Capital Power
Second Quarter 2015 Conference Call
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Corporate Participants

Randy Mah
Senior Manager, Investor Relations

Brian Vaasjo
President & CEO

Bryan DeNeve
SVP, Finance & CFO

Conference Call Participants

Paul Lechem
CIBC World Markets

Ben Pham
BMO Capital Markets

Andrew Kuske
Credit Suisse

Linda Ezergailis
TD Newcrest

Robert Kwan
RBC Capital Markets

Matthew Akman
Scotia Capital

OPERATOR: Welcome to the Capital Power's second quarter 2015 results conference call. At this time all participants are in listen-only mode. Following the presentation the conference call will be opened up for questions. This conference call is being recorded today, Monday, July 27th, 2015. 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 Capital Power's second quarter 2015 results, which were released earlier this morning. The financial results and the presentation slides for this conference call are posted on our website at capitalpower.com. We will start the call with opening comments from Brian Vaasjo, President and CEO, and Bryan DeNeve, Senior Vice President and CFO. After our opening remarks we will open up the lines to take your questions.

Before we start, I would like to remind listeners that certain statements about future events made on this conference call are forward-looking in nature and are based on certain assumptions and analysis made by the company. Actual results may differ materially from the company's expectations due to various material risks and uncertainties associated with our business. Please refer to the cautionary statement on forward-looking information on Slide 2.

In today's presentation we will be referring to various non-GAAP financial measures, as noted on Slide 3. These measures are not defined financial measures, according to GAAP, and do not have standardized meanings described by GAAP and, therefore, are unlikely to be comparable to similar measures used by other enterprises. Reconciliations of these non-GAAP financial measures can be found in the Management's Discussion and Analysis for Q2 2015. I will now turn the call over to Brian Vaasjo for his remarks, starting on Slide 4.

BRIAN VAASJO: Thanks Randy and good morning. I'll start off with a quick review of the highlights for the second quarter. We had a solid operating performance with an average plant availability of 90%, reflecting both planned and unplanned outages for all assets. We reported normalized earnings per share of $0.10, which was slightly below expectations but higher than the $0.07 for the second quarter of 2014.

Funds from operations of $70 million were modestly below expectations and lower than the $85 million for the same period a year ago. Based on the results in the first half of the year and our expectations for the remainder of 2015, our outlook has modestly improved but remains at the lower end of our stated FFO target range.

Turning to Slide 5, this slide summarizes the plant availability operating performance of our plants for the second quarter of 2015, compared to the same period a year ago. As mentioned, average plant availability in the second quarter was 90%, compared to 92% in the second quarter of 2014. Operating performance was below our expected rate, reflecting the 73% availability at the new Shepard facility. This was a result of a 28-day unplanned outage relating to the heat recovery steam generator. Repair work on this defect has been completed and the Shepard facility returned to operations in late June. In the second quarter, we also completed a major scheduled outage at Genesee 1 that reduced the unit's availability to 72%.

Turning to Slide 6. On May 29th, K2 Wind became fully operational in Ontario and capable of generating 270 MW, with one-third of the generation capacity belonging to Capital Power. The output is contracted to the Ontario Power Authority under a 20-year PPA. Capital Power, Samsung Renewable Energy, and Pattern Energy Group are equal partners on the K2 Wind project. Capital Power's share of the final construction costs is expected to be $310 million. With the addition of K2 Wind, the company's total generation capacity of 577 MW now represents 18% of the company's overall capacity, with the majority of the wind output under long-term PPAs.

Moving now to Slide 7 to discuss the recent changes to Alberta carbon emissions regulations. On June 25th the Alberta government announced changes to the Specified Gas Emitters Regulations, or SGER. SGER requires facilities that emit 1,000 [should be 100,000] tonnes or more of greenhouse gasses per year to reduce emissions intensity by a specific target. The changes will increase the required reduction in emissions intensity from the current 12% to 15% in 2016, and 20% in 2017. There were also an increase in the cost of contributions to the Alberta Tech Fund, from the current $15/tonne to $20/tonne in 2016, and $30 in 2017. We expect that between 2016 and 2020 the increase in Capital Power's compliance cost will be partially mitigated by higher wholesale power prices directly caused by the new regulations. The company has a significant inventory of low-cost carbon offset credits that have been developed over the past eight years, which are expected to offset the balance of the compliance costs through 2020.

