Company Participants

- Beth W. Cooper
- Michael P. McMasters

Other Participants

- Insoo Kim
- Tate Sullivan

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. My name is Chris and I'll be your conference operator today. At this time, I would like to welcome everyone to the Chesapeake Utilities Third Quarter 2018 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you. Beth Cooper, you may begin the conference.

Beth W. Cooper

Good morning, everyone, and thank you for joining Chesapeake Utilities' third quarter 2018 earnings conference call. We appreciate all of you taking the time to join us this morning. We're hosting today's call live from our Silver Lake office in Dover, Delaware. And joining me on the call today is Mike McMasters, President and CEO, as well as other members of our management team.

Before we begin, I would like and the team would like to extend our recognition and appreciation to all veterans who have served this great country of ours. We honor and salute all who have served in the military on this day being recognized as Veterans Day.

Now turning to slide 2. Before we begin, I would like to remind you that today's presentation may include forward-looking information. We would refer you to our Annual Report on Form 10-K that discusses those factors that may cause actual results to differ from forward-looking information.

Turning to slide 3, in terms of our year-to-date performance, you'll see that our earnings year-to-date remain very strong, up over 21% compared to the nine months ended September of 2017. The key drivers of our growth year-to-date include our regulated energy business being up $7.5 million in terms of net income again or approximately 29% year-to-date. The key drivers of this higher performance include our Eastern Shore rate case and our 2017 System Expansion Project, our Northwest Pipeline project and several other Peninsula Pipeline expansion projects, our return to more normal weather, natural gas distribution growth and, finally, our Florida GRIP and Electric Reliability Program.

On the unregulated energy side, we are also up on a net income basis, when you look at it, 8.7% year-to-date. This is being driven largely by continued propane customer growth, AutoGas and also increased service revenues and wholesale margins. They too had a return to more normal weather and finally continued growth in our Aspire Energy business.

Some other things to keep in mind, as you look at our third quarter, that in particular, overall, we, as a company, see our results being in line with our internal forecast that we talked about earlier in the year, and I'll touch on that in just a minute, and also our previous communications regarding the year. And for the third quarter, what you continue to see year-over-year is that we have ongoing fixed costs that are highlighted given the seasonal revenues in the second and third quarters. Lastly, again, we continue to reaffirm our forecasted 2018 earnings per share growth of 17% over adjusted 2017 EPS of $2.89. And that does include, I'll talk about in a minute, some potential very minor impact from Hurricane Michael.

Turning to slide 4, when you take a look at the quarter, once again, the third quarter results were in line with our internal forecast for the quarter. Net income was $5.5 million or $0.34 per share. We saw continued growth in the Regulated Energy segment before the impact of the tax – the TCJA, the Tax Creation and Jobs Act. You'll see that our operating income was actually up $2.4 million or 15% for the quarter. We had continued profitable growth in all of our businesses on the regulated side, with the biggest factor for the quarter being our pipeline expansions adding $3.6 million in terms of margin.

On the Unregulated Energy side, once again, as those businesses continue to grow, you see the seasonality of the third quarter coming out in this particular quarter.

Turning the slide to page 5, in terms of our year-to-date performance, I talked in the beginning about our 21% growth in net income. That represented about $6.8 million or $0.40 per share, driving us to $38.8 million on a year-to-date basis. Continued profitable growth across the natural gas value chain, including sales, distribution and transmission, as well as strong electric distribution and propane distribution growth are driving the year-to-date results.

Eastern Shore's $117 million System Expansion Project remains on track, and Mike will talk about that a little bit later on. And then, lastly, once again, at the bottom, you see the overall impact of our Regulated Energy segment adding, in terms of operating income growth, 21.6% on a year-to-date basis.

Digging into the quarter and looking at it from a per share standpoint, once again, the key drivers from the gross margin perspective, I talked a little bit about Eastern Shore and Peninsula Pipeline's expansion that added $3.6 million. Eastern Shore, the outcome from the rate case added $1.2 million. Our reliability programs added about $800,000 for the quarter and, finally, our natural gas growth and expansion also added about $734,000.

