NASDAQ - ALLETE

Moderator: Mary Hunter
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10:00 a.m. ET

Operator: This is conference # 43088897.

Operator: Good day and welcome to the ALLETE Second Quarter 2016 Financial Results Call. Today's call is being recorded.

Certain statements contained in this conference call that are not descriptions of historical facts are forward-looking statements, such as terms defined in the Private Securities Litigation Reform Act of 1995. Because such statements can include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements.

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The company undertakes no obligation to revise or update any forward-looking statements or to make any other forward-looking statements whether as a result of new information, future events, or otherwise.

For opening remarks and introduction, I'd like to now turn the conference over to ALLETE President and Chief Executive Officer, Alan R. Hodnik. Sir, you may please begin.

Alan R. Hodnik: Good morning everyone and thank you for joining us today. With me is ALLETE's Chief Financial Officer, Steve DeVinck.

This morning, we reported second quarter financial results of $0.50 per share on net income of $24.8 million. Last year's results were $0.46 per share, which included approximately $0.03 per share of profit from ALLETE Clean Energy's construction of a wind facility for Montana-Dakota Utilities that was completed late in 2015.

As expected, this quarter's results reflect lower sales to Minnesota Power's taconite customers with some mining operations remaining temporarily idle during the quarter. We are seeing positive trends develop on the foreign steel dumping front that have been negatively impacting taconite production on Minnesota's Iron Range since the beginning of 2015.

The United States Department of Commerce has made a number of final determinations and continues to pursue additional cases in its duty and anti-dumping investigations. These efforts appear to be having a constructive impact on the levels of imported steel coming into our country.

According to the United States Census Bureau, May 2016 year-to-date imports for consumption of steel products are down approximately 30 percent compared to May of 2015. Consequently, we are pleased that the import share of the domestic market has fallen from a peak of 34 percent in March of last year to roughly 25 percent in June of this year. Throughout this cycle we have proactively managed our expenses and sold power into the wholesale power market in an effort to mitigate earnings impact. Taconite production cycles are part of Minnesota Power’s history, as you know, and our team is very adroit in dealing effectively with them.

Based on nominations we received on August 1, Minnesota Power's large power taconite customers are expected to operate at approximately 90 percent of full demand levels for September through December 2016. This compares to the 80 percent of full demand nomination levels received for the last period. Although taconite production levels remain below full capacity we are encouraged by Northshore Mining and United Taconite's recently announced restart dates that point to improved overall production levels by Cliff's Natural Resources customers.

In June, Cliff's Natural Resources extended contracts with Minnesota Power for its United Taconite and Babbitt mine operations under new 10-year agreements. Cliff's also signed its first ever contract with Minnesota Power, a 15-year agreement to serve its Northshore Mining operation.

In a second quarter conference call to investors, Cliff's Chairman Lourenco Goncalves reaffirmed his commitment to additional investment in their Minnesota mining operations. Upcoming on August 11, I will be joining Minnesota Governor Mark Dayton and Cliff's Chairman Lourenco Goncalves as they break ground on a $65 million expansion at their United Taconite plant. United Taconite will produce a new specialized super-flux pellet, called "Mustang", which will replace a flux pellet now made at Cliff's Empire operation in Michigan. Cliffs' Empire operation in Michigan is scheduled to shut down at the end of 2016.

With respect to Cliff's Northshore Mining operation at Silver Bay, an operation that has historically self-generated its electric power, will now be served by a new Minnesota Power contract that represents significant new retail load for Minnesota Power. These recent developments in the mining sector and other forest products related initiatives support our belief in the long-term sustainability and health of Minnesota Power's service territory.

Our emerging and complementary energy infrastructure and related services companies posted financial results generally in line with our expectations, and we expect future growth as they execute their strategies.

Last year's additions of new wind generation facilities in Southern Minnesota and Pennsylvania, are contributing to solid financial performance at ALLETE Clean Energy. ACE currently owns and operates about 537-megawatts of fully contracted generating capability and is actively seeking additional opportunities as it answers our nation's call for more renewable energy.

We remain excited about the prospects for U.S Water Services, our newest member to the ALLETE family of businesses. Similar to ALLETE Clean Energy, U.S Water will further balance and complement our core regulated businesses, while providing long-term earnings growth.

