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Q3 2018 ALLETE Inc Earnings Call

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CORPORATE PARTICIPANTS

Alan R. Hodnik *ALLETE, Inc. - Chairman, President & CEO*

Robert J. Adams *ALLETE, Inc. - Senior VP & CFO*

Steven Wayne Morris *ALLETE, Inc. - VP, Controller & CAO*

CONFERENCE CALL PARTICIPANTS

Elizabeth Roi Guynn *Mizuho Securities USA LLC, Research Division - Assistant VP*

PRESENTATION

Operator

Good day, and welcome to the ALLETE Third Quarter 2018 Financial Results Call. Today's call is being recorded.

Certain statements contained in this conference call that are not descriptions of historical fact are forward-looking statements, such as terms defined in the Private Securities Litigation Reform Act of 1995. Because such statements can include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements.

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For opening remarks and introductions, I would now like to turn the conference over to ALLETE President and Chief Executive Officer, Alan R. Hodnik. Please go ahead.

Alan R. Hodnik *ALLETE, Inc. - Chairman, President & CEO*

Well, good morning, everyone, and thanks for joining us today. With me are ALLETE's Senior Vice President and Chief Financial Officer, Bob Adams; and ALLETE's Vice President, Controller and Chief Accounting Officer, Steve Morris. Today, we reported third quarter 2018 financial results of \$0.59 per share, a net income of \$30.7 million. Similar to last quarter, we had several timing differentials, which Steve will discuss in a moment. ALLETE's year-to-date results support our full year 2018 earnings to be near the midpoint of our original guidance range of \$3.20 per share to \$3.50 per share.

Before Steve and Bob go through the details from the quarter, I would like to share a few thoughts. We are hard at work as always with initiatives to deliver shareholder value in the near term, while positioning ALLETE to create and drive long-term value in a sustainable energy future. A good example of our commitment to an even more sustainable energy future is Minnesota Power's EnergyForward initiative. Minnesota Power is continuing its efforts on reaching a goal of 44% renewable energy by 2025, with natural gas and more renewable as key components.

The recently approved Nemadji Trail Energy Center will keep our region energized with a dependable, sustainable and high-quality energy supply. Minnesota Power's latest EnergyForward energy resource package pairs NTEC with additional solar and wind, which will provide a reliable backstop to carbon free, but nonetheless, still highly intermittent wind and solar energy generation that is a significant part of Minnesota Power's generation mix. The Minnesota Public Utilities Commission has already approved 10 megawatts of additional solar, and is expected to take up Minnesota Power's Tenaska Nobles 2 wind initiative in the first quarter of 2019.

Another key EnergyForward initiative underway is the construction of the Great Northern Transmission Line. Construction of which I just had the pleasure of inspecting from the air yesterday. Minnesota Power's GNLT initiative will deliver 250 megawatts of carbon-free hydro energy from Canada with construction on schedule for completion in 2020. These transformative projects represent significant capital investments in support of cleaner and more sustainable energy sources as MP answers the call to transform the nation's energy

landscape.

As we discussed in our last quarterly update, we are making difficult but necessary decisions with our workforce and related expenses. Following a more difficult rate review outcome earlier this year, Minnesota Power intensified efforts to rescale its operations and overall cost structure to manage the impact of the commission's rate review decisions. While challenging, Minnesota Power is making good progress on this effort to put the company on a trajectory to earn its allowed return on equity.

We are pleased to report that Minnesota Power's taconite customers continue to operate close to full production levels. We are optimistic about the long-term outlook of Minnesota's mining interests as evidenced by high levels of production with existing facilities, coupled with new capital investments being deployed into these operations. Likewise, with new longer-term labor agreements at Cleveland-Cliffs and United States Steel.

We are also excited about permitting progress in support of a new non-ferrous mining operation. Minnesota Power's natural resource-based commercial and industrial customers provide a unique differentiator bringing opportunity for long-term organic growth through required infrastructure investment and additional load that will benefit Minnesota Power.

At our Energy Infrastructure and Related Services businesses, ALLETE Clean Energy is well on its way with many initiatives that set the stage for multi-year earnings growth. ALLETE Clean Energy is on schedule and on budget as it continues refurbishment activities at several of its wind energy facilities. ALLETE Clean Energy is also evaluating other wind facilities it owns for additional refurbishment opportunities.

I will provide additional comments in my closing remarks. But first, I will ask Steve and Bob to go through the third quarter financial details. Steve?

