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Aqua America, Inc. (WTR)

Investor and Analyst Meeting - Q4 2017 Earnings

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MANAGEMENT DISCUSSION SECTION

Brian Dingerdissen
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Good afternoon, everyone and thank you for joining us for Aqua America's full year 2017 earnings and analyst update. If you did not receive a copy of the press release, you can find it by visiting the Investor Relations section of our website. The slides that we will be referencing can be found on our website. There will also be a webcast of this event and a transcript available on our site.

As a reminder, some of the matters discussed during this call may include forward-looking statements that involve risk, uncertainties and other factors that may cause the actual results to be materially different from any future results expressed or implied by such forward-looking statements. Please refer to our most recent 10-Q, 10-K and other SEC filings for a description of such risk and uncertainties. During the course of this call, reference may be made to certain non-GAAP financial measures. A reconciliation of these non-GAAP to GAAP financial measures is posted in the Investor Relations section of our website.

As most of you know, our Analyst Day and announcement of guidance was originally scheduled for January 17th. With the passage of the Tax Act, we postponed the event and combined it with our earnings report in order to take the time to evaluate the impact of tax changes on our results and future guidance. We appreciate you taking the time out of your busy schedules to attend today's event.

Presenting today is Chris Franklin, Aqua America's Chairman and Chief Executive Officer; Dave Smeltzer, the company's Chief Financial Officer; Rick Fox, the company's Chief Operating Officer; Dan Schuller, Executive Vice President of Strategy and Corporate Development; and Kimberly Joyce, Vice President of Regulatory and Government Affairs. In addition to those presenting today, Chris Luning, Aqua's General Counsel and Ben O'Brien, who recently joined the Investor Relations team at Aqua are also in attendance. Today's presentation is expected to be one hour. After the formal presentation, we will open the floor for questions.

At this time, I'd like to pass it over to Chris Franklin, our Chairman and CEO.

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

Hey, thanks, Brian and welcome to all of you here at the exchange and those of you who are on the webcast as well. I think we have a good solid agenda here for you today. We've combined a number of things in this presentation, right. We have our year-end earnings call for 2017, we've got our Analyst Day presentation and we're going to hit some hot topics as well, topics like impact of the Tax Act on our financials.

First on the agenda, I'll provide a brief overview, acclimate those of you who are maybe new to the story or new to the industry and then I'll pass it over to Dave. Dave will take you through the 2017 financial results, the impact of the Tax Bill on the company and then we'll talk a little about the rate activity. I know the Pennsylvania rate case is a hot topic that you want to hear about. And then Rick will talk about the operations of the company; and we've had a really strong operational year in 2017. And then Kim will talk about our legislative and regulatory efforts, which, if you follow our story you know pretty well that our work in regulatory and legislative is pretty key to our growth strategy.

And then Kim will – Dan will follow-on right after Kim and he'll talk about the update of our growth strategy and he'll also talk about particularly the municipal water – wastewater effort that I think has been very successful, particularly over the last couple of years. And then I'll summarize and will give you the 2018 guidance, which you've already seen at this point in our release. And then we'll open it up for questions.

So let me begin with a general overview. The company was started – we talked two years ago when we were here at this – or similar room here at the Exchange, talking about, we are 130-years-old. So obviously two years later, we're 132 years old. We're the second-largest publicly traded water utility in the country; have been for some time. We have a footprint that covers eight states. We have 1,600 dedicated professionals who operate the company and serve our customers now in the eight states with three million Americans.

Our passion, frankly, is our mission statement; protecting and providing Earth's most essential resource, and we couple that with our corporate values, so we deliver that service to our customers with integrity, the pursuit of excellence and with great respect for each other and for our constituencies. As many of you know, we are primarily a regulated utility, right. We get – 90% of our assets are water utility assets, 10% are wastewater assets. We have almost no unregulated or market-based activities at this point.

You'll recall, a couple of years ago when we were together, we talked about divesting of what we thought of as really not scalable unregulated components and we spent the last two years and we have executed against that strategy very nicely, and we're down to essentially zero, or just a small amount of unregulated activity. And so we also discussed a couple of years ago, we applied a new strategy based on a couple core competencies and the strategy is a three-pronged growth strategy. You'll recall that it's really the acquisition of private and municipal utilities, wastewater utilities. Secondly – second prong is the strategic M&A focused growth, really on regulated utilities. And third is the growth in the market based business, which you probably know has taken less of our focus on growth and more on divestitures as I just mentioned.

So that's been our focus for the last couple of years in particular and Dan is going to give you a lot more detail on our progress through that in just a few moments. And finally, as those of you who have been following our story know very well, we are very focused on rewarding shareholders and we've done that through the return of capital in the dividend. Our dividend policy continues to be very straightforward and now we've come 73 years straight with having paid a dividend. And in fact we increased the dividend in September of last year by 7%.

So let's talk about the industry here for a moment. You can see our footprint here in this slide. But the U.S. water and wastewater industry remains very fragmented and we've been talking about this for many years: 50,000 water systems in the country or more; 16,000 wastewater systems across the country. And the vast amount of our population in the United States still receives their water from a municipal system. Matter of fact, in the water side, 85% municipal, 15% regulated companies like ours, and in the wastewater side it remains at about 97% municipal. The good news for us is, this fragmentation for us spells opportunity. We think and we believe that we can continue to be a consolidator and really said more specifically I think, a solution for particularly municipal systems that are feeling – or having difficulties. We've been very successful in this effort compared to even the – our most recent history. And again Dan's going to take you through what it looks like over the last couple of years.

Now in terms of infrastructure, 2017 really saw a renewed focus – really renewed national dialog on our country's infrastructure. And throughout the year, the nation's roads, bridges, water and wastewater systems, particularly in the last couple years post Flint, Michigan have been a key topic of conversation. This chart that you're looking at here is an indication of a couple of things. One, the aging of our infrastructure; hence, the vast cost associated with the upgrade of these systems.

And secondly, the issue of deferred maintenance, right. While we're making a, what I'll call significant investment in our water and wastewater systems, much of the country and the municipal side in particular has been unable to do that because of constraints. And so, we see deferred maintenance in this as well. But again, when we look at this chart, we see opportunity. Think about this; we are about $4 billion of rate base and we're the second largest publicly traded wastewater utility in the country.

This talks about $700 billion of potential need. If you think about what the American Water Works Association talks about, they're talking about nearly $1 trillion of need just in the water sector over the next 20 years. So there's no question that upgrading water/wastewater infrastructure is a major challenge across our country. And I think our company is well-positioned to be a player and a solution to much of that infrastructure need.

Let's take a quick look back at 2017, just couple highlights. So, our results were in line with expectations. Dave will take you through why our results were $1.35 EPS that you saw last night. Obviously, there is some impact from the Tax Act. Dave will take you through that in a moment.

But beyond pure financials, I'd like to talk a little about how far we've come since we were last here in 2016. We had, as I said, celebrated 130 years in business and we had also introduced a new management team. We had a refined strategy and I'm proud to say that I believe our results stand on their own and then this management team has delivered very nicely, not only on the strategy, but on much of the other work that we've undertaken as well.

