Valener Inc.

Q1 2016 Results

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CORPORATE PARTICIPANTS

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Pierre Despars
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Mariem Elsayed
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CONFERENCE CALL PARTICIPANTS

Ben Pham
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PRESENTATION

Operator

Good afternoon and welcome to Valener's First Quarter 2016 Earnings Conference Call. At this time all participants are in a listen-only mode. Following the presentation we will conduct a question and answer session. Instructions will be provided at that time for you to queue up for questions. If anyone has any difficulties hearing the conference, please press star followed by zero for operator assistance at any time. Please note that this call is being recorded, today Friday, February 12, 2016 at one o'clock Eastern Standard Time.

I will now turn the call to Ms. Mariem Elsayed, Senior Advisor, Investor Relations. Please go ahead Ms. Elsayed.

Mariem Elsayed, Senior Advisor, Investor Relations

Thank you, Jonathan. Good afternoon and welcome to Valener's first quarter 2016 conference call. With me today from Gaz Métro are Sophie Brochu, President and Chief Executive Officer, and Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer.

This call is being webcast and I encourage you to download the supporting slides, which are available in the investor section of Valener's website under events and presentations.

As always, certain subjects we will cover involve forward-looking information. Please refer to the cautionary note section, which can be found on the second page of our presentation, as well as in our quarterly MD&A, which was published earlier today and is available on our website and on SEDAR.

We may also refer to certain indicators that are non-GAAP financial measures and should not be considered in isolation or as substitutes for other performance measures that are in accordance with GAAP.

I will now turn the call over to Sophie.

Sophie Brochu, President & Chief Executive Officer, Gaz Métro

Merci, Mariem. Bonjour à tous. Good afternoon, everyone.

Despite ongoing pressure on energy prices and increased market volatility, Valener's cash flows and financial situation remained solid, stable, and sustainable heading into fiscal 2016.

Valener generated normalized operating cash flows of $10.4 million in the quarter ended last December. This is up 5 percent from the year ago period. Normalized operating cash flows per common share were $0.27 per share, up 4 percent from the prior year period and in line with Valener's recently increased common dividend. Adjusted net income attributable to common shareholders was $16.5 million for the first quarter of 2016, up 5 percent from the first quarter of last year. This was driven by higher results at Gaz Métro that were partially offset by lower wind power results.

Less favourable wind conditions, which is a risk inherent to these types of operations, resulted in an average utilization factor of 35 percent for the Seigneurie de Beaupré Wind Farms in the first quarter, which is down almost 4 percent from the same period last year. This was partially offset by Wind Farm 4 running during the entire first quarter of 2016 compared to just one month for the same period last year. Still, in the absence of start-up costs and given the payment of $12.9 million receivable for construction costs from Hydro-Québec, the wind farms generated operating cash flows totalling $31 million in the first quarter of 2016, up $18.1 million from the same period of last year.

Onto Gaz Métro on slide five. Excluding non-recurring items Gaz Métro generated net income of $75.3 million during the first quarter of 2016, a 9 percent increase over the first quarter of last year. These results were driven by the positive impact of the appreciation of the U.S. dollar on our U.S. operations, a timing difference between the recognition of sales and expenses, as well as growth in Gaz Métro-QDA's non-rate-base investments. These were partially offset by lower natural gas and electricity sales as a result of the warmer weather and some lower LNG deliveries.

Let's now take a look at the progress we're making on our developing projects as well as some highlights from the first quarter. I am now on slide six. In November we signed a major three-year commercial agreement with National Grid, one of the leading distributors of natural gas in the northeastern United States, in order to supply its storage facilities in New England with LNG from our LSR plant in Montréal. Upon obtaining the required regulatory approvals we will begin supplying National Grid's gas distribution companies with significant volumes of LNG. Talking about LNG, the expansion work at our LSR plant in Montréal to triple liquefaction capacity is progressing and we expect the commissioning to take place sometime in late 2016.

On the Vermont front, last January VGS received the Vermont Public Service Board's confirmation of the Certificate of Public Good initially issued in December 2013 and the recovery of costs relating to the first segment of the Addison project. The decision had been pending since October 2015 following an agreement reached between VGS and the Vermont Department of Public Service, capping costs of the project segment at US$134 million. We are pleased with this decision, which will allow the project to move forward as planned and provide natural gas to the counties of Vergennes and Middlebury that currently do not have the option to select natural gas as a heating alternative. We are also happy to report that the first segment of the project, consisting of 17 kilometers of pipelines, was gassed up in February. We expect the remainder of construction work to be finished by the end of 2016 and to date we have invested about US$90 million into this project.

