

Canadian Utilities Limited

Second Quarter 2023 Results Conference Call Transcript

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Speakers: Colin Jackson, Senior Vice President, Finance, Treasury, Risk & Sustainability
Brian Shkrobot- Executive Vice President and Chief Financial Officer

Conference Call Participants:

Linda Ezergailis TD Securities, Inc. – Managing Director
Robert Hope Scotiabank – Director - Equity Research
Maurice Choy RBC Capital Markets – Research Analyst
Benjamin Pham BMO – Managing Director
Mark Jarvi CIBC Capital Markets – Research Analyst

Operator:

Welcome to the Second Quarter 2023 Results Conference Call for Canadian Utilities Limited. (Operator Instructions)

I would now like to turn the conference over to Mr. Colin Jackson, Senior Vice President, Finance, Treasury, and Sustainability. Please go ahead, Mr. Jackson.

Colin Jackson:

Thank you. Good morning, everyone.

We're pleased you could join us for Canadian Utilities second quarter 2023 conference call. With me today is Executive Vice-President and Chief Financial Officer, Brian Shkrobot.

Before we move into our formal agenda, I'd like to take a moment to acknowledge the numerous traditional territories and homelands on which our global facilities are located. Today, we're speaking to you from our ATCO Park head office in Calgary, which is located in the Treaty 7 region. This is the ancestral territory of the Blackfoot Confederacy comprised of the Siksika, Kainai and Piikani Nations, the Tsuut'ina Nation, and the Stoney Nakoda Nations that include the Chiniki, Bearspaw and Goodstoney Second Nations. The city of Calgary is also home to the Metis Nation of Alberta Region 3. We honour and respect the diverse history, languages, ceremonies and culture of the Indigenous people who call these areas home.

Brian will begin today with some opening comments on recent company developments, our financial results, and key trends and expectations for our businesses in 2023. Following these prepared remarks, we will take questions from the investment community.

Please note that a replay of the conference call and a transcript will be available on our website at canadianutilities.com and can be found in the Investors Section under the heading Events and Presentations.

I'd like to remind you that our remarks today will include forward-looking statements, which are subject to important risks and uncertainties. For more information on these risks and uncertainties, please see the reports filed by Canadian Utilities with the Canadian Securities regulators.

Finally, I'd like to point out that during this presentation we may refer to certain non-GAAP and other financial measures such as total of segment measures, adjusted earnings, adjusted earnings per share, and capital investment. These measures do not have any standardized meaning under IFRS, and as a result they may not be comparable to similar measures presented in other entities.

Now, I'll turn the call over to Brian for his opening remarks.

Brian Shkrobot:

Thanks Colin and good morning, everyone. Thank you all very much for joining us today for our second quarter 2023 conference call.

Canadian Utilities achieved adjusted earnings of a \$100 million or \$0.37 per share in the second quarter of this year, compared to \$136 million in the second quarter of last year. As expected, the impact of our Alberta distribution utilities rebasing following our second successful performance-based regulation cycle resulted in lower year-over-year earnings in the second quarter. On its own, this rebasing contributed to a year-over-year decline in earnings of approximately \$25 million. While significant, this is certainly not unexpected in a rebasing year, especially with a phenomenal out performance we achieved last year, a final year of PBR2.

Looking ahead to the rest of year, we expect to see the earnings pressure associated with this rebasing peak in the third quarter, and in the fourth quarter we expect seasonality benefits and our annual spending profile to create potential opportunities for year-over-year growth.

Overall, despite the earnings pressure from rebasing, we still believe that our full year performance for these businesses will be in line with the expectations that we've shared previously. More specifically, we continue to believe that we'll be successful in achieving out-performance largely in line with our long-term historical performance. This will limit the single year earnings decline for this year to levels largely consistent with what we experienced back in 2018 following PBR1.

