EDP - Energias de Portugal
Wednesday, 3rd November 2017
11:30 Hrs UK time
Chaired by António Mexia

Company Participants

- **António Mexia, Chief Executive Officer**
- **Nuno Alves, Chief Financial Officer**
- **Miguel Viana, Head of Investor Relations**

Operator

Good morning, ladies and gentlemen, thank you for standing by and welcome to EDP's 2017 Nine Months Results Conference Call. At this time, all participants are in listen-only mode. I must advise you the conference is being recorded today on Friday 3 of November 2017.

I would now like to turn the conference over to your first speaker today, Miguel Viana, Head of IR. Please go ahead.

Miguel Viana

Good morning, ladies and gentlemen. First of all, thanks for being with us today in this conference call, for the presentation of EDP 2017 nine months' results. As usual, we will begin with a presentation providing an overview of the results and the main developments during the period. Afterwards, we will move to the Q&A session, in which our CEO, António Mexia and our CFO, Nuno Alves, will be fully available to answer your questions.

We would like to highlight that like in past quarters, we are taking questions submitted via the web, so please ask our question only through the webpage www.edp.pt. We expect that this call will last no more than 60 minutes. Now I will give the floor to our CEO, António Mexia, who will give us an update on the main highlights of the period.

António Mexia

Thank you, Miguel. So, good morning, everybody. Thanks again for participating in this conference call. I will be doing the first slides as usual, with the key messages, and then, I will come back to the Q&A. I would like to start by highlighting the 13% increase of our EBITDA to €3.269 billion, of course benefiting from the €558 million gain on the sale of Naturgas closed last July. In terms of recurring EBITDA, we see a decrease of 4% to €2.711 billion, penalized essentially by a 52% decline on our hydro production in Iberia, following another abnormally dry quarter.

Today, it's raining in Lisbon, yesterday also, but October was the driest month since we have registrations of usage of dams in Portugal. So, a long time ago. As you will see renewables, okay. Brazil, Okay. And of course, this reduction is explained by the Generation & Supply we will see. But I would also like to immediately talk about efficiency, because it depends on us. Our OpEx for efficiency program achieved savings of €103 million, 23% above the initial target. And if you see by business area, OpEx fell by 1% in Iberia. The OpEx per megawatt decreased by 2% at EDP renewables and OpEx Brazil once again is evolving below inflation. Regarding net debt, it fell by 5% to €15.1 billion, following the €1.9 billion positive impact from the portfolio reshuffling, which includes the full disposable of Naturgas Distribution and the acquisition of a further 5% stake in EDPR renewables, both closed between late July and August.

Following these deals in mid-August, S&P has finally upgraded EDP to BBB minus and EDP is now investment grade with stable outlook by the three credit rating agencies. An important milestone for the future development of our interest costs, which by the way in the first nine months of the year have already shown the 13% decline following the reduction of the average cost of debt to 4.1%. Overall our net profit grew 86% year-on-year to €1,147 million while our recurring net profit decreased 4% year-on-year to €633 million.

Moving to the slide 2, the 4% decline of our recurring EBITDA, reflects importance of the portfolio diversification. I think that clearly, when we mentioned the impact on Generation & Supply we see here clearly the value of the portfolio of EDP. So EDPR represents 37% of our business mix with the EBITDA increasing 17% driven by an 8% capacity increase, mostly driven by the U.S., Mexico and Brazil and 1st farm down in our UK offshore project.

EBITDA in regulated networks in Iberia includes a €24 million negative impact from the deconsolidation of Naturgas in the third quarter. On the pro-forma basis, EBITDA in electricity distribution in Portugal and Spain, fell by just 1% due to previous years' adjustments only.

EBITDA in Generation & Supply decreased by 35%, of course strongly penalized by the adverse hydro conditions and higher fuel and regulatory costs. Finally, as you can see, EBITDA of Brazil rose by 13% in euros and 1% in real. And clearly, here I would like to stress the active management of the uncontracted volumes. And an integrated hedging strategy for the old portfolio that allowed to mitigate the negative impact from weaker hydro. So, rain, unfortunately, is also not going well in Brazil but, clearly the hedging strategy allows and the over-contracting – and the contracting volumes allowed to manage very well these risks.