Today, Aqua's opportunity – and I truly believe this – Aqua's opportunity to grow is greater than it ever has been before, largely because of what we see in this municipal market. Now, in 2016 I identified our core competencies that we would use as building blocks for our growth strategy. And we talked about what we do well, right. We deploy capital in infrastructure; pipe, plant, we do it very well. We don't overbuild, we don't under-build it. We do it right in that sweet spot and we do it of size. We recover that CapEx we spend through the regulatory process and we do it almost seamlessly. And why is that? We have strong regulatory work and relationships in each of the states, built because of credibility in the work we do, the customer service we deliver.

And finally, then we operate the companies we have with excellence and very efficiently. We've talked about that efficiency many times over the years. Over the last couple years we've actually exceeded the amount of capital that we had planned and we plan to invest another $500 million in 2018. We invested a record $478 million. $500 million this year in 2018 will be another record, but $478 in 2017. And I'm happy to report that 2017 was our best environmental quality – our environmental compliance I should say, year in our history; so for water and wastewater, best on record.

And for 2017, the board – our board's executive compensation committee adjusted the short term incentive plan to include some of these metrics. And so they're actually portrayed in our proxy. The results in 2017 were no doubt a great start, but we've always taken our customers and our compliance very seriously, and these metrics are just a way of demonstrating our continued focus in this area.

One of the other key factors that's fueled our growth is acquisitions. And in 2016, we talked about our heightened focus on municipal acquisitions. We talked about this increased [indiscernible] (00:13:21). We had done so many small acquisitions and we talked about a new range of a minimum of 2,500 customers and to 25,000 customers as a ideal sweet spot for the acquisitions we would do moving forward. Right now, we have six pending acquisitions – municipal acquisitions I should say under agreement. The six we just announced in December, it was in Pennsylvania. And while we hope to close some of these transactions back in 2017 as we predicted, some of them were delayed in the regulatory process. Kim will talk a little bit more about that in detail. But I remain confident, as I believe our management team does as well that we'll close these acquisitions in 2018 and we'll work through some of the finer points with regulators in the coming several months. This progress really wouldn't be possible without the work led by Kim and her team in the legislative and regulatory arena. This work has really opened up the possibilities for us to grow the company at a much faster pace.

And finally, I wanted to make one more mention of something that maybe we don't typically talk about with the financial community, but it's around the culture that we created or are evolving at the company. You may say it's obvious; but nevertheless I'll state it out loud that our employees are responsible. They are the ones that make this company successful. And so, they understand that we work at a mission-based company, right, we talked about protecting and providing Earth's most essential resource. When you come to work every day with a mission just beyond feeding your family, it takes on another light. And our employees understand that often they are the difference, they are the wall between water-borne illness and health. And so they understand that they have an awesome responsibility and they take it very, very seriously. In fact they come to work and many of them offer up a comment that they feel like they're making a contribution to our society every day.

Now, the leadership team and I have spent considerable time over the last couple years on things like succession planning and employee training and development and modernizing our facilities to really open up more innovation and more collaboration among our teams. We've changed some policies. Trying to keep millennials – or attract millennials is a completely different approach, and we've had to adapt some things so that we attract and retain really, really good people. And I think we've made many of those adjustments.

So let me just conclude by telling you that I see real results from our work. In fact, a firm that does our employee engagement work for us indicated that we have improved in all categories – that was just taken in – at the end of 2017 – compared to three years ago, we've improved in all categories. And they've further indicated and I quote that we are on the verge of something significant at our company given the employee engagement and the response and improvement we've seen in our results. So, for those of us who really care deeply about the team that makes all this happen, it was very heartening and very encouraging.

So with that, I'm going to turn it over to Dave Smeltzer, our Chief Financial Officer. Dave?

David P. Smeltzer

Chief Financial Officer & Executive Vice President, Aqua America, Inc.

Thanks, Chris and good afternoon, everyone. Today I'll discuss our financial performance for 2017. I'll go into some details on the impact of the Tax Cuts and Jobs Act. I'll also address our recent rate activity, the outlook for rate activity in 2018 including discussion of our upcoming Pennsylvania rate case.

So let's start with the full year 2017 results. Our revenue was down a bit, down really entirely because of our discontinuation of certain market-based businesses. You can see the Regulated segment was up just about 1%; and that was due to rates, surcharges and growth, offset by a fairly significant decline in sales, which I'll show you in a future chart.

O&M expenses were down year-over-year, again because of the market-based decline. So you can see on the next line, Regulated segment O&M expenses were up less than 1% and that was due to reduced production costs, having converted a purchased water supply to one of our own supplies. And so on a normalized basis, our O&M is probably up in the 2% to 4% range.

Net income and earnings per share were both up about 2.5%. Rates, surcharges and repair tax offset by the lower sales and importantly, a $3 million charge related to the Tax Act got us to this ultimate conclusion. And I'll talk about that a little bit later.

Operating revenue. As you can see, we finished last year about $820 million, so we had increases in revenue, $9 million from rates and surcharges and about $4.5 million from our regulated growth. But you can see we had some offsets to that; about $15 million down in revenue related to the discontinuation of those non-regulated businesses. And then about $9.5 million down related to a decline in consumption from 2016 to 2017.

Operating and maintenance expenses were down 5.8% for the year. When you dive into it, that was due largely to the decline in market-based activities, drop in O&M by $15.5 million. We also saw drops in O&M and production costs, as I mentioned earlier, about $6.3 million and employee-related costs about $3.8 million. Overall, we did have about a $7 million increase in the normalized expenses of the company about 2.3%. As I said, in the future we can think about O&M in the 2% to 4% range.

Earnings per share followed the pattern and we saw an increase in earnings per share from tax repair benefits, from rate cases and surcharges, net expense decreases and then some regulated growth; all provided increases to earnings per share. On the down side, we saw that consumption was a big cause of the decrease in earnings, $0.03 from that $9 million drop in sales. And there it is, the impact of the Tax Act, $1.08 and I'll talk about that shortly and then another penny from a variety of other things to result in the $1.35 for the year.

So let's go into some of the details on the Tax Act and this occupied the first couple weeks of the year. So, we spent a good bit of time on this issue. We had – before the Tax Act we had deferred taxes on our books of over $1 billion. And so, those deferred taxes have been collected from our customers. They were collected at a rate of 35%. And now, when they ultimately go through the tax process, they're going to be paid at a rate of 21%. So we have to account for that 14 percentage point difference.

And so, there's two ways we account for it. One, related to deferred taxes that are not rate regulated; and a second, related to tax – deferred taxes that are in fact rate regulated and incorporated into our rate making process. So first of all, those that are not rate regulated, we tallied up those deferred taxes and when we revalued them, they came down about $3 million, but because they are not rate regulated that $3 million hit the P&L. So that was the charge we took in December that caused us to miss at the end of the year $3.1 million related to things like deferred comp, goodwill and other things that really aren't part of the rate-setting process.

The vast majority of our deferred taxes were however incorporated into the rate making process and that revaluation from 35% to 21% made a $303 million difference. And so that entry was a reclassification on our books. So we took it out of deferred tax and put it into regulatory liability because since we've collected that money from our customers and now we're not going to have to pay it in the future, that's a regulatory liability that will be payable to our customers over a period as defined by the public utility commissions.