Moving to our natural gas distribution business in Australia, we continue to see strong growth in key operating metrics such as new connections and system volumes. The in-country inflation trend within Australia continues to contribute to our year-over-earnings pressure. As we discussed on our first quarter conference call, 2022 saw us enter the year with a full year annual inflation expectation of 3 per cent in Australia. By the time the year had ended, however, full year inflation had reached almost 8 per cent. This surge in inflation resulted in strong earnings last year, but more importantly, an earnings profile that built beginning in Q2 of 2022 and rapidly progressed throughout the year.

As a result of this trend in the prior year, our second quarter of 2022 earnings were exceptionally strong, creating a comparable that is difficult to compete with as 2023 inflation levels begin to moderate. This trend result in us reporting a year-over-year decline of \$5 million for this business in the quarter.

Similar to what we saw in our second quarter results, we expect to see continued pressure in Q3 and Q4 related to the CPI trend and for it to push full-year results lower than last year. For added colour, when we spoke following our first quarter call, in country estimates were suggesting full year inflation in Australia to be between 4 per cent to 5 per cent. Now, we continue to believe that this is an appropriate expectation, but do see signs to suggest that inflation may trend closer to the 5 per cent end of this range and be slower to recede than previously expected.

Moving on to our Electric Generation business, we continue to see strong earnings contributions from our existing assets, and those that we've acquired earlier this year. Along with our Forty Mile Wind and Adelaide assets performing in-line with expectations operationally, we also saw earnings benefit from a strong Alberta merchant power pricing. This pricing strength help offset lower than normal wind levels in Alberta during that quarter. As a reminder, our long-term power purchase agreement for Forty Mile Wind did not come into effect until July 1st of this year which allowed us to capture these strong merchant market trends in a quarter.

Before diving into our capital investments, I just want to touch on the recent wildfire activity in Alberta. Despite significant wildfire activity this year, our businesses have been successful in limiting customer outages and avoiding any safety incidents related to these events. My sincere appreciation goes out to all our employees who work so tirelessly to restore a service and to support first responders. With wildfire activity in Alberta slowing significantly since its peak earlier in the second quarter, our teams continue to remain focused on restoration efforts and we do not expect to see any negative impact to earnings as a result of these events.

Moving on to capital, I just want to briefly touch on the capital investments we made in the second quarter. The second quarter saw us invest \$336 million in our business with \$287 million of this spending being within our existing utilities. This ongoing utility investments ensures that continued generation of stable earnings and reliable cash flows will also drive a rate base growth. The remaining capital was primarily related to our ongoing renewable generation initiatives and the second quarter saw us achieve full commercial operation at our Barlow solar generation facility.

We continue to push closer to completion of our previously announced Deerfoot and Empress solar developments and expect commercial operation of these facilities this year. We've also seen great progress in advancing numerous projects within our acquired renewables development pipeline and expect the upgrading of our Forty Mile Wind asset to be completed by year-end.

Overall, the second quarter was a key inflection point in this rebasing year. The earnings pressures, we expected related to rebasing and Australia inflation became more pronounced than they were in the first quarter as offsetting seasonality and timing impacts faded. That being said, rebasing is something we've dealt with before, and it's a key part of the PBR framework. We remain focused on driving exceptional results for our shareholders and position our business to maximize growth in earnings as we exit this key regulatory transition period. I look forward to providing further updates on the progress of our numerous growth initiatives as the year progresses.

That concludes my prepared remarks. Now, I'll turn the call back to Colin.

Colin Jackson:

Thank you, Brian.

In the interest of time, we ask you to limit yourself to two questions. If you have additional questions, you are welcome to rejoin the queue. As most of you know, the ATCO Q2 call immediately follows this, and I'd like to just note that Katie Patrick, Executive Vice President, Chief Financial & Investment Officer has joined us in the room.

I will turn it back to the conference Operator now for questions.

Operator:

Thank you. (Operator Instructions).

Our first question comes from Linda Ezergailis with TD Securities. Please go ahead.

Linda Ezergailis:

Thank you. I'm just wondering in terms of your PBR reopener that was triggered for 2022 for your electrical and natural gas distribution utilities. I'm wondering what the process for resolving it, what is the range of possible outcomes, and what informs management's confidence that you don't expect any adjustment?

