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Valener Inc.

Q2 2018 Results

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[1] Formerly Gaz Métro Limited Partnership

CORPORATE PARTICIPANTS

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Robert Kwan
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PRESENTATION

Operator

Good morning and welcome to Valener and Énergir's Second Quarter 2018 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 and 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 May 10, 2018 at 11:00 a.m. Eastern Time.

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

Mariem Elsayed, Senior Advisor, Investor Relations, Valener Inc.

Thank you, Daniel. Good morning and welcome to Valener's second quarter 2018 conference call. With me today from Énergir are Sophie Brochu, President and Chief Executive Officer, and Éric Lachance, Senior Vice President, Corporate Affairs and Chief Financial Officer, both acting as managers of Valener.

This call is being webcast and I encourage you to download the supporting slides, which are available in the Investors 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 that was published earlier today and is available on our website and on SEDAR.

We may also refer to certain indicators that are non-US 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, Énergir, L.P., acting as manager of Valener

Merci beaucoup, Mariem. Bonjour à tous. Good morning, everyone.

Second quarter results were strong. Valener generated adjusted net income of $33.9 million, up $1 million from last year, and EPS of $0.87 compared to $0.85 in Q2 of 2017. For Énergir, excluding a one-time gain, adjusted net income was $150 million for the second quarter, up $7.5 million from last year.

Of course, we are very pleased with this quarter's results. Our commercial and geographical diversification strategy continued to serve us well, with energy distribution activities in both Québec and the United States driving the solid financial performance. By offering an expanded energy portfolio, including renewable and less emissive energies, we are well positioned to serve Énergir's clients in Canada and south of the border and to continue delivering value by way of stable and predictable financial performance for Valener's shareholders.

And, against the backdrop of Valener's stability, Énergir continues to make strides in innovation and to focus on growth opportunities. Effectively, in partnership with the city of Saint-Hyacinthe, we are now able to offer renewable natural gas in Québec. Biomass, in this case agricultural waste, is used to produce biogas, which then gets injected into the QDA distribution network. L'Oréal is our first customer signed up for this type of energy and demand is growing. Operations at Saint-Hyacinthe are ramping up and we are now turning our attention to signing similar agreements with other producers of biomass in order to meet the growing customer demand for renewable natural gas.

Standard Solar, which we acquired a year ago, continues to ramp up following a period of uncertainty surrounding the American government's decision to impose tariffs on solar modules. As of March 31st of this year, Standard Solar has completed the construction of solar projects totalling 10 megawatts and, as of today, seven more projects are under construction that will add 33 megawatts to the balance sheet and be coming on line in the next few months. Based on its current pipeline of projects, we expect to spend approximately $145 million in CapEx over the course of Q3 and Q4 to further develop Standard Solar.

And with all this, we continue to invest in our larger operations. Subject to the approval from the Régie de l'énergie, QDA will be expanding in five municipalities, adding almost 70 kilometres to its network. With these projects we are partnering with the government, which will be injecting most of the equity required for the projects. We are thrilled to be bringing the benefits of natural gas to customers who currently cannot get it, but have been requesting it.

GMP and VGS are expected to invest about C$230 million over the course of the year in order to maintain and strengthen their networks in order to continue to ensure reliable service to their customers and to develop GMP's solar. Note that all of our regulated entities filed their 2019 rate cases with their respective regulators during the second quarter. Éric will take you through some of the details in a minute.

Our customers are always top of mind, and our commitment to their satisfaction, their safety, and their wallet is reflected in the proposals submitted to the regulators.

I will now turn the call over to Éric.

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

Thank you, Sophie. I'll start with an update on the impacts of the US tax reform before getting into the numbers of the second quarter.

On to slide four, you will recall that in February we explained that we were reducing deferred tax liabilities by $238 million to reflect the new lower federal corporate tax rate of 21 percent. As a result, we also recorded an increase in regulatory liabilities on the balance sheet of $247 million, representing the amount that GMP and VGS will be giving back to customers over time.

The period over which these amounts will be amortized and returned differs between GMP and VGS. Based on the IRS normalization rules and the nature of the items that led to the recognition of the deferred income taxes to be refunded to the customers, deferred amortization schedules were proposed in the 2019 rate cases that each utility filed with the VPUC this quarter. As a result, for GMP and VGS combined and subject to VPUC approval, a total of approximately US$30 million of regulatory liabilities related to the tax reform would be repaid in 2019 with the remaining expected to be amortized over an estimated average period of 40 years, which represents approximately US$4 million per year.

