Capital Power Corporation
Third Quarter Results Conference Call

November 1, 2010; 11:00 MT

OPERATOR: Welcome to the Capital Power Corporation's conference call to discuss the third quarter 2010 results. At this time, all participants are in 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. I would like to remind everyone that this conference call is being recorded on Monday, November 1, 2010 at 11:00 a.m. Mountain Standard Time. I will now turn the call over to Randy Mah, Senior Manager Investor Relations. Please go ahead.

RANDY MAH: Good morning and thank you for joining us today to review the third quarter 2010 results for Capital Power Corporation. The press release and the presentation slides for this conference call are posted on our website at www.capitalpower.com. This conference call is also being webcast from our website. Joining me on the call this morning is Brian Vaasjo, President and CEO, and Stuart Lee, Chief Financial Officer. After our opening remarks, we will open up the lines to take your questions.

Before we begin, let me direct your attention to the cautionary statement regarding forward-looking information on slide number two. Certain information in this presentation and in responses to questions during this conference call contains forward-looking information. Actual results could differ materially from conclusions, forecasts or projections in the forward-looking information, and certain material factors or assumptions were applied in drawing conclusions or making forecasts or projections as reflected in the forward-looking information.

Please refer to pages 16-18 of this presentation which contain additional information about the material factors and risks that could cause actual results to differ materially from the conclusions, forecasts or projections in the forward-looking information and the material factors or assumptions that were applied in drawing conclusions or making a forecast or projection as reflected in the forward-looking information.

I will now turn the call over to Brian for his remarks starting on slide number three.

BRIAN VAASJO: Thanks, Randy and good morning. I'll start off by providing an update on a number of items. Capital Power delivered solid performance in the third quarter with $0.55 of normalized Earnings Per Share. With our baseload generation capacities essentially all hedged for the remainder of 2010, in the low $60 per megawatt range, we were essentially unaffected by the weak Alberta spot prices. Through nine months, our financial performance is tracking slightly ahead of plan for 2010.

On October 19th, we completed the acquisition of the Island Generation facility for a purchase price of approximately $207 million, plus closing adjustments. The 275 megawatt facility located on Vancouver Island is the first addition to our fleet via acquisition. With a contracted cash flow from its 12-year PPA, it further solidifies the contracted portion of our portfolio. Integration of this asset has gone well.

On October 5th, Capital Power Corporation and Capital Power Income L.P. announced that the Partnership was initiating a process to review its strategic alternatives. The intent of this strategic review is to explore alternatives to maximize value for the Partnership's unitholders and CPC shareholders. Capital Power supports the review process, which is expected to take place over the next several months.

Our construction projects are progressing well. Keephills 3 remains on-track to commence operation in the second quarter of 2011. The Quality Wind project now has an EPC contract in place and is starting construction through beginning initial site work. The Port Dover and Nanticoke wind project is progressing through Ontario environmental approval processes.

Turning to slide four, this slide highlights the operating performance of our facilities. Overall, weighted average plant availability was 95% in the third quarter. Excluding CPILP plants, the weighted average plant availability was 93%, which was in line with our expectations.

Unit 2 of the Clover Bar Energy Centre has been offline for approximately six months due to a mechanical failure in the main turbine section, was back on line on September 22 and has been operating well. With the scheduled outage at Genesee 3 in October, the company has relied on the Clover Bar Plant to successfully manage our Alberta power portfolio and this process has worked well as anticipated.

I'll now turn the call over to Stuart.

STUART LEE: Thanks, Brian. I'll begin my remarks starting on slide five with financial summary of the third quarter results. As Brian mentioned, Capital Power had solid year-over-year financial performance with strong normalized Earnings Per Share and Funds From Operations.

Third quarter results were impacted by higher margins from merchant trading and an estimated $8 million insurance recovery that was recorded for business interruption related to the Clover Bar 2 outage. The insurance claim is expected to be settled before the end of the second quarter of 2011.