On July 21st, our region experienced a broad and devastating storm that included large hail, flooding and straight line winds reaching 100 miles per hour. These storms left up to 46,000 Minnesota Power customers without electric service. I am proud of our utility teams from Minnesota Power and Superior Water, Light and Power, as well as industry mutual aid partners who braved the aftermath of this storm; an aftermath which included extremely high temperatures and humidity making work on power restoration for our customers and employees, even more difficult. I would like to especially thank the outstanding mutual aid assistance our teams received from Ameren, Interen, MP Technologies and M.J. Electric, along with a multitude of tree removal crews for their help in getting power back up for our customers.

Thoughtful positioning efforts for our regulated operations, through the Energy*Forward* initiative, in tandem with our energy infrastructure and related services businesses, move ALLETE forward and keep our strategy intact to deliver shareholder value through earnings and dividend growth. I will make some additional comments after Steve takes you through the quarterly financial results. Steve.

Steven DeVinck: Thanks, Al. And good morning everyone. Before I begin, I encourage you to refer to the 10-Q we filed earlier today for more details on the quarter. For the second quarter of 2016, ALLETE reported earnings of $0.50 per share on net income of $24.8 million and operating revenue of $314.8 million. This compares with $0.46 per share on net income of $22.5 million and operating revenue of $323.3 million in 2015. Net income in 2015 included $1.5 million or $0.03 per share for ALLETE Clean Energy's profit on the wind energy facilities sold to Montana-Dakota Utilities in the fourth quarter of 2015.

Net income in 2015 also included acquisition costs of $900,000 or $0.02 per share. Earnings from ALLETE's Regulated Operations segment which includes Minnesota Power, Superior Water, Light and Power, and our investment in the American Transmission Company were $22.6 million, compared with $23.3 million in 2015. This quarter's results reflect lower industrial sales and higher depreciation and property tax expense, partially offset by increased sales to other power suppliers and lower operating and maintenance expense. In addition, our equity earnings in ATC decreased $400,000 after tax, due to period-over-period changes in ATC's estimate of a refund liability related to MISO return on equity complaints.

Operating revenue from regulated operations increased $4.9 million or 2 percent from 2015 primarily due to higher transmission revenue, pricing under wholesale power sales agreements, and FERC formula-based rates partially offset by lower industrial sales, fuel adjustment clause recoveries and Conservation Improvement Program recoveries. Transmission revenue increased $6 million primarily due to period-over-period changes in our estimate of refund liabilities related to MISO return on equity complaints. Despite relatively flat overall kilowatt hour sales, revenue increased $3.8 million from 2015, due mostly to higher pricing on our wholesale power sales agreements compared to last year. For example, our long-term power sales agreement with Basin provides for increased prices as we invest in environmental upgrades.

Kilowatt-hour sales to our industrial customers were down as expected, due to reduced taconite production. In addition, demand revenue from our industrial customers was down in 2016, as a result of lower demand nominations during the quarter. Revenue from our wholesale FERC customers increased $1.1 million primarily due to additional environmental upgrades and other investments. Fuel clause recoveries decreased $3.5 million due to lower fuel and purchase power cost attributable to our retail and municipal customers.

On the expense side, fuel and purchase power expense decreased $2 million or 2 percent from last year, primarily due to lower purchase power prices. Transmission services expense increased $4.8 million for the quarter or 42 percent from last year, primarily due to period over period changes in our estimate of a refund for MISO transmission expense related to MISO return on equity complaints. Operating and maintenance expense decreased $4.3 million or 7 percent from 2015 primarily due to lower benefit expenses. In addition conservation improvement program expenses were $1.7 million less than in 2015 and conservation improvement program expenses are recovered from certain retail customers, resulting in a corresponding reduction in revenue.

We remained committed to cost containment at Minnesota Power to reduce rate increases for our customers, improve our return-on-equity over time, and mitigate some of the impacts of cyclicality facing our customers in taconite mining.

Depreciation and amortization expense increased $4.6 million or 14 percent from 2015, primarily due to additional property, plant and equipment in service.

Equity earnings in ATC decreased $600,000 or 13 percent from 2015 due mostly to period over period change in ATC's estimate of a refund of liability related to MISO return on equity complaints.

Net income at ALLETE Clean Energy decreased $400,000 and revenue decreased $15.2 million for the second quarter of 2016, primarily due to the construction sale of a wind energy facility to MDU last year. Results for 2015 included $1.5 million of net income and $20.5 million of revenue related to that transaction. 2016 results at ALLETE Clean Energy also included higher earnings attributable to the July 2015 Armenia Mountain acquisition in Pennsylvania. 2016 earnings were also negatively impacted by slightly less than normal late spring wind conditions.

U.S. Water acquired in February of last year is a leader in integrated water management to a growing number of industrial and commercial customers throughout the United States.

