Baird Virtual, Food, Fuel and Water Symposium
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Middlesex Water CEO Dennis Doll Participated in Baird's Virtual, Food, Fuel and Water Symposium on June 17, 2020 with Baird's Ben Kallo and David Katter. While the actual replay is no longer available, the following is a transcript of that Symposium fireside chat.

Doll: Thank you Ben and David for hosting us this morning and thank you to all of you who are signed in and have an interest in our company. I'll share a couple of comments with you relative to an overview of our Company. For those of you who don't know us, we are largely a water and wastewater services business located in central New Jersey. We serve customers in both New Jersey and Delaware and a very small operation in Pennsylvania. We serve a little more than 100,000 customer connections but it is actually a population of close to half a million. We serve a fair amount of municipal systems on a wholesale basis that are interconnected through our systems in New Jersey. We're also in the contract operations business where we perform water and wastewater services for municipal and industrial clients in both Delaware and New Jersey. We have market cap of a little over $1 billion and we've been in business since 1897 and, again, highly regulated, largely on the water and wastewater side which is about 85% of our revenues.

Doll: We are heavily regulated, as I indicated before, both from an environmental perspective as well an economic perspective. We are required to follow all of the regulatory requirements of the U.S. Environment Protection Agency, of the environmental regulators in the states where we do business, with respect to water quality requirements and wastewater effluent requirements. On an economic basis, we are regulated by public utility commissions in the states where we do business. For those of you who don't know how the rate making process works, the water industry is literally the true remaining monopoly in the utility business. It is rate base rate of return regulation, where we are given an authorized return on our equity. We make money for shareholders based on the investment we make in utility plant through our capital program.

Doll: On the growth side, we are very fortunate in our Delaware operations to have some really extensive organic growth that has occurred in that state going back to the early 90s. We continue to add customers every month from buildout from either existing developments or new projects that developers have taken on. You may recall from the crash in 2008, where real estate took a big hit, things certainly slowed down a little bit but it continued to still grow at a reasonably healthy pace even despite that since 2008. Now we're seeing even more new projects come online in addition to infill on existing projects.

Doll: As I said, we are in the contract operations business. Ideally we would rather own some of these systems rather than just operate them, but you may be aware that there could be some fairly significant political challenges relative to the sale of a municipal system to an investor owned utility like our Company, so that's a big challenge for municipal leaders. We go in and we say basically tell us what problem you're trying to solve and we'll figure out a way to help you get through that, whether it's an outright sale or a contract operation or some hybrid. So that's worked quite well for us. That's who we are. We're not the largest company in the peer group, but we're not the smallest, but we've got some good growth opportunity, we've got excellent regulatory relations and we have a really well trained, talented work force and that's all worked quite well for us. That's just a brief overview of who we are and I'll hand it back to Ben if there are some questions.

Kallo: ***Great, maybe let's start out with you had a CapEx plan approved. Could you talk about that and sort of give an overview of it and then maybe just talk about where you are with that and how you've navigated through COVID when it comes to your CapEx deployment.***

Doll: Sure. Well we had publicly stated, going back to our 10K, that we are spending approximately $124 million in 2020, another $112 million in 2021 and $59 million in 2022. That program, that plan, is still on track. Of course there has been a bit of a slowdown relative to COVID-19, but not much frankly. We, all the way to the middle of March when things really started to get more challenging, made the decision that we were not going to hold back on our construction program. The governors in Delaware and New Jersey allowed construction for essential businesses, which is what we are, and virtually all of our construction takes place outdoors replacing water mains. We have a very large capital project at our largest treatment plant in New Jersey, where we are building an ozone treatment plant, changing from sodium hypochlorite to ozone as the primary disinfectant. That's a $70 million project -- so we were grateful to be able to keep that going. The contractors that we work with were all very grateful that we were able to keep them employed. Of course we've reprioritized some things to ensure that we weren't negatively impacting customers. For example, where we have to do tie-ins to service lines from the main in the street to the home, we're not leaving customers without water for an extended period of time which is a requirement in order to be able to do that final connection. Overall things have moved along quite well and we're quite happy with our progress.