Turning to Slide 8, Capital Power's Board of Directors has approved a $0.10/share increase in the annual dividend. Effective with the third quarter dividend, the quarterly dividend will increase 7.4% to $0.365 from $0.34 per share. Our contracted cash flow base has grown significantly with the recent additions of Shepard and K2 Wind in 2015 and, as you are aware, the Board bases its dividend determination on a level of sustainable cash flows attributable to contracted assets. Moreover, Capital Power is well positioned to consistently increase the dividend while also investing in growth opportunities.

I'll now turn the call over to Bryan DeNeve.

BRYAN DENEVE: Thanks, Brian. I'll discuss our financial results starting on Slide 9. In the second quarter, the company generated $70 million in funds from operations, which was modestly below our expectations, which reflected the impacts from the unplanned outage at Shepard that I'll discuss shortly. Normalized earnings per share of $0.10 in the second quarter.

In the second quarter, the Alberta government announced changes to the corporate tax rate, increasing the provincial rate from 10% to 12% effective July 1st, 2015. As a result of the tax rate increase, we recognized $19 million in additional deferred income tax expense. Overall, the increased

Alberta tax rate is not expected to have a cash income tax impact on the company until 2018.

Moving to Slide 10, I would like to review the performance from the Alberta commercial plants and portfolio optimization segment. Alberta power prices averaged $57/MWh in the second quarter of 2015, compared to $42 for the second quarter 2014. The Shepard outage occurred primarily in June, coinciding with other non-Capital Power operated plant outages as well as warmer weather. This resulted in Alberta spot prices averaging $97/MWh in the month, compared to $21 in April and $54 in May. With our commercial production 100% sold forward in June, the company was required to cover a short market position at prevailing spot prices. Although the high spot prices negatively impacted the second quarter results, it also caused a temporary increase in forward rates that we were able to take advantage of to benefit our portfolio position over the last half of the year. We also capitalized on the higher forward rates by increasing our hedge positions from 49% to 86% in 2016, and from 12% to 25% in 2017, compared to our position at the end of the first quarter.

Turning to Slide 11, I'll review our second quarter financial results compared to the second quarter of 2014. Overall, second quarter financial results primarily reflect the impacts from the unplanned Shepard outage. Revenues were $83 million, down 65% from Q2 2014, primarily due to the unrealized changes in fair value of commodity derivatives and emission credits, and lower results from portfolio optimization. Excluding the mark-to-market adjustment, revenues were $254 million in Q2 2015, slightly higher than the $253 million in Q2 2014. Adjusted EBITDA, before unrealized changes in fair values, was $92 million – up slightly from the second quarter of 2014. All plant segments had higher adjusted EBITDA year-over-year, which was offset by higher corporate expenses. The increase in corporate expenses was due to higher finance expenses and depreciation and amortization from the completion of the Shepard project. Income tax expense also increased in the second quarter from the increase in the Alberta statutory corporate income tax rate that I discussed earlier. Normalized earnings per share of $0.10, increased 43%, compared to $0.07 a year ago. Funds from operations of $70 million were modestly below our expectations for the quarter, and down 18% year-over-year.

Turning to Slide 12, I'll quickly cover our financial results for the first half of 2015 compared to the same period in 2014. Overall, the year-to-date results showed a slight improvement. Revenues were $441 million, down 20% year-over-year, primarily due to unrealized changes in fair value of commodity derivatives and emission credits. Adjusted EBITDA, before unrealized changes and fair values, was $208 million, up 6% from a year ago due to higher EBITDA contributions from both the Alberta Commercial Plants and Portfolio Optimization segment, and the Alberta Contracted Plant segment, which were partly offset by higher corporate expenses. Normalized earnings per share were $0.40 on a year-to-date basis in 2015, up 3% compared to $0.39 a year ago. Funds from operations are $178 million for the first half of 2015, which is up slightly on a year-over-year basis.