Brian Shkrobot:

Hi, Linda. Thanks for your question. Yes, I guess maybe just to start off on June 30th of this year, the AEC initiated a proceeding for both our Electric Distribution and our Natural Gas business, as a reopener clause was triggered for both our utilities in the final year of the PBR program. It just kind of highlights the exceptional outperformance that we were able to generate throughout the PBR term, but more significantly in the last year.

In this proceeding that you see will determine whether a reopening or potential adjustment to our 2018 and '22 plans are required. Really at the heart of this assessment is whether the outperformance achieved was due to a malfunction or a design error in the PBR framework as opposed to the strong management of the underlying utilities.

So, this is not new for us, we experience the same reopener proceeding at the end of the first PBR term and we view that we will be successful given that we truly believe and we could demonstrate that it's really response of management actions and not a design flaw in the plan. Part of that is that you can

look at the all the other utilities, we're all under the same program and same plan and none of them have reopened. So, we fully expect as we go throughout this proceeding we'll be able to demonstrate that and don't expect any, I guess, negative impact or adjustment as a result of that proceeding.

Linda Ezergailis:

Thank you. That's very helpful context. Maybe just as a follow-up, in terms of more broadly, your utilities framework. A recent mandate letter for Alberta's Minister of Affordability and Utilities contained a bullet about lowering a transmission and distribution cost and some other elements that could potentially impact your company. How do you think the government might achieve this and what might be the financial impact, if any, on your utilities, and if you have any other perspectives on this mandate letter, we'd appreciate it.

Brian Shkrobot:

Yes. Thanks for the question, Linda. Yes, in terms of—obviously, affordability is top of mind of all our customers and Albertans. Certainly, it's top of mind for our company as we conduct ourselves. In terms of the mandate letter, we fully expect to be in active conversations with the government, and we have been. The first thing of note is, and the government has acknowledged this, we're the only utility in the province that actually saw a rate reduction in 2023—a meaningful rate reduction. That's the best thing that we can do is continue to operate our utilities as efficiently as possible and then pass on those savings to customers.

We'll also be looking at—I know they're going to review the AUC and the AESO, and there's definitely, I guess, opportunities for savings to be had across the utility sector in terms of some of their capital deployment, some of the policies, investment criteria. So, I think it's early days. We'll be active in those discussions, but we don't anticipate any negative impact to our business. The Alberta government and our regulator has been very firm in upholding the regulatory construct, which is a very positive thing, and we expect that to continue.

Linda Ezergailis:

Thank you. I'll jump back in the queue.

Operator:

The next question comes from Rob Hope with Scotiabank. Please go ahead.

Robert Hope:

Good morning, everyone. In the MD&A, there was some commentary on the newly rebranded EnPower, potentially reviewing financial alternatives that include a spin out of, I guess, the renewable power business. Can you maybe talk to some of the thinking behind the financial review here? Is the growth here too large to handle on the balance sheet? Or do you think it's not being properly valued inside of CU?

Brian Shkrobot:

Yes. Thanks, Rob. Well, first of all, I think it's important to emphasize that we certainly haven't made any definitive decisions and that we're simply just exploring/examining all options. As you've kind of heard us speak about previously, we continue to see significant opportunities for growth in connection with the energy transition, including existing and new opportunities in both our kind of newly branded ATCO Energy Systems and ATCO EnPower.

So, although we've kind of historically relied on whether it's cash from operations, recycling of capital, partnerships, and debt issues to fund our growth, and it certainly has served us well to-date. But as we look ahead, however, we recognize that future growth does likely require capital and financing beyond the traditional sources we utilize. So, as a result of this and the intention of just being transparent within the market, we have announced our intention to explore all means of financing and including the potential creation of a separate entity.

Our intent over the upcoming months is to gather feedback from investors, partners, and other stakeholders to help inform our planning going forward and ensure that we're making the best decisions. Once we've completed that assessment and review of the various options, we'll certainly disclose any material decisions. As with all of our decisions we make, we evaluate these opportunities to the lens of shareholder value creation and long-term growth and stability of our businesses.