Steven Wayne Morris ALLETE, Inc. - VP, Controller & CAO

Thanks, Al, and good morning, everyone. I would like to remind you that we filed our 10-Q this morning and encourage you to refer to it for more details on our third quarter results.

For the third quarter of 2018, ALLETE reported net income of \$30.7 million or \$0.59 per share compared to \$44.9 million or \$0.88 per share for the same period in 2017. Before I go to the segments, I will call out several significant timing variances and other items for quarter-over-quarter comparison considerations.

Recall that results for the third quarter of 2017 reflect a \$7.9 million after tax or \$0.16 per share favorable impact for the regulatory outcome related to the allocation of North Dakota investment tax credits. For the third quarter of 2018, results include a \$5.5 million after tax or \$0.11 per share reserved for interim rate refunds, a \$3.1 million after tax or \$0.06 per share reduction in transmission revenue for a true up of transmission rates that were billed in 2017, and approximately \$1 million after tax or \$0.02 per share of additional income tax expense related to the impact of tax reform for nondeductibility of certain benefit expenses.

These decreases were partially offset by the timing of approval for financial incentives under the Minnesota Conservation Improvement program, which benefited the third quarter of 2018 by \$2.1 million after tax or \$0.04 per share. Now a few details from our business segments.

ALLETE's Regulated Operations segment, which includes Minnesota Power, Superior Water, Light and Power and the company's investment in the American Transmission Company recorded net income of \$29.8 million, a decrease of \$4.4 million compared to the same quarter last year. Net income at Minnesota Power was lower than 2017, primarily due to the timing of reserves recorded for interim rate refunds, which amounted to \$5.5 million after tax in the third quarter of this year. Recall that we recorded the full year impact of interim rate refund reserves in the fourth quarter of 2017 to reflect the Minnesota Public Utilities Commission decision in our 2016 rate review.

Also contributing to the decrease was a \$3.1 million after tax reduction in transmission revenue for a true up of MISO transmission rates



billed in 2017 to be refunded in 2019. These decreases were partially offset by the timing of approval of our conservation improvement program financial incentive of \$2.1 million after tax. The 2017 financial incentive of \$3.9 million after tax was recognized in the second quarter of 2017. In addition, lower operating and maintenance expense benefited the quarter as compared to 2017.

Revenue from kilowatt hour sales decreased \$1.5 million after tax from 2017, primarily due to lower sales to industrial customers, partially offset by higher sales to residential and commercial customers. Sales to industrial customers decreased 3.5%, primarily due to lower sales to UPM Blandin, as a result of the closure of the smaller of its 2 paper machines in the fourth quarter of 2017, and Husky Energy's idling after the fire at its refinery in April of this year.

Net income at ALLETE Clean Energy increased \$400,000 from the same quarter in 2017. Net income in 2018 included increased revenue from better wind conditions and \$800,000 after tax of additional production tax credits generated from its multi-year refurbishment strategy. These increases were partially offset by higher operating and maintenance expenses.

U.S. Water Services' net income increased \$400,000 from 2017 to \$1.7 million. Net income in 2018 reflected increased revenue resulting from the September 2017 acquisition of Tonka Water and increased chemical sales, partially offset by higher operating expenses. Although results for the quarter were higher than last year, the third quarter of 2018 was lower than our expected results, which was negatively impacted by the timing of capital equipment sales. Bob will provide more details on U.S. Water Services' third quarter results in a moment.

ALLETE's effective tax rate for the third quarter was 1.3% compared to 24% in 2017. The decrease from 2017 was primarily due to the reduction of the federal income tax rate and lower pretax income. ALLETE's financial position is supported by strong cash flow and a healthy balance sheet. Cash from operating activities was \$298.1 million year-to-date and our debt-to-capital ratio was 42% as of September 30, 2018.

I'll now hand it off to Bob for additional comments on our financial performance. Bob?

Robert J. Adams ALLETE, Inc. - Senior VP & CFO

Thanks, Steve, and good morning, everyone. It is gratifying to me to see the benefits of our multi-pronged diversified business strategy playing out in real time.

Our year-to-date financial results are reflective of many successes and as always, not without some challenges, including the timing impacts reflected in our quarterly results that Steve just detailed. As I mentioned, we expect our full year 2018 guidance earnings to be near the midpoint of our original guidance range of \$3.20 to \$3.50 per share. In terms of our major business segment guidance, we similarly expect both the Regulated Operations and our Energy Infrastructure services segment to be -- near their respective midpoints.

We have made notable progress across the company on our various strategic initiatives and goals so far in 2018. And I remain highly confident in our ability to achieve our average annual growth objective of 5% to 7%.