I'll conclude my comments with our financial outlook on Slide 13. The average Alberta power price of $43/MWh in the first half of 2015 is consistent with our original forecast assumption of $44/MWh. At the beginning of the year, our Alberta base load position for 2015 was significantly hedged in the mid-$50/MWh range, which is not materially changed. Based on the year-to-date results and our expectations for the balance of the year, our outlook has moderately improved from three months ago but remains in the low end of our $365 to $214 [should be $415] million FFO guidance range. Capital Power's financial strength is based on our foundation of contracted cash flow, which is not impacted by fluctuations in Alberta's power price outlook. We remain confident in our credit rating and dividend growth outlook.

I will now turn the call back to Brian Vaasjo.

BRIAN VAASJO: Thanks Bryan. I'll conclude with an update on our targets and corporate priorities. The charts on Slide 14 show our year-to-date operational and financial results versus the 2015 annual targets. The first six month's average plant availability was 94%, consistent with our target for 2015. Our sustaining CAPEX was $35 million versus the $65 million annual target. We reported $92 million in plant operating and maintenance expense versus the $180 to $200 million annual target. Finally, we generated $178 million in funds from operations. Overall, we are on track to meet our 2015 annual operational and financial targets.

Turning to Slide 15, we have two development and construction targets in 2015 relating to the K2 Wind project in Ontario and Genesee 4 & 5 here in Alberta. As mentioned, the K2 Wind project was completed on time and on budget in the second quarter. For Genesee 4 & 5, our goal is to transition to the construction phase this year. We are on track with the COD for Genesee 4 targeted for 2019 based on our shared view with Enmax that this is the earliest date that the Alberta market would need this additional generation.

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

RANDY MAH: Thanks Brian. Oliver, we're now ready to start the Question and Answer session.

QUESTION AND ANSWER SESSION

OPERATOR: Thank you. As a reminder, you may queue up to ask a question by pressing the number '01'. To withdraw your question, press the '#' sign. So we have one question here by Paul Lechem from CIBC. Please go ahead.

PAUL LECHEM: Thank you, good morning. Just to start off with the Shepard outage. Maybe could you give us some thoughts on why a plant which is, maybe only two months old, would have a major outage at this point? And do you have any – will there be any warranty or insurance recoveries on the outage?

BRIAN VAASJO: Good morning Paul. The outage itself was as a result of basically a design flaw that has been analyzed, re-engineered, and corrected within the HRSG structure. Essentially, it was under-designed from a pressure perspective – and just a component of it and that component, again, has been replaced. So we don't anticipate any further issues associated with the outage or what that design flaw was.

The question of whether or not this is normal or not. Generally speaking, in the first year or so of new plant operations, there's an expectation that you'll have lower availability, either overall through the year, a lower availability, or whether there be incident availability. Certainly this outage, I would say modestly exceeded the magnitude of unavailability for this year but certainly is within the scope of normal kinds of activities that happen with new plants.

PAUL LECHEM: Ok, then the question on warranty or insurance coverage or recovery?

BRIAN VAASJO: So, the outage itself is not large enough to trigger business interruption insurance. The actual material costs are being covered by the vendor.

PAUL LECHEM: And were you not able to…you say you had a short position but would you not be able to have covered that off through your Clover Bar peaker? Was there not enough…or had you sold Clover Bar production forward as well in the quarter?

BRYAN DENEVE: We had sold some of the Clover Bar production forward in the quarter based on our expectations of prices. So, certainly, with Shepard not being available, that would have removed about 100 MW from our position. So, certainly, it was a combination of two things: we had sold some of it forward and then we lost the 100 MW of length out of Shepard.

PAUL LECHEM: Got you. And, lastly before I hand it off, but in your MD&A or in your commentary you said that your outlook for the balance of the year has modestly improved so I was just wondering what is improved that gives you that, that allows you to make that comment?

BRYAN DENEVE: Yes, so, what occurred was as we saw spot prices increase dramatically in June, in particular near the back end of June, we also saw an increase in forward prices over the balance of 2015. Now, certainly, we had some length remaining in the balance of the year for 2015 so we were able to sell that length forward at higher prices than we had anticipated earlier in the year.