That refund will generally be paid over the remaining life of the property, so that's probably going to be 40 years or 50 years over which that $300 million gets paid back. Interestingly, the tax impacts on 2017 were exclusively because the bill was signed in 2017. So on that signing date, we literally had to revalue those taxes and that's why it became a 2017 event versus 2018.

So moving to 2018, we see some tax savings obviously in many of our subsidiaries. Those tax savings will be deferred on our books for future return to customers. And I'll show you how that works a little bit in the next couple slides. There are some exceptions to that. And Pennsylvania, our largest state, representing kind of half the company is one of those exceptions. And Pennsylvania, many of you remember, a number of years ago we opted to take the repair tax benefit to the P&L; was actually ordered for us to do that in the context of a rate case. And so, we have that. And in 2018 in fact we see – and 2017, the impact of the repair tax was greater than the pre-tax income. So we actually have a tax loss in Pennsylvania. And so, the application of a lower tax rate to this tax loss produces less benefit than would have otherwise been the case. So it's actually a little bit of headwind for us right now.

We also see a slight positive impact related to our market-based and certain of our other non-regulated divisions. You'll remember that our customers have actually benefited for many years from the repair tax. This is why we've been out so long and you'll see it's going to be a total of seven years that we'll be out and during that time we've been able to show acceptable returns while our customers' haven't had to pay more and all because of the repair tax benefit.

So, a couple quick slides on Accounting for Tax Reform. I know this is why you all came here today, to hear about Accounting for Tax Reform, but in short we're going to accrue that 21% for our Federal taxes in 2018. But we – we will still be recovering it at 35%, right. So we're going to have that other 14% coming in via our customer bills. But we won't record that as revenue. So you're actually going to see a decline in revenue related to the Tax Act, as this differential will be booked against revenue and the creation of a regulatory liability, again, to be paid back to our customers over some period of time defined by our regulator.

Now I've put together a little P&L. You should disregard the numbers, they – they're not in proportion necessarily to how it's going to turn out, but I just wanted you to see how this is going to work. So, our P&L will see two major changes. There'll be a change in the revenue. It would appear today that, that revenue decline is going to be less than $20 million, but there will be a corresponding and relatively equal change in the Federal Income Tax expense as well. And so those two will offset and in the end, our net income will be very much as expected.

The last impact of the Tax Act is one that you may not think about much. We develop some of our property through contributions from builders who want to build houses and have water and wastewater service, and these are called contributions in aid of construction and customers' advances on construction, a pretty big number on our balance sheet. So, we estimate in a typical year we bring in about $27 million in contributions and advances. And the taxes on that – now that it's taxable – as it was after the Tax Act of 1986, some of you might remember, that lasted about 10 years before it went away, but – but now it's back. And so that tax is going to cost us about $6 million. Importantly, it's not a P&L; it's only a tax event, there is no real book event, and it reverses over the life of the property. So it'll be $6 million in and then it'll be $6 million out over the life of the property. It is a balance sheet only matter and to a large extent the deferred tax asset that's created by this entry will be recognized in many of our states in the rate base calculation. So we should be all square there.

We see a number of key benefits coming out of the Tax Act. And some of them are a little bit duplicative, but I find them all very interesting. First of all, for the most part, across our states, we're going to see some reduction in rates and that reduction takes place on the bills without impacting the company's profitability; so, good thing. As far as our M&A program goes, we believe it will help in the comparability to municipal bills. So again, helping us to buy municipalities without providing as much of an increase as they might have previously expected.

We see it reduces the future increases required related to capital additions. Good thing for our customers. 7:1 projects become 8:1 projects – kind of my favorite. If you don't know what 7:1 projects are – is probably not terribly meaningful, but the short version is this: 7:1 project means that there are plenty of instances around the company where we can infuse up to $7 of capital to relieve $1 of O&M expense. And if we do that we're square, the customers' are square, right, rates don't change. But instead of having an O&M expense on the books that doesn't generate anything for shareholders, we have that $7 of capital that does create a return. So it's good for the shareholders but square for the customers.

So we have enhanced the ability to do those projects, because now with the Tax Act and the decrease in our revenue requirement calculation, those projects now become 8:1 projects. And also, lastly, it permits really more system improvements for the typical 5% DSIC. And so, all good things in our ability to serve our customers while retaining a reasonable level of profitability.

So we wanted to talk in a little bit of detail about the Pennsylvania rate case. And as I said, we last filed in 2011, so it will be – it will be a seven-year stay out. The longest stay out that I recall in my 32 years with the company is probably about 24 months. We might have gone a little bit longer once or twice in the early days, but 24 months was pretty typical. So, this is very special.

So we expect to file sometime this summer and complete the case in the spring of 2019. And there are a number of interesting issues. And so we just thought we'd throw them out there for you. It will be not only our first case in seven years; it will be over $2 billion of capital. You see that sketched out in the right side. It's literally eight years of Pennsylvania capital. It's interesting phenomenon, right; we're staying out seven years and yet we have eight years of PA capital here. And that's because there's a new format in Pennsylvania that's called the Fully Projected Future Test Year. So whereas last time, we got to look forward for one year, this case we get to look forward for two years. Thus, the extra year of eight beyond the seven-year stay out.

It'll be our first case with Consolidated Water and wastewater systems. Over 20 acquisitions; will first be incorporated into our rate making process. It will be the first filing using this new Fully Projected Future Test Year, which is a nice advantage and will help to minimize the regulatory lag that we see, particularly in the first year following the rate case. And there will be a few issues in the case relative to tax, including the Tax Act as well as the first case following our implementation of the repair tax.

So this is a look at the time table. And you can see the length of the stay out. I'll just talk to the right side of the chart. We implemented our first PA DSIC October 1, 2017. We would expect Phase 2 – well, Phase 2 was in fact implemented January 1 and then Phase 3, we would expect to be implemented on April 1. And we had plenty of capital actually to implement the entire 7.5% surcharge on 10/1, but we thought it would be best – and we know the Commission thought it would be best to phase that in over several periods and chose one-third over three periods to phase that in. And so you'll see that last phase kick in on 4/1, as I said.

So, let me talk a little bit about rate activity. 2017, we completed a number of rate cases and surcharges amounting to about $22 million. 2018, we've actually already completed some cases and surcharge and that's an amount of $11 million. I'm sure a big chunk of that is in our 1/1 implementation of Phase 2, moving the PA DSIC from 2.5% to 5%.

We have a number of pending rate cases and surcharges. And you can see they amount to about $16 million in our Illinois, New Jersey, and Virginia divisions. And additional rate information and other information can be found in the appendix of this presentation.

So, want to thank you for your time. And at this point, I'll turn it over to our Chief Operating Officer, Rick Fox. Rick.

Richard S. Fox

Executive Vice President and Chief Operating Officer, Regulated Operations, Aqua America, Inc.

Thanks, Dave, and good afternoon.