As you know, as these sums are returned to customers, the portion of the rate base that earns a return will increase by the same amount. As a result, we expect the net effect on the 2019 net income to be slightly positive. As for cash flows, despite a slight pullback in 2019, we don't expect to alter Énergir's financing strategy as a result. Note that at this time we're still assessing the potential impact of the BEAT and the interest deductibility limitation rules.

Now on to Valener on slide five. Valener generated adjusted net income of $33.9 million in the second quarter of 2018, up $1 million from the second quarter of last year. Adjusted net income per share was $0.87 in the second quarter of 2018, up from $0.85

per share in the second quarter of 2017, driven by higher net income from Énergir that was partly offset by lower net income from the Seigneurie de Beaupré Wind Farms.

Normalized operating cash flows were higher. $14 million in the second quarter of 2018 compared to $11.3 million last year. The stronger cash flows were mainly the result of two factors. First, the timing of the Seigneurie de Beaupré distributions. While there was a $2 million distribution from one of the wind farms this quarter, the corresponding 2017 payout was in Q3. Secondly, distributions from Énergir were $900 thousand higher because of increased numbers of units held by Valener and a $0.01 per unit increase in Énergir's quarterly distribution.

On to slide six, Énergir's Québec distribution activities, or QDA, generated $116.6 million of net income in the second quarter. That's $2.2 million more than the second quarter of last year and $5.5 million more than what was anticipated in the rate case. The year-over-year increase stems mainly from the favourable impact of regulatory timing, which is expected to reverse over the course of the year, and an increase in delivered normalized natural gas volume as a result of strong economic growth in the province. Note that the regulatory timing refers to temporary differences between when revenues and expenses are earned or incurred compared to what had been anticipated in the rate case. These are always expected to reverse of the course of the fiscal year. Given QDA's higher than anticipated performance during the first six months of the year and based on the most recent year-end projection, we now expect the segment to end fiscal 2018 with net income of at least $6 million higher than the $132.7 million initially projected.

As mentioned last quarter, for fiscal 2019 the Régie de l'énergie has confirmed the requested 8.9 percent authorized ROE for 2019 as well as the earnings sharing mechanism. In March and April 2018, QDA submitted the second phase of its 2019 rate case to the Régie. The second phase requests, among other things, a 4.1 percent reduction in average rate and an average rate base of $2.15 billion. That is a $36 million increase compared to the 2018 rate case. The lower rates requested reflect the growth in volume since our last filing, lower transportation and load-balancing rate charged by TCPL since January 2018, as well as the net amount returned to clients relating to shortfalls and over-earnings from fiscal year 2016 and 2017. As for the higher rate base, the $2.15 billion requested is to take into account QDA's recent CapEx investments. We expect a decision will be made by the fall of 2018.

On to Vermont, on slide seven, notwithstanding the effect of a stronger Canadian dollar, Énergir's Vermont operation generated net income of $36 million in the second quarter of 2018, up $6.4 million from the second quarter of last year. Results were mainly driven by the parameters in GMP's 2018 rate case, the increase in VGS's average rate base, which now reflects the completion of the Addison County natural gas project, and the favourable impact of regulatory timing of certain revenues and expenses, which is mostly expected to reverse over the course of the year.

In April of this year GMP filed its 2019 rate case with the VPUC based on the cost-of-service method. GMP is requesting an authorized ROE of 9.3%, a 49.8% equity capital structure, and a regulatory year starting January 2019 and ending September 2019 in order to tie its regulatory year to the company's fiscal year. Given higher procurement and transmission cost, as well as a lower anticipated volumes delivered as a result of various energy efficiency measures adopted by GMP's customers, 4.45% rate increase is proposed in this rate case. This increase is, however, more than offset by the effect of beginning to reimburse customers the regulatory liability recorded following the implementation of the US tax reform. As a result, and subject to the approval of the VPUC, GMP customers can expect to see a global rate decrease of 0.5% in 2019. The filed rate case also calls for an average asset base of US$1.56 billion, a US$130 million increase from 2018 reflecting recent CapEx investments in Vermont Transco as well as in solar energy projects. Finally, the rate case also includes a return of US$13.9 million to customers, representing their share of the synergy savings from the merger with CVPS. A decision by the VPUC is expected in December.