On the Unregulated Energy side, in those businesses, there were slight declines on the margin side, driven by lower retail propane margins per gallon, lower consumption and also some true-up of some imbalance positions related to our natural gas marketing subsidiary. Our operating expenses were slightly higher than quarter-over-quarter to the tune of about $6.7 million. Those, once again, are largely driven by growth and become more pronounced in the third quarter due to the seasonality. And finally, overall, from a tax perspective, you'll see that the overall impact, when you look at it on a quarterly basis, was about a $0.01 with the shift being from the TCJA on the gross margin side, offset by the income tax side.

Turning to the next slide, we wanted to talk a little bit about Hurricane Michael and we'd first like to begin by saying that we are extremely grateful to our employees and volunteers for the dedication that they showed to both our customers and our colleagues during this most expansive restoration effort in our history.

Our commitment to the safety and well-being of our customers, colleagues and communities has been and will continue to be until we're done at the forefront of each and every action that we've taken to restore service and recover from the storm. At one point, more than 1,200 employees, contractors and volunteers were engaged in this restoration effort, working around the clock, rebuilding several miles of power lines, replacing over 2,000 electric poles and hundreds of transformers with more resilient, storm-hardened equipment, capable of withstanding extreme weather.

Our FPU subsidiary worked closely with federal, state and local emergency management officials to ensure that all communities impacted received the necessary resources. It truly was, as I mentioned before, the most expansive restoration effort that we've ever had in our history and, as shown on slide 7, we actually included some of the pictures of this effort and we've also included a hyperlink that you can copy into your browser and actually see a video that was put together regarding these efforts.

In terms of the impact on us, on slide 8, what you will see is that, first off, we have restored power to all customers who can access power. And overall, more than 13,000 customers in our particular situation were impacted. In addition to those who have accepted power and are now back up and using electricity, we are working with those customers who are repairing or rebuilding to restore service once they are able to take service from us. Our current estimate is that our repair and service restoration costs will exceed $50 million. Those types of costs have historically been recovered through rates.

At the present time, we reserve approximately $122,000 every year in Florida for potential storm damage. And when we think about the impact of this storm, we are at a great place overall and expect there to be minimal impact on our earnings per share of $0.01 to $0.03 per share at most, and once again, we are still reaffirming our earlier year guidance in regards to 2018 EPS.

Turning to slide 9, in addition, and I'm going to talk in a few minutes about the margin that we are expected to generate on the projects that we've undertaken, but it's important to note that continued strong organic margin growth that our natural gas distribution operations are achieving. I talked earlier about for the quarter that this represented $734,000 for the quarter, but on a year-to-date basis, you will see that, through September, we've added $4.1 million of incremental margin, largely two-thirds of it being driven by customer growth, customer growth throughout all rate classes in Delmarva and in Florida and with additional growth that's been generated by our expansion as well in Northwest Florida.

In both regions, we are experiencing customer growth that exceeds the industry average. On Delmarva, it's basically 3.8% when you look at it for the quarter, in Florida, while it doesn't mean as much in terms of you're really looking at the margin contribution, because there is not a lot of residential heat load, but regardless still customer growth of anywhere between 2.2% and 2.6%, depending on whether you look at it on a quarter or year-to-date.

Turning to slide 10, in regards to where do we stand in regards to the TCJA and working with our various regulatory jurisdictions, from the FERC standpoint, basically, our customer rates have been adjusted, associated with TCJA for Eastern Shore, and we've refunded $902,000 year-to-date. And then we have our next rate case, basically at that time, there will be an establishment as it relates to refunds associated with the regulatory liability as a result of the deferred tax revaluation.

