EDITED TRANSCRIPT

Q2 2018 ATCO Ltd. (TSX: ACO.X, ACO.Y) and Canadian Utilities Limited (TSX: CU, CU.X) Earnings Calls

EVENT DATE / TIME: JULY 26, 2018 / 08:30 AM MDT

ATCO Ltd. (ACO.X, ACO.Y) and Canadian Utilities Limited (CU, CU.X)

Q2 2018 Earnings Call

July 26, 2018 08:30 am MDT

CORPORATE PARTICIPANTS

Dennis DeChamplain *ATCO Ltd. and Canadian Utilities Limited – Senior Vice President and CFO*

Anthony Maher *ATCO Ltd. and Canadian Utilities Limited – Vice President, Controller*

Katie Patrick *ATCO Ltd. and Canadian Utilities Limited – Vice President, Finance & Risk*

Myles Dougan *ATCO Ltd. and Canadian Utilities Limited – Senior Manager, Investor Relations*

CONFERENCE PARTICIPANTS

Jeremy Rosenfield *Industrial Alliance – Research Analyst*

Andrew Kuske *Credit Suisse Securities (Canada), Inc. – Research Analyst*

Mark Jarvi *CIBC Capital Markets– Director, Institutional Equity Research*

Linda Ezergailis *TD Securities, Inc. – Managing Director*

Robert Kwan *RBC Capital Markets (Canada) – Managing Director*

Patrick Kenny *National Bank Financial (Research) – Director, Equity Research*

Ben Pham *BMO Capital Markets (Canada) – Managing Director, Pipelines & Utilities Analyst*

Ross Fowler *UBS – Executive Director*

OPENING COMMENTS

Dennis DeChamplain *ATCO Ltd. and Canadian Utilities Limited – Senior Vice President and CFO*

Good morning,

Before we start with your questions I just want to take a couple of minutes to make a few opening remarks if that's alright with you.

As usual, Anthony Maher, Katie Patrick and Myles Dougan are with me today.

We had some mixed results this quarter. Two of our businesses had growing earnings and one business had lower earnings.

Higher earnings in ATCO's Structures and Logistics' business were driven by improved space rental fleet activity and sales of used workforce housing fleet. Our strategy to adjust and re-size our rental fleet is working. Our other strategic goal is to continue improving space rental utilization and we are making progress here as well. In both these areas I think we exceeded our expectations this quarter.

Structures & Logistics also completed construction on a new manufacturing facility in Santiago, Chile. This step further cements the business foundation we are re-establishing in South America.

Higher earnings in CU's electricity generation business were mainly due to stronger market conditions in Alberta. Both our Independent Power Plants and Thermal PPA plants benefited from improving power prices in Alberta. Continued operational excellence and high availability was also helpful for the Thermal plant earnings.

The impact of rate re-setting continued to have an impact on CU's natural gas distribution earnings. The seasonal natural of the natural gas distribution earnings always has an impact on second and third quarter results as natural gas demand is driven by winter heating needs in Alberta. But the impact of the rate re-setting under the second generation of PBR was a major factor for lower earnings this quarter. We still expect that our full year earnings contribution from this business will be strong and we are working hard to implement new operational efficiencies across all our business lines to make this happen.

We continue on our transformation path for the organization and unfortunately that means we had some staff reductions this quarter.

These changes, the majority of which were in CU, also meant we booked some restructuring costs that were mainly related to these staff reductions and associated severance costs. There were also costs related to decisions to discontinue certain projects that no longer represent long-term strategic value to the Company.

From a cash flow perspective, about half of these costs were already incurred in prior quarters and the remainder will be booked through 2018 and 2019.

On the capital investment side of things, we have invested $462 million in capital growth projects in the second quarter. 95 per cent of this capital was invested in Canadian Utilities assets that earn a return under a regulated business model or are under commercially secured long-term contracts.

Construction on CU's Alberta PowerLine project continues to be busy with tower foundation installation and tower assembly proceeding ahead of schedule. The target energization date of June 2019 remains on track.

Regarding our financial strength, I'm pleased to say that in Q2, DBRS affirmed its A-high long-term corporate credit rating and stable outlook for ATCO subsidiary CU Inc. We expect to see DBRS' report on Canadian Utilities and ATCO later this summer.

Now I'm sure you have some specific questions so I will turn the call back to you.