So, let's see the, on slide 3 the impact of the normally low Iberian resources in Iberia in 2017.

As we can see, hydro production fell by 6TWh in the first nine months of 2017 following the hydro production 43% below average versus last year's 66% above average, when you compare to the first nine months. And, as I already mentioned, prospects for the first quarter are not bright. October was the driest month in the last 20 years, with hydro falling 7% below historical average and by the end of the month there was still a generalized drought situation in most of the Iberian Peninsula, meaning also that the hydro reservoir at an abnormally low level for this time of the year, better in Portugal than in Spain, but in any case, lower than average.

Slide 4, I think it's important to talk about asset allocation strategy.

Over 2017 we have continued to readjust our exit mix through significant investments in renewable assets with long-term contracts mostly in U.S., Brazil and Mexico with significant disposal concentrated in the Iberian market and namely the disposal of gas distribution and a minority stake in wind farms in Portugal in line with our long-term strategy regarding the trend in a new geographical mix. So, we have been moving of course geographies. Note the cash-in of €500 million of the sale of gas distribution in Portugal occurred only in October. So, I think if we need to notice.

The portfolio reshuffling deals in particularly, following the lower than initial similar acceptance rate of the tender offer EDPR resulted in an extra net impact on a debt of €1 billion versus our previous scenario of full acceptance, an effect that of course reinforces our financial flexibility for the next couple of years.

Next slide, **slide number 5**, I think it's important also. As I referred at the beginning, our net interest cost continued to show a steady decline supported by continued decrease of both average cost of debt and net debt. The recent rating upgrade by S&P and also, for the Portuguese Republic have reinforced the decline of our marginal cost of debt over the first nine months from the three main currencies for our operations. 80% basis point decline of our five years-bond yields in euros, a 60 basis point decrease in our five years bond in U.S. dollars and more than 300 basis points fall of our benchmarking interest in Brazilian real, that are significant moves that should provide further declines on our average spending cost over the next quarters.

Moving to slide 6, electricity distribution Portugal new regulatory period. On October 15, the Portuguese electricity sector regulator has published its proposal for electricity distribution and last resort supply regulated revenues for 2018 with the total amount of €1,076 million. This means first that we have now a good visibility on the regulatory framework for the 2018-2020 period during which we will be entitled with a return on regulated assets of around 5.85% which is linked through the evolution of the 10 years Portuguese bond yields.

Regarding accepted costs, regulatory depreciation levels are now fully based on IFRS counting. Ending with the previous heritage of old Portuguese GAAP depreciation methodology, so with no further evolution from that front. So, no further eventually downside on that front. Moreover, although we were expecting a higher level of annual amount of accepted stranded HR costs to be included in this period, the regulator opted for a more gradual pace recovery over the next decade. This fact is penalizing our 2018 EBITDA, but with no material impact in terms of present value. So, basically what we were expecting to be recovered in three years – maximum four years, it was basically extended to a 10 years-period. So, no impact in value, but of course, with lower revenues in the short term.

In terms of efficiency, the new framework provides significant incentives which EDP will try to pursue.

Slide number 7, regulatory end of discussion on generation in Portugal.

First of all, regarding CMEC final adjustment calculation, the regulator assumed €154 million figures without providing details on methodology assumed. On this issue, a final decision by the government is expected before the year end. And of course, we need to understand exactly how this figure is different from what we're producing in our technical group between REN and EDP. But of course, 154 is what we have in the proposal.

Second, regarding changes in generation tax, the government decided to exclude the amounts paid by generators for social tariff and CESE as input for the calculation of the clawback. Additionally, the government has also decided to revise the methodology of the clawback tax already paid between 2015 and now, and ask ERSE to assume that these previous years' adjustment should revert to electricity customers during 2018. On these subjects, I want to be very clear and till the end of this month, the government should define both the new clawback parameters, which should preserve I stress these, the competitive equilibrium among Iberian electricity generation players on both side of the border, and the previous years' adjustment amount.