As for VGS, it filed its cost-of-service proposal for 2019 with the VPUC in February of this year. The proposal calls for an authorized ROE of 8.5 percent and a 50 percent equity capital structure. It also includes a 3.8 percent decrease in global rates that takes into account a 14.8 percent rate reduction as a result of lower natural gas prices, the effect of beginning to reimburse customers the regulatory liabilities recorded following the implementation of the US tax reform, as well as a 4 percent increase in distribution rates. VGS is also requesting the use of US$8.1 million collected through its System Expansion and Reliability Fund as well as an asset base of US$264.2 million, a US$16 million increase from 2018. A decision by the VPUC is expected in time for the new rates to take effect as of November 1, 2018.

The natural gas transportation segmented generated net income of $7.1 million, down $300,000 from last year, in part due to the lower spot volumes transported by PNGTS. Notwithstanding lighter short-term deliveries, demand for natural gas in New England is growing and there is a limited number of pipelines in the region. A process conducted by PNGTS in summer 2017 resulted in the signature of new contracts for a total of approximately 170,000 dekatherms per day. To meet this additional demand, PNGTS will be increasing its network capacity by, among other things, adding a compressor to the Elliot station while leveraging upcoming work at TQM East Hereford station located near the border with Vermont and New Hampshire. Work is expected to be completed towards the end of 2019 and the projects are scheduled to come on line in November 2020. In March, the NEB approved a request to add compression on TQM network and in April the regulatory application to add compression on the PNGTS network was submitted to the FERC. PNGTS's future customers are expected to obtain the regulatory approvals required to contract the additional capacity by summer 2018.

On to slide eight. In electricity production we recorded net income of $1.3 million in the second quarter, compared to $1.6 million last year as power generation was impacted by two weeks of frost in March 2018 even though winds were higher than expected. Also, in the first quarter, Standard Solar entered into an agreement with a tax equity partner for the financing and development of certain solar projects. The partnership, coined Solar One, calls for the financing of solar projects worth approximately US$50 million where Standard Solar finances 60 percent and the partner the remaining 40 percent. As of March 31st the partner had invested about US$9 million. As a reminder, using a tax equity partner also means using the HLBV, or hypothetical liquidation at book value, accounting method. The impact of the HLBV method on net income was US$2.1 million in the second quarter of 2018 and US$2.7 million for the first six months of the year.

Finally, in Energy Services, Storage and Other, excluding a one-time $4.4 million gain, we generated adjusted net income of $2 million during the second quarter, up $200,000 from the second quarter of 2017. The gain was the result of a sale of server hosting assets by Gaz Métro Plus in February 2018 that were deemed to be non-core to the business.

On to slide nine, in corporate affairs where, among other things, we record our financing costs, development expenses, as well as revenues and corporate expenses not allocated to other segments, we recorded a net loss of $13 million in the second quarter of 2018 compared to a net loss of $12.3 million in the second quarter of last year. The increase in expenses was driven by higher financing costs related to the issuance of long-term debt from unregulated activities in May 2017 and changes to the holding structures made in the first quarter of 2018.

Q2 CapEx totalled $80 million and included mainly maintenance capital expenditures. We continue to expect fiscal 2018 CapEx to range between $535 million and $560 million, including investments in affiliates as we continue investing in securing and reinforcing our networks and supporting Standard Solar's expansion initiatives. As such, Q3 and Q4 CapEx figures should be higher than investments made in Q2 2018.

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

QUESTION AND ANSWER SESSION

Operator

Thank you. At this time I would like to remind participants that in order to ask a question by phone you must dial star and then the number one on your telephone keypad. We'll pause for a moment now to compile the Q&A roster.

Again, that is star one to ask a question.

Your first question comes from the line of Robert Kwan with RBC Capital Markets. Your line is now open.

Robert Kwan, RBC Capital Markets

Good morning. You noted that you're still assessing the BEAT plus the interest deductibility caps. I'm just wondering, do you have some early kind of analysis or thoughts on how that might play out for you?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

No. At this stage it's really an assessment. That being said, we don't have, at the holding level we don't have double leverage in the US, so that should not be meaningful. And for BEAT, for the close future, we still have a lot of reinvestment opportunities in the States so it's not, it would not be significant in the short term.

Robert Kwan, RBC Capital Markets

Okay. So, I guess, the early analysis is that it's not likely to be much of an issue for you.