PAUL LECHEM: I got you. Ok, thank you.

OPERATOR: The following question is from Ben Pham from BMO Capital Markets. Please go ahead.

BEN PHAM: Ok, thank you. Good morning everybody. I wanted to follow up on the last commentary. You indicated that you've increased your forward pricing but in your presentation; maybe I missed this or misunderstood, you mentioned that your mid-$50's forward price is unchanged? Can you reconcile that for me?

BRYAN DENEVE: Well, the mid-$50's is approximate value of our forward hedges so, certainly, we've seen that increase relative to Q1 earlier this year.

BEN PHAM: Ok, so it moved up a little bit in terms of your average hedge pricing for the balance of the year but it's roughly still in the mid-$50 context?

BRYAN DENEVE: That is correct.

BEN PHAM: Ok. Just on – going back to Shepard, I wanted to check in on the capacity payments for the quarter. With an unplanned outage, was there a reduction in your capacity payments at all? How does that play out with an unplanned outage?

BRYAN DENEVE: Right. So, under the contractual arrangements we have in place for Shepard, there's provisions there for a certain amount of unexpected outages. What happened in June is that we had a negative variance, or under-recovered on the capacity payment of about $1.8 million.

BEN PHAM: Ok. And, maybe, if I may, my last question is on your commentary about the expectation for power prices increase with the carbon tax and I'm just wondering what are you budgeting for '16 pricing?

BRYAN DENEVE: Our price expectations for 2016 are more or less consistent with current forward prices.

BEN PHAM: Ok, great. Thanks for taking my questions.

OPERATOR: The following question is from Andrew Kuske from Credit Suisse. Please go ahead.

ANDREW KUSKE: Thank you, good morning. I guess my question is in relation to the dividend growth on a longer-term basis. How do you and the Board really think about that dividend growth? Is it something that could be consistent, year after year or it going to be more sporadic as larger projects come online? And, then, I guess the second element to the question is: just for proportionality of cash flows, how should we think about longer term? Obviously there is a fine level of cash flow for contracted assets, and maybe the second bucket is more merchant exposure, and then, maybe, the third bucket is, essentially, your optimization portfolio and how do you think about bars around those?

BRIAN VAASJO: So, in terms of the dividend, in the longer term and how might you think about it, I think, as we've demonstrated, we're on a path of increasing $0.10 a year. And, I think a reasonable expectation that until you see significant step up in cash flows and one that is certainly sustained, we would continue at that level. And again, when you see a step up, you would see a raise in the level of dividend and then that would set, sort of, the new bar for increasing dividends. You would not expect the dividend to be going up and down, just a constant set of steps going up.

In terms of how would we think about it as it relates to the different sources of cash flow and are there any bounds around that? Certainly, we look at the contracted cash flow, at the levels it is today as the foundation. And as you go forward, without other contracted assets added to the portfolio – there's a modest contribution by the merchant cash flows. But again, over the medium and longer-term are going to grow pretty substantially associated with rising power prices in Alberta.

Now, we wouldn't see forming a significant amount of dividend increase associated with increasing cash flows from the merchant business because in of itself, is subject to great volatility. So again, wouldn't see that as forming a significant amount of a base of sustained growth in cash flow. In terms of optimization, the optimization would depend largely on whether that is coming from merchant or contracted assets. Then we would see it falling into one bucket or the other in terms of its contract contribution to dividend growth.

ANDREW KUSKE: Ok, that's very helpful. And then just on the risk management side on the optimization portfolio. Has anything really changed there or is the last quarter really, the outage at Shepard is a bit more of an anomaly as opposed to anything that's certainly normal course. But is there anything changing on a risk management perspective, on a go forward basis, given where we see power pricing in Alberta right now?

BRYAN DENEVE: No. Certainly we continue to have virtually all of our base load portion of our portfolios contracted forward as we look forward for 2015. We'll be optimizing that as we move forward in time, but there hasn't been any changes in our risk management approach. Certainly, there's going to be times when we face operational upset, which will have adverse consequences, but we believe over time the strategy we've been deploying on selling forward has created a net benefit for the organization and will continue to do so on a go-forward basis.