I'm starting my 17th year with the company and I'm in my third year in this role. And I'm proud to lead the men and women who actually make this company tick as they staff our plants, visit our wells, repair our pipes, operate our lab instruments, read our meters, and plan our capital program.

I will discuss Aqua's future capital investment plans, our continued focus on effective and efficient operations and our recent safety results. As Chris and others have already said, Aqua at its core is an infrastructure company. We own and operate assets, things like reservoirs, water treatment plants, wells, pumping equipment and pipelines. These assets are required to provide water and wastewater services to our nearly 1 million customer connections.

The chart on the screen shows the types of assets we own and the total regulated earning value or rate base that they represent. Since the last Analyst Day two years ago, we have added 300 miles of pipe, one surface water treatment plant, four wastewater treatment plants and numerous wells and large tanks in the communities that we serve, all of this to further benefit our customers. And as a result, our rate base has grown from $3.4 billion to approximately $4.1 billion.

Now, let me explain a little bit more about these investments. First, I want to talk about the pace of spending. Here on this slide, you can see our average annual capital spending and our projection for 2018 through 2020. The bar at the right shows our average annual capital spending plan for the next three years at more than $460 million per year, and as a result we expect to invest about $1.4 billion during the three-year period ending 2020. These figures do not include any investment for new acquisitions that have not yet closed or the capital that these acquisitions will eventually require.

The next slide shows the forecasted breakdown by percent of the types of capital that we will actually complete in this same three-year period. As you can see, as usual, more than half of the capital will be spent on upgrading our water Mains & Services. These are the pipes that deliver clean water to our customers and also the pipes that deliver the removed wastewater to our treatment plants. In addition to the roughly 150 miles of regular replacement of pipes that have reached the end of their useful life, two of the larger projects are a new seven-mile transmission main in Pennsylvania and a second redundant transmission main underneath the Ohio River, both of these for reliability.

Next are concerning treatment facilities. More than 30% of our spending will be used to improve both drinking water and wastewater treatment plants. This includes three major water plant upgrades in Ohio, Pennsylvania and New Jersey and a brand new surface water treatment plant in Texas. It also includes six major wastewater treatment plant upgrades in Pennsylvania, Texas, Indiana and North Carolina. One last thing. As a testament to

Aqua's strong engineering and construction capabilities, this nearly $1.4 billion in capital is comprised of more than 2,800 unique projects managed by our engineers, construction crews and inspectors and accounted for and funded by our accounting team and finance employees. Our ability to deliver these prudently managed and cost effective capital projects is one of Aqua's strengths, a strength that we intend to use to help acquired municipalities maintain and revitalize their communities.

This next slide shows the current size of the different regulated state operations. It includes the number of water and wastewater connections and the amount of rate base in each state. You will notice that we expect to reach the 1 million customer connections milestone during 2018.

As many of you are aware, Aqua has been an industry leader in efficiency. Properly managing operating expense is part of that culture at Aqua and we continue to do a number of things to sustain that leadership. We pay attention to every dollar spent on behalf of our customers and we reward employees for identifying better and cost-saving ways to accomplish our responsibilities. However, let me be clear on one point. Our drive to be the most efficient water and wastewater utility doesn't mean we cut corners: quite the opposite; we invest in employee development, we deploy efficient technologies, and we spend the funds required to operate our systems properly. We just think we have the best people and the most efficient ways of doing this. And this is important too: as we acquire larger municipal systems, it is our practice to hire all current employees and we don't use layoffs to reduce expenses. Rather, once we institute Aqua's way of doing things, we find that we do not need to replace everyone who retires or is promoted. This is good business for Aqua and it saves our customers' money.

Now I'd like to spend a moment on one of the techniques that we use to improve our operations and our costs. We have started numerous cross-functional and/or cross-location work groups that we call One Company Initiatives. These groups work collaboratively to share best practices, identify and either eliminate or exploit anomalies and establish consistent operating procedures. These OCI groups, like the one on Energy Optimization depicted on the slide help us leverage our extensive knowledge and expertise that resides in each of our states and corporate organizations.

In the past years, more than 20 OCI groups have formed and focused on topics like regional chemical bids, treatment optimization, water loss, and energy management. These groups have, and will continue to be the origin of many of the cost saving practices and technologies that keep Aqua efficient.

Finally, back at the office, we normally start each meeting with a discussion about safety. Today I'll conclude my remarks on this topic. At Aqua, our work involves considerable risk, but because of our duty to customers to provide a continuous supply of our sustaining services my fellow employees perform their work at all hours of the day, all seasons of the year, and unfortunately in all sorts of weather like hurricanes, floods, ice, sweltering heat, and bitter cold. Yet, because we must work in all of these environments and because we care about our co-workers and their families, we spend considerable time, energy, and resources preparing our employees to work safely and constructing our workplaces to be safer. Chris talked about Aqua being a mission-based company. One of these missions is running our business so that our employees are able to perform their roles without getting hurt and being able to return home to their loved ones each day without an injury.

I'm proud to say that in 2017, we had the safest year in the history of Aqua. We suffered fewer lost-time injuries, had the fewest days of lost work, provided more than 16,000 hours of specific safety training and made significant improvements to the inherent safety of our workplaces. This was a team effort, involving all of our employees and for that I'm extremely proud. Good safety is also good business. Our employees appreciate our care for their well-being, and our costs are reduced when we have fewer injuries. And lower costs are good for our customers' and the utility rates they pay.

Thank you for your time today.

Next up is Kim Joyce, our Vice President of Regulatory, Government and External Affairs to discuss Legislative and Regulatory priorities. Kim.

Kimberly A. Joyce

VP-Regulatory, Legislative & External Affairs, Aqua America, Inc.

Thanks, Rick. Good afternoon, everyone. My name is Kim Joyce and I oversee our Regulatory and Legislative initiatives and as well as our communications team, our volunteer efforts, and our community giving.

For those of you that follow the Water industry, you know the basics of our regulatory model. The basics and really the mission have stayed the same; provide safe and reliable water and wastewater service, work cooperatively with our regulators, customers, community groups and key stakeholders, and strive to operate our company in the most efficient manner so we continue to provide a fair return for investors.

As far as our Regulatory model, Aqua files traditional base rate cases and continues to be one of the most capital intensive industries, proactively investing in our communities in a timely and prudent way. At the same time, we know that many things in our industry have changed. With new technology, we're getting consistently better at understanding in parts per trillion what's flowing through our water treatment plants and we can receive real-time feedback from our customers if there is an unexpected main break in the winter time on our social media platforms.

Post Flint, Michigan water quality and the state of our infrastructure has been a national topic and we see lots of interest from our legislators across the country. And that has translated into many discussions about stricter environmental standards and the desire for more proactive infrastructure replacement. Just some recent examples include Indiana's passage of legislation that allows regulated utilities like Aqua to replace lead pipe laterals that are owned by the customers.

And in New Jersey, legislation was recently passed that requires our fellow government-owned providers of water service to provide asset management plans and capital plans on a long term scale. We use this slide here to demonstrate how the commissions that regulate investor-owned utilities and the states that we operate in have adapted to this change.