As we head into 2016 we continue to deploy our capital wisely in order to support the integrity and the development of our gas and electricity networks and to ensure our increased presence in the promising LNG market. To this effect, we have submitted our expansion plans into the regions of Bellechasse and Asbestos to the Régie de l'énergie du Québec. We have already obtained approval for Bellechasse. Of course we also continue to support our U.S. subsidiaries in the straightening and expansion of their gas and electricity distribution networks in Vermont.

The robustness of our business model, namely our regulated entities, helps safeguard Gaz Métro from significant fluctuations in earnings and this despite current economic conditions in the energy sector. And with this embedded shield along with globally mounting appetite for greener energy solutions, we remain confident in the company's short and longer-term resilience. Accordingly, Gaz Métro's capex program for 2016 and Valener's dividend and targeted dividend growth remain absolutely intact.

Finally, I'd like to take a moment to reflect on Gaz Métro's presence at the United Nations conference on climate change in Paris last December. Following two weeks of talks, 195 states approved what was a historic agreement to reduce greenhouse gas emissions. Natural gas and Gaz Métro will clearly be part of the solution in order to achieve Québec's future energy transition strategy. And the provincial government has recognized, on several occasions, the role that natural gas will and must play, particularly in the industrial and heavy and maritime shipping areas, in order to reach the province's lofty GHG reduction goals for 2020 to 2030 horizon. Of course, many municipalities will also have their role to play, which is why we will continue to work closely with each of them, notably to spur the development of biogas in Québec.

I am now pleased to turn the call over to Pierre.

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

Thank you, Sophie.

Let's review segment performance. On to slide eight, Gaz Métro's Energy Distribution segment generated net income excluding non-recurring items of $71.7 million during the first quarter of fiscal 2016, up $7.1 million or 11 percent from the first quarter of last year.

Natural Gas Distribution in Québec generated net income excluding non-recurring items of $53.4 million, up $4.7 million from the first quarter of fiscal 2015, mainly as a result of a timing difference between revenue and cost recognition, which is expected to reverse by the end of fiscal 2016, and an increase in capitalized interest on non-rate-base investments. The increase was partly offset by lower deliveries as a result of warmer weather. November and December temperatures were 29 percent warmer than expected in areas serviced by Gaz Métro, resulting from this year's strong El Nino effect.

As a result of the application of U.S. GAAP, Gaz Métro was required to record a one-time regulatory asset of $79.3 million relating to employee future benefits in the first quarter of 2016. Under U.S. GAAP, accounting for this regulatory asset was not permitted as of the opening balance sheet date of fiscal 2015 and was therefore written off through an adjustment to deficit. Following a decision by the Régie in December 2015, the regulatory asset was once again recorded, significantly inflating Gaz Métro's net income. As a result of this decision, regulatory and U.S. accounting for employee future benefits are now well aligned. We therefore do not expect such impact on net income ongoing forward and have recorded the entire $79.3 million gain as a non-recurring item.

Green Mountain Power and Vermont Gas generated a combined net income of $18.3 million during the first quarter, up $2.4 million from the first quarter of 2015, as a result of the favourable effect of a stronger U.S. dollar, and the increase in both entities average rate base. It has been partially offset by lower electricity revenue, also due to warmer weather.

Turning to slide nine, the Natural Gas Transportation segment generated net income of $4.5 million during the first quarter, up $600,000 or 15 percent compared to the same period last year. This was driven primarily by the favourable impact of the stronger U.S. dollar and a lower interest cost as a result of the final payment, in the second quarter of fiscal 2015, of amounts owed to PNGTS customers following a rate decision by the FERC.

In Energy Production, we generated net income of $500,000 during the first quarter, down $400,000 from the year ago period mainly due to less than favourable wind conditions, which were partially offset by Wind Farm 4 running for a full quarter in fiscal 2016 compared to just one month in the year ago period following its commissioning in December 2014. Note that no distributions were paid out during the first quarter of 2016, as these will usually be paid during the second and the fourth quarters. We continue to expect that we will receive approximately $8 million in annual distributions on a run-rate basis from the Seigneurie de Beaupré Wind Farms.