In the third quarter, there was recognition of a future income tax liability of $11 million relating to the company's investment in CPILP as a result of CPILP's review of its strategic alternatives.

Third quarter results also include recognition of $7 million in indirect administration expenses for the company's obligation to EPCOR for ongoing operations and maintenance costs related to the decommissioning of the Rossdale power plant.

Turning to slide six, I'll review our Q3/10 performance on a year-over-year basis.

Revenues of $508 million, were down slightly from $511 million in the third quarter of 2009. The decline was mainly due to unrealized fair value changes, partially offset by higher revenues from the Alberta commercial plants and portfolio optimization segment.

Both gross margin and operating margin were up 11%, primarily attributable to the year-over-year increase in the Alberta commercial plants and portfolio optimization segment. The segment benefitted from higher margins realized on the merchant trading portfolio and the recognition of the $8 million related to the business interruption insurance recovery at Clover Bar.

Reported Earnings Per Share were $0.32 in the third quarter, compared to $0.64 in the third quarter of 2009. However, after adjusting for various items that I'll outline shortly, normalized Earnings Per Share were $0.55 in the third quarter, up from $0.42 in the same period last year.

Looking at cash flow, Funds From Operations were $106 million in the third quarter, up 14% from a year ago. And excluding the non-controlling interests in CPILP, Funds From Operations were $86 million, up 23% from the prior year.

Moving to slide seven, this slide outlines the various items used to calculate the normalized net income figure of $12 million in the third quarter of 2010. Starting with reported net income of $7 million, you need to adjust for the fair value changes in CPLP and CPILP. Adjustments in CPLP needed to be captured at 27.8% and tax-effected. Adjustments in CPILP need to be captured at 8.3% and tax-effected. As you can see from the slide, there are five items that have been normalized for and tax-effected at their appropriate after-tax rates. The sum of the normalized earnings items is approximately $5 million resulting in normalized net income of $12 million or $0.55 on a per share basis.

Turning to slide eight, this slide summarizes the financial performance for the first three quarters of 2010. As you can see in the slide, the third quarter performance matched the strong first quarter performance with normalized Earnings Per Share of $0.55.

On a 2010 YTD basis, normalized Earnings Per Share is $1.15 and we're slightly ahead of plan on our full year guidance.

The company continues to generate healthy Funds From Operations on a deconsolidated basis of $207 million for the first nine months of 2010. To provide some perspective on our ability to generate discretionary cash, if you annualize the nine months figure, you get $276 million, which is substantially higher than the approximately $150 million required for the annual dividends and average maintenance capex.

As we look ahead to a better Alberta power market and to the substantial new cash flows relating to our pipeline and projects under construction, we feel very good about our financial flexibility at the Capital Power Corp level.

Now turning to slide nine, I'll conclude with a review of financial outlook for the remainder of the year. The Genesee 3 plant had its scheduled outage in October which will result in an expected maintenance expense or approximately $7 million and lower operating margins for the facility.

The Island Generation facility is expected to contribute approximately $4 million in operating margin for the fourth quarter based on the October 19th closing date.

We expect capex, excluding capex for CPILP and acquisitions, to be approximately $88 million in the fourth quarter and approximately $345 million for the year as a whole. This includes the addition of $60 million for wind development projects and a $20 million reduction for Keephills 3 that was deferred to 2011.

The income tax impact from CPC's investment in CPILP relating to CPILP's review of strategic alternatives was not previously recognized in our outlook. Excluding the $11 million tax provision before non-controlling interest, our outlook for 2010 full year's results is consistent with previous guidance. The YTD normalized Earnings Per Share of $1.15 is tracking slightly ahead of our plan and we're now well positioned to meet our earlier full year guidance for 2010.

I'll now turn the call back to Brian.