Total revenue at U.S. Water Services was similar to the second quarter of last year. Revenue from chemical sales and related services increased 5 percent to $27.2 million, compared to $25.9 million last year. Revenue from equipment sales and related services was $7 million versus $8.5 million in last year's second quarter. Equipment sales can have more period-to-period variability in chemical sales. Net income at U.S. Water increased $400,000 this year, due primarily to lower expense related to purchase accounting adjustments. 2016 also reflects increased investments in back office systems and support at U.S. Water Services as we create a platform for future growth.

The corporate and other segment, which includes results from BNI Energy, ALLETE Properties and other miscellaneous corporate income and expenses, reported a $1.4 million net loss this quarter, compared to a net loss of $4.4 million for the same quarter in 2015. The decreased loss was primarily the result of lower income tax expense. ALLETE's effective tax rate for the quarter ended June 30, 2016 was 15.9 percent, compared to 22.3 percent in 2015. We anticipate the effective tax rate for 2016 will be approximately 16 percent.

In April, we indicated that our full year earnings will likely be in the lower half of our earnings guidance range of $3.10 per share to $3.40 per share. As a result of the potential for higher storm-related operating and maintenance expense, slightly higher refund reserves at ATC, and assuming normal weather for the rest of the year, we believe our full year earnings will likely be at the low end of our earnings guidance range of $3.10 to $3.40 per share. We continue to assess the impact from the recent July storm damage, but estimate restoration could be in the $4 million to $6 million range, some of which will be capitalized.

We have filed for regulatory approval to defer the expense portion of the restoration costs, but we cannot predict ultimate approval or timing. Our estimate of full year earnings assumes normal weather patterns for the remainder of the year. Warmer than normal winter weather at Minnesota Power and slightly less than normal late spring wind conditions at ACE have negatively impacted earnings by approximately $0.05 per share in the first half of 2016. Beneficial weather conditions in the second half of the year could slightly improve our full year outlook. Minnesota Power will be filing in the fourth quarter, a request with the Minnesota Public Utilities Commission to increase base retail electric rates.

The request will focus on seeking recovery of investments that have enhanced and added resiliency to the region's electric system. These investments have included upgrading thermal generating units, repairing and strengthening our hydroelectric generating resources, investments in new and existing transmission assets to improve reliability and modernizing distribution and customer systems. It has been almost seven years since Minnesota Power last sought a general rate increase. Minnesota Power plans on requesting interim rates from the MPUC that if approved, would be implemented in early 2017. Details about the size and other attributes of the case will be disclosed when the case was filed.

ALLETE's financial position continues to be solid. Cash from operating activities was $146.2 million and our debt-to-capital ratio was 46 percent as of June 30, 2016. We are an organization committed to financial discipline as we execute on delivering value to our shareholders. Al?

Alan R. Hodnik: Thank you for the financial update, Steve. I have a few more comments and updates to make before Steve and I take your questions. ALLETE is a growing energy company that provides sustainable energy solutions through our initiatives at our regulated utility businesses and at our complimentary energy infrastructure and related services businesses.

First, regarding Minnesota Power's Energy forward initiatives; Minnesota Power is moving forward with significant progress on its energy forward strategy and the balancing of its energy supply. We are focused on making strategic investments to reduce emissions, add renewable energy and build transmission which will answer the nation's call for cleaner energy forms. Minnesota Power's proposed Great Northern Transmission Line continues to attract national attention and support. Recently, during a North American Clean Energy and Environmental Partnership Summit supported by Canadian Prime Minister, Justin Trudeau, Mexican President Enrique Pena Nieto, and President, Barack Obama, the Great Northern Transmission Line was called out as a cross-border initiative in support of a common North American commitment to the advancement of clean and secure power.

We anticipate a final decision on the Presidential Permit for the project by the

United States Department of Energy very soon. Minnesota Power expects to begin construction on the transmission line in 2017. This project will provide investment and growth opportunities through the end of the decade, as it positions Minnesota Power to move carbon free hydroelectric generation from Canada into Minnesota and the upper Midwest.

With respect to natural gas generation, Minnesota Power continues to pursue this option as part of its Integrated Resource Plan, recently approved by the Minnesota Public Utilities Commission.

Secondly, regarding new industrial load in our region; our natural resource-based economy and proximity to energy rich Canada and North Dakota, provide ALLETE with a unique mix of business opportunities to fuel earnings growth and investment for the future. PolyMet's proposed copper, nickel and precious metal mining operation in northeast Minnesota is making significant progress as it moves along in the permitting process. Since receiving a determination of adequacy on its final environmental impact statement from the Minnesota Department of Natural Resources in March, PolyMet has started to file permit applications required prior to construction and operation of the mine. Critical water-related permits were filed in early June with the permit to mine submittal to be forthcoming. Minnesota Power would begin to supply between 45 and 50 megawatts of new load to a 10-year power supply contract that would begin upon start-up of the mining operations.