Moving to slide 8, further efficiency effort.

I think it's basically the natural response to negative developments on the regulatory front. We have to work even harder on the efficiency front, as we have been always doing. As a result, we are committed to double the 2018 effort from €25 million to €50 million in what concerns the outperformance in terms of our cost saving versus the target defined in our OpEx IV. Corporate efficient program presented in the market in May 2016. So, we were already with the target of plus €25 million. We have now a target of €50 million namely on the distribution front, where this postponement of revenues needs to put in of course new pressures. The main drivers for these new wave of efficiency efforts are:

- first, the extension of the zero-base budgeting to several of our major divisions, following the success cases in EDP Brasil and the strong case also in generation in Portugal. So, we will extend this to all the other business units.

- second, further improvement on O&M management, mainly on generation plants in Portugal, moving from an availability focus to a market flexibility focus for obvious reasons, and continue the improvements at EDPR that were strongly proved already in the last two years.

- third, a strong focus on digitalization and automation.

- fourth, a reinforcement in terms of staff restructuring program.

Slide 9, update on asset allocation for 2018-2020.

Moving forward, EDP has a competitive advantage versus other European entities, it is now having a strong visibility in terms of investment opportunities as attractive returns focusing two main areas:

- Renewables. We have PPAs in feed-in tariff assured by the amount of 0.8GW for 2018. Regarding the 2019, 2020 period EDPR has already secured PPAs in feed in tariff for an average of 200 megawatts per year and we are in an advanced stage to deliver the 2020 target present in our business plan, to which we count on the positive prospect for our strong renewables development in the different platforms that we have.

- Second, on a second front, in Brazil, we will build five electricity transmission lines, which should represent BRL 3.1 billion on investment, more or less BRL 800 million of which 95% will be until between 2019 and 2021. I would like just to mention that this investment will have an expected EBITDA contribution by 2021, close to the EBITDA loss, we did disposal of Naturgas, although representing a much lower investment. It's almost three times less relating to the EBITDA that we will be receiving.

On the side of disposal regarding our 2020 business plan, we have still pending around €600 million of asset rotation deals to complete. Having decided to postpone €300 million budgeted for this year into 2018 due to the extra flexibility that the balance sheet allows, for obvious reasons.

Moreover, the company has decided and I think it's an important development to stress it – to pursue a build, operate and transfer model, which we started with UK offshore project to complement the asset rotation model.

This should allow to increment current business opportunity without impacting balance sheet leverage, so I think it has several advantages that as you will see in the next quarter.

Slide 10, update on 2017 guidance following the harsh second half market conditions.

We estimate that these Iberian electricity market namely in terms of much lower than average hydro volume, combined with very high power price for the second half of the year, should represent negative impact in the range of €70 million to €80 million in the second half, the second - two quarters in the last quarter of 2017.

As a result, we are giving visibility of EBITDA guidance between €3.5 billion and €3.6 billion range and between €850 million and €900 million for net profit. Moreover, we expect to further reduce the net debt to between €14 billion and €14.5 billion by the end of the year with the exact figure mostly depending on the precise timing on the refunding of the €300 million VAT that we have still pending in Spain.

I would like to highlight also that our stable dividend policy with the dividend as far as you know is not impacted at all by any of these adjustments due to the weather-related effects in 2017. This is clearly a firm commitment.

Concluding, we plan to provide you with a strategy update during the second quarter of the 2018 which will provide visibility on our financial targets already post 2020.

So, thank you very much. Now, I will pass the floor to Miguel. He will go through the detailed analysis and I will come back to the Q&A. Thank you.

Miguel Viana

Thank you. Starting on Page 12 with an overview of Iberian market in the first nine months of the year, we can see that it was marked by a 56% reduction in terms of hydro production, which was compensated by a 47% increase in terms of coal and gas production which together with increase of fuel costs lead to an increase in terms of average pool price of plus 48% year-on-year to €50 per megawatt hour.