I know there is a lot of information on this slide and we'll highlight some of the boxes here in more detail on the upcoming slides. But it does visually demonstrate how the Water industry is proactively adapting to change.

So, some of the boxes of the previous slide referenced infrastructure mechanisms. And we often get asked the question, which states that Aqua serves customers' has an infrastructure mechanism and what does it look like? The Water industry pioneered this regulatory best practice starting in Pennsylvania in 1996 and it's now used in over 25 states and includes the electric and gas industries. Regulators really see this mechanism as a way to target infrastructure that is a major need of replacement and just as importantly, it spreads out the costs of those improvements incrementally for our customers.

This table shows the six states where Aqua currently has a targeted DSIC infrastructure program, and each state processes and reviews the infrastructure improvements a little bit differently. Since the 1996 adoption in Pennsylvania 20 years ago, the commonly referred to DSIC has changed in a number of different ways. For example, in Illinois, the Illinois Legislature recently modified its DSIC mechanism and extended the period of recovery over a longer period of time with no cap and included different types of infrastructure. North Carolina, our customers have and will see real improvement in the secondary water quality aspects of their water within North Carolina WSIC. In North Carolina, this mechanism targets groundwater-related issues related to naturally occurring iron and manganese in their water. And third, in Ohio, the Ohio Legislature increased their infrastructure mechanism to 12.75% for water and 9% for wastewater and it now includes additional plants such as filters and chemical feed systems and on the wastewater side it includes sludge hauling equipment and lift stations. And these are all important policy shifts that help us address our customer needs.

Transitioning to a newer regulatory best practice, the next slide talks about fair market valuation. When we were here last time in January of 2016, the water industry had just started talking about fair market valuation legislation which had passed in Illinois in August of 2013. And as Chris mentioned, the water industry is pretty unique in the utility space and just the sheer number of water and wastewater providers there are, both government-owned and regulated like Aqua.

There are many well-run municipal water providers across the country. However, there are others that are struggling for a variety of different reasons. In the event a government-owned water or wastewater provider wants to focus on other issues like police force, fire stations, it could be struggling to find the capital needed for infrastructure upgrades or it simply doesn't want to continue to take on the potential risks of providing water or wastewater service.

Having the option of selling at Fair Market Value can make a sale of potential possibility. At its core, Fair Market Value transitions from moving the valuation of the system from its depreciated original cost to what its Fair Market Value worth is.

Today New Jersey, Illinois, Indiana and Pennsylvania have passed their own versions of this Legislation. The Legislation in Illinois is working very well after a number of years and Aqua Illinois has completed five acquisitions under this Legislation with two deals pending approval. In Pennsylvania, Fair Market Valuation Legislation was passed in April of 2016 and as with any new piece of legislation, the commission, municipalities in Pennsylvania, and regulated companies are implementing the new statute with great care, making sure any transaction ultimately benefits our current customers, those future customers, the environment, and the company.

In Pennsylvania so far, Aqua has received approval from the Commission for two acquisitions under this legislation; New Garden, and Limerick. New Garden is a wastewater system with 2,106 connections and the PUC approved this transaction on June 29. It is currently being appealed to Commonwealth Court where the Commission and Aqua Pennsylvania will be on the same side advocating for the approval of the transaction, and we expect an order in the third quarter. Limerick is also a wastewater system with 5,434 connections, and the PUC also approved this transaction and found the deal to be in the public interest.

Although in the Limerick case the Commission made a deduction to the rate making rate base, we're confident moving forward that with each transaction that is approved in Pennsylvania, we'll learn from it, municipalities will learn from it, and it will create a great opportunity for consolidation in Pennsylvania where it makes sense to do so.

We know that the investment community is looking closely at these two acquisitions in Pennsylvania. And just like when the first DSIC was passed in Pennsylvania two decades ago, it took time to figure out the process and the procedure. Here we remain confident that we will bring both transactions to closing. Aqua plans on providing water and wastewater service for the next 132 years and making sure that we, along with the Commission and the statutory advocates feels comfortable with the process and the procedure is very important

The next two slides are also vitally important to our success as a water and wastewater provider. The first slide focuses on our commitment to communicating with our customers and change that is evolving in this area. Gone are the days when our customers only received a monthly or sometimes quarterly bill or a rate case notice. Our customer is our culture and their expectations are changing. And many of our customers are as committed to the environment as we are and they want to understand how their water usage impacts the environment, what types of infrastructure the company is replacing and they certainly want to understand the quality of the water that's being delivered to their homes. We strive to deliver these message and – messages in a variety of different ways that serve all of our customers' preferred method of communication and it's going to be a continued focus for us and an expectation that we will continue to deliver on.

Coupled with a focus on communicating with customers is our commitment to the communities we serve. Aqua is a mission-based company with water professionals that truly care about the service they provide and the connection between our professional mission and our personal mission is very linked. We see this in our volunteer opportunities such as tree plantings and river cleanups and through our corporate giving strategies which help support communities that we serve and even some around the world.

In 2017 we created the tagline, The Ripple Effect to highlight the interconnection between the service we provide every day that impacts our customers on a personal level along with our dedication to the communities we serve. We're very excited heading into 2018 about serving our current communities and stand ready to do that for our new Aqua customers.

So thanks to you for your time today and I will turn it over to Dan Schuller.

Dan J. Schuller

Executive Vice President Strategy and Corporate Development, Aqua America, Inc.

Thank you, Kim and thanks to all of you for joining us. Today I'm going to remind you of our growth strategy, take you through our transaction process, give you a snapshot of our historical growth performance, talk about a few transactions yet to close, and briefly discuss our acquisition pipeline.

Our fundamental growth strategy remains the same as I presented to you back on Analyst Day of 2016. Our three-pronged growth strategy is really an outgrowth of our core competencies. As has been said earlier, three of our key strengths are: investing capital to rehabilitate and upgrade infrastructure, that is, pipe replacement, plant expansions; earning return often on that capital through a regulatory process; and running our businesses as efficiently as possible.

First, the primary driver of our growth is our Municipal Initiative. That is, acquiring water and wastewater systems from cities, towns and authorities. Aqua has invested a considerable amount in this initiative in terms of time, people and training, as well as in process development to enhance our abilities to succeed in this key initiative. I will be discussing the investment process, our recent results, and 2018 projections of our Municipal Initiative in the next few slides.

Second, from time to time, as opportunities present themselves, we evaluate strategic M&A targets. These is either publicly traded or privately held regulated utility businesses, ranging in size from a few hundred millions to billions of dollars in enterprise value. While most often these are water utilities like the water company that changed hands last year, we would consider other utilities or infrastructure businesses, or we could apply our core competencies.

Finally, we also evaluate market-based businesses, MBAs as we call them with traits and characteristics which would complement our Regulated utility business and are large enough to supplement our earnings. As you may recall, Aqua has been exiting a number of sub-scale local MBAs. Certainly, additional MBAs would have to meet our growth needs. Today, we aren't spending much time on MBAs. We're more reactive than proactive, responding to opportunities that come our way. I say that in contrast to the muni initiative, where we're constantly playing offense; seeking out opportunities, and working to develop them into transactions.