QUESTIONS & ANSWERS

Regulatory Developments

What do you think will be the outcome of the PBR re-opener proceeding?
On this issue, first we need to see if the AUC determines a re-opener is even warranted. If the AUC determines further work on this proceeding is warranted, then we will have to see what the scope of the second phase will be. If it proceeds to a second phase, a decision is highly unlikely in 2018 and would likely happen in 2019. This is not something that has been subject of a regulatory proceeding in the past, so it is difficult to predict the course of the proceeding.

We filed our submission for the first phase stating that the higher earnings in 2017 were a direct result of management's response to the incentive to implement efficiency improvements and not due to a flaw in the PBR framework, and therefore adjustments are not necessary nor are they appropriate.

The range of outcomes is quite wide at this point, but our base case would be that there is no retroactive impact and the rules for PBR2 continue as already set. Given our actions are in line with the spirit and intent of incentive based regulation we believe the base case is the reasonably fair outcome of this proceeding

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Can you provide an update on the GCOC?

We expect a decision in the third quarter of 2018, likely in August. The current Generic Cost of Capital or GCOC proceeding will establish the capital structure and return on equity for 2018, 2019 and 2020.

What is causing the delay in the Electric Transmission 2018-2019 GTA application decision?

In June 2018, Electric Transmission responded to the second round of information requests on this proceeding. Interveners have filed a motion regarding the latest responses, requesting further information on the updates to forecast costs regarding the Shared Services initiative, recent employee reductions, common groups, and changes to the CWIP-in-rate base refund and have requested these updates prior to filing Intervener Evidence. This motion may impact the timing of the oral hearing scheduled for September 24, 2018. As a result, we believe it is now unlikely that we will receive a decision in time to record the impact in the 2018 financial results.

When you get the electric transmission 2018-2019 GTA decision, what will be the uptick to adjusted earnings?

It is difficult to predict regulatory outcomes, however the total amount that we could achieve is about $18 million if the AUC approves everything we asked for. The more likely scenario is some amount below that.

Can you provide an update on the UAD Legislation?

In April 2018, the Minister of Energy introduced Bill 13 in the provincial legislature. This legislation encompassed several electricity transition policies, including the transition to a capacity market; disposition of utility assets; specified penalties for energy service providers; small-scale community generation; and changes that enable existing and useful transmission policy elements to be properly captured in the appropriate legislation and regulation. If enacted in its initial form, Bill 13 would have introduced significant changes to the regulatory framework in which the Company operates, and would have introduced increased uncertainty for utility investments.

On May 30, 2018, the Ministry amended Bill 13 by removing section 1(2), which was the section of the Bill discussing the disposition of utility assets. The motion to amend Bill 13 was passed by the Alberta Legislature on May 30, 2018.

The PBR utilities have the use of a Z factor for the replacement of assets damaged or destroyed by exogenous events as well as the recovery of lost revenue and additional expenses associated with the exogenous event. The PBR utilities also have other regulatory avenues available to them to recover rebuild costs associated with exogenous events in the event a Z factor application was not used.

Our natural gas distribution utility was successful in its Z factor application for the 2013 Calgary floods. It was also successful in its Z factor application for the 2016 Fort McMurray wildfires. In the third quarter of 2018, our electric distribution utility will be making a Z factor application the impact on its assets from the 2016 Fort McMurray wildfires.

Electricity

What will be your plans for Battle River unit 5 if it is turned back to ATCO?

Canadian Utilities is actively investigating opportunities to run the asset as part of its merchant portfolio as a natural gas fired facility. The final capacity market design is generally looking positive for incumbent generators. A new natural gas supply line will be required to supply fuel should we decide to move forward with a conversion. This line could be installed by Q4/19. We are finalizing our analysis for coal to gas conversion of Battle River unit 5 and should be able to give you more information next quarter.

What's the timing on the solar procurement process?

On June 20, 2018, the Government of Alberta announced that a new solar energy procurement process will be unveiled in August 2018 to replace the Negotiated Request for Proposal program that was cancelled in February 2018.

We have 75 MWs of potential solar projects in Alberta, including the Kneehill Solar Generation Facility Project where ATCO and Samsung are proposing to build and operate a 25 MW solar power generation facility located near Three Hills, Alberta. We will continue to look for opportunities to advance our solar projects either through this Government of Alberta procurement process or through other long-term contracts.

What are your thoughts on the Alberta Capacity Market?
The AESO released its final version of the Comprehensive Market Design, or the CMD, in June 2018. The first auction is scheduled to take place in November 2019 for a 1-year contract period covering Nov 2021 to Oct 2022. ATCO believes the CMD and the included mitigation framework remains workable and will support existing investment and limited new investments such as coal to gas conversions.