Kallo: ***Dennis, it was a pretty big CapEx Plan compared to what you guys have done in the past. Can you talk about what's driving that in New Jersey and how we should think about going forward and not asking "What are you going to do next?" Is this a sustainable capital deployment plan as you get bigger or is it an anomaly?***

Doll: Well, we've characterized the current plan as a program called Water for Tomorrow. Water for Tomorrow includes a number of relatively large capital projects, the ozone treatment plant being the largest. We just completed a $52 million transmission main, a 42 inch main, 4 ½ miles long, through a number of densely populated municipalities in New Jersey. We started planning for that project about 5 years ago and thankfully we just completed it in March. A very important redundant line so we can take the single artery out of our main treatment plant in New Jersey for maintenance as needed and increase pressures, flows and so forth as needed throughout the distribution system. So those are two very large projects in the program. There's no shortage of need for upgrade and replacement of infrastructure, not only within our systems, being over 100 years old, but also across the country as many are seeing in the media and thankfully our regulators -- they get it. They understand the fact that there's going to be a continued need for upgraded replacement of utility infrastructure in the water business among other utilities so they're very supportive of our program. It's the largest program in our history. We, obviously, only share the three-year capital outlook, but we do believe that going forward there is no shortage of need to continue to invest in our systems and we'll continue to do that prudently and safely.

Kallo: ***Thank you. Could you talk about how the rates factor in with this plan and then also in light of COVID, I think there has been some sort of freeze on rate increases in different jurisdictions across different utilities and maybe you can just give us an update of what you're seeing there for you and also for the industry and how that impacts your plans.***

Doll: Sure, well first of all we are not currently in a request for a base rate increase in either Delaware or New Jersey, which is fortuitous because this is not a popular time to be asking customers to pay more for water or wastewater services with so many people struggling with job loss and all the other financial aspects of COVID-19. With that being said, we will need to go into rates at some point and I'll call it the medium term. We're still refining our plan to determine when we will need to do that and these large projects that I described will be part of that request. These are all prudently incurred costs and we have no reason to believe they will not be fully recoverable. That's all good news. We continue to reap the benefit of some favorable tax treatment, which is also helping in the short term on the net income side. We are capitalizing the interest AFUDC on all of our large construction projects so that also helps earnings while we're under construction. So that's all working just fine. We will be in for rates at some point, and I've been in rate cases my whole career, our CFO Bruce O'Connor could do this in his sleep. It never comes without its challenges but at the same time we are quite confident, based upon regulatory relations, we've been getting great outcomes in our cases and we see this as being no different.

Kallo: ***Just to stick on the regulatory side, we get the question quite a bit about what differentiates investor owned utilities when it comes to public utility commissions. Can you talk about that? Maybe a broader question that has come up also is, what do you see as a priority of the utilities commissions now and how is that different within your two jurisdictions?***

Doll: Great question. One of the keys to is to make sure that we're aligned with our regulators on our plans. Our regulators, as you might imagine, are dealing with the effects of COVID-19 as much as anyone. Clearly public perception relative to the cost of utilities, you did mention Ben, the fact that our Company along with all of the investor-owned utilities in New Jersey voluntarily agreed with our commissions to not shut off our customers for non-payment during this pandemic and we actually reinstituted service to customers who were already shut off for non-payment. We thought that was the right thing to do and thankfully our regulators, in both New Jersey and Delaware, are looking at a mechanism for our water companies to basically defer and address this in a future rate case in terms of the net cost of the effect of COVID-19. So we are in alignment with our regulators on working through a plan to make that happen. We're aligned with our regulators with respect to the temporary non-shutoff of customer services and it is important to keep that relationship collaborative and strong because we're all trying to do the same things for customers, recognize we also have an obligation to our shareholders so we have to balance that and to our employees as well. I don't want to forget that. I made the commitment to our employees in mid-March that no one was going to lose their job or be furloughed as of a result of this pandemic. Thankfully, we've got good technology in place where people are able to work from home. A significant portion of our employee population continues to work from home and that's all working fabulously, much better than I had anticipated. So keeping the morale up among our employees and letting them know financially they weren't going to have to be concerned, that's not to say their spouses and partners haven't lost their jobs or been furloughed. Some of them are struggling. We are very thankful that we've had relatively little impact of the virus itself on our employee population. Balancing all those needs, employees, shareholders, customers and certainly regulators has been a key challenge for the last three months and we're just going to continue to do that.