As you may have read in the press, the Essar project has filed for bankruptcy protection. Although this development is certainly a bump in the road in the near term, we believe that engagement from Governor Dayton and state of Minnesota officials will set the stage for more clarity on direction from this point forward.

Cliff's Natural Resources has publicly shared the view that the Essar site is favorable for a direct reduced iron facility, an enhanced product suitable for use in electric arc furnaces. We have and continue to support this project, regardless of ownership status. We continue to believe that it is not a matter of if, only a matter of when the Essar facility begins producing next generation iron ore products. The project, as currently designed would bring up to 110 megawatts of new load in Minnesota Power's wholesale municipal segment, once it reaches full production level and by taking service from the City of Nashwauk. The quality of the ore body is one of the best in the region and there has been over $1 billion worth of investment made at the Essar site to-date.

We are very excited about a new development which supports the strength of our resource rich service territory. This excitement results from a recent announcement by Louisiana-Pacific, a Fortune 500 company that is considering the construction of a $440 million home siding manufacturing plant in Minnesota Power's service territory. As proposed, the plant would employ 250 people, utilizing northeastern Minnesota's vast timber resources to produce home siding that is long-lasting due to it being more resistant to insects and weather than other siding options.

The Louisiana-Pacific plant would be a nice fit at Minnesota Power's Laskin Energy Park. We expect to hear more about this project and what it means for new electric load as Louisiana-Pacific finalizes the details of the planned facility.

Regarding our complementary energy infrastructure and related services businesses, ALLETE Clean Energy and U.S. Water Services strategies are positioned to serve our country with cleaner energy sources and conservation. Cleaner energy sources and conservation, which we believe are already or will be driven by rising societal expectations, enhanced regulation and natural resource scarcity.

ALLETE Clean Energy's wind facilities are running as expected in their respective regions, but naturally have some variability depending on wind patterns. ACE's portfolio of generation is positioned for earnings growth in 2016, with the wind energy facilities it acquired during 2015. Additional facilities will be considered for ACE's portfolio supported by financial discipline and long-term power sales agreement.

We expect U.S. Water Services to further complement our core regulated operations and balance our exposure to business cycles. Financial performance is generally what we expected at this stage and we continue to invest in back office systems and support to ensure a sound platform for future growth. The company continues to look for strategic tuck-in acquisitions, which expand its geographic reach, bring in new customers, and diversify its customer base. Thank you for your time and for your investment with us. At ALLETE, we are confident in our ability to deliver sustainable shareholder value to earnings and dividend growth. At this time, I will ask the operator to open up the line for your questions.

Operator: At this time if you would like to ask a question you may do so by pressing star one on your telephone keypad. If you wish to withdraw your question simply press the pound key. Your first question comes from the line of Chris Ellinghaus with Williams Capital. Your line is open.

Chris Ellinghaus: Good morning guys, how are you.

Steven DeVinck: Morning Chris

Alan R. Hodnik: Good Morning.

Chris Ellinghaus: Steve, I think, if I picked this up correctly, I think you mentioned that CIP was down $1.7 million for the quarter, is that correct?

Steven DeVinck: Both expense and revenue.

Chris Ellinghaus: OK. Should we be expecting, recognition in the third quarter to be down as we sort of have seen in recent memory?

Steven DeVinck: There are two components to the CIP program. One is a flow-through, which means that as expense goes up or down, revenue goes up or down correspondingly. And that's what I referred to today. There is also a financial incentive that is approved annually and you probably heard us talk about that or disclose that. And that likely will be, it has been recently approved the financial incentive for 2016. It will likely be recorded in the third quarter.

Chris Ellinghaus: OK, great. As far as the nominations go with the change primarily Utac and was there any change in Keetac at all?

Steven DeVinck: That's correct. The change was primarily United Taconite, Keetac remains idle at this time.

Chris Ellinghaus: OK. Can you give us a little color on your expectations with the RFP?

Alan R. Hodnik: Well, the Public Utilities Commission, recently approved our Integrated Resource Plan as you know and in response to the MPUC's July 18th order approving that plan, we are issuing RFP's for potential additional renewable supply options as well as potential demand response or customer co-generation resources before we advance any new long-term generation resources that would be intended to meet MP's needs over the next decade. So it's a response to an MPUC request and it's too early to say where that's going to go at the moment, but the RFP's are out there.

