, it’ll be reflected in what those rules come out with.

Ali Agha

I see. But just from, I guess, a big picture point of view, would we expect that there would be some headwinds from this? Or – I mean theoretically, the rules would be such that this would not be an issue going forward?

Jim Hatfield

There’ll be headwinds until ultimately you get it reflected in rates, whether that’s what we ask for in this case or down the road based on the final rules, which we don’t have yet.

Ali Agha

I got you. And then lastly, Jim, I just wanted to confirm, you mentioned the need for some equity or small equity going forward. But you don't need that for this rate case, right? That 54.7%, that's based on your actual capital structure? Or does – is there some equity needed to calibrate to that level as well?

Jim Hatfield

No. Our capital structure is 54.7% as of June 30, that's what we filed in the case.

Ali Agha

Right. Okay. Thank you.

Operator

Our next question comes from the line of Charles Fishman with Morningstar. Please proceed with your question.

Charles Fishman

Thank you. Don, I think I first met you over 20 years ago and sort of followed you around and the – or the Board at Pinnacle West certainly made a great decision when they took you out of St. Louis.

Don Brandt

Thanks, Charles.

Charles Fishman

The only question I have is effective tax rate, 14% that you're using in your key factors for next year. Can you give a little more color on that, Jim? Or – and what will likely – I mean, I assume that will rise as we go forward here in the next decade.

Jim Hatfield

Well, what it is, is it's really a reflection of the deferred tax flowback through TEAM 3, which really will be reflected in effective tax rate for the foreseeable future. But based on the fact that we're giving it back over 27.5 years, roughly.

Charles Fishman

Okay. So we can – it will stay at around this level over the next few years?

Jim Hatfield

All things equal.

Charles Fishman

Okay. Got it. That's the only thing I had. Thank you.

Operator

Thank you. We have reached the end of the question-and-answer session. I would now like to turn the floor back over to management for closing comments.

Stefanie Layton

Thank you for joining us all today. This concludes our call.

Operator

Ladies and gentlemen, this concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.