For example, a separate entity, a transaction of this nature would only be pursued if we saw clear signs of it being financially accretive, beneficial to shareholders, and the best interest of all entities within our group, as we look to position our business for long-term growth and stability.

Robert Hope:

I appreciate that. Then just maybe in terms of the outlook for growth. As you take a look at the backlog of renewable power projects that you have, can you maybe update us on which ones are percolating to the top and whether any progress has been made on the Alberta development projects or the Australia hydro facility?

Brian Shkrobot:

Yes. Great. Thanks for the question, Rob. Yes, in terms of we are—like I mentioned in my opening remarks, we're continuing to make some really good progress. We mentioned the Barlow coming fully commercial operational, and Deerfoot and Empress projects are progressing well, and that combined will have capacity of over 100 megawatts. We're also working on our upgrading of our Forty Mile Wind assets and add an additional 20 megawatts, and we expect that by the end of the year. The next item in the development pipeline that we're actively working on and making progress is our Forty Mile Solar project, which will add an additional 220 megawatts of solar production.

I guess long story short is all our development pipeline is progressing well on all fronts. We're happy with the progress. We're being proactive with supply chain to make sure that materials are ready when we need it. And yes, continue to see a healthy pipeline of growth there.

Robert Hope:

Thank you. I'll hop back in the queue.

Operator:

The next question comes from Maurice Choy with RBC Capital Markets. Please go ahead.

Maurice Choy:

Thanks and good morning. Can I just follow up on the discussion about ATCO EnPower and potentially separating them to separate entity. You mentioned that any transaction needs to be—to have clear signs of being financially accretive. I assume by this you mean EPS, and if so, can you also talk to how you might size this with respect to the mix between utilities and non-regulated cash flows or earnings. What are your guardrails over there?

Brian Shkrobot:

Yes. Thanks, Maurice, for the question. As I previously mentioned, certainly, we're at the very early stages and just exploring all options, and so we haven't really defined it completely what that would look like. Generally, we would expect, just like our branding, we'd have non-regulated businesses in our new branded ATCO EnPower, and then the regulator gas and electric utilities in our ATCO Energy Systems.

So, I think it's just too preliminary at this stage, Maurice, to kind of get into that detail because we're at the very beginning stages. When we get a little bit further down the path and come up with some of that analysis, we'll freely share that with you.

Maurice Choy:

Understood. I guess if you think about what—obviously, this is a very early stage, but what have you ruled out in terms of options to finance this growth because, obviously, today, you're announcing the EnPower or the non-reg business contemplated, possibly taking a minority stakes in your regulated business, is that something you consider or maintaining a majority of 90 per cent stake in utilities versus 10 per cent non-reg, is that an important part of your decision?

Brian Shkrobot:

I guess, maybe, I'll restate, Maurice, that we're exploring all options. We certainly have ample cash on our balance sheet, continue to have access to debt and equity markets, and we just kind of came out and just to continue to reiterate that we're exploring various alternatives like partnerships, asset sales, and even potentially the creation of a separate ATCO EnPower entity. So, we continue to explore a variety of those options to support our growth and add value to shareholders.

In terms of the growth, and we kind of gave some guidance on this in the past, we continue to believe that the non-reg portion of our growth could, at the end of the day, represent potentially a 20 per cent of portion of our business. So, the structure and makeup of our businesses going forward, we don't expect to change from that guidance that we gave.

Maurice Choy:

Got it. That makes sense. Maybe if I could ask about your growth capex expectations for your energy infrastructure business over the next three years. I know that at the start of the year, you had around \$800 million of capex for '23 to '25, but it's unclear to me what projects are included in there. Maybe you could just speak to that.

Brian Shkrobot:

Sure. Thanks, Maurice. So, yes, in terms of our kind of capital spend and we've kind of already talked about we're progressing a number of our solar initiatives with Deerfoot, Barlow, Empress projects. We also are progressing our Forty Mile solar, which is adding additional 220 megawatts. And then on top of that, we have that 1.5-gigawatt pipeline. There's continue to be progress in that, where we go to the Forty Mile Phase II. So, those are kind of like the sanction projects that we got going now. Obviously, more in the pipeline. We've talked about hydrogen being potentially a significant investment area that's kind of not in those base numbers, but obviously has the potential to be significant.

