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ALE - Q2 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

PRESENTATION

Operator

Good day, and welcome to the ALLETE Second Quarter 2018 Financial Results Conference Call. Today's call is being recorded. Certain statements contained in this conference call that are not descriptions of historical facts are forward-looking statements, such as terms defined in the Private Securities Litigation Reform Act of 1995. Because such statements could -- 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'd like now to turn the conference over to ALLETE's President and Chief Executive Officer, Mr. Alan Hodnik. Sir, please go ahead.

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

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 second quarter 2018 financial results of \$0.61 per share on net income of \$31.3 million. Setting aside year-over-year timing differentials, ALLETE posted a solid quarter.

We remain confident in our full year 2018 earnings 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 highlight several areas of interest. We remain committed to delivering superior value to our shareholders through a balanced strategy that will not only achieve our financial objectives, but will also extend our strong track record of environmental stewardship, social responsibility and best practice governance.

Amidst considerable industry transformation, state and federal policy swirl and related economic cycles, our dedicated and talented teams have created a stronger and more robust company. It is without question that ALLETE's most valuable assets are its innovative employees who are working collectively to truly deliver differentiated results on behalf of all stakeholders well into the future.

Minnesota Power is making good progress on furthering its sustainable energy positioning, specifically, the next phase of its EnergyForward strategy, a strategy that entails more renewables, complemented by the addition of natural gas, The Nemadji Trail Energy Center or NTEC, is a proposed natural gas plant that will support further expansion of Minnesota Power's renewable generation mix, while providing critical grid stability. These actions are consistent with Minnesota Power's stated objectives to become 40% renewable by 2020, including 2/3 wind, solar, hydro, biomass and gas and 1/3 environmentally-compliant coal.

Likewise, construction continues on another significant EnergyForward initiative, the Great Northern Transmission Line. MP's GNTL initiative is designed to move 250 megawatts of carbon-free hydro energy from Canada and construction is on track for completion in 2020. These transformative projects represent significant capital investment, all aimed at answering the call for cleaner and more sustainable energy sources.



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On the regulatory front, Minnesota Power's request for reconsideration of several items in its recent rate review was denied by the Minnesota Public Utilities Commission. Although we were disappointed in this particular outcome, we continue to believe Minnesota's regulatory framework is generally constructive and supportive of our longer-term strategy. Consistent with our expressed commitments to ensure Minnesota Power earns its allowed return on equity, the company is making thoughtful and measured progress on plans to re-scale its operations and overall cost structure.

Minnesota Power's taconite customers continue to operate at strong production levels. We anticipate these levels will continue, supported in part by improved domestic steel markets and the Trump Administration's focus on reducing unfairly traded imports. We remain optimistic about the long-term health of Minnesota's world-class mineral district, as evidenced by major new capital investments in taconite processing operations and recent permitting progress in support of new non-ferrous mining operations. Indeed, we believe the strength of Minnesota Power's commercial and industrial segment will enable us to realize outpaced organic growth over the long run.

We were saddened by an event that occurred at one of Superior Water, Light and Power's valued customer's facilities. On April 26, 2018, an explosion and fire at Husky Energy's refinery in Superior, Wisconsin brought emergency response challenges to our host communities and disrupted operations at their facility. Although certainly an unfortunate event, we are thankful there were no serious injuries and both the community and the company are working towards a new future. Under normal operating conditions, Superior Water, Light and Power provides approximately 14 megawatts of average monthly electric demand to Husky Energy, in addition to Husky being a high volume water customer. The explosion and fire at the refinery resulted in \$27 million in damage and \$53 million in expenses, according to Husky's second quarter results released last Thursday.

The facility remains at minimal operations and Husky expects it will take at least 18 to 24 months for normal operations to resume. Husky has said insurance is expected to cover the cost of damage, interruption to business and any third-party liability. In addition, Husky's Chief Operating Officer, Rob Symonds, signaled in a call with investors that they will rebuild the refinery using the insurance proceeds.

At our Energy Infrastructure and Related Services businesses, we are pleased to report that ALLETE Clean Energy has made significant progress on refurbishing activities at their Storm Lake and Lake Benton wind energy facilities. ALLETE Clean Energy continues to evaluate its portfolio for additional refurbishment opportunities.

Construction is well underway and on plan for the Thunder Spirit project ALLETE Clean Energy is constructing for Montana-Dakota Utilities. Construction will be ramping up later this year and in early 2019 on projects it will operate under long-term power sales agreement with other offtakers. ALLETE Clean Energy continues to evaluate potential acquisitions of existing renewable facilities, as well as opportunities for new projects, supported by its strategic investment in wind turbines that are qualified for federal production tax credit safe harbor provisions.

I will provide additional comments on our outlook in my closing remarks. But first, I will ask Steve and Bob to go through the second 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 second quarter results.