The Energy Services, Storage and Other segment generated net income of $1 million in Q1, down $500,000 from the prior year period, largely as a result of lower LNG sales. The decline was mainly because of a significant short-term contract executed in the first quarter of 2015 that did not repeat this year. This was partly offset by improved profitability at Gaz Métro Plus and Solutions Transport.

Onto slide ten, last quarter we guided to approximately $485 million in capex investments for fiscal 2016, in particular for the extension and improvement of the energy distribution system in Québec and Vermont as well as for the LSR plant expansion project. As of the end of the first quarter we have already invested $125 million in property, plant and equipment and are on track to deploy the remainder over the course of the year.

As of January, Gaz Métro started paying out distributions of $0.29 per unit per quarter, up 3.6 percent from the previous level of $0.28. This was the first time that Gaz Métro's distributions were increased since Valener's inception. In tandem, Valener paid out its recently increased quarterly dividend of $0.27 per share in January, up 3.8 percent from the previous level. As a reminder, we expect to increase this new annualized dividend of $1.08 per share two more times through 2018 and by $0.04 each time.

Valener seeks to pay out the majority of its available cash flows in a sustainable manner. This means analyzing cash flows excluding non-recurring items and the impacts of irregular events such as atypical weather patterns or timing differences between accounting and taxable income. This also means maintaining enough flexibility to invest in Gaz Métro when need be without, to the extent possible, being dependent on the capital markets.

Note that as of the quarter ended December 31, 2015, Valener and Gaz Métro are now presenting their financial statements in accordance with U.S. GAAP. As such, Q1 2015 figures have been restated. The most notable differences resulting from the conversion to U.S. GAAP include:

A change in the way we account for our joint ventures. Whereas under Canadian GAAP we use the proportionate consolidation method to account, we are now accounting for them using the equity method. Accordingly, you'll note that previously Gaz Métro recorded is proportionate share in each of its joint venture assets, liabilities, revenues, and expense in the corresponding line items of its own financial statements. Now, under the equity method, Gaz Métro initially recognizes the investment at cost on the investment line in the balance sheet. This amount is then annually adjusted to reflect Gaz Métro's prorated share of net earnings in the investment and reduced by the amount of distribution received.

As previously described, Gaz Métro was required to record a one-time regulatory asset of $79.3 million relating to employee future benefits as a result of the application of U.S. GAAP and, as you'll recall from our year-end 2015 call, Gaz Métro-QDA's quarterly net income distribution has changed upon conversion to U.S. GAAP. This is the result of a difference in quarterly amortization methods for regulatory assets and liabilities. On an annual basis, however, there will be no impact on Gaz Métro-QDA's net income. Finally, Valener has accounted for its share of the aforementioned adjustments recorded by Gaz Métro upon its conversion to U.S. GAAP.

On slide 12 we chart out Gaz Métro-QDA's rate case net income for 2016 based on U.S. GAAP. As you can see, the rate case remained unchanged regardless of the conversion to U.S. GAAP. And on slide 13, we highlight QDA's 2015 quarterly net income under each U.S. GAAP and Canadian GAAP. Note that despite some fluctuation on a quarterly basis QDA's annual net income is not significantly different between both sets of accounting principles.

Finally, on January 12th, after many discussions with Valener on the matter, Standard & Poor's downgraded the company's corporate credit rating from BBB+ to BB+ following a methodology change in the way they rate companies whose significant assets consist of one or two non-controlling equity interests. We view this downgrade, which affected only five companies globally out of the thousands that S&P rates, as unjustified and, as such, Valener requested the withdrawal of the rating. It is our opinion that the downgrade to BB+ was unwarranted and excessive as it did not accurately reflect the quality and the stability of the cash flows of Gaz Métro, Valener's principal investment. It failed to provide an accurate reflection of Valener's creditworthiness. It was also not the outcome of an event affecting Valener or Gaz Métro's operation and it did not account for the fact that Valener is well represented on Gaz Métro's board and has significant influence on Gaz Métro's distributions. It was merely the result of an amendment to Standard & Poor's rating methodology that came just weeks after the agency had reaffirmed our BBB+ corporate credit rating.