ANDREW KUSKE: Ok, that's very helpful. Thank you.

OPERATOR: The following question is from Linda Ezergailis from TD Newcrest. Please go ahead.

LINDA EZERGAILIS: Thank you. A question about your maintenance activity for the balance of the year. Can you give us an update and comment on if K3 is scheduled for Q3 or Q4?

BRYAN DENEVE: Yes, so the outage, planned outage for Keephills 3 has been moved forward from

September to the August time frame. And that was due to a number of factors, just that were being taken into account the market environment.

LINDA EZERGAILIS: Ok, that is helpful. And just, maybe more of a high level question. To the extent that you can comment on any discussions you've had with the government as well as subsequent discussions with the debt rating agencies on their views on the Alberta power market and if that's changed, would be helpful.

BRIAN VAASJO: So, with respect to discussions with the Alberta government on the carbon side, Linda, there really has been not a lot of new information. But what I can say is the messages from the government have remained consistent with the early readings that we had. They are certainly, as they move forward across the Alberta economy and across all sectors, they are extremely sensitive to employment, the economy, and respect existing investments. So, we continue to have a relatively positive view as to what the outcome will be of the further deliberations of the government.

LINDA EZERGAILIS: That's helpful. And the debt rating agencies? Have you had any conversations with them and how they looking at the Alberta government and the market situation?

BRYAN DENEVE: Yes, so we met with S&P and DBRS in early June and that was an area of discussion. From our perspective, they are taking a wait and see view. They want to see what the new government does in Alberta and what sort of policy changes they make. They haven't pre-determined a negative or positive perspective at this point.

LINDA EZERGAILIS: Ok, that is helpful. Thank you.

OPERATOR: The following question is from Robert Kwan from RBC Capital Markets. Please go ahead.

ROBERT KWAN: Good morning. I guess, just looking at the 2016 hedges – it looks like…or, let me ask you this way. Is there any change in the volume assumption or is the movement down in the total hedge price a function of just hedging in at lower prices indicative in the forward price?

BRYAN DENEVE: It is due to selling forward at lower prices than the average at the 49%.

ROBERT KWAN: Ok. And, so, I know that there was the—it sounded like there was a little bit of potential optimism around 2016 pricing, whether that was CASA-related in terms of capacity coming out of the market – is it fair to say that, based on—on what you've done on the hedging, that really your focus now is on 2017?

BRYAN DENEVE: I think we've reached a point where 2016…certainly feel we're in a very good place in terms of the amount we've sold forward. We will continue, of course, to monitor what is happening in the Alberta market. If we believe there is an opportunity there to further increase that hedge position, we certainly would. But, yes, I would agree – 2017 becomes an increasing year of focus for us and certainly we're looking to increase that hedge percentage as we move forward in time.

ROBERT KWAN: But as you look at, kind of, your price expectation and the supply situation, is the relatively low percentage for 2017 just a function of lack of liquidity in the curve or is there an actual bullish view on that year?

BRYAN DENEVE: It would be a combination of the two. So, certainly we have more bullish expectations around '17 than where we've seen those prices typical trade. But, also, to your point we still have quite a bit of liquidity in June on 2017 where we're able to take advantage of that. But liquidity remains very low for that period.

ROBERT KWAN: Ok, that's great. Maybe the last question just on G4, G5 – you've talked in the past about how you've built a lot of flexibility into the equipment and construction timing, just allowing you to move the in-service date around to best fit your guy's views. At what point do you have to fully commit and really put the pin in for, at least, the first unit to come in?

BRIAN VAASJO: That timing would be well into next year.

ROBERT KWAN: Ok. That's great. Thanks very much.

BRYAN VAASJO: Thank you.

OPERATOR: The following question is from Paul Lechem from CIBC. Please go ahead.

[PAUSE]

OPERATOR: Paul, please go ahead.

PAUL LECHEM: Oh sorry. Just a question on the Beaufort Solar. On the other renewable projects you moved Beaufort Solar into construction. Just wondering if you have any of your other US renewables projects that you expect to be sanctioned through the remainder of this year? Do you have, are you getting closer on contracting any of them to allow you to move forward, on the wind side, maybe?