Do you think you will be mitigated from offering into the capacity market?

ATCO expects offers from its generating units to be mitigated in the capacity market. We do not believe the proposed capacity market mitigation framework will impede us from recovering costs and making a rate of return. The AESO has proposed to mitigate the offers of all existing generating units controlled by capacity suppliers that can profitably increase capacity clearing prices by 10% or more by increasing offer prices. The AESO estimated that portfolios with more than 1050 MW UCAP (a proportion of a firm's total capacity) will be mitigated in the first auction, which is likely to include ATCO. As a mitigated supplier, ATCO will be permitted to offer at prices up to 0.8x net cost of new entry (net CONE). Net CONE is the revenue required by a peaker unit from the capacity market for entry, when energy market revenues are also considered.

What about the new version of the energy market? Do you expect ATCO will be mitigated from offering into the new energy market as well?

The AESO is proposing to mitigate portfolios greater than or equal in size to the remaining supply cushion in the hour (i.e. if supply cushion is 1000 MW or less, then a 1000 MW portfolio will be mitigated). The AESO believes that the lower energy market margins will be recovered by generators through the capacity market.

On your Alberta merchant portfolio, what do your power hedging amounts look like going forward?

Our hedging program looks similar in the second half of 2018 and first half of 2019. Later into 2019, we start to see some of our existing hedges trail off.

How much capital to do you plan to plan to spend on APL in the second half of 2018?

The remaining capex in our plan for APL in 2018 is about $100 to $200 million. We will have to see how soon winter starts and if that gives us a good start on winter construction in 2018 or if it gets pushed into 2019.

Pipelines & Liquids

What happened with Q2/18 earnings in natural gas distribution?

Our natural gas distribution utility earnings are impacted by weather variations and typically Q1 and Q4 (winter) are higher earnings quarters, while Q2 and Q3 (spring and summer) are lower earning quarters.

The other factor impacting natural gas distribution earnings this quarter is the rate resetting process under the new 5 year PBR period which is in place from 2018 to 2022.

The storage and water infrastructure business results didn't appear to be as strong as we had forecast. What is the outlook for this business line in the second half of 2018?

The timing of storage revenues has been a factor so far this year. In the back half of the year, we should see some improved performance.

Structures & Logistics

How does your Structures & Logistics project lead list look?

We have a decent lead list of projects we are looking at and hopefully we can secure our fair share or more of those. But the size of each project is smaller than in years past. In 2018, we have seen an increase in leads in the natural resource sector, mainly in Alberta, BC and the U.S. We are also optimistic about opportunities in Chile as well as building a decent lead list of high density urban residential modular housing leads. While natural resource sector leads remain our largest sector for leads, the percentage change in the lead list that is in infrastructure, education and urban residential housing sectors has grown at a much faster rate in the last year.

Can you talk about how the new ATCO Sabinco manufacturing facility will help with your South American growth?

Having a larger manufacturing plant with greater production capacity and shorter turnaround time increases the market potential, particularly for large projects associated with expansion in the mining sector. It will be approximately the same size and have a similar production capacity to the Chilean competitor who has long held the largest market share. This will enable ATCO Sabinco to compete directly for the largest slate of workforce housing projects directly with the largest competitors and at a more cost-effective price than before.

Last quarter you said we should expect a similar year to 2017 but you have already achieved the same earnings as last year by Q2 this year. What should we expect for Structures & Logistics going forward?

That is true, Structures & Logistics had a good second quarter. Our strategy to adjust and re-size out rental fleet is working and, as you can see in our MD&A, higher earnings were driven in part by sales of used workforce housing fleet. Our other strategic goal is to continue improving space rental utilization. That too is happening and the results are showing up this quarter. In both these areas I think we exceeded our expectations this quarter.

The third goal is to secure additional long-term services contracts and major projects with customers. Non-traditional modular markets such as public education facilities, high density urban residential housing and correctional facilities offer development opportunities and we have been successful in these areas in building up our lead list. But we have more work to do and any new contracts secured in this area of the business won't have a material impact on earnings until 2019. In general, we would hope to replicate about the same level of earnings in the second half of this year that we achieved in the first half.

What is the update on the LNG Canada workforce housing camp opportunity?