That concludes the call. Operator, we'll now open the line for questions.

QUESTION AND ANSWER SESSION

Operator

Ladies and gentlemen, if you would like to ask a question, please press star then the number one on your telephone keypad. Again, that's star one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from Ben Pham with BMO Capital Markets. Please go ahead.

Ben Pham, BMO Capital Markets

Thanks. Good afternoon, everybody. On just your last commentary on the rating downgrade and withdrawal, are you planning to add another agency then? Does this impact your access to the pref market or the debt market at Valener if you need to access that in the future?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

We have a DBRS rating and it does not impact our access to the pref market because we already have one credit rating.

Ben Pham, BMO Capital Markets

Okay. So you only need one. Okay.

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

Yeah.

Ben Pham, BMO Capital Markets

Okay. So I remember last quarter you guys said that you were planning to pay down the debt that you layered on at Valener, I think at 120 it doubled, so has that view changed now that S&P isn't there anymore?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

No, it doesn't change our strategy in terms of repaying the debt at the Valener level. So, no, it makes no difference. And I have to say fundamentally the business of Gaz Métro didn't change, the business of Valener didn't change; it's only a methodology change at Standard & Poor's. A fact which is amazing is that they confirmed our BBB+ rating in December and a month later, with that change, they just reduced it to BB+. And the reason why is that the maximum rating at those companies like Valener who have significant investments in non-controlling assets is, the maximum rating you can get is BB+.

Ben Pham, BMO Capital Markets

Okay. Yeah, it seemed like a pretty drastic move. The only thing I want to check is how do you think about your—just with your guidance on a dividend, the timeframe that you're willing to talk about, because you first came out with three years, now it's two, so as we head towards another year do you plan to keep rolling it one year forward?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

Okay, yeah, we announced last year the increase in January. This year we did it at the end of our fiscal year. And we intend to confirm it year after year. As you know, a dividend change is something that is decided on a yearly basis but we already confirmed and saying that we will maintain that growth in the dividend over the growth of the two coming years. We're in the process of revisiting our strategic plan and review the long-term forecasts and when we'll be ready we'll announce if there is subsequent increase.

Ben Pham, BMO Capital Markets

Okay. That's it for me. Thanks, everybody.

Operator

And, again, if you would like to ask a question, please press star one on your telephone keypad.

Your next question comes from Robert Kwan with RBC Capital Markets. Please go ahead.

Robert Kwan, RBC Capital Markets

Good afternoon. Just first on QDA and the emissions credits purchases under the C&T regulation, I'm just wondering have you been able to refine your thoughts as to how you would plan to restock the inventory and what type of lead time as you start to chew through the credits?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

We have a strategy to purchase those credits a couple years in advance and, as you see, at the end of the year we had approximately $300 million in assets for those credits. So this is the strategy that we have for going forward. So we're not waiting to be at the last minute for buying those credits.

Robert Kwan, RBC Capital Markets

Okay. And is that something you just need to constantly review with la Régie?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

Yeah. We have to file on a quarterly basis with the Régie and annually we present the strategy with the Régie.

Robert Kwan, RBC Capital Markets

Okay. So the plan right now is, well obviously, I guess, if you view quarterly they could change, but really to be looking at that constantly a couple years in advance and then what would move the dollar amount around would really just be the cost of the credit itself?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

Yep.

Robert Kwan, RBC Capital Markets

Okay. Just on, ah, for Green Mountain Power, so for GMP you're highlighting lower demand from things such as solar. I'm just wondering is there anything that you're thinking about applying for to change the rate design to protect against things like that.

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

We have to be clear, in the first quarter the major impact is linked with the weather. You have to remember that there's no weather normalization at Green Mountain Power level so we were in a situation that there was a significant decrease in the demand over there.

In the context of renewable generation, we are in the process of developing some solar. We are also looking at the rate structure but we're not in a mode at this moment to change that rate structure.

Robert Kwan, RBC Capital Markets

Okay. Do you view that though just based on geographically where it is but also from what you're seeing as the uptake on distributed generation, do you see that as a major threat? Like is it something high on your priority list to change the rate structure?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

No, it's not a threat. In fact, at Green Mountain Power it's an opportunity. Because you have to remember in Vermont a distributor can own generation. So we're in a situation where we have the opportunity to develop, to invest in generation, and this is what we are intending to do in terms of solar and this is what we've done with the wind farm.

