Q3 2022 Earnings Call

Company Participants

- Bryan Hanson, Executive Vice President and Chief Generation Officer
- Daniel L. Eggers, Executive Vice President and Chief Financial Officer
- Emily Duncan, Vice President, Investor Relations
- Joseph Dominguez, President and Chief Executive Officer
- Kathleen L. Barron, Executive Vice President and Chief Strategy Officer

Other Participants

- David Arcaro, Morgan Stanley
- Durgesh Chopra, Evercore ISI
- Paul Zimbardo, Bank of America
- Shar Pourreza, Guggenheim Partners
- Steve Fleishman, Wolfe Research

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Constellation Energy Corporation Third Quarter 2022 Earnings Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. (Operator Instructions). As a reminder, this call may be recorded.

I will now like to introduce your host for today's call, Emily Duncan, Vice President, Investor Relations. You may begin.

Emily Duncan {BIO 19245511 <GO>}

Thank you, Amy. Good morning, everyone, and thank you for joining Constellation Energy Corporation's third quarter earnings conference call. Leading the call today are Joe Dominguez, Constellation's President and Chief Executive Officer; and Dan Eggers, Constellation's Chief Financial Officer. They are joined by other members of Constellation's senior management team, who will be available to answer your questions following our prepared remarks.

We issued our earnings release this morning along with the presentation, all of which can be found in the Investor Relations section of the Constellation's website. The Earnings Release and other matters, which we discuss during today's call contain forward-looking statements and estimates regarding Constellation and its subsidiaries that are subject to various risks and uncertainties. Actual results could differ from our forward-looking statements based on factors and assumptions discussed in today's material and comments made during the call. Please refer to today's 8-K and Constellation's other SEC filings for discussions of Risk Factors, and other circumstances and considerations that may cause results to differ from management's projections, forecasts and expectations.

Today's presentation also includes references to adjusted EBITDA and other non-GAAP measures. Please refer to the information contained in the appendix of our presentation, and our Earnings Release for reconciