EDITED TRANSCRIPT

Q4 2017 ATCO Ltd. (TSX: ACO.X, ACO.Y) and Canadian Utilities Limited (TSX: CU, CU.X) Earnings Calls

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CANADIAN UTILITIES LIMITED
An ATCO Company

ATCO Ltd. (ACO.X, ACO.Y) and Canadian Utilities Limited (CU, CU.X)

Q4 2017 Earnings Call

February 22, 2018 09:30 am MDT

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OPENING COMMENTS

Dennis DeChamplain *ATCO Ltd. and Canadian Utilities Limited – Senior Vice President and CFO*

Good morning,

Before we start with your questions I just want to take a couple of minutes to make a few opening remarks if that's alright with you.

As usual, Anthony Maher, Katie Patrick and Myles Dougan are with me today.

2017 was another banner year for ATCO's utility businesses with more than 7 per cent earnings growth. Continued investment and rate base growth helped our regulated businesses deliver more energy to more customers than ever before.

But 2017 was not without its challenges. Persistent weak commodity prices impacted financial results in our Structures & Logistics business.

Demand for Structures & Logistics’ major workforce housing products is directly related to capital spending cycles and levels of development activity in the natural resources sector. A significant reduction in customer capital expenditure programs limited our opportunities for major workforce housing projects and increased competition put downward pressure on profit margins across all Structures & Logistics' business lines.

Our Independent Power Plant business was also adversely impacted by lower realized prices.

However, with continued investment in regulated and long-term contracted assets, and a renewed sales and customer focus in all of our businesses, ATCO achieved strong earnings in 2017 and, in fact, Canadian Utilities set a new earnings record.

In December 2017, Canadian Utilities announced the acquisition of a long-term contracted, 35 MW hydroelectric power station based in Veracruz, Mexico. The $114 million transaction closed February 20, 2018. We continue to look for these kinds of investments to expand and diversify our asset base.

At the same time, we expect to invest $3.5 billion in our Regulated Utility business in the next three years. This capital investment is expected to contribute significant earnings and cash flow and further cementing our high quality earnings base that underpins our dividends.

On the topic of dividends, as you saw, in January we announced our first quarter 2018 dividend with a 15 per cent increase over the 2017 dividend at ATCO and a 10 per cent increase at Canadian Utilities. We are very proud of our long track record of annual dividend increases.

Now I’m sure you have some specific questions so I will turn the call back to you.

QUESTIONS & ANSWERS

Structures & Logistics

What should we expect for ASL earnings going forward?

A similar year to 2017 seems likely unless we announce new contract wins. We are looking at a number of opportunities in other markets, not to the size of a Site C or a Wheatstone, but with potential.

Our goal is to continue improving space rental utilization and securing additional long-term services contracts with customers outside of the natural resource sectors. Expansion will be focused in select global markets, including Canada, Australia, South America, Mexico and the U.S. Non-traditional modular markets such as public education facilities, high density urban residential housing and correctional facilities offer development opportunities.

What was the rationale behind the CU sale of the 24.5 per cent ASL ownership by Canadian Utilities?

The 24.5% ASL ownership was more a function of history than design and wasn't intended to be a permanent aspect of the corporate structure.

From the CU perspective, this transaction simplifies its organizational structure and makes CU a pure play energy infrastructure and utility company. It also provides CU will cash flow that can be used as equity financing for its on-going capital growth program.

Are they any other structural changes envisioned such as the collapse of the ATCO and Canadian Utilities holding structure?

No, we are not considering collapsing the ATCO and CU structure.

Is this transaction part of a plan to sell the Structures & Logistics business to a third party?

No, ATCO is not planning to sell the Structures & Logistics business.

How did you come to an agreed upon price in the sale of Canadian Utilities' 24.5 per cent ownership of Structures & Logistics to ATCO?

The two independent Boards voted on this transaction and agreed to it. Directors who are on both Boards, or who are conflicted, abstained from the vote. In addition, we used a third party fairness opinion.

How do we interpret the $79 million value of the recent ATCO Frontec contract win with the Canadian Armed Forces?

The five-year contract is valued at $79 million of gross revenue over the life of the contract. It has an option for a five-year extension.

Will you look at acquisitions for Structures & Logistics growth?

Yes, we consider acquisitions as part of our growth strategy. Typically, for ASL, these are bolt-on size acquisitions that provide us with access to a new market or region. The 2016 Chile acquisition for 50 per cent ownership of ATCO-Sabinco is an example of that type of acquisition. That acquisition was for about $25 million so that the type of size we would consider as a bolt-on acquisition.

How does your Structures & Logistics project lead list look? What about potential for a workforce housing LNG project in BC?

We have a decent lead list of projects we are looking at for 2018 and hopefully we can secure our fair share or more of those. The LNG Canada project in BC continues to be a potential workforce housing project for us along with others.

Electricity

What is your outlook for Alberta Power prices?

The retirement or mothballing of about 1,400 MW of thermal plants tightened the supply/demand balance in the last few months. The January 1, 2018 implementation of the new Carbon Competitiveness Incentive Regulation also increased coal unit variable costs by about $15/MWh on average.

In general, we see the upward trend in power prices continuing in the near term.

Do you plan to participate in the next REP auctions?

On February 5, 2018, the Government of Alberta announced the next two auctions totaling 700 MW; one for 300MW and one for 400MW.

The 400MW auction will have an Indigenous participation component, which we think is promising, as it is is an aspect of our business culture we consider a strength, and may present some additional opportunities for us to work with Indigenous groups on some proposals in the future.

The 300MW auction will be structured similarly to REP 1 with wind as the most likely successful technology.

How much business development activity have you expensed in the fourth quarter and 2017?

Our business development initiatives have ramped up and certainly played a part in the lower earnings contributions from Independent Power Plants. The acquisition of the hydro plant in Mexico and further activity in the distributed generation portfolio in Mexico contributed to those higher business development costs as well.

We will continue exploring for new opportunities to add value-creating assets to our portfolio, either through greenfield, brownfield or acquisition.

What are your earnings expectations for the Mexican hydro acquisition?

We estimate it will contribute about $5 million per year in the first full year of operation.

Is the Veracruz area a strategic region for ATCO in Mexico?

Yes it is. In addition, to the hydro facility, we are pursuing a partnership with CYDSA for midstream development opportunities in this region. Veracruz is a center for the energy industry in Mexico and with the energy reforms under way there, we think there is good long-term potential for business expansion.

What is the status for North AB hydro development?

In December 2017, the Government of Alberta announced the contracts awarded for the first phase auction of the renewable electricity program totaling 600 MW.

On February 5, 2018, the Government of Alberta announced the next two auctions totaling 700 MW and further details are expected at the end of February.

While we've had several meetings and discussions with the Alberta Ministry of Environment and Parks and Alberta Energy on the topic of hydro development in the north, we understand the priority focus of the government is on these auctions at the present time. That doesn't preclude us from continuing our discussions in the future on hydro development in the North.

What is the latest update on your solar projects?

We participated in the Negotiated Request for Proposals for 75 MW of solar generation and are awaiting a response from the Government of Alberta.

Our proposed three, 25 MW Kneehill solar power facilities would be located approximately about an hour's drive northeast of Calgary, near Three Hills, Alberta.

The Government of Alberta has not provided a concrete timeline at this point regarding the results of the NRFP.

What are your thoughts on the Alberta Capacity Market?

We are evaluating the first draft of the Comprehensive Market Design for the capacity market, released by the AESO on January 26, 2018, with final version expected on June 29, 2018. The first auction is scheduled to take place in November 2019 for a contract period from November 2021 to October 2022.

The single year term length for all resources may delay new investments until supply tightens. This will potentially benefit coal to gas conversions.

ATCO will continue to evaluate the details and to work with the AESO and market participants to refine the design. However, generally we see the capacity market as favoring incumbent generation and enabling for coal-to-gas conversions.

Do you expect a ramp-up in cash flow from Alberta PowerLine when it comes into-service in mid 2019?

Alberta PowerLine is not contributing cash flow while it is in construction. It is contributing earnings though under service concession arrangement accounting.

The fourth quarter 2017 earnings were lower mainly due to interest on the $1.385 billion of bonds issued in October, being partially offset by the structured deposit note interest income.

The Balancing Pool has announced it is beginning consultation on the return of the Battle River unit 5 PPA. When do you expect the final decision from them on a turn back of the PPA and what are the expected proceeds?

The Balancing Pool's timing between the consultation period and notification of turn back of the Sundance PPAs was about two months. Therefore, we anticipate the BR5 termination would be announced by the Balancing Pool potentially in March with a 6 month period until the termination and turn back of the PPA.

The Balancing Pool has estimated the termination payment will be approximately $63 million. For Battle River, there are aspects of the PPA turn back that allow for recuperation of fuel supply costs, so in the event that the Balancing Pool provides us with notification of turn back, we will discuss those terms with them.

What will be your plans for Battle River unit 5 if it is turned back to ATCO?

We are exploring opportunities to run the asset as part of our merchant portfolio. Coal-to-gas conversion for all our coal units is being analyzed. The final capacity market design will be a part of that decision-making.

Pipelines & Liquids

The natural gas distribution utility did well from an earnings perspective in 2017? How should we be thinking about 2018 for the earnings from the PBR utilities?

PBR is set up to incent us to find efficiencies, and we have been able to do so in the past and will continue to work on that. Finding these efficiencies is good for our shareowners and good for our customers.

We are confident about the strategies we have in place to find ways to continue to lower costs while providing safe and reliable service. However, in the first couple of years of PBR2, we are unlikely to make the same levels of ROEs we made at the end of PBR1.

We will leverage our innovation and technology in order to keep lowering costs. We think continued IT and procurement improvements, and centralization of administrative activities can provide additional cost savings. The productivity factor in PBR2 is less than in PBR1, which means the offset to the inflation factor is lower. That means that operational improvements and efficiencies have a larger potential impact on the bottom line.

We also get a 50 basis point add to our base ROE in 2018 and 2019 as an efficiency carry over mechanism because of our success with the first generation of PBR. That will be helpful to earnings out of the gate in PBR2.

The revenue calculation for return on and return of capital is based on the average capital spent during 2013 to 2016. That means that we could make more earnings if we invest less in PBR2 because the revenue for capital is set, but the actual capital amounts are not.

Can you explain any changes in PBR2 that came out of the AUC's February 5 PBR2 decision?

The PBR framework substantially remains the same as the December 2016 AUC PBR2 framework decision. It continues to adjust rates by inflation less productivity and continues to contain a capital funding mechanism called the K-bar. However, the Commission did alter some aspects of the going-in rates as well as how the K-bar mechanism works with an annual calculation of the K bar including a true-up of WACC.

The other main change is a more stringent set of rules around how anomalies will be judged for acceptance as part of O&M cost allowance in going-in rates.

Is the ROE used for PBR2 going-in rates set now?

Yes, the going-in rates for PBR2 are set based on an 8.5 per cent ROE.

What is the future capital investment run rate in natural gas transmission business?

We expect system replacement of aging pipelines and modest customer growth will continue to require capital investment and will generate rate base growth. The need for additional natural gas transmission as part of the coal-to-gas conversion may also create capital investment opportunities and rate base growth.

Could you explain a little more about the CYDSA MOU that you released in December? Is Canadian Utilities or ATCO the partner on this MOU?

Canadian Utilities is the partner. Our intention is to work together with CYDSA to explore and develop midstream opportunities in Mexico's oil and gas industry. It is early days in our business relationship and we have a few business partnership steps to take first.

The initial focus will be on underground hydrocarbon storage in salt cavern formations and depleted reservoirs, and will also include opportunities in gas gathering and processing, natural gas liquids extraction and fractionation.

Would you see this Mexican storage as a business opportunity to take on merchant or commodity risk or are you focused on contracted storage opportunities?

For any large capital projects, we look for long-term contracts to back stop the investment. The project doesn't have to be fully contracted, but we look for a substantial portion to be contracted though a small amount of exposure may be a natural consequence of certain activities.

For your hydrocarbon storage facilities in Alberta, are there additional development and expansion opportunities?

We have four caverns under contract today with two in-service now and two being brought into service in the next few months. We also have over 30 caverns of additional development potential right in the same area.

Can you review the nature of the water supply contract you have with Inter Pipeline?

We have a long-term commercial agreement with Inter Pipeline to provide water services to their newly authorized PDH plant in Fort Saskatchewan, Alberta. The water services contract will commence by 2021 with final determination of timing subject to customer notice, which is expected in the first quarter of 2018. We can use our existing water service facilities in the area already so we don't expect there will be need for much additional capital for this project.

Corporate & Other

Do you expect the Corporate segment contributions to change in 2018 or 2019?

From a Canadian Utilities perspective, the preferred share dividends are the largest corporate expense. Preferred share dividends were about $64 million in 2017. Our preferred share dividend expense would change of course if we issued any preferred shares; but at this time we don't have specific plans on that front.

Retail energy is also recorded in CU corporate. We would expect the retail energy results to improve in 2018 as we build up that business and grow our customer base.

What is the impact of the IFRS 15 Revenue Recognition implementation?

When we come out with our first quarter 2018 interim financial statements, we will retroactively re-state 2017 revenues. This change will likely result in additional earnings. The biggest impact will be on the electricity generation business where earnings and cash flow were front-end loaded in our contracts as the recovery of capital decreases over time. This new revenue standard formalizes that.

What are your plans for dividend increases going forward?

Finance theory says that absent other changes, dividend growth in the long-run will be in-line with earnings growth.

Our payout ratio is still below our Canadian peers. We're taking a longer term view on our earnings growth and a return from the bottom of the commodity markets as part of our thinking on the 2018 dividend increase.

Would you consider a Normal Course Issuer Bid as an option in the future instead of further 10 and 15 per cent dividend increases?

We have an NCIB program in place already that would allow us to take that step if we decide to do so.

Would you consider a hybrid debt offering as part of your financing plans?

At the Canadian Utilities level, yes we would consider hybrids as an alternative to a preferred share issue if we were looking to raise capital.