BRIAN VAASJO: Thanks Stuart. Turning to slide ten, I'll provide a status update on our 2010 corporate priorities. For our operational targets, the plant availability of 94% or higher is not expected to be reached this year. With the issues with the Clover Bar units, we now expect average plant availability to be approximately 90% for 2010.

The sustaining capex target of $60 million continues to be on track.

Our construction and development objectives include our share of the remaining construction project costs for Keephills 3 facility, which has total targeted cost to us of $955 million and a completion date scheduled for the second quarter of 2011. As indicated earlier, this objective also continues to be on track.

With the announcement for the contract awards for the Quality Wind and Port Dover & Nanticoke wind projects earlier this year, and now with the acquisition of the Island Generation facility, our objective of committing at least $500 million towards capital opportunities that meet or exceed our target rates of return has been exceeded two fold.

Based on normalized EPS of $1.15 for the first nine months of the year, we are slightly ahead of plan to achieve our financial expectations for 2010, with normalized Earnings Per Share expected to be approximately in line with the annualized 2009 levels. And finally, we have a shelf in place to facilitate the refinancing of the $245 million.

Turning to slide eleven, as part of our 2010 corporate priorities, I've stated our goal of delivering total shareholder return that is greater than the average of our peer group. As you can see from the chart, after nine months of performance, we are on target to achieve this goal. Capital Power's total shareholder return is 17.2% compared to the peer group average of 17%.

I'll now turn the call back over to Randy.

RANDY MAH: Thanks Brian. Peter we are ready to start the question and answer session.

QUESTION AND ANSWER SESSION

OPERATOR: Okay, thank you Randy. So, if someone would like to ask a question, please press the number 01 on your handset. To exit the question queue, you can always press the # sign. So our first question comes from RBC Capital Markets, Robert Kwan. Please go ahead, Robert.

ROBERT KWAN: Great, thank you. Just wondering on Island Gen. Could you give me some colour on how you are looking at the permanent financing, and whether the CPILP kind of process, and maybe waiting for that to be resolved is factoring into your timing?

STUART LEE: Sure thanks, Robert. The process with CPILP doesn't impact on timing. I think we would expect to put the permanent financing, particularly on the debt side, in place relatively quickly to be followed by the equity component.

ROBERT KWAN: Okay and just based on what you are seeing right now in terms of your share price versus say the preferred market, do you have, are you leaning in any particular direction?

STUART LEE: You know, we continue to look at both, obviously with where preferreds are at right now, it continues to be attractive for issuers, so I don't think we have a specific plan yet between the two, but maybe a little bit of a bias towards prefs (preferreds) .

ROBERT KWAN: Okay. Just when you are looking at your EPS here you got $1.15 as you pointed out and I believe the '09 annualized is about $1.20, so basically, I know you said its close but that's implying something in the range of $0.05 for Q4. I know you've got the G3 outage, but I'm just kind of wondering, is there something else going on that you are seeing that would bring the results down to something like what you did in Q2?

STUART LEE: We would expect that we should be able to modestly beat our earlier guidance. But again, I think we're comfortable with what guidance we provided and would be hopeful that we'll see some upside to it.

ROBERT KWAN: Okay. Just my last question; the Alberta Contracted segment was quite strong, I think it's the strongest quarter you've had to date. But we've seen better availability in the past and this would have been the lowest availability incentive pricing. I was just wondering if there was any additional colour on that segment.

STUART LEE: Yes, so if you look at the operating margin for the Alberta Contracted segment, it was about $48 million for the quarter, which compares with $46 million for Q1 and last September I think it was around 47. So, pretty consistent performance. As you mentioned, the availability incentive income would have been down slightly given where power prices were at. The one thing we did have in the quarter was we had a slight pick-up from the sale of some emission credits back into the Balancing Pool, which is the PPA offtaker. And so there was a little bit of pickup from that.

ROBERT KWAN: Do you have a number kind of around that?

STUART LEE: It was just in the $1-$2 million range.