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

For the short term, no.

Robert Kwan, RBC Capital Markets

Okay. And just so I'm clear, the dollar impact that you gave, the slightly lower cash flow impact, is it materially less than the US$34 million revenue impact that you outlined?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

Basically you want to translate, based on what we return to customers, what's going to be the cash flow impact for us. Is that it?

Robert Kwan, RBC Capital Markets

Yeah. Like you just kind of used the term slightly lower, so is there some material offset or is it really the two pieces in terms of the revenue reduction?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

No, it's really the revenue reduction. But, that being said, since it's going to be earning the regulated returns on it, it's going to be financed as it is always based on the capital structure. So it's not one-for-one in terms of impact on equity cash flows.

Robert Kwan, RBC Capital Markets

Okay. Maybe just taking a step back and finishing on this topic, like even if there was something more material in cash flow, you have very strong credit ratings, so can you just maybe talk about your thoughts of how you would absorb anything unforeseen? Would you just take a downgrade or would you actually look to inject equity?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

Right now we're committed to the current rating, so likely equity. And just be clear, that's for Énergir.

Robert Kwan, RBC Capital Markets

Correct. And then maybe I'll just finish with respect to QDA. Can you just refresh what the non-regulated rate base investment is right now and what you're projecting that to be as part of 2019?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

Honestly, I would have to check and come back to you. I don't have the number offhand.

Robert Kwan, RBC Capital Markets

Okay. Is it also materially different as we head into 2019 or is it about the same amount?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

It could be different.

Robert Kwan, RBC Capital Markets

Okay. Okay, thank you very much.

Operator

Again, if you would like to ask a question, please dial star one on your telephone keypad.

Your next question comes from the line of Ben Pham with BMO Capital Markets. Your line is now open.

Ben Pham, BMO Capital Markets

Hi. Thank you. I wanted to follow up on your slide on US tax reform, and a couple of different moving parts there, but I'm more curious that, ah, the computation on that, did that impact how you thought about the dividend growth going forward?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

No.

Ben Pham, BMO Capital Markets

Okay. So it wasn't a material impact on cash flow.

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

Not material enough to impact our guidance on dividends, no.

Ben Pham, BMO Capital Markets

Okay. All right, that's good to hear. And anything going on, I hopped on a little bit later, with Standard Solar in the quarter?

And maybe an update on the tax equity market. It looks like it's opening up a little bit here for some participants out there.

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

Our tax equity partner market is still open, we have a good sign, so no difficulties in the one we closed and we don't foresee any difficulties for future ones in the current market conditions.

And the first part of the question, could you remind me?

Ben Pham, BMO Capital Markets

Just going forward in terms of, you mentioned some targets last year at the investor day in terms of ongoing investments. Anything really change there from that perspective?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

No, I think so far our best estimate remains that Standard Solar can do around 100 megawatts per year in terms of projects and that the tax, not the tax reform but the trade tariff case really was sort of a timing difference. It slowed down the pipe but, that being said, now we're seeing the pipe being firming up, and as you've seen from the numbers, the 100 that we announced, the 100 remains realistic for next year.

Ben Pham, BMO Capital Markets

Okay. And can I close off just on tax equity again? In terms of the cost though, because I've heard costs of that source of capital went down almost 6 percent at one point in time versus, say, 8 percent to 9 percent historically, but still pretty robust in the 6 percent to 7 percent range. Is that what you guys are seeing as well or is it a little bit of different tax equity guys you're speaking to broadly?

Éric Lachance, Senior Vice President, Corporate Affairs & Chief Financial Officer, Énergir, L.P., acting as manager of Valener

I won't comment because it's competitive and, you know, we're in the market ourselves to shop, if I may say, the partners we choose. So I won't comment on this one, but you seem to really understand the market well.

Ben Pham, BMO Capital Markets

Okay. All right, okay. Thanks for your time.

Operator

Your next question comes from the line of John Mould with TD Securities. Your line is now open.

John Mould, TD Securities

Thanks very much. All my questions were just actually answered, so I'll hope back in the queue. Thanks.

Operator

And there are no further questions over the phone line at this time. I'll now turn the call back over to the presenters.

Mariem Elsayed, Senior Advisor, Investor Relations, Valener Inc.

Thank you.

Operator

This concludes today's conference call. Thank you for your participation. You may now disconnect.