For the second quarter of 2018, ALLETE reported net income of \$31.3 million or \$0.61 per share, compared to \$36.9 million or \$0.72 per share for the same period in 2017. 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 \$26 million, a decrease of \$6.4 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 \$5.6 million after-tax in the second quarter of this year.

If you recall, 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 the timing of approval of our Conservation Improvement Program financial incentive and lower transmission revenues. These decreases were partially offset by lower operating and maintenance expense and higher revenue from residential, commercial and municipal customers as a result of more favorable weather conditions as compared to 2017.



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Our 2017 financial incentive of \$3.9 million after-tax was recognized when approved by the Minnesota Public Utilities Commission in the second quarter of last year. We have asked the Commission to approve our 2018 Conservation Improvement Program financial incentive request of approximately \$2 million after-tax and expect a decision in the third quarter of this year. Net income at Superior Water, Light and Power was higher, due to increased rates, which were implemented in August 2017, and more favorable weather conditions as compared to last year.

A few additional comments on the Minnesota Power rate review status that Al mentioned earlier. On April 2, 2018, Minnesota Power filed a petition for reconsideration with the Minnesota Public Utilities Commission requesting reconsideration of certain decisions in its order dated March 12, 2018. In an order dated May 29, 2018, the Commission denied Minnesota Power's petition for reconsideration. The Commission did accept, however, the Minnesota Department of Commerce request for reconsideration to reduce the depreciable life of Boswell Units 3 and 4 and common facilities to 2035. The additional revenue requirement related to the change in depreciable life is offset through the utilization of the benefits of the lower federal income tax rate, enacted as part of tax reform.

A few details from our other business segments. Net income at ALLETE Clean Energy increased \$3 million from 2017. Net income in 2018 included \$3.9 million after-tax of additional production tax credits, as ALLETE Clean Energy continues to execute on its refurbishment strategy, and a lower federal income tax rate as a result of tax reform. Of the \$3.9 million in additional production tax credits, \$2.6 million resulted from the qualification of additional wind turbines in 2016 and 2017. These increases were partially offset by higher operating and maintenance expense and lower revenue resulting from lower wind resources.

U.S. Water Services net income decreased \$400,000 from 2017. Net income in 2018 included higher operating expenses, partially offset by increased revenue, primarily resulting from the September 2017 acquisition of Tonka Water. The second quarter of 2018 was also negatively impacted by the timing of capital project sales. Bob will provide more details on U.S. Water's second quarter results in a moment.

ALLETE's effective tax rate for the second quarter was a benefit of 20.8% compared to an expense of 16.5% in 2017. The decrease from 2017 was primarily due to the reduction of the federal income tax rate, lower pre-tax income and additional production tax credits.

ALLETE's financial position is supported by increased cash flow and a strong balance sheet. Cash from operating activities is \$194.4 million year-to-date and our debt to capital ratio was 42% as of June 30, 2018.

I'll now hand it off to Bob to review our earnings guidance and positioning for 2018. Bob?

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

Thanks, Steve and good morning everyone. I am pleased with how the year is shaping up. And although we have had timing impacts during this quarter, as Al alluded to, our full year earnings expectations remain firm. As Al mentioned, we are confident with our previous stated 2018 earnings range of \$3.20 to \$3.50 per share.

Based on solid progress we continue to make on key positioning investments across the company, I'm also very confident in ALLETE's ability to deliver on average annual earnings growth guidance provided earlier in the year of 5% to 7%. Between now and 2020, the vast majority of this growth will be driven by improved returns and rate-based investments at our regulated businesses and significant growth from ALLETE Clean Energy's refurbishment initiatives and new wind energy facilities.

Consistent with our original strategic plan, U.S. Water Services is being positioned to be a material contributor to ALLETE's overall earnings in the '20-'21 time frame. Toward that end, we are continuing to add capabilities, expand our geographic footprint and end markets and improve operational efficiencies, both through organic initiatives and acquisitions. We are beginning to see improved financial performance from Minnesota Power with a focus on earning its authorized ROE in 2019.

Although we are quite pleased with our progress, there is more to do on our operating and maintenance expense reduction initiative. Consistent with our financial discipline throughout all of the ALLETE businesses, earning our cost of capital is a priority for the long-term sustainability of our company.

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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 on May 25, 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.

At our Energy Infrastructure and Related Services businesses, ALLETE Clean Energy is energized and busy with the refurbishment of several wind energy facilities it owns, as well as with the construction of wind energy facilities for sale and to own and operate under the long-term agreements with high quality business partners. Upon completion of its already announced projects, ALLETE Clean Energy will have over 700 megawatts of carbon-free renewable wind energy generation in its portfolio.

ALLETE Clean Energy's project development backlog of over 400 megawatts, including 200 megawatts of refurbishment projects yet to complete, represents a secured pipeline of significant earnings growth we are just beginning to realize. On top of this, ALLETE Clean Energy is pursuing additional new projects and has project proposals of approximately 1,600 megawatts, which must be in service by 2021.