ROBERT KWAN: Okay, great. Thank you very much.

OPERATOR: Okay, thank you. Our next question comes from Canaccord, Juan Plessis, please go ahead.

JUAN PLESSIS: Great, thank you very much. In regard to the Clover Bar insurance claim that you recorded in the quarter, is the $8 million based on an estimate of the likelihood of success and just wondering how much more would there be to come, if you got 100% of that claim.

STUART LEE: It's not based on likelihood of success, Juan. It's effectively based on… Our insurance company has acknowledged the fact that they accept the fact that there is a claim outstanding. We've estimated the potential recovery based on the operations of the Unit 3, which is basically the identical facility and so that's how the estimate was based. So, we are fairly comfortable in the estimate that we've provided and booked.

JUAN PLESSIS: Okay, thanks for that. In regards to the strategic alternative process at Capital Power Income created an $11 million tax provision, I'm just wondering why that was done now and you didn't wait until what direction you were going to go in with those process?

STUART LEE: Thanks, good question. It's really a function of GAAP. A GAAP requirement and so effectively when the IPO happened the carrying costs of the asset didn't change, particularly the EPCOR 72% interest. For tax purposes, it got re-valued at fair value, so effectively what you've got is a different tax basis and accounting basis: a lower tax basis, which generally gives rise to future income tax liability. At the time we did not book that liability, because it was not obvious that would reverse. So under GAAP we weren't required to reverse it. But when we made the announcement, it no longer is obvious that that won't reverse. If there was a sale, you could end up with a booking of the future income tax liabilities. So, under GAAP we are effectively required to book it at the time of the announcement.

JUAN PLESSIS: Okay, thanks for that. Now just in terms of your effective tax rate going forward, it looks like it was 24% in the quarter. Is that a good number to use going forward?

STUART LEE: It's in the range of what we would expect.

JUAN PLESSIS: Okay, thank you very much.

OPERATOR: Okay, thank you very much. Our next question comes from BMO Capital Markets, Michael McGowan. Please go ahead.

MICHAEL MCGOWAN: Hi, good afternoon. I have a question regarding the $7 million unrealized loss on the bond forward contracts that was recorded interest expense. What instruments do those relate to and what liability are you hedging?

STUART LEE: Michael, we are effectively hedging the long term interest rates. So, when the EPCOR debt maturity happened earlier in June, for $245 million, we put a bond forward in place of $200 million expecting that we would be issuing long term debt and so we wanted to effectively lock in the interest cost associated with that, and not have exposure to changes in interest rates. Obviously in the interim we haven't yet issued long-term debt and the bond Canada's have come off significantly since June and that's effectively why we've recognized the loss on that instrument.

MICHAEL MCGOWAN: So there will be a cash settlement whenever you arrange permanent financing for that liability.

STUART LEE: There will be a cash settlement between now and March when that hedge expires. And having said that, the offset to that obviously is the fact that we are going to end up locking in a long-term interest rate at very attractive rates.

MICHAEL MCGOWAN: Okay and just with respect to Island Generation, you mentioned you gave some guidance there regarding expected operating margins going forward, but also mentioned that your actual operating cash flow from that facility is going to decline by about 7% per year going forward. What's really driving the difference between your accounting margins and your cash flow?

STUART LEE: So under GAAP, we are effectively recognizing deferred revenue, so we've effectively flattened out their earnings profile even though the cash flow profile is declining. And that's what gives rise to a relatively stable EBIDTA for accounting purposes; but on a cash flow basis, a decline under the terms of the PPA.

MICHAEL MCGOWAN: Oh, okay. And just one last question with respect to the Unit 2 that was out for a good part of the year. Now you booked the $8 million tax recovery on that power plant. Just how much of that relates to first and second quarters versus third quarter?