As I have expressed repeatedly, in addition to meeting earnings growth goals, all of the ALLETE businesses are expected to achieve their respective risk-adjusted rate of return for those over time. Accordingly, we are highly disciplined in our decision-making around new investments and are focused on attaining key efficiency metrics. We certainly have more work to do, but we are well on our way and with a dedicated and highly skilled workforce, I am confident in ALLETE's future.

In that spirit, financial performance from Minnesota Power is improving as promised, despite some headwinds created from the previously announced customer closure of a smaller paper machine in fourth quarter of 2017 and the impact of a fire that occurred at a Wisconsin-based refinery in the second quarter of this year. To be clear, we believe Minnesota Power will achieve its ROE goal of 8.25% this year and we continue to be focused on cost containment efforts to close the gap between our actual and allowed ROE.

Though we are pleased with our progress, the Husky Energy refinery plant idling could present an added challenge in 2019. However, this idling is expected to be temporary as Husky has stated they anticipate normal operations will resume sometime in 2020.



Along with the positive earnings implications from improving its earned ROE, Minnesota Power's progress on EnergyForward projects and the potential for significant load growth set the stage for earnings growth and expansion in coming years.

Superior Water, Light and Power continues to invest in growth initiatives to enhance the quality and reliability of electric, gas and water services provided to its customers. Driven primarily by the large capital investment plan, Superior Water, Light and Power filed a rate increase request with the Public Service Commission of Wisconsin earlier this year, requesting an average increase of 2.7% for retail customers. The filing seeks an overall return on equity of 10.5% and an equity ratio of approximately 55%. On an annualized basis, this filing is expected to result in additional revenue of approximately \$2.4 million. We anticipate a decision on this filing by the end of the year.

At our Energy Infrastructure and Related Services businesses, ALLETE Clean Energy is pursuing its 4-pronged growth strategy including optimization of its existing facilities, building, owning and transferring facilities to others; building, owning and operating facilities under long-term power sales agreements; and acquiring additional renewable facilities. In addition, ALLETE Clean Energy's continued focus on operational excellence as we scale the business is driving efficiencies and profitability to our bottom line.

As part of the portfolio optimization growth plank, the company is on track to complete refurbishment of both the Storm Lake 1 and 2, and Lake Benton facilities, representing approximately 290 megawatts and is evaluating an additional 50 megawatts for possible PTC requalification. News on that requalification effort is expected before year-end.

Yesterday, ALLETE Clean Energy announced the completion and sale of the Thunder Spirit project to Montana-Dakota Utilities, which includes an after tax margin of approximately \$9 million. As you may recall, this was anticipated to close nearing the year-end and as part of our original 2018 earnings guidance. This sale will be recognized in our fourth quarter results. In total, ALLETE Clean Energy operates an existing fleet of 535 megawatts, a fleet that will grow to approximately 720 megawatts upon the completion of Clean Energy #1 and South Peak by year-end 2019. The construction of wind energy facilities for sale and to own and operate it under long-term agreements represents a core skill set.

ALLETE Clean Energy is ramping up on its growth trajectory and 2019 will be a year of significant construction activity. These projects will provide meaningful contributions to ALLETE's growth over the next several years. On top of this, ALLETE Clean Energy is evaluating a pipeline of potential renewable projects for acquisitions and is pursuing additional new projects and has proposals of approximately 1,600 megawatts, which must be in service by 2021. We couldn't be more pleased with ALLETE Clean Energy's accomplishments to date and the potential for more opportunity on the way. These multi-year earnings growth initiatives are in plain view, are already significantly contributing to ALLETE's earnings and will increase in coming years.

U.S. Water Services with its robust nationwide platform and strong reputation is also positioned for growth in an emerging industry that we believe will gain momentum as the nation continues to move forward towards more sustainable use of water and energy. In addition to growing the top line of the business, we are also focused on driving improved business efficiencies, which will improve bottom line performance.

In fact, our year-to-date chemical and related services sales is up approximately 7% over last year. The timing of revenue recognition for capital equipment sales, which represents approximately 30% of overall revenues, is dependent on when the equipment is actually shipped and received by our customers. As we have previously noted, these sales are typically less sensitive to seasonality, but may be dependent on construction schedule changes made by customers that are beyond our control.

Our current 2018 capital equipment backlog includes a disproportionately large amount of projects, approximately \$15 million, which are scheduled to be shipped late in the fourth quarter, driven by customer requests who are coordinating these receipts as part of a larger capital project. As a result, there is risk that some of these shipments could slip into the first quarter of 2019 from a timing standpoint.