U.S. Water Services is positioned for growth in an emergent industry that will gain traction as the nation continues to move towards more sustainable use of water and energy. As Steve just highlighted in the details of our financial results, part of U.S. Water Services' revenue recognition is generated from sales of capital equipment. The timing of revenue recognition is dependent on when the equipment is actually shipped and received by our customers. Though capital equipment is typically less sensitive to seasonality, our backlog indicates a disproportionate amount of capital equipment orders, approximately \$15 million, to be shipped in the fourth quarter. In large part driven by customer requests, we are coordinating these receipts as part of a larger capital project.

As a result, there is the potential for some of these shipments to slip into the first quarter of 2019 from a timing standpoint, affecting both net income and cash flow generation from this business segment. This potential has been factored into our overall guidance confirmation of \$3.20 per share to \$3.50 per share. We are pleased that U.S. Water's second quarter chemical sales increased by approximately 5% over the same quarter last year. The solid performance was impacted by increased competition with our PHYtOUT product.

I remain very optimistic about the prospects for ALLETE's unique portfolio of businesses, given the solid growth prospects, significant cross-business synergies, and tremendous optionality they can provide over the long run. All of these facets working together positions us to provide significant long-term shareholder value creation. AI?

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

Well, thank you for the 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 value for our shareholders, driven by our nation's focus on infrastructure expansion and the call for more sustainable energy and water solutions. As expressed, next steps around Minnesota Power's EnergyForward strategy continue to evolve. Last quarter, we reported that the Minnesota Department of Commerce weighed in favorably relative to the role of and need for this NTEC Initiative.

Since then, and as part of the normal process, an administrative law judge assigned to the case issued a recommendation that the Minnesota Public Utilities Commission deny approval of the NTEC agreements. We strongly disagree on a number of points in the ALJ report. Minnesota Power and the Department of Commerce have filed exceptions to the administrative law judge's recommendation. The ALJ recommendation, while important, is not binding on the Minnesota Public Utilities Commission. The Commission is expected to hold a hearing on NTEC in the fourth quarter of 2018.

As I mentioned at our first quarter call, Northern Minnesota's frigid winter allowed for robust GNTL construction. To-date, most of the permitted right of way has been cleared and the pouring of foundations, erection of transmission towers, and stringing of wire have commenced. Minnesota Power expects to spend approximately \$110 million on construction this year with an estimated total of \$330 million upon completion of the transmission line. Meanwhile, north of the border, Manitoba Hydro is progressing with necessary regulatory and governmental approvals for their transmission line, which will connect with the GNTL.

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On the new customer front, PolyMet's proposed copper, nickel and precious metal mining operation has made significant progress on major permitting milestones. On June 28, 2018, the United States Forest Service and PolyMet closed on an administrative land exchange, which resulted in PolyMet obtaining surface rights to land needed to develop its mining operation. Earlier this year, the Minnesota Department of Natural Resources and the Minnesota Pollution Control Agency released PolyMet's draft permit to mine and also with air and water discharge permits. The public comment periods for these permits are now complete. The final environmental impact statement requires records of decision by federal agencies, which are expected this year, before final action can be taken on the required federal permits to construct and operate the mining operation. Minnesota Power could supply between 45 to 50 megawatts of new load under a 10-year power supply contract that would begin upon start-up of the mining operations.

And now, a few comments on ALLETE's Energy Infrastructure and Related Services businesses. ALLETE Clean Energy has made significant progress refurbishing wind turbines located at several wind energy facilities in Minnesota and Iowa and is firmly on schedule to complete these projects in 2020. ACE expects performance and availability improvement at these facilities upon refurbishment completion, further enhancing an already attractive carbon-free energy source for offtakers. We believe these refurbished facilities are well positioned to extend long-term power sales agreements already in place and strengthen ALLETE Clean Energy's market position.

We believe U.S. Water Services is well positioned for growth as it captures revenue streams in the emerging integrated water management industry. This business is strategically developing solutions to help customers achieve efficient and sustainable use of their water and energy systems.

With more than a half of the year now behind us, we look forward to continued execution of our differentiated strategy, a strategy designed to deliver further growth in earnings and dividend. We believe ALLETE's family of businesses will continue to benefit from investment growth opportunities, primarily driven by demands for cleaner energy forms and water conservation, along with our nation's renewed focus on infrastructure improvement and expansion.

Thank you for your time and for your investment in ALLETE. At this time, I will ask the operator to open up the lines for your questions. Octavia, are you on the call?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) I'm not showing any questions in the queue at this time.

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

Well, thank you, Octavia, Steve and Bob and I thank you for being with us this morning and for your interest in ALLETE. We will see all of you later this fall and potentially at the EEI Financial Conference in November. Thank you everyone and have a good day.

Operator

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



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