BRIAN VAASJO: At this point in time the Bloom project looks quite positive. We're involved in a couple processes that may well allow that project to move forward this year on a fully contracted basis.

PAUL LECHEM: And can you give us a sense of how big that would be in terms of dollar amount?

BRIAN VAASJO: Bloom, actually in part is dependent on…there's a little bit of optionality associated with one of the particular bids. The overall total capital cost is in the order of $225…probably $300 million in total in terms of order of magnitude. But again, we would have a tax equity partner associated with that so the call on our capital, ultimately, would be a portion of that.

PAUL LECHEM: Ok. Maybe if I could just ask one last question, following up on Robert's question on G4/G5, the timing. So, if you need to make a decision next year on whether you're moving forward on G4. And, if pricing ends up where the forward curve is, how do you make a decision at that point if pricing is still—it's close to your high-$40's number? Is that that the right number? Is it a pricing issue that will allow you to move forward? I mean, do you need to see better pricing than that? Do you need to see better forward curves than that? What is it that's going to allow you to actually make a big capital commitment at that point?

BRIAN VAASJO: Well, as you know Paul, forward curves, as you move out, get less and less reliable. It's based on very, very thin trading. It will be based on, obviously, although we can't share our views per se with Enmax, we'd have to both be coming to a conclusion that the supply/demand balance for 2019 and beyond would be sufficient to be moving power prices up. And, again based on independent views as to the supply/demand balance.

And again, with the flexibility that we have, certainly 2019 could become 2020. And that's been the whole thesis of the way that we've put this project together. But again, you do have to look at the fundamental supply and demand balance as opposed to the forward curves when you get out that far.

PAUL LECHEM: Ok, thank you.

OPERATOR: The following question is from Matthew Akman from Scotia Bank. Please go ahead.

MATTHEW AKMAN: Thank you very much. I'm not sure if I missed if you guys quantified the impact of the Shepard outage on EBITDA or cash flow?

BRYAN DENEVE: No, we didn't break out that impact separately but, certainly that outage was the primary driver of the negative variance we had in Q2 for the Alberta commercial portfolio.

MATTHEW AKMAN: Which portion of the contracted output of the plant does that impact effect? Because there are three portions, there's a tolling agreement, and then some other contract, and a contract for differences. Or is it all three portions?

BRYAN DENEVE: It would be all three portions combined.

MATTHEW AKMAN: So even the piece that's directly contracted with Enmax is affected that way?

BRYAN DENEVE: Yes. It would be, I think as I mentioned earlier, the tolling arrangement with Enmax under the availability incentive terms and conditions, we would have realized a net loss of about $1.8 million.

MATTHEW AKMAN: Ok. And, in terms of what you said Bryan, about having additional length that you guys could use to offset, was that somewhere in the trading book? Because the base load plants were contracted already for the balance of the year, right?

BRYAN DENEVE: That is correct. So 100 MW from Shepard is merchant for us and, yes we lost that available generation, which is part of our base load piece.

MATTHEW AKMAN: I'm just wondering if the profit that you guys anticipate offsetting the second quarter negative variance has been locked in already or is that something that's still dependent on market conditions for the back half of the year?

BRYAN DENEVE: For the most part it's locked in.

MATTHEW AKMAN: So that must have been a quick trade.

BRYAN DENEVE: It was a lot of trading activity in the back half of June.

MATTHEW AKMAN: Ok. Thank you very much. Those are my questions.

OPERATOR: So we currently have no other questions queued up. As a reminder everyone, you may queue up to ask a question by pressing the number '01'. To withdraw your question, press the '#'. Thank you.

RANDY MAH: We'll just wait a moment to see if there are any further questions.

[PAUSE]

RANDY MAH: Ok, I guess none. Thank you for joining us today and for your interest in Capital Power. Have a good day everyone.

OPERATOR: Ladies and gentlemen, this concludes Capital Power's second quarter 2015 conference call. Thank you for your participation and have a nice day.

[TRANSMISSION CONCLUDED]