Next, let's talk about our acquisition process. This slide outlines the disciplined process we follow as we evaluate and ultimately approve or reject municipal acquisition opportunities. Our Investment Committee, comprised of eight members of our senior leadership team is the decision making entity for our company's leaders to evaluate, provide input on, and ultimately price and structure our acquisition opportunities. Of course, for larger opportunities, the Investment Committee decision requires further approval by Aqua's Board of Directors. As our municipal initiative has grown, the Investment Committee has begun to convene every two weeks or three weeks to review opportunities.

In order to provide important details and prepare our state teams for Investment Committee, we initiated what we call a Kitchen Cabinet, where our states can bring opportunities for early review before going to the IC. The Kitchen Cabinet is staffed by a subset of the IC members. Overall, our IC was very active in 2017. The Kitchen Cabinet met a total of 11 times to preliminarily review opportunities and we had 28 regularly scheduled IC meetings and follow-up calls. All-in-all, we reviewed 37 new potential opportunities at the IC throughout 2017. Now, not all of these opportunities have come to fruition yet and some municipalities will ultimately decide not to sell, but I think the figures give you a sense of the opportunity set that we are seeing.

For 2015 through 2018, we're projecting an average year-over-year growth rate of 1.7%. In those years, we're averaging a total of 17,000 new customers annually with approximately 8,600 coming from acquisitions. As you'll notice, in 2017, our growth rate was 1.1%, which was lower than our initial guidance of 1.5% to 2%. We had two large deals in Pennsylvania with combined 7,500 connections whose closings were delayed to 2018. As Kim mentioned, while these deals have been approved by the PAPUC, we encountered certain regulatory challenges in bringing them to closing. We anticipate these two deals will close this year, and thus we expect to have year-over-year growth of approximately 2.6% in 2018. In terms of organic growth, we've seen an increasing number of new connections with Texas and North Carolina being the strongest contributors.

Finally, I'd like to point out an upcoming milestone for Aqua. We're very excited to be surpassing the 1 million customer benchmark in 2018. It's an exciting time for Aqua and we look forward to bringing even more customers into the Aqua family.

Let's now move on to talking about 2018 projected municipal closings. We have six municipal acquisitions that are signed and slated to close this year. These municipal acquisitions, including the two mentioned on the previous slide will add 16,325 new customers. We're purchasing these systems for a total of $151 million. You'll note that half of these fit within our target range of 2,500 to 25,000 connections. But we still have some smaller transactions. We continue to emphasize for our corporate development team the need for target-sized deals. So I think you'll continue to see transaction sizes increase going forward.

With Fair Market Value treatment, we target getting our entire purchase price recognized as rate base. With these six acquisitions, if we get our expected rate base and a reasonable cap structure and ROE, we should earn $7 million to $7.5 million in new net income or approximately $0.04 of EPS. As you know, there may be stay outs, or it may take a few years until the next rate case, but we'll ultimately earn on the authorized Fair Market Value rate base.

Our last slide gives you a snapshot of the large acquisitions currently in our development pipeline. Our top 10 municipal opportunities have nearly 300,000 connections. Think of these as places where we are in discussions with municipal leaders and have, in many cases, submitted written indications of interest. While these larger opportunities are difficult to get to the finish line, our state teams and our senior managers remain focused on doing just that.

I'll also note that these 10 deals are in four of our states. So they're not all concentrated in one or two of our largest states. There's several important acquisition drivers that facilitate our opportunities. The one we see most often is that municipals want to use the proceeds of sale for economic development or for other fiscal needs. Of course, the Fair Market Value Legislation, where it exists in our states of operation have been critical in unlocking opportunities. Under this Legislation, municipalities can receive fair compensation for their systems including contributed property and pipe and plant that was funded with grants, and we can recognize the price of these systems in rate base. It's a win-win for both parties. Plus, Regulatory Commissions in many of our states favor consolidation and the efficiencies that come from scale.

Finally, you can expect us to continue to be active and creative on the municipal front. While we prefer to identify proprietary opportunities and develop them into bilateral conversations, we will of course initiate discussions that lead to auction processes and will participate in RFP processes that have been started by municipal leaders. In every case, we will deliver the full strength of Aqua; our subject matter experts and the attention of management and put our best foot forward to win.

And with that, I'll hand the mic back to Chris.

Christopher H. Franklin

Chairman, Chief Executive Officer and President, Aqua America, Inc.

So thanks to the team. I think hopefully you took away the level of focus that they bring to the job every day and we're very proud of the team we field. I'm going to wrap up very briefly with a quick summary and then the guidance and then we'll open it up for Q&A.

So, key point, right. Since 2015, O&M expensed for the utility has grown by only 0.8%. So I think the focus on O&M control continues to be in place. Secondly, despite spending nearly $2 billion in infrastructure improvements, the company has now filed for a rate case in Pennsylvania for more than six years – as they've said, almost seven years with growth in EPS for each of those years.

Just last year, we achieved the best environmental compliance record in the company's history. We achieved the safest year on record in the company's history and we've led vast new regulatory and legislative efforts to improve our growth efficiency and recovery of capital.

We've accomplished the signing of more than – more municipal acquisitions in the last two-and-a-half years than we did in the previous eight years combined. And in fact, our internal investment committee as Dan said, considered 37 different opportunities. Many of those remain in the pipeline. So I can tell you that there's not a more dedicated, focused or hardworking management team in the industry and we remain very focused on quality customer service, value for shareholders, and opportunities for our employees. I couldn't be more pleased with not only the team, but our results at this point.

So with that let's pivot to 2018 guidance. You've all seen the release last night. I've seen some of your reports already come out this morning. And so, let me just repeat what you've read. We expect full year earnings per diluted share to be in the $1.37 to $1.42 range. Remember, we don't have PA rate case completed until 2019. We expect to invest $500 million next year – or this year, I'm sorry, 2018, for – this is a record amount as I've said before, and about $1.4 billion over the three-year period to 2020. And I think it's important to note that nearly half of that capital, call it 48% is covered by surcharge-type mechanisms like the DSIC and additionally a little bit of that capital in addition to that is covered in the Pennsylvania rate case. So a lot of our capital is accounted for on a regulatory basis already.

Remember that this capital is really to strengthen our existing infrastructure for the customers that are in our groups today. And in fact any newly acquired systems, the purchase price and the capital to improve those systems would be above and beyond the $1.4 billion that we mentioned in our budget.

Rate base over the period is expected to grow by 7% and I want to reiterate that the Pennsylvania – that Aqua Pennsylvania expects to file a rate case in 2018 and get the proceeds from that rate case in 2019. So year-over-year, we're expecting as Dan said customer growth to be in the 2% to 3% range. And as Dan shared, by the end of the year we hope to cross the 1 million customer mark.

So with that, that concludes the formal portion of our discussion. What I'd like to do now is open it up for questions and I want to remind you that attendants in the room have microphones and we are on a webcast, so preferably you wait to ask your questions so you have a microphone in front of you.

So with that, I'll open it up for questions.