And this recent environment, as we can see in page 13, our Generation & Supply division in Iberia saw a 9% reduction in production following a 59% reduction in terms of hydro production, which together with the increase in terms of fuel cost and also some regulatory costs implied an increase in terms of average production cost by 95% to €33 per megawatt hour.

Combined this with the increase of average selling price to customers which was much lower so 2% year-on-year, this resulted in a 39% decline in terms of EBITDA to €518 million.

Moving to regulated energy networks in Iberia. The highlight goes, of course, for disposals, gas distribution in Spain closed the sale on July 27, and more recently the disposal of gas distribution in Portugal sold on October 4. So on a proforma basis we can see that the electricity distribution in Portugal and Spain EBITDA, went down by 1% year-on-year, negatively impacted essentially by adjustments from previous years, while the OpEx just for the electricity networks showed a very positive performance going down by 1% year-on-year.

Moving to EDP Renováveis, which represented 37% of our EBITDA in the period, we can see that the installed capacity has increased by 10%, mostly due to U.S., Mexico and a little bit of Brazil, with justifying the 10% increase in terms of production. In terms of EBITDA, as we can see in page 16, EDPR's EBITDA increased by 17% overall, supported by

EBITDA growth in North America, so namely U.S. and Mexico, Brazil and also the 1st farm down in our Moray wind offshore project in UK.

At the level of EDP Brasil, we can see in Page 17 that recurring EBITDA in local currency was slightly up by 1%, benefiting from an integrated hedging strategy for the whole business portfolio. This has mitigated the negative impact from weak hydro conditions particularly in the third quarter of 2017 with hydro reservoirs at 19%, GSF for 62% and PLD up to BRL 436 per megawatt hour.

Regarding operating costs. As It was already referred, they were supported by the good results of the OpEx for corporate wide efficiency program, which resulted in – with OpEx costs in Iberia going down by 1% in the period. At level of EDPR, the core OpEx per megawatt excluding forex going also down by 2%. And in Brazil the OpEx in local currency adjusted to inflation is slightly below, so we had cost evolving slightly below inflation in the period.

Moving to balance sheet on page 19, we can see that debt, as a whole, in the Portuguese Electricity System continue to show a clear downward trend. So, for the total system debt, it went down by €0.2 billion in the first nine months of the year. And the more recent forecast by us is a decline of €0.4 billion for the full 2017, and also, the numbers available in the 2018 tariff proposal point at €0.7 billion decline for the next year.

Regarding EDP stake, in this first nine months of the year, it rose by €0.3 billion year-to-date, but it is expected to be flat year-on-year by the end of the year. So, staying in line with 2016 year-end of €1 billion on further securitizations to be closed before year end.

On page 12, our net debt excluding regulatory receivables, showed a decrease of €1.2 billion year-on-year supported by €1 billion of organic free cash flow. Including, obviously, the combined impact of the portfolio reshuffling which had a positive impact of €1.9 billion in the period and reflecting also the dividends paid to EDP shareholders, so close to €0.7 billion, has also the €0.6 billion negative impact from one off factors in the period. So, the VAT to be refunded later on, and other €0.3 billion related with the decline of regulatory receivables in 2016. It includes also positive impact from forex of €0.5 billion mostly due to the dollar.

Moving to page 21 regarding available financial liquidity. It amounted to €5.5 billion by October and these numbers of October already include the new revolving credit facility negotiated by the amount of €3.3 billion and with the maturity of October 2022, so this €5.5 million fully cover the refinancing needs beyond 2019.

Moving to financial costs, recurring net financial costs went down by 9% to €582 million, supported as it was referred before by 13% decline in terms of net interest costs.

This decline was partially offset by lower financial revenues mostly from capitalized interest and revenues from regulatory receivables and also negative forex.