STUART LEE: So, none of it would relate to first quarter. But the majority of it, overwhelming majority of it would relate to Q2. When obviously when May prices spiked you saw a lot of the peaking facilities operating in the province at fairly high capacity levels which would have been the case for that particular unit as well. You would have seen more of a balance towards Q2 than Q3.

MICHAEL MCGOWAN: Okay, so the vast majority of that should actually be allocated to the second quarter.

STUART LEE: Correct.

MICHAEL MCGOWAN: Okay, thanks a lot.

OPERATOR: Thank you and our last question comes from Credit Suisse, Andrew Kuske. Please go ahead Andrew.

PAUL TAN: Hi, good afternoon, this is Paul Tan on behalf of Andrew. Just a quick question. What was so different with your optimization strategy this quarter versus last because the performance was notable different. Was there anything different with regards to the VAR or anything else strategic related to it?

BRIAN VAASJO: So, from any particular point in time, or any comparison from quarter to quarter, they tend to change fairly significantly or can potentially change fairly significantly; depending on your outlook on price, depending on your outlook certainly on your plant availability, but also the other facilities in the province so basically any particular quarter can have significantly different strategies. We haven't been speaking to specific strategies around each of the quarters thus far, and in fact they can very well change from month-to-month and week-to-week. So again, to try and draw a difference between the quarters is pretty difficult and certainly something that we have not been doing thus far.

PAUL TAN: Great, thank you.

OPERATOR: Okay, thank you. Actually we did have one more person queue up for a question, TD Newcrest, that's Linda Ezergailis. Please go ahead, Linda.

LINDA EZERGAILIS: Thank you. Just a follow up question on your tax rate guidance; the 20-25%, I guess 24% as suggested earlier effective tax rate. Would that be for a calendar year or for a quarter? Because if it's for a calendar year, that would imply a pretty high tax rate in Q4.

STUART LEE: I think the overall view on our tax rate would be in that mid-20 range; not on a cash tax basis, but on accounting tax basis.

LINDA EZERGAILIS: Yes, would that be for Q4 or would that be for the calendar year 2010?

STUART LEE: That would be generally for calendar year 2010 and even going into 2011 I don't get any specific variances coming out of permanent differences.

LINDA EZERGAILIS: So, maybe that would partially address one of the earlier questions as to what's going on to bring Q4 earnings down, that would imply quite a high tax rate.

STUART LEE: I would have to come back and check on Q4, our estimate on Q4 tax. I don't expect it to be a significant view of difference higher than 24% - 25% coming into Q4.

LINDA EZERGAILIS: Okay. And just as a follow-up, how long was G3 down in October for their outage?

STUART LEE: G3 has been down for almost the full month of October.

LINDA EZERGAILIS: But it's back up now.

STUART LEE: It's not back up yet, but we would expect it to be back up within the course of the next week or so.

LINDA EZERGAILIS: Okay. Alright, just another follow-up question. Any changes to your hedges for 2012 at all, or?

STUART LEE: No material changes at this point for 2012.

LINDA EZERGAILIS: Okay and any updates on your expected timing of the ECT for Kingsbridge 2?

STUART LEE: We expect it to be sometime in Q1.

LINDA EZERGAILIS: Okay, great that's it. Thanks.

OPERATOR: Okay, looks like others are queuing up here. Next question is from RBC Capital Markets, Robert Kwan, please go ahead.

ROBERT KWAN: Thank you. Just if you are looking at the growth outlook, just wondering if you are seeing better risk adjusted value right now between Greenfield developments, acquiring long-term contracted plants or acquiring merchant, maybe with merchant being some shorter contracts attached to them right now?

BRIAN VAASJO: So, generally as we see the market, Robert, certainly there are opportunities for Greenfield, particularly around renewable opportunities. Certainly we are continuing to see that in British Columbia and in Ontario.