Our 2019 capital equipment backlog thus far remains strong at approximately \$20 million, excluding any potential shifts from 2018. In addition to capital equipment shipment timing risk in 2018, we continue to experience increased competitive pressure with our pHytOUT



product, the subject of recent U.S. Water Services patent defense litigation I mentioned in the second quarter.

The combination of these 2 factors has caused us to lower our earnings expectations for the business segment. This impact, however, is expected to be offset by higher earnings at ALLETE Clean Energy, driven mostly by higher PTC earnings recognition. Thus, when taken as a whole, we expect our original earnings contribution estimates of \$0.75 to \$0.85 per share from Energy Infrastructure and Related Services, corporate and other, to be near the midpoint.

In close, I remain very optimistic about the prospects for ALLETE's family of businesses given their solid positioning for the future. I believe ALLETE will continue to provide significant long-term shareholder value creation through earnings and dividend growth. Consistent with our timing in 2018, we will be providing our 2019 annual earnings guidance and dividend update in February of next year. Al?

Alan R. Hodnik ALLETE, Inc. - Chairman, President & CEO

Well, thank you for the financial update, Steve and Bob. The execution of ALLETE's differentiated strategy is well underway throughout our diversified family of businesses. ALLETE is positioned to grow and create for our shareholders, great value driven by focus at state and national levels on infrastructure expansion and the need for more sustainable energy and integrated water solutions.

As mentioned in my opening remarks, Minnesota Power's EnergyForward strategy is moving ahead. We are pleased with our progress on the GNTL construction. To date, the majority of clearing has been completed and the pouring of foundations and setting of towers is well underway. Minnesota Power expects to spend approximately \$110 million on construction of the GNTL this year and estimates our total investment to be \$330 million when complete.

Manitoba Hydro is also hard at work with necessary regulatory and governmental approvals for their transmission line, which will connect with the GNTL at the Canadian border. The Nemadji Trail Energy Center proposal successfully completed a major regulatory hurdle in Minnesota. In late October, the Minnesota Public Utilities Commission approved the gas plant project after considering comments from various stakeholders. We are very pleased with this decision, now enabling Minnesota Power to advance required environmental permitting in the state of Wisconsin.

NTEC is a key component of its EnergyForward Resource Package, balancing reliability, affordability and environmental stewardship for a sustainable energy future. This project represents an investment opportunity of approximately \$350 million for our company in partnership with Dairyland Power Cooperative based in Wisconsin.

On August 22, Minnesota Power filed the 250-megawatt Nobles 2 wind power sales agreement with the Minnesota Public Utilities Commission. The Nobles 2 wind project is an important component of the EnergyForward Resource Package initially filed in July of 2017. We had intended to refile the wind PSA in December of 2017, however, Congress passed federal tax reform, which impacted the pricing of the project and certain provisions within the original power sales agreement with Tenaska were renegotiated. In connection with tax reform changes, Tenaska lost a prospective equity investor and ALLETE and Tenaska began discussions about a potential investment in the Nobles 2 project. Our efforts have been wholly focused on maintaining the viability of this very beneficial renewable project. While no investment agreements have been executed, Minnesota Power and Tenaska signed a revised PSA in August, which brings considerable value to Minnesota Power's customers with pricing that reflects qualification for 100% production tax credit, geographic diversity and most importantly, preservation of a more optimal transmission positioning in an increasingly congested MISO queue and transmission grid.

On the new customer front, PolyMet's proposed copper, nickel and precious metal mining operation expects to complete its permitting requirements by the end of this year. Recently, the Minnesota Pollution Control Agency sent proposed water and air permits to the U.S. EPA for final approval.

Records of decision from the federal agencies will enable final action to be taken on the required permits, and once received, PolyMet believes it will begin construction on the project with production to follow 18 to 24 months after construction is completed. The PolyMet project presents a significant step up in load for Minnesota Power, resulting in a new and differentiated customer requiring 45 to 50



megawatts of power under a 10-year power supply contract that is effective with the startup of mining operations.

And now a few comments on ALLETE's Energy Infrastructure and Related Services businesses. I am extremely proud that construction of the Thunder Spirit project ALLETE Clean Energy built for Montana-Dakota Utilities was completed at the end of October. This significant achievement further solidifies ALLETE Clean Energy as a reputable and proven developer of renewable energy projects, and one well positioned for future opportunities. ALLETE Clean Energy is making significant progress on its wind turbine refurbishment initiative involving facilities in Minnesota and Iowa.