Kallo: ***Great. I want to come back to the culture and what you said there and I thought that was very good to highlight about job security and what you've done for your employees and I want to talk about that when we talk about ESG and on a broader level later. What have you seen in terms of, you mentioned not shutting off customers, have you seen large changes in people not paying their bills or slow pay or how could you quantify that?***

Doll: Well we have not yet migrated to monthly billing. We still bill quarterly, other than for our large, industrial, commercial customers. That makes it a little more challenging to get data on a timely basis relative to the impact on customer payments, but we are seeing a bit of an impact with respect to cash flow. To date, it's not significant. Significant is a very subjective word. We don't believe that the ultimate impact is going to be material, and as I indicated, we are working with our regulators to develop a mechanism to get recovery of the net impact of COVID-19. The impact of shut offs, the impact on cash flow relative to late payments or delinquent payments, all becomes part of that mix that will be addressed as part of that order when it ultimately comes out. We have excellent banking relationships; we've got committed lines of credit with major banks, so we have no issue with respect to continuing to finance our capital program. So cash flow, even though we're seeing a little bit of an impact, it's really not significant.

Kallo: ***When we're talking about capital funding and CapEx, could you talk about getting a secondary last year? Remind us of the size? And I think you also did some debt as well. If you could walk us through what you've done and what needs to be don't to fund that CapEx Plan.***

Doll: As you would imagine, with a very large capital program, and our obligation to keep our capital structure largely within a 50-50 mix for debt and equity, there's obviously a need to raise capital periodically. We did go out with a secondary offering in November with net proceeds of $43.7 million dollars. We used that to pay down short term debt and, again, fund the capital program. Then we also did some debt in 2019 as well. We did two pieces there: $53.7 million first mortgage bonds ($32.5 million at an interest rate of 4% and $21.2 million at 5%) through the NJEDA. We will need to do some more debt in the not too distant future, again to keep the capital structure in balance, but it's all coming together nicely.

Kallo: ***Great! Maybe you could talk about being awarded the operating contract for Highland Park. Also weave in -- I think you have another operating contract like that so you have some experience doing it, and how this overall fits into your business.***

Doll: As I indicated earlier, we'd rather be owners of these systems, but if the political winds don't allow for that, then we are happy to be a contract operator, which does differentiate us to some degree from others in our peer group. Highland Park was a nice contract. It's physically adjacent to our distribution system in New Jersey. They actually get all their water from us. We sell them water on a wholesale basis and now we will also operate their system on a contract basis. We think it's a great opportunity that continues to solidify our relationship in this region as a trusted service provider and we're hoping that will lead to more opportunities. Our largest contract operation is the City of Perth Amboy, NJ. It is physically interconnected with one small interconnection, so we can sell them water on an emergency basis, but that's 12,000 water, 12,000 wastewater customers. We were there for 20 years and we were the successful bidder in 2019 for a renewal of that agreement. It was a competitive process, but having great knowledge of the infrastructure and the financial model, we were able to secure that contract thankfully. We're there for another 10 years. They didn't want to go out for another 20 years so we're there for 10 and also for 10 years in Highland Park.

Kallo: ***On that topic, how competitive are these contracts like Highland Park? I know there are some other utilities present in New Jersey, so how competitive are these?***

Doll: They're very competitive. We were competing against some of the national names that you're familiar with. But we like to think that between the relationships we've developed with the municipal officials and our reputation for providing good service has impact. Obviously, it always comes down to money in the end. One big element in these agreements is understanding the risk profile. I stay very focused, and our team stays very focused, on the risk reward profile. We don't want growth for the sake of growth. The risk has to be manageable, it has to be able to produce a reasonable rate of return for our shareholders and we're just not going to get into business that we have no business being in or get deals for the sake of putting out a really nice press release and then being faced with the reality of having to run it and make money at it, so we're very careful. We're not completely risk averse, don't get me wrong, but we manage our risk carefully and we make sure that it's risk that we believe we can mitigate, transfer, manage and so forth.