Finally, the lower financial costs and income taxes, and also the higher non-controlling interest justify the 86% growth of reported net profit to €1,147 million and the 4% decline of recurring net profit to €633 million.

So, with this, we conclude the presentation. We'll have now a short period of music just to move to the Q&A session. So just hold on by one minute, two minutes in order to move to the Q&A section.

Q&A

António Mexia

Hello. So, let's go through the questions. And first, I would like to start with **that question by Jorge Guimarães from Haitong regarding the regulation in Portugal** and other people also mentioned this.

First, clawback. As we speak, we expect decisions with the new parameters by the end of November. In what concerns the retroactive figures I want to be very clear also in the sense that, the figures that were out there don't have any relation with the reality. In what concerns the future I think that the idea of having a competing positioning on both side of the border levelized playing field by the generators on both side of the border is still the name of the game. And, so we cannot estimate the impact in the sense that we believe that the previous system, was basically targeting that same objective. So, let's wait and see how can we be assured of this competitive positioning on both sides of the border.

In what concerns guidance by Rui Dias from UBS. Your question of course, you are mentioning that to reach the interval between €850 million and €900 million, why can we reach this if we have only 140 recurrent net profit in the third quarter?

Clearly, as you know, even with these hydro conditions that I've mentioned that are not, are not good, the last quarter is always the second best, and our estimation is that we will reach a minimum of €200 million to €230 million recurrent, so maximum €280 million on the last quarter of the year. So, we feel comfortable with this figure. Renováveis delivers, Brazil delivers and even with the tighter hydro, we are still confident of a minimum of €220million, €230 million net profit for the last quarter.

Guidance for 2018, Jorge again and Carolina from Morgan Stanley. It's still early to guide on 2018. We are at the beginning of the budgeting process, as usual. Of course, we need to understand the end of month in what concerns regulation. We still also need to understand better what are the weather conditions But, as we speak there is no evidence as of today, that 2018 will be a dry year. By the way it happened in 2015 and then 2016 was clearly very different from 2015, and we expect that at least between two weeks and four weeks of rain would be needed to ensure normalization of hydro production.

Versus our business plan, in any case: positives are favourable FX evolution, namely Brazilian real versus euro, the lower interest costs backed by upgrades of S&P and first the deleveraging with the sale of Naturgas; on the negatives, the energy tax keeps on, rather than decreasing 50%, that was our initial estimation, the review not value-destructive but lower pace of the HR stranded cost payment and distribution; uncertainties as electricity prices are slightly better than forecasted, although the ultimate impact will depend on spreads. Hedging policy is in line with past years, we have already forwarded 21 TWh with the €55/MW, with customers.

So, we will be talking about 2018 as soon as we have more news on the regulatory front.

Nuno, do you want to comment on the question of...

Nuno Alves

There is a **question** here **from Javier Garrido**, on the **liberalized performance in the third quarter vis-à-vis the second**.

I think that, the areas that made it looks a good performance in the third quarter have to do with, essentially, better ancillary services. We had also reduced losses on the third quarter vis-à-vis the second quarter. And, also you should take into the analysis that you have a cost on the liberalized sector, which goes down into the derivatives on the financial line. So, if you want to put it net-net you should have to put it above EBITDA to compare with the second quarter. And that's about €20 million on the financials, which if you were to compare with the second quarter, you should have it on above the line. So, those are essentially the ones.

And as far as leverage, there is a **question here from Rui Dias of UBS,** concerning the **deleveraging and the targets for 2020**.

We have no reason to change those targets. You're asking if we could soften it, no we've always said that the targeted leverage was very important. We still want to upgrade ourselves by the rating agencies at least one more notch. So, we will not be happy until we get that. And we still have estimated that we can achieve that by 2019 and 2020. So, until then, we will strive to reduce the leverage of EDP.

And as far as **cost savings** on this, just added measures that we took, in order to compensate, especially the **distribution regulation**. There's a couple of questions went from **Rui Dias and another from Javier**.