There are two modular structures opportunities for LNG Canada. Downstream for a 4,500 person camp and upstream for several camps along the pipeline route. We are looking at both sets of opportunities. The most likely downstream option for us is to be a modular manufacturing supplier of these works. The schedule is compressed so it is likely the manufacturing of all these units will be split between more than one supplier. On the upstream portion, there are a number of smaller camps that we think we are well situated for, pending FID by LNG Canada of course.

I saw Kinder Morgan announced they have begun construction activities on TMX expansion again. What is the latest update on any modular or camp work you may secure on the TMX pipeline to BC?

ATCO has a First Nation partnership with the Simpcw First Nation. About 1/3 of the Trans Mountain pipeline will traverse Simpcw territory. There are several proposed workforce housing camps within their traditional territory. We are well placed to secure work for the supply of workforce accommodation should the project continue to proceed.

Corporate & Other

Can you provide some more details about the Restructuring Costs you booked this quarter?

We continued on our transformation path for the organization and unfortunately that means we did incur some staff reductions this quarter. About 2/3 of these restructuring costs relate to staff reductions and associated severance costs, and the other 1/3 is costs related to decisions to discontinue certain projects that no longer represent long-term strategic value to the Company. From a cash flow perspective, about half of these costs were already booked and the remainder will be booked through 2018 and 2019.

How does taking this restructuring cost today help your business tomorrow?

More broadly, the work we are undertaking today on operational efficiency improvements is expected to lower our costs and make us more competitive. And with respect to all of our utilities, these operating initiatives will be a part of our goal to continue generating strong returns on equity. I've spoken before about some of the initiatives we are taking in our electricity business, pipes and liquids and back office functions with the consolidation of departments throughout the companies and a large part of the restructuring charge reflects the downsizing because of these initiatives to lower our go-forward costs.

What projects did you discontinue that no longer serve strategic value to the company?

It relates to several smaller projects on the operations side as well as business development side of our organization. These costs were already incurred so there will be no ongoing material cash flow impact.

I see you have some new statements about dividend growth in your MD&A. What are your plans for dividend increases going forward?

At Canadian Utilities, we aim to grow dividends in-line with our sustainable earnings growth, which we link to growth from our regulated and long-term contracted investments. As you know, we have $3.5 billion on regulated utility and $1 billion long-term contracted projects over the next three years. We expect net rate base growth in our utilities to average between 4 and 5 per cent per year over that time.

We are proud of our track record of annual dividend increases and we recognize that our payout ratio has risen in recent years. Finance theory would say that dividends and earnings increases should run roughly in-line. We will continue to review our performance, long range prospects, balance sheet strength and credit metrics as part of our thinking on dividend rates.

ATCO, as a holding company, currently receives a majority of its earnings contribution from Canadian Utilities, so its dividend increases would roughly track to those at Canadian Utilities. However, ATCO's payout ratio is well below Canadian Utilities and it has the Structures & Logistics business as well as Commercial Real Estate in its Corporate Segment, so there may be some room for a differential there.

Corporate earnings loss is higher in Q2/18 at $20 million. What are these "certain other expenses" mentioned in the MD&A?

Our largest expense in the CU corporate segment is the preferred share dividend expense which costs about $16 million per quarter. We had a number of different, smaller one-time expenses at CU Corporate this quarter. Generally, CU Corporate segment has a run rate of around $18MM of cost per quarter.

What are your debt needs at CU Inc. in 2018?

Our CU Inc. debt needs will be about what we issued last year before the refinancing amount or about $250MM to $300MM.

What is your strategy for growth on top of the $4.5 billion 3 year capital plan that you have disclosed?

This $4.5 billion capital plan is heavily focused on Alberta investment. Our intention is to look for additional projects or acquisitions to add to this capital plan. Our business development focus is on this additional capital investment and asset diversification outside of Alberta in select global markets. This may take the form of additional organic growth or M&A opportunities.

In Australia, we are actively looking at opportunities to expand in all our business lines, but particularly in long-term contracted assets or regulated assets.

In Mexico, we believe there is good potential and opportunities for investment. It is one of those markets where we can secure a long-term PPA for a new power plant build, for example. We are learning that business doesn't happen as quickly in Mexico as in other markets but with the energy reforms underway, we believe there is good potential and opportunities for investment.

In Chile, we believe our Structures & Logistics foothold will provide a strong foundation upon which we can expand with potential growth opportunities in other South American markets and in our other business lines.

In the United States, we currently have two Structures & Logistics manufacturing facilities and continue to believe that there is further expansion potential for this GBU.