Maurice Choy:

Just to clarify, I'm going to assume that the Central West Pumped Hydro is not in there, notwithstanding the LTESA (Long Duration Storage Long-Term Energy Supply Agreement) results a couple of months ago.

Brian Shkrobot:

Yes, I think in terms of the Central West project. For that project, currently, since we did not get the LTESA, we're currently on hold right now. We continue to work with the government to gather support for that project, and we truly believe that large-scale commercial green hydrogen facility or storage will be needed, and it makes a lot of sense for Australia.

To-date, we haven't been successful in getting the LTESA but there'll be other rounds, and we'll continue to explore with the government alternative funding arrangements. We've been successful at securing the \$9 million grant funding for the New South Wales related to this project, so I guess we'll continue to give you updates as that progresses.

Maurice Choy:

Great. Thank you very much.

Operator:

The next question comes from Ben Pham with BMO. Please go ahead.

Benjamin Pham:

Hi. Thanks. More of a quick follow-up. The rebranding, is that just simply a rebranding or is there some movements in legal structure, just how CU's running those two businesses in terms of responsibilities and capital allocation?

Brian Shkrobot:

Yes. Thanks, Ben, for the question. So, in terms of rationale, as we look to shape the future of Canadian Utilities while continuing to deliver long-term value for our customers and shareholders. We recognize there's unique opportunities and dynamics between both our kind of non-regulated businesses and our kind of electric and gas utilities.

So, acknowledging this and the fact that each of these businesses are pursuing their own distinct growth strategies and excelling in our respective markets, we embarked on the creation of this branding of ATCO Energy Systems and ATCO EnPower brands to create market distinction for each segment.

We believe that this brand evolution will bring greater strategic focus to the two businesses, and we believe it creates greater organizational alignment to enable both ATCO Energy Systems and EnPower to realize their exciting growth trajectory. So, nothing more than that at this stage.

Benjamin Pham:

I got you. It sounds like you'll have a decision for the market sometime later this year. I think that was my read from your commentary.

Brian Shkrobot:

In terms of are you referring, Ben, to the evaluation of various financial options? Is that what you're referring to?

Benjamin Pham:

Yes. Exactly. It sounds like it's more early stage now revealing things, getting feedback. Do you have a sense of when this will be all done?

Brian Shkrobot:

Yes. I think we'll continue to complete the review for the rest of the year. Again, the decision might be nothing, continue the course. So, I think we'd give updates as we go and I'm sure you'll ask us the same question in our Q3 call and year-end call, and we'll be happy to give you an update of where we're at.

Benjamin Pham:

Okay. Got it. Maybe lastly on Australia with filing a new access arrangement. I mean, I get the whole CPI situation and rebase, but how do we think about really just maybe more broader, bigger changes into that access arrangement with rebasing and ROE is probably moving up to allowed ROE, is it just as simple as a flow-through or is there more bigger impacts to consider?

Brian Shkrobot:

Yes. No, I think—great question. In terms of the access arrangement, we've been active in that process for some time, and I think for the biggest impact is we will get higher allowed ROEs under the AA6 than what we received under the AA5, which is obviously great in terms of earnings and from a cash perspective. So, that's probably the biggest part of what to expect under the new access arrangements. Obviously, we put a lot of work to make sure that our decarbonization programs and various capital activity that we're doing to support our customers will get approved as part of this access arrangement.

That's kind of the key focus, making sure that the framework supports the treatment of our ESG goals, enabling hydrogen blending, and making sure that keeps long-term options to decarbonization trends available to us and part of that submission. ROEs is, probably, again, the biggest thing to expect from the outcome of this proceeding.

Benjamin Pham:

Okay. I got it. Thank you.

Operator:

The next question comes from Mark Jarvi with CIBC. Please go ahead.