Sophie Brochu, President & Chief Executive Officer, Gaz Métro

Maybe to give you a little colour on that side of financials, I think the State of Vermont is quite innovative and unique because the way Green Mountain worked with the regulator and the population is to allow people who do not necessarily have the capital to invest personally in those type of facilities see the utility do it by itself, allowing that customer to get the benefit and the overall operating system to get the benefit. So whereby in other jurisdictions the distributed generation is in conflict and harming the utilities, in this precise example at GMP it's exactly the opposite. So I think we need to salute Mary Powell's approach to this development and the fact that the whole state benefits from such an approach and not only the people who have the money to invest in those capex.

Robert Kwan, RBC Capital Markets

So, sorry, maybe I'm not understanding how the structure works. So if a resident installs rooftop solar and they pay for the whole thing is there not a rate structure there that is significant or meaningfully variable such that you're not, you're only being compensated for the fixed chart yet they're still on the grid?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

Yes, they are—we are compensated by the, ah, just for the fixed charge, but there's, at Green Mountain Power they can invest and lease those rooftops, so that adds assets to the rate base that compensate in terms of revenue. And at this point it has not been, there has not been significant impact.

Robert Kwan, RBC Capital Markets

Okay. And I guess bottom line is you don't see really a big risk of people going and doing it themselves rather than doing it through you.

Sophie Brochu, President & Chief Executive Officer, Gaz Métro

Actually it is the opposite.

Robert Kwan, RBC Capital Markets

Okay, perfect. And then maybe just last on the LNG side of things, I know last year you had that kind of short-term contract that was a big lift. What happened with that demand? Was it because of the warmer weather or did they shift to a competitor? Do you have some colour behind that?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

Yeah. What happened is that had, ah, we have to manage our capacity of LNG through the whole period of the winter and we have worked to perform on the, let's say on the liquefaction in fall, so we had less availability, and we also have committed some capacity to some customers that have subsequently a delay in their operation. So that's a mix of different things but, ah, and lastly it was one specific customer for a one-timer and we had all that capacity at that time.

Robert Kwan, RBC Capital Markets

Perfect. Thank you. Oh, sorry, Pierre?

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

No, it's fine. Okay.

Robert Kwan, RBC Capital Markets

Okay. Thanks, Sophie. Thanks, Pierre. I'm good.

Sophie Brochu, President & Chief Executive Officer, Gaz Métro

Maybe a bit of colour on that. I think 2016 is clearly a transition period on the operating mode with LNG because, as Pierre was saying, we've been working from the existing liquefaction capacity. That's what we're doing right now. We are doing construction work to triple the capacity. So we need to fine-tune the deliveries in 2016. There will be a little bit of febrility there but the fundamentals of the business is actually quite good. I want to underline that Le Groupe Desgagné have just announced the order of two additional LNG major carriers with an option on two others. So these folks will be moving six ships ultimately with LNG. Just that is huge demand that is coming up. The cycle of sales on LNG with industrial loads and Maritimes loads is longer than what would be with gas use, natural gas, for obvious reasons, but fundamentally the demand is still very good. And in the U.S., you know, LNG is not that sensitive to weather. It is, but to a lesser extent. And the deals that we do with the distributors in the U.S. northeast is to manage their peak shaving requirements. So those sales would be made in advance of the winter so that they can fill their storage and the actual weather on that specific year would maybe impact their use of their own storage but the use of natural gas is less weather, of LNG for that specific use is less weather dependent.

Robert Kwan, RBC Capital Markets

That's great. Thank you very much.

Operator

And, again, if you would like to ask a question, please press star one on your telephone keypad.

There are no further questions at this time. I will now turn the call back over to the presenters.

Sophie Brochu, President & Chief Executive Officer, Gaz Métro

Thank you for taking the time. Happy Valentine.

Pierre Despars, Executive Vice President, Corporate Affairs & Chief Financial Officer, Gaz Métro

For those not in Québec don’t forget it’s a statutory holiday in Ontario on Monday. Bye.

Operator

Ladies and gentlemen, this concludes today’s conference call. You may now disconnect.