QUESTION AND ANSWER SECTION

Q

Hey, Chris. I know you lay out a 7% rate base CAGR. Is there any reason that your EPS growth wouldn't at least be commensurate with that 7%, now that we're back in Pennsylvania getting rate relief?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Yeah. I would think about it this way, Jonathan. Two of those years are pre-PA rate case, right. So we talk about 2018 and then 2019 will be in – should be in the case, but – so, some of that period is not in the rate case, but it will follow in the – in coming years, should follow rate base growth and earnings growth should be similar. Dave, you want to add anything to that? I think we have – do we have another microphone for Dave?

David P. Smeltzer
Chief Financial Officer & Executive Vice President, Aqua America, Inc.

A

Can you hear me? All right. Yeah, no I think Chris hit it. We're still doing very well in Pennsylvania. That's not why we're not in a rate case now. Our earnings report would suggest we're over-earning a little bit. And so, clearly some of the capital will move to correct that situation before we get into the capital that will be used to really raise rates. So we do have that little headwind, which creates a difference between those two growth rates.

Q

Okay. But then certainly once the PA rate case goes into effect, we should be able to assume that EPS growth is at least on track with rate base and then whatever kind of M&A you might do in addition to that?

David P. Smeltzer
Chief Financial Officer & Executive Vice President, Aqua America, Inc.

A

That's how we would think about it. Yeah.

Q

Okay. And then can you give a little more color on what would or wouldn't fit into the strategic M&A for Aqua? For instance, how interested would you be in acquiring a regulated electric utility that say is owns generation or perhaps regulated utility with significant non-regulated businesses?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Yeah, so I would point you back to Dan's slide on our strategy. Clearly, we can't talk about anything that's in – would be in a pipeline. What I can tell you is that we will stick closely to our strategy, which essentially says we'll grow municipal water and wastewater systems and private water and wastewater systems in that first prong. And as we think about strategic M&A – would be in a regulated – largely regulated in that prong. And we would capitalize on our core strengths. So Jonathan, I wouldn't see us looking for anything, at least primarily outside of, call it infrastructure that we can put in place, we could recover through, call it rates or regulatory process and then operate a regulated utility as efficiently as possible. If we think about then in our third prong, the only thing we would look at, if we looked at what we call MBA or Market Based Activity would be something that was very close to our core competencies, right, something close to our core; it would be complementary to our utility business, which is our primary business and that would be to some degree supplementary to earnings, would enhance earnings. And unlike our previous entrée into the unregulated, we would think about it as opportunities to be scalable. So that's how I would think about those.

Q

On the regulated side though, I know previously you've mentioned like a gas utility pipes, you're comfortable with that. How about on the electric side, whether it's just [ph] TMD (01:09:57) versus actual generation, owning power plants, running those?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Yeah. I mean, clearly when you think about a FERC-regulated transmission company, those are interesting. But there's only one that I'm aware of, and that is not in our primary set, right. But as I think about other opportunities in this space, I would point you right back to that strategy again that it's got to fit with those core competencies and with those key strategies. That's the only way we're going to do it. We're going to stick very closely to those, Jonathan.

Q

My question is kind of the reverse of Jonathan's question. So, we saw last week that a gas utility was interested in acquiring the Pittsburgh water system. They have kind of officially said that they had put in an RFP. We had Northwest Natural making an acquisition in Idaho. So I'm wondering, as you look at these four states where you are doing Fair Market Valuations, if you're seeing an increase in competition from kind of relatively new competitors that hadn't previously been interested in the water market.

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

It's a good question, again. I think as you look at the Pittsburgh situation in particular, that's an acute situation if you're familiar at all what's happening in Pittsburgh. That's in the newspaper every day. There's water quality and operational type problems. They've had outsiders in to run that system for a while. They've changed management a number of times. They've put different structures in place. And so, I think they need a solution. But in general, to your question about increased competition, we really haven't seen increased competition. We've seen some new players enter the space. Up in New England, we saw an electric enter the space within the year – last year. But we really haven't seen on a – on individual, especially our target market in water and wastewater, we really haven't seen increased competition in those areas, especially in the size range that we're looking at, call it 2,500 to 25,000, it's typically been the same players.

Q

Thank you. So, first on the earnings growth. So I understand that you are spending more CapEx to catch up with the rate based growth to commensurate with the earnings growth, but – so you are saying that the – the ability to grow your earnings with the rate base is going to be more of a 2020 type of timeframe, so 2018 and 2019 – I mean, 2018 we already know, but 2019 is also going to be below – or weaker than the rate base growth earnings here?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Well I – we only give one year guidance just to start with. But I would think about this, we're spending our CapEx, growing our rate base at 6% to 7%. And so, I would think about it in those terms, but also the fact that, as Dave said, we are over-earning in some of our key jurisdictions, and so essentially what we've got to do is – and we're spending capital at a large pace – at a fast pace. And so, those returns on equity are coming down that we're achieving.

And so as we go forward, we should get back [indiscernible] (01:13:39) situation where we need to go in for rates. As you can see, in a number of jurisdictions we are in for rates currently and then planning some, Pennsylvania being one of those. But CapEx spend continues to be strong. But again, in a situation where you have some over-earning, you've got to move through that before you go in for rates again. So again, I stick to the one year guidance, 2018, and I'm happy to give future guidance on where we think we're going from there post the Pennsylvania rate case. Dave, I don't know if you have anything to add to that.

Q

Okay. So just, I thought that the plan – original plan was to actually file the rate case in Pennsylvania more like the end of 2018. Now it seems like it's middle of the year. You admit that you're over-earning. So what's the reason for filing a rate case in Pennsylvania?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Well, we won't be over-earning, right, we won't be – at the current pace of the capital spend, we won't be over-earning. Shortly we'll be back into – as a matter of fact, we had to get into a rate where we could file a distribution system improvement charge at the end of last year. And so we're now moving to a situation where we won't be over-earning; we're just slightly over today. So, we always, as we talk about the filing of the Pennsylvania rate case, what we typically discussed is the adjustments, I'll call them micro-adjustments to adjust to whatever the conditions are, the capital spend, the repair tax issues and we – to make sure that we're earning at the appropriate level before we would file for rates. And again, I'll defer to Dave. If you have anything you want to add to that?

David P. Smeltzer
Chief Financial Officer & Executive Vice President, Aqua America, Inc.

A

No. Yeah. I would just say that for years we've done rate cases in Pennsylvania. But this is the first time we have the Fully Projected Future Test Year. So rather than looking out one year for capital, now we're looking out two years for capital. And really, that's one of the key differences that makes it possible now to talk about a rate case in the situation in which we exist today, because we're not just looking at 2017 capital for a historic test, we're not just looking at 2018 capital, but we're actually incorporating 2019 capital. And we're very confident, by then, we will be in a position to require a rate increase in Pennsylvania.

Q

I just had a question on the $300 million deferred income tax [ph] fee as you refund your customers (01:16:11). I'm curious to know why you think you can return it over 40 years to 50 years versus the gas and electrics are doing it all within the next 12 months to 24 months in general.