Chris Ellinghaus: OK and one last thing, can you give us a little color on Northshore and how we should anticipate that contract affecting Minnesota Power going forward, you know, sort of vis-a-vis, the two units there at Northshore and how that might get phased out and how you might phase in that load?

Steven DeVinck: Sure. So there is approximately just under a 100-megawatts of generation on that site and it's comprised of two units. Initially, one unit will be shut down and we will serve Northshore mine that load for the one unit that's shut down. In two or years, the other unit will be shut down and we will provide their full requirements. That unit is a critical element to the transmission grid in northern Minnesota, so it can't all be taken down at once until some of the required improvements to the transmission grid are made, so that both units can be taken out.

Chris Ellinghaus: OK, great. Thanks for the details.

Alan R. Hodnik: Thank you, Chris.

Operator: Your next question comes from the line of Paul Ridzon with KeyBanc. Your line is now open.

Paul Ridzon: Good morning. What's that statutory timeline in Minnesota -- 11 months adjudicated case?

Steven DeVinck: I believe its 10 months, but the commission has the ability to extend that.

Paul Ridzon: And the storm costs, I think you said $2 million to $4 million or $4 million to $6 million, what did you say?

Steven DeVinck: We estimated currently at $4million to $6 million, some portion of which will be capitalized.

Paul Ridzon: And is that pretax or after tax?

Steve DeVinck: That is pre-tax.

Paul Ridzon: And no word yet as to whether you'll be able to defer the O & M piece of that?

Steven DeVinck: Not yet. We just filed that request this week.

Paul Ridzon: How long should that take to get an answer?

Steven DeVinck: I'm not totally sure on that. We're hopefully we get an answer before the end of the year.

Operator: Your next question comes from the line of Brian Russo of Ladenburg Thalmann. Your line is now open.

Brian Russo: Hi, good morning. Is there a scenario, which ALLETE Clean Energy could submit a proposal in this 300 megawatt RFP process, considering the expertise in constructing wind farms and operating and et cetera?

Steven DeVinck: Sure. That is possible. We'd have to pass affiliated interest requirements and things like that, but ALLETE Clean Energy certainly has the expertise and does have some land options in North Dakota. So, yes, that is possible.

Brian Russo: OK. So, something you guys are considering?

Steven DeVinck: Yes.

Brian Russo: And when will be RFP be concluded?

Alan R. Hodnik: Expecting that process to sort of wrap-up in earnest sometime in late October or early November. And then we would move into an assessment period during the month of November as we get these RFPs back. So kind of that end of the year timeframe.

Brian Russo: OK, great. And then, could you just comment on the existing ACE PPAs and kind of a rough timeline of when those PPAs expire?

Steven DeVinck: Sure. We disclose that. So those expiration dates are in our 10-Q, so Brian, if I could refer you to that. That probably be best.

Brian Russo: Would you say the current PPAs are above market given where we've seen wholesale power prices in the region?

Steven DeVinck: There is a mixture of both, above and below market.

Operator: Your next question comes from the line of Glen Pruitt with Wells Fargo. Your line is now open.

Glen Pruitt: Hey guys, thanks for taking my question. So I was wondering if you could comment on re-powering opportunities at ALLETE Clean Energy related to wind projects given the IRS clarification on PTCs.

Alan R. Hodnik: Sure. This is Al. There are opportunities to re-power the wind facilities that we have. Some of the facilities that we picked up in the Midwest, for example, are slightly older vintage and so certainly that's a consideration for ALLETE Clean Energy at those sites. And frankly, if we were to look at other sites to acquire and there's potential to do some upgrading with those as well. That would certainly be in ACE’s thinking.

Glen Pruitt: OK, great. So no specific projects right now that you're looking at, but there are opportunities?

Alan R. Hodnik: There's opportunities, but nothing specific at this point, Glen.

Glen Pruitt: OK, great. Thank you.

Alan R. Hodnik: You're welcome.

Operator: Thank you. And at this time, I'm showing there are no further participants in the queue. I'd like to turn the call over to ALLETE's President and Chief Executive Officer, Alan R. Hodnik for any closing remarks.

Alan R. Hodnik: Well, Steve and I thank you again for being with us this morning and also for your investment and continued interest in ALLETE. We'll see you some time up the road here as Steve and I get out on site visits. Thank you very much.

Operator: Ladies and gentlemen, thank you for your participation on today's conference. This concludes the program. You may now disconnect. Everyone have a great day.

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