In Delaware, we've made a filing and the PSC is currently reviewing our filing. In Maryland, we basically filed and reached a settlement. We've already refunded $783,000. Rates have been adjusted and there is a methodology and schedule in place as it relates to the regulatory liability associated with the deferred tax revaluation.

In Florida, we have filed on the natural gas side and hearings are tentatively scheduled in the fourth quarter for all natural gas utilities. On the electric side, we've reached an agreement with the PSC and there's currently a hearing scheduled in December with a proposed combination of reductions associated with the fuel cost recovery, base rate as well as application to the storm reserve over the next several years.

Turning to slide 11, always paramount to our continued growth is ensuring that we have a strong balance sheet in place to support our growth. You'll see at the end of September, our equity as a percentage of total capitalization sat at approximately 50%. Our short-term debt was approximately 26% and our long-term debt, the remaining 24%. We already have scheduled to convert and refinance part of our short-term debt to long-term debt with $50 million scheduled to happen later this week and another $100 million to be refinanced no later than August of next year at across the 3.98%.

This financing has ensured that we can continue to invest for the future. For 2018, our forecast is still $216 million. This does not include any impact from the hurricane restoration efforts that I talked about earlier. And to-date, we've already expended for new investments $176 million. So, those investments that we've been making have continued to propel our earnings growth. Mike will talk a little bit about that later on.

But as you can see on slide 13, those investments as well as various regulatory initiatives have added incremental margin for the quarter of $6 million, on a year-to-date basis $16 million and for this year, $20.6 million. And if you recall looking back over time, Chesapeake historically, over the last five years, has generated total incremental margin year-over-year between $18 million and $22 million. So, from these projects alone, we'll generate just under $21 million this year.

And now, I'm going to turn it over to Mike to touch on some of the projects that are currently underway.

Michael P. McMasters

Thanks, Beth. Yes. Turning to slide 14, I guess the first project I want to talk about is the Eastern Shore projects. Essentially, we've had the largest project in our history this year, 23 miles of looping in Pennsylvania, Maryland and Delaware, 17 miles of new mainline extension and two pressure control stations in Sussex County. And we've also upgraded our interconnect with TETCO, for 3,750 dekatherms of new compression, at the compressor stations, two pressure control stations as well. Total capacity increase of 61,162 dekatherms. Estimated capital investment $117 million. We spent about $103 million to-date.

Capital spend in years 2017 through 2019, the annual margin $15.8 million for the first five years and then $13.2 million thereafter.

As I mentioned earlier, it's the largest project in our history. We've introduced 24-inch pipeline into our system, which is the first time. And we hope to plan on completing the construction of remaining loops and place all segments into service by the first quarter of 2019.

Turning to slide 15, we've got a Del-Mar Energy Pathway project underway. We've made the filings with FERC. The pipeline – 6 miles of pipeline looping in Delaware, 13 miles of new mainline extension in Sussex County, Delaware, and Somerset County. New pressure control stations, new delivery stations in Sussex County, Delaware, and in Somerset County, Maryland. Estimated capital investment of $37.1 million. The capital spend is expected to occur from 2018 to 2021. There's really two pieces to this project. The first one in Sussex County for $2.8 million of margin and the second one in Somerset County for $2.3 million.

We look at the next steps, and we've filed with the FERC on September 14 to get our certificate application, and we continue to develop the project's facilities and successfully obtain all required permitting. The FERC process is ongoing and is subject to approval. By participating in the Maryland bidding process for Somerset County, we've basically had a bid of – that will generate $2.3 million of annual margin, but it's dependent upon the State of Maryland awarding the contract. We are the leading candidate for the contract.

Turning to page 16, Peninsula Pipeline Company and CFG, the Northwest Pipeline Expansion, this also was a very significant expansion, $6.5 million in annual margin, $44.3 million in total capital investment, and went into service in May of 2018. This project has not only the existing capacity that we're serving today, but we also have significant opportunities to add additional customers.