Katter: ***My question, you mentioned a little bit, but you say you'd rather be owners rather than operators of a system. I understand the political winds you refer to, but can you maybe just discuss from a return perspective, and a risk perspective, why that's the case and the differences between owning and operating a system?***

Doll: Sure, well with the operating contracts, the way we approach it is all about operating margins. We have a target margin that we look for in any individual contract and we may be willing to settle for a slightly lower margin if it's a larger deal. If it's a smaller deal typically it would be a larger margin, because frankly we don't want a negligible impact on the bottom line to be too much of a distraction from the rest of the business -- so it has to be worthwhile. And the reason I say we'd rather own than operate, the way these deals typically work, are the capital requirements are all the obligation of the municipal partner. As the service provider, and as the licensed provider, we recommend what the capital program should be but it's their obligation to fund it and if they can't fund it, or choose not to fund it, that can create operational problems. So we look for some guarantees because we're the licensed operator so ultimately that's the risk that falls to us, so we have to make sure they stay in compliance with regulations, with legislation, etc. Again, a lot of that goes to being a credible partner so when you tell them they have to replace infrastructure of a certain kind they believe you and they'll support it.

Katter: ***Along the risk profile you were discussing, can you discuss the M&A environment, and I understand you're not chasing acquisitions, but from regulatory perspective your view on fair value legislation and where policy is headed?***

Doll: Fair Value Legislation has gotten a lot of attention in a number of places around the country. Closer to home, in Pennsylvania, it's gotten a lot of attention and there's been some deals that have been done under that legislation. My understanding is that the process has gotten more refined over time, so it's not quite the opportunity it may have been, but there's still some opportunity there. I don't know that we'll see Fair Value Legislation coming to NJ or DE. I've got my own personal philosophy relative to how Fair Value Legislation impacts customers. I mean basically you're asking the customers of a larger customer base to pay to solve the problems of an acquisition. So that has some political ramifications to it and some philosophical ramifications. If it ever does get enacted in the states where we do business, again we have an obligation to our shareholders, and we will play by the rules of the game as effectively as anyone and do our best for our customers and shareholders.

Kallo: ***Dennis, as you did your secondary last year and your stock has appreciated and you've crossed over the billion dollar market cap threshold, you now have stock for currency, how does that enter into your M&A thoughts? Are you sticking to your knitting and focused on your two jurisdictions or are you starting to look around to something that's adjacent that could also start fitting in as you build out through acquisitions as well?***

Doll: Using the stock as currency only is relevant to an acquisition of another regulated utility. It's obviously not relevant with respect to acquisition of a municipal or government owned system. So then the question is, Ok, well where are those opportunities to acquire investor owned systems in NJ, DE or states beyond that? One thing I've been clear on over time is we're not going to go to a state that is 1,000 miles away where our larger peers and competitors have a very strong foothold, where we would be at a large competitive disadvantage unless we wanted to way overpay for the system. We're not going to overpay because, as many are aware, anything that you pay above book value or rate base for these systems is a premium that is largely not recoverable in customers' rates. It basically erodes earnings per share. Of course we're looking all the time, but it's got to be a good fit for us. But I also say, even if we don't have the kind of growth relative to acquisitions of investor-owned utilities, there are plenty of opportunities to still partner with municipal systems, either on a contract basis or by acquisition. As I indicated before, acquisitions are tougher because of the political aspect. All that being said, as I also indicated, there is no shortage of opportunity to invest in utility plant and our Company for the foreseeable future. That is relatively low risk with relatively secure returns, so we are not going to forget that that is the engine that drives our ability to do all these other things and we will make sure that we are very prudent and careful where we look at other opportunities.

Kallo: ***On the environmental front, PFAS and PFOS have gotten a lot of attention. Can you talk to us about that and how it impacts you and what you see there more broadly?***

Doll: Sure, it affects us mostly in NJ. We have one of our larger wellfields which has been impacted by PFAS. In fact, we have identified the polluter and we are engaged in litigation with that polluter, which is slow, but we have an extraordinarily strong case we believe and ultimately we hope to get some recovery on that front. But in the interim, New Jersey has implemented one of the tightest regulations in the country relative to PFAS, PFOA and PFOS and we will have an ability to meet that regulation and we do have a project underway at this well site. It's roughly a $30 million project in order to remediate the impact. We're currently in compliance and believe we will continue to be in compliance. As you've seen in some states it's a race to zero on PFAS. There's still science out there that would indicate it may not be the concern that some believe it is at these low levels, but there's also a political aspect to that as well where governors want to be viewed as environmentally progressive with respect to health and safety. Some of the regulations are not well founded in science but they are what they are and we will deal with them.