When you look at the acquisition activities, we see an increasing amount of activity on the merchant side or un-contracted facilities. There's likely a little bit of price creep on the upside, which would imply maybe risk adjusted returns, maybe, a little bit lower than they have been. But again, a lot of it also depends on what your particular outlook is. The market is a pretty stable; increasing supply, new people participating in the M&A markets.

On the contracted side, certainly see some increasing activity there as well and certainly increasing competition. But certainly when you get down to it, each asset or groups of assets tend to be sort of their own story and when you look at it from a risk adjusted returns standpoint, we're still pretty pleased with what we are seeing out there in the market.

ROBERT KWAN: Okay, but just maybe from the Capital Power perspective where are you seeing the best risk adjusted returns right now?

BRIAN VAASJO: I think we would probably have to say on the merchant side. Those are where there's likely the growing number of opportunities and certainly a more limited number of players.

ROBERT KWAN: Okay. Just my last question, there was comment you made earlier about with the G3 outage, that Clover Bar was managing the outage and I'm just wondering if you could explain that a bit. I'm just wondering why unless you had a bunch of hedges against G3 that you needed to service.

BRIAN VAASJO: So as you go through the cycle and you know there's ways to look at it. One, Robert, certainly is that it could be covering commitments associated with Genesee 3. On the other hand, it could also be covering a short position. There are a number of alternative strategies around an outage and certainly the availability of having effectively for us, 250 megawatts of peaking facilities, which matches our portion of the Genesee 3 outage, is an excellent position to be in on all strategies associated with an outage. It's generally a comment, referring to the fact that it certainly did play into our strategy for how we dealt with the outage and certainly do expect its overall a positive result.

ROBERT KWAN: Okay, great. Thanks very much.

OPERATOR: Okay, thank you. Our next question comes from Patrick Kenny from National Bank. Please go ahead Patrick.

PATRICK KENNY: Thank you. Just an extension to Robert's question actually, Brian, just looking at longer-term with your merchant exposure declining here as you bring on more contracted projects. Just wondering if you had kind of a target percentage for your merchant cash flows?

BRIAN VAASJO: Well, from the merchant cash flow standpoint, we really don't have a target. We speak broadly about having 50% contracted and 50% merchant facilities from an even standpoint. But certainly our focus is more on ensuring we have that contracted base providing that stability of cash flow. So we don't per se have a target for merchant. One of the somewhat bizarre elements of at least looking at it again at the superficial level, if power prices go up in the province of Alberta, we end up sort of off-side on the EBIDTA measure when you're relating contracted to merchant. We do have a more focused view on the cash flow that we get from the contracted side than from the merchant side.

PATRICK KENNY: Okay, then also just looking from a regional perspective, obviously British Columbia and Ontario, big focus right now, but any thoughts about opportunities down into the US or is that the main reason why you weren't interested in purchasing the L.P.?

BRIAN VAASJO: So, certainly we continue to have a huge interest in the US from the acquisition standpoint and continue to be very, very active on that front. From a development standpoint, we have over time looked at a number of opportunities for development. As it turns out, many of them in the California or South-western US market in general. So, we continue to look at both. Despite the fact that most of our efforts looking at US acquisitions, it is a little bit peculiar that we ended up with a Canadian acquisition first. We certainly will be continuing our activities of looking for acquisitions in the US.

PATRICK KENNY: Okay, thank you. Those are all my questions.

OPERATOR: Okay thank you, there are no questions in the queue for now.

RANDY MAH: Okay thanks operator. If there are no more questions, we'll conclude our conference call. As a reminder, Capital Power Corporation will be hosting its second annual Investor Day event on December 9th in Toronto. A press release with more details on the event will be issued later this week. Thanks for your participation on today's call and I look forward to seeing you in December at our investor day event. Have a good day everyone.

OPERATOR: Ladies and gentlemen, this concludes the Capital Power Corporation Conference Call to discuss the third quarter 2010 results. Thank you for your participation. Have a nice day.

[CONFERENCE CALL CONCLUDED]