ALLETE Clean Energy remains comfortably on schedule to complete these projects in 2020. Upon completion of this initiative, we believe these refurbished facilities will be well positioned to extend long-term power sales agreements already in place, further strengthening ALLETE Clean Energy's market position for the future.

In addition to these significant advances with its strategy, we expect to update you in future quarters as ALLETE Clean Energy ramps up construction activity on almost 200 megawatts of new wind energy generation beginning in early 2019 related to projects that will operate under long-term power sales agreements for other high-quality offtakers.

Last, but not least, ALLETE Clean Energy continues to evaluate the marketplace for strategic acquisitions of existing renewable facilities and bidding on opportunities for additional investment in new projects using previously acquired PTC-qualified wind turbines. ALLETE Clean Energy's growth is accelerating with more to come.

We believe U.S. Water Services is well positioned to be a key player in the water services industry, offering solutions for integrated water management with a focus on water stewardship. U.S. Water Services offers strategic solutions to a broad mix of industry helping its customers navigate through many challenges posed by growing scarcity and by complexity of regulation of this precious resource.

With more than half the year now behind us, I'm pleased with our progress executing on our differentiated strategy. A strategy designed to deliver further growth in earnings and dividends. We believe ALLETE's family of businesses will continue to benefit from investment growth opportunities, primarily driven by demands for even more sustainable forms of energy, and a renewed focus on infrastructure improvement and expansion. Thank you for your time this morning, and for your investment in ALLETE.

At this time, I will ask the operator to open up the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Elizabeth Gwynn of Mizuho.

Elizabeth Roi Gwynn Mizuho Securities USA LLC, Research Division - Assistant VP

My first question is this 3% to 4% utility growth expectation that you guys have talked about in the past, is that off the midpoint at the regulated utilities or the actual 2018 number?

Robert J. Adams ALLETE, Inc. - Senior VP & CFO

That would be off of the actual 2018 number.

Elizabeth Roi Gwynn Mizuho Securities USA LLC, Research Division - Assistant VP

Okay. So that was perfect. And then, at Minnesota Power, what was your earned ROE in 2017? And then how would you expect your 2018 net income to compare to last year?

Robert J. Adams ALLETE, Inc. - Senior VP & CFO

So in 2017 -- this is approximate now Lizz, our ROE would be about 7.25. And 2018, we're on a path, as we said, to earn 8.25 and are allowed 9.25 as you know.



Elizabeth Roi Guynn Mizuho Securities USA LLC, Research Division - Assistant VP

Right. Okay. Because I think what I'm sort of wondering about is your midpoint guidance at the regulated utilities that you talked about sort of a justification for this year, does that put you at an 8.25 ROE at the...

Robert J. Adams ALLETE, Inc. - Senior VP & CFO

Yes, it does. Yes, it does.

Elizabeth Roi Guynn Mizuho Securities USA LLC, Research Division - Assistant VP

Okay. Perfect. And then what will be the big drivers in the fourth quarter to help offset the lower 3Q earnings number?

Steven Wayne Morris ALLETE, Inc. - VP, Controller & CAO

Steven Morris here. So recall last year in the fourth quarter, we took a large charge for interim rate refund reserves of \$32 million. So that all reverses in the fourth quarter. So that will -- that's about a 9 -- yes?

Elizabeth Roi Guynn Mizuho Securities USA LLC, Research Division - Assistant VP

Is that \$32 million after tax?

Steven Wayne Morris ALLETE, Inc. - VP, Controller & CAO

Yes. So that's -- well, it's about a \$19 million after tax charge that we had in the fourth quarter of last year and that was offset by some depreciation increases that we had of about \$25 million pretax. So that net number will have a significant benefit in the fourth quarter. In addition, ALLETE Clean Energy, as we just talked about, closed out on the Thunder Spirit wind farm with a \$9 million after tax profit that will be recognized in the fourth quarter. Those are the 2 major drivers.

Operator

(Operator Instructions) And I'm showing no further questions at this time. I'd like to turn the call back over to Alan Hodnik for his closing remarks.

Alan R. Hodnik ALLETE, Inc. - Chairman, President & CEO

Well, Steve and Bob and I thank you again for being with us this morning, and for your interest in ALLETE. Certainly, we'll see many of you soon at the EEI Financial Conference or later this year at other energy conferences. Thank you, and have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. That does conclude today's program. You may all disconnect. Everyone, have a great day.

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