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Yeah, that's interesting. The way it works is, the accounting requirement is that these taxes be reversed through the ARAM method, Average Rate Assumption Method and that method calls for the reversal over a period that is the remaining life of the property. Now, if you're talking about an electric utility with perhaps some short life property you know maybe that makes sense. But when you come to our space, and most of the property are water mains that last over a 100 years, they have a very long property and the longest tax life that we can have. So, we're confident that our return of this money to our customers is going to be over that longer tax life and the 40 years or 50 years that we've discussed.

Q

I don't think that this is a tax life issue. Was more a question, this is a windfall, and then that's why the electrics and gas returning faster to kind of please the regulators. I don't know if this is a water industry thought process or this is just different versus the electric and gas sectors or the utilities?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Yeah. There may be maybe some issues in the electric industry where it's unrelated to specific plant, but our deferred taxes are really exclusively related to the depreciation differences in all of our operating plan. So, we don't have a choice. We don't select the refund method. It's been dictated by the IRS, the commissions have all signed on to that, and that's the method that all of our water peers are using to return these excess taxes.

Q

Great. And a follow on is, what's your current FFO to debt that you guys are getting, and what's going to be the impact to your credit once this is – the average for the other big players I think was a 300 bps hit, and are you willing to issue equity to defend your rating at the current rating that you have?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

That's a really good question today. And you know we definitely see an impact there. However, for us, it is certainly nowhere near 300 bps, it's probably less than a 100 bps. And based on where we are today with sufficient coverage over our downgrade threshold. We certainly don't see an impact on our credit rating as a result of tax reform.

Q

Thank you. Hi, Chris. Mitch Verity at [indiscernible] (01:19:03). How are you doing?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Good to see you.

Q

Just a quick question for you. I apologize if this was asked, I stepped out. Regarding the DSIC mechanism – and I've asked this before, I just want to see if there's an update. From time-to-time, I hear there's pushback from the consumer advocates. So I'm just wondering if you're seeing any of that or if there has been any kind of sense that that might be coming where you could see a pushback on the DSIC moving forward?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Yeah. Fortunately, I don't foresee any pushback from the, either regulators or the consumer advocates on the DSIC. I think generally what we've seen is an acceptance that in fact this is a way of gradualism in rates, right, bringing rates up. It's investment typically only in capital. Every state's a little bit different in how they – what they allow in the DSIC mechanism, but generally it's been accepted as a proven way to put capital in. Some states require some pre-approval, other states don't. But each state seems to have gotten comfortable at this point with that approach. And again, I'll point to Kim Joyce here if you think there's any... No? So, I think we're very comfortable, [ph] Rich (01:20:12) where we are with the consumer advocates and the DSIC.

Q

Okay. Great. Thanks, Chris. And then just one other question too regarding the regulatory environment overall throughout the country. Are there any states that you see that are becoming more favorable that Aqua does not participate in where maybe Aqua could someday make an acquisition and grow its footprint in the said state?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

You're asking about secret sauce?

Q

Yeah.

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

So we would be interested in expanding. I think we've said this many times, [ph] Rich (01:20:41). At one point we were in 14 different states; we're in eight today. We make decisions on regulatory climate all the time. I would say, for starters we're very fortunate that we're in eight states with very strong regulatory climates, just I'll say, constructive. Would we go to others and are there targets? We are looking at a couple of other states right now. I prefer not to say which ones, given the competitive nature of the market, but I think there are states that have climbing regulatory – I'll point to one that we haven't been active in, but I think that has vastly improved; in Arizona, right, it still is an elected commission, but I think that commission has become very constructive. And I think the companies that do business there have done very well since the improvement in that commission.

Q

Thank you very much, Chris. I appreciate it.

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

You bet. Any other questions?

Q

I'll just revisit the strategic M&A. Would you say is this something that you're actively considering opportunities today, or are you exclusively focused on the muni deals given the pickup in activity in that space?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Yeah. So I would say every day our focus is on the muni work, right, every day. We have teams deployed in each one of our states; every day they think about the muni deals. Occasionally, when an opportunity might meet our strategy and our core competencies, occasionally we would consider an opportunity that might meet those and we would evaluate it at the board level and we would make decisions at that point. But those, I would say are occasional views.

Q

Okay. And then to get clarity, Dave, in terms of equity needs, nothing in the foreseeable future, given I guess kind of sort of steady state within your expectations on the muni deal front to fund the actual budget, and then reasonable number of kind of muni deals?

David P. Smeltzer
Chief Financial Officer & Executive Vice President, Aqua America, Inc.

A

Yeah. I'd love to issue equity, right, because that would mean we have so many municipal deals coming that it's starting to throw our capital structure off and we need to rebalance, right. But as we just look at the capital that we're deploying over the next number of years and the standard M&A transaction that we've done historically, no, we don't see the need for equity in the short term.

Q

And what short term? Is it for your budget?

David P. Smeltzer
Chief Financial Officer & Executive Vice President, Aqua America, Inc.

A

I'd say two years.

Q

Right. And then, last – and I might have missed it, on the top 10 muni deals development, what level of like development are these on? Are they exclusively negotiated deals that you're in or are they kind of open bids? Like, how likely are they to I guess materialize and how should we handicap it?

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

Well, maybe as we migrate a microphone toward Dan here, I would say, [ph] Jonathan (01:23:46), that they are in multiple different stages, and I think several different approaches. As Dan said, we've become more aggressive in the sense that if we see a struggling municipal, we will offer our solution publicly. And so we have been more aggressive than we have before. But let's all just remember that you can't [ph] hostilely (01:24:12) take over a municipal. They either want to sell and sell or not. But we, I think through our predictive modeling have now identified those that are most likely to sell, only because they have issues, whether it's compliance or financial challenges or pension issues or whatever it might be, we try to narrow down that field to something that is more probable. And so, when we offer our solution, we like to think about those ways. But Dan, maybe talk about at what stages they're in.

Dan J. Schuller
Executive Vice President Strategy and Corporate Development, Aqua America, Inc.

A

Yeah. Absolutely, [ph] Jonathan (01:24:44). So there's 10 deals listed here and as I said, these are generally places where we're in dialogue with municipal leaders. In certain cases, we've made offers. A number of those has been unsolicited, what we'll term indications of interest. And you've seen some of that activity from us, if you kind of watch the news.

But when I look at this list, one quick count, I get to about – it's kind of almost 50/50 or maybe six of them are kind of proprietary deals as we'd call them where we've initiated it and we're in discussions. We may or may not have put a proposal in. And then the others I would say are more processes if you will, where we're in dialogue with municipality but others may be as well.

Q

Yeah.

Christopher H. Franklin
Chairman, Chief Executive Officer and President, Aqua America, Inc.

A

[ph] Jonathan (01:25:31), just to give you a sense, I mean it's been publicly reported, so I'm not giving any – anything confidential here, but these deals, while we think there are more opportunities in the market than ever before, they are hard and the one I'll point to is in Pennsylvania where we offered to freeze rates for 10 years and we offered a very large purchase price and that one never went forward. So you can see just in – and that one is very troubled – it was not, I would say, troubled, but that one could use our help, let's just say that. Just tough to do.

Any other questions? All right. I thank you for your time, both here in the room at the exchange and on the webcast. Appreciate it and look forward to your questions and comments in the future. Thanks so much for joining us.