Kallo: ***We'll probably spend the whole time on New Jersey and not on Delaware and I know that that's a great piece of your business. Could you talk about what you're seeing there and opportunities for growth? I know there's customer growth; you talked about that, but maybe inorganic growth through acquisition.***

Doll: They're two very different profiles between New Jersey and Delaware. As small of a state as Delaware is, it's very wide open, lots of farm land so we continue to expand our service territory organically. We do look at acquisitions in Delaware. There aren't as many towns there as there are in New Jersey. A lot of things are done by the counties. There are only three counties in DE: Sussex, Kent and New Castle. Most of our business is in the southern two thirds of the state. Our largest growth area is in Sussex County and a significant majority of the outstanding building permits in Sussex County are part of our franchise territory so, again, that goes back to the organic growth issue. Acquisition is a little tougher. We've done several, in fact we did one last year. It was an investor owned utility with about 1,000 customers. We did another one a few years before that which was about 600 customers. So you're going to see little things like that now and then. They're not game changers, they don't move the needle dramatically, but that's the business we're in and we'll do more of that. We do have some more contract operations there as well. One of our largest is a large chicken processing facility where we're doing wastewater pretreatment at their facility. The chicken industry, for those of you who don't know, is very large in Delaware. We have about 50 small contract operations in DE. Some of them are more profitable than others, in terms of their contribution to the bottom line but they're all very small. We may or may not do more of those. Again, we don't want them to become too much of a distraction from the core business. We still have a capital program in DE. We're upgrading facilities all the time: pump stations, installing mains and developer projects. There's no shortage of need in DE, but relative to NJ it is a smaller capital program.

Katter: ***Speaking of the capital program, I think one thing that investors really have been focused on is the P&L impact of this accelerated CapEx cycle we've entered. I was wondering if you could maybe talk us through how we should think about these investments following through and specifically touch on the repair tax deduction and kind of what's going on there.***

Doll: The Repair Tax Deduction has been a significant contributor to the bottom line for the last two years. This was a deal we negotiated with our regulators in our last rate case in NJ where we, as every utility, was required to implement the tangible property regulation promulgated by the IRS, which resulted in a $17 million dollar tax refund to our company. This included an amortization of the additional deferred income tax over a four year period. We were thankful that we were able to negotiate to be able to keep the entire financial benefit of that negotiation for our shareholders. Unlike some of our peers in the industry, where they we all required to implement it, had to share -- say 50-50 with the customer, some even more than that. So we got to keep that for the shareholder for four years so we're two years into that. In addition to that amortization, our capital program has been re-profiled to take advantage as best we can of that tax preferred projects because not every capital project qualifies under the tangible property regulations. For those who may not be aware, those regulations allow you to cap to expense for tax purposes things that have been traditionally capitalized which continue to be capitalized for book purposes. Between the new construction or the new investments in utility plant, where we get that favorable deduction and the amortization of the additional deferred income taxes, that's what's driving that tax number that you'll see for the foreseeable future.

Kallo: ***Adding onto David's question, when do you start seeing an earnings impact with the CapEx deployment you have?***

Doll: As I indicated, we're not in for rates currently. We're looking at month by month where we stand relative to our authorized return on equity in all of our jurisdictions. As you're aware, the concept of regulatory lag, you don't wait until you're under earning before you file because it could take roughly nine months to get an outcome. We've been fortunate to get outcomes in as little as six months, again, that goes back to our relationship quality with the various stakeholders. So you're taking a forward look, you're taking a current look and you make sure you get in there so by the time, in a perfect world, the day rates go into effect is the day where your return on equity is starting to deteriorate. So it's not a perfect science, but it's a very detailed process and we've done good things with that over time and we see no reason why we shouldn't be given fair treatment for all the investment we continue to make in the next case, when we ultimately file.

Kallo: ***On that note, what are the regulatory filings coming up? Can you just give us a timeline for New Jersey and Delaware? At the same time, you've mentioned some sort of a rate recovery for the non-shutoffs so could you talk about that please?***

Doll: Sure. The only thing of any significance, and it's really not that significant, is we do have a Purchased Water Adjustment Clause (PWAC). We do buy some water from another regulated utility in New Jersey -- just to supplement our supply in certain parts of our system. As they go in for a rate increase we get, through this PWAC, immediately the ability to pass on that impact in our rates. So we have that going on but no base rate cases in effect currently so nothing of any significance in 2020 that we would see. We may or may not file by the end of this year or early next year but clearly that's a very public process so when we do -- the world will know it.