Essentially what we're doing is an extra €25 million of cost savings in 2018 that we are aiming at about €7/8 million in personnel costs below what would be the normal number for the year and another €15 million or so, on admin costs. The restructuring to allow us to have lower personnel costs will be booked this year. So, we will have a negative restructuring cost on personnel still this year, one extraordinary, but then we will save us about €6/7 million next year in less personnel than otherwise.

And as far, this obviously compares or mitigates the EBITDA reduction on distribution. I would say it probably will not cover the whole thing. But since we were €25 million ahead on our OpEx plan plus this €25 million we should be close to mitigate the EBITDA loss of the stranded cost on HR.

Antonio Mexia

So, I would follow on with the equity story. We have questions from **Jorge, Haitong**, **Pablo, HSBC** and **Stefano** from **Credit Suisse**. Basically, all of them relate to **what are the results** and **what we intend to do with renewables**.

As I already been mentioning we are not moving, we are not taking any decision. So we feel comfortable with the current situation. And so, nobody should expect any move from us in what concerns this issue.

In what concerns a **fresh question since yesterday of the U.S.** regulation raised by **Jorge Guimarães** from **Haitong, and Carolina** from **Morgan Stanley.** What I want to tell is the following, we have not until now ever speculated about any positive impact. And we have never considered any positive impact from the tax bill. We will not consider it today the idea of starting speculating about what could be the other side of the tax bill with negative impact, eventually. As you know, the actual situation was reached by a bipartisan agreement. The positioning of the situation in the U.S. market is very clear. Anybody can guess whatever anybody wants. So, it's – as you know, starting guessing about this is always a difficult exercise in the U.S. Everything always end up being different from what you expect. For now, we will not speculate neither on the plus neither on what is eventually negative. So, let's wait and see. Any other – any exercise on this will be futile.

Okay. Nuno, do you want to....

Nuno Alves

A couple of questions here on – more on the financing side. There's a **question on hybrid bonds** regarding proposals by S&P to make it easier for hybrid mechanisms and tendering for hybrids. And if we can have most of the **balance sheet by issuing instruments of longer maturity**. So, those two questions.

And as far as the S&P changes or reviews, we're just following on what the requests for comments are right now. But we have as a matter of principle, no intention of touching the hybrid we have. But, obviously, we'll keep in touch with what's going on.

And as far as issuing longer maturity bonds, I guess that's something that we've been talking. It's something that we have done already this year, and we will continue to do so. We will continue to utilize the opportunities of an environment of very low rates and that we have right now. And as we need, we will issue bonds, typically minimum seven years up to 10 years. So, if we feel it's the timing, we will do it.

There is a **question on securitization**: why the regulatory receivables are going up in the balance sheet, if they're going down on the system? That's typical because we finance the system. And the part that we don't own gets paid the principal, so we have to pay their principal. So, until we securitize, the balance sheet goes up and then once we securitize, the deficit goes down. This is what we've said and we maintain the commitment: by the end of 2017, the amount of the deficit in the balance sheet will be pretty much the same as it was at the end of 2016. So, that means we will be selling some tariff deficit during the fourth quarter.

We **have a question on net debt by end of the year if it includes the full amount of Naturgas sale**. No, we don't expect to collect the deferred until the end of the year. So, the remaining €200 million will not come this year.

Miguel Viana

I think we have no more questions. So, I'll pass to our CEO just for the final remarks.

António Mexia

Okay. So, thank you very much for the time and the questions. I would like to stress that even with very challenging weather conditions, we have presented the results that I think are positive. We have done, and we will be doing always what depend on us. We are mentioning also, as an example, the cost.

I would also like to stress again that the figures that were out there on the negative side, namely on regulation in Portugal are totally wrong. I want to be very clear on this. And I'm sorry, but we need to wait to know a little bit more until the end of November, and we will revert to you in what concerns this final environment of regulation in Portugal. In what concerns the rest, basically you can be sure that the various options that we have been building will be delivered and we will keep on track as we have done until today.

So, thank you very much. See you soon. Bye-bye.