Turning to slide 17, the PPC New Smyrna Beach Pipeline, $1.4 million of annual margin, $9 million of total capital invested, partially in-service, fully in-service during the fourth quarter 2018. There's the pipeline, 14 miles, increased pressure and volume for FPU's distribution system, resolves a pipeline capacity constraint.

Western Palm Beach County expansion on slide 18, a $3.4 million annual margin, we'll expect to see $2 million of that in 2019, $20 million total capital invested, expect to be in service mid-2019.

Turning to slide 19, slide 19, this really speaks to that quadrant that we've talked about for several years now, strategic plan execution. What you're going to see with Chesapeake is that, when it comes to capital expenditures, we are among the highest – in this particular case, we are the highest in the group. We are approximately just slightly less than 25% of our capitalization, 23.14% of our capitalization is what we've spent in capital for the last three years on average.

When you look at us from an ROE perspective, you'll see the median is 9.4%, but you're going to see Chesapeake up at 11.62%. So, we are in basically the 80th percentile when it comes to ROE and 84th percentile when it comes to EPS growth over the three-year period ended 2018. So, again, strong results.

Total shareholder return on slide 20. You look on the right-hand side, you'll see that we've had a significant success over the years. For 20 years, 75 percentile, performance in total shareholder return, 73 percentile performance for 10, 82 percentile for 5, 60 percentile when it comes to 3 years, and the most recent year or 12 months – or 3 years, excuse me, is 45%, 46%.

When you come to TSR annualized for CPK shareholder returns against the performance peer group, and what you'll see in the first year, 9% total return, that is above the 50th percentile, slightly below the 75th.

If you move to the three year-average, you'll see Chesapeake is at 19 percentile, again, 21 percentile will be 75th percentile, so we're slightly below that again. When you look at the five-year, you're going to see us at 22%, which puts us above the 75th percentile, and it continues there for the 10-year and the 20-year, again, exceeding the 75th percentile.

Turning to slide 21, our annualized dividend and payout ratio, as you could see from the graph from 45% payout in 2013, we've hovered around the 45 percentile to 42 percentile for the entire time period. Most recently pulled back to 44 percentile in 2018. We're looking to increase dividends at a rate slightly lower than our EPS growth. We want, long term, our dividends to be sustained by earnings per share growth.

Turning to slide 22, we'll talk a little about our strategy. We are consistently looking to identify new opportunities to drive our future earnings growth and increased shareholder return. We're doing this through a variety of methods, but seeking new development projects to serve new customers, provide new services and expand into new service areas.

This includes distribution, transmission, marketing and CHP. We're investing in pipeline systems that provide natural gas service to downstream customers such as LDCs, cooperatives, municipalities, industrial end-users and power plants.

We are pursuing expansion projects that serve long-term commercial, industrial customers. We're investing in propane opportunities to access new markets with significant growth potential. Our engagement strategies with employees to continually build our strategic infrastructure for sustainable growth. This is a critically important topic. Investing our talent and targeted development plans and training, engaging with communities where we work and live, pursue brand excellence through safety awards, top workplace and Chesapeake Cares events.

Turning to slide 23, we're very proud of our track record of identifying strategic opportunities and producing superior total returns, driven by earnings and dividend growth. We're energized by our team, our corporate strategy and execution, our financial and operating performance and our future growth plans and objectives. This is a result of our excellent team and culture that values both capital discipline and entrepreneurship. We are driven to find innovative ways to serve our customers, while honoring our obligation to serve in a safe and environmental responsible manner and to provide investors a competitive return on their investments with us.

With that, I guess, we'll take questions.

Q&A

Operator
Thank you. [Operator Instructions] At this time, there are no questions in queue. I'll turn the call back over to the presenters.

Michael P. McMasters
Thank you very much. I want to thank everyone for your continued support of our company. We are continuing our efforts to identify opportunities and to drive our growth and increase our shareholder returns. Thank you very much for your attention. Good night – good day.