Mark Jarvi:

Yes. Thanks. Good morning. I wanted to turn to the disclosure where it's in the MD&A about Suncor withdrawing from the hydrogen project. Maybe you can't speak for them, but what it kind of means for you guys? How much would you be willing to shoulder yourself? Would you need to bring in another partner? I guess, does that factor in at all in terms of what you're reviewing in terms of the EnPower options?

Brian Shkrobot:

Yes. Thanks for the question. As we kind of stated in the MD&A, and I'll state today, we remain committed to our hydrogen project and continue to move forward the development of that project going forward. Certainly, the project has significant potential to supply hydrogen to domestic and international markets, including the Alberta gas grid, industrial, municipal, and commercial transportation users. As we kind of noted in our MD&A, that's subsequent to our quarter that Suncor Energy had provided notice the intention to withdraw. So, again, just to reiterate, this definitely has not changed our commitment to hydrogen project nor is it to our ongoing Atlas Carbon Capture project as well.

So, in terms of progress going forward and our commitment, we're in discussions with other hydrogen off-takers across the value chain and continue to believe that there's demand in the local market that exceeds the facility capacity even without the previously contemplated offtake from Suncor.

With the announcement, we are also in active discussions, I'll mention that we're in active discussions with other operating partners. We're also heavily involved in discussions with the government. Even as late as last week, we continue to receive some great support for the project. So overall, still progressing forward, very committed.

In terms of the overall size tranche, we don't think that will be materially different. Obviously, if it goes the volumes that we're expecting, partnerships will likely be expected. But again, it's still going to be a meaningful project in terms of our stake. But obviously, we're working—continue to work with government off-takers, trying to get the regulatory certainty and government certainly on some of the policies decisions.

So, obviously, still early days, but the progress on this project is definitely proceeding. We've completed the DBM phase of the project and are now evaluating progress to the next phase, which is the FEED. Hopefully, that answers your question.

Mark Jarvi:

Yes. So just to clarify, Brian, you said bringing in operating partners, but you also said sizing it. So, do you think that those operating partners would also shoulder some of the CapEx and the equity investment as well, right? So, your total commitment wouldn't necessarily change relative to what you would have assumed 6 to 12 months ago?

Brian Shkrobot:

That's correct. When the dust settles, that's what we expect. Yes, we expect operating partners to have an equity stake inside, and ensure that we have the right balance between all parties and our investment for what we're planning to take on. So, yes, although there will be some change in that overall partnerships, we don't think that would be materially different than what we contemplated going in.

Mark Jarvi:

Got it. In terms of the cost of capital proceeding 2024, it seems like maybe increasing is moving towards the formula sort of updated views in terms of when we'll have clarity on that, and then what comes with that as well in terms of, I don't know, a review of earnings sharing mechanisms criteria for reopeners. Does that all fall in the same proceeding or is there a separate sort of proceeding that has to kick off or any of those other elements?

Brian Shkrobot:

Yes, great question. Yes, in terms of kind of update, we've kind of completed our hearings where we're kind of waiting the decision. Interesting enough, there was quite a bit discussion on a formula, and a commission came out and signaled they're definitely not set on having a formula. So, I guess I don't want to say that's a certainty. If anything, it's up in the air, whether or not the commission will go with the formula. They might instead arrive at a 2024 generic cost of capital parameters, but we'll need to weigh that against kind of the regulatory burden of continuous generic cost of capital proceedings.

In terms of the earnings sharing, that should come out as part of that decision as well, and I guess we'll wait the outcome of where the commission lands.

Mark Jarvi:

In terms of timeline, when do you think you'll have clarity?

Brian Shkrobot:

Yes. I think the decision is expected to be in October of this year.

Mark Jarvi:

Okay. Great. Thanks.

Operator:

(Operator Instructions)

As there are no additional questions, this concludes the question-and-answer session. I would like to turn the conference back over to Mr. Colin Jackson for any closing remarks.

Colin Jackson:

Thank you so much, Charice, and thank you all for participating today. We appreciate your interest in Canadian Utilities and we will look forward to speaking with you again soon.

Operator:

This concludes today's conference call. You may disconnect your lines. Thank you for participating and have a pleasant day.