Katter: ***Shifting gears, part of this conference is geared towards ESG and Sustainability. With that end, we do have a question from the audience about how you think about***

sustainability. Whether it's wastewater collection treatment, water recycling, what metrics do you think ESG investors should use to compare you with your industry peers?

Doll: Great question. Many may be aware we issued our inaugural Corporate Sustainability Report just a few months ago, which goes into great detail about who we are as a company, our culture, our focus on the environment, our focus on all aspects of ESG. The one thing that we still have to focus on is we don't yet have all the metrics that we need to be able to share with the investing community and other stakeholders. So that's under development. Directly to your point, David, first of all we've been an environmentally-focused company by default ever since we were formed. Obviously, water quality, water is ingested by human beings so quality is an enormous, enormous focus and as we continue to say, we're not in the water business, we're in the public health business because it really is a huge public health issue. With wastewater effluent, same thing. As Chairman of the Water Research Foundation, we're beginning to do a lot of research on the potential impact within wastewater of COVID-19 as a way to determine where there might be hotspots and so forth. The point is, we're very focused both within our company and nationally with respect to research on these issues and with respect to the impact on our own company. So the metrics are key, and one of the things that I'll share with the group that I struggle with is how to fully, fully vet out the impact of our carbon foot print. I indicated we're building this large ozone treatment plant in NJ. Ozone treatment plants take an awful lot of electric energy to produce ozone. You use a lot of electricity to generate ozone. So on the one side, we're adding to our carbon foot print by increasing our electricity use. The challenge that I think we have, and this was a great point I picked up yesterday from your ESG presentation, what we need to do is also quantify the follow on effects of that project. For example, by putting in ozone we're going to eliminate problems that are developing within our wholesale customer systems for disinfection byproducts, haloacetic acids and trihalomethanes. Currently, they're required to expend an enormous amount of time and cost, especially with the use of electric energy, to manage their systems, to mitigate the impacts of disinfection by-products, in terms of mixing within their tanks, how they're pumping, where they're pumping. So the fact they we're going to implement this project is going to save on the carbon footprint of a number of our customers -- so one of the challenges is going to be how to quantify that. And then certainly, we're generating electricity today making our own chlorine based products through sodium hypochlorite, which takes electricity to produce that, so that will go away. I just use that as one example of the complexity around developing a metric that we want to be meaningful and that we want to be able to improve upon over time. That just one example of a number we're focusing on.

Katter: ***Are adjacent water systems interested in your ESG practices and disclosures as you talk to them about operating contracts?***

Doll: The answer is absolutely. We talk about it. At the municipal level I find their challenges are more around costs because there is a significant need for infrastructure upgrade and replacement, so they're trying to figure out how to make all that happen without having a significant impact on their residents. Within their own systems and their own communities they're very focused on the environmental aspect of ESG and on the social aspect as well. We view ESG as somewhat of a differentiator and, apart from the right thing to do, a differentiator from a competitive perspective because it has to be a given that you're doing these things just to be able to do business going forward. At some point it will be viewed as part of our DNA and it just has to be a given.

Kallo: ***Last question, there are differences between a water, gas, and electric utility and in the market, water utilities trade at a higher premium. From your personal standpoint, what's the advantage of a water company over another utility?***

Doll: You look at the past and gas and electric utilities have typically enjoyed, over time, a higher authorized return on equity because the perception has been that they are riskier businesses than water. I would argue that the water industry requires a higher authorized return on equity because the risks are probably more significant than many may believe. With respect to water quality and all the regulation we just talked about and the impact on public health. I'm not suggesting for a minute that electric and gas doesn't have significant risks but, I think as a minimum, we should share at the same level of authorized returns as our electric and gas peers. And we are the last true monopoly. We are truly rate base rate of return regulation. Our customers can't go anywhere else. The electric industry was deregulated years ago and that seems to be working reasonably well but I don't see that ever happening in the water industry. So it's a different risk profile but in many respects it's very similar. So we understand the rules of the game very well and we maximize them as best we can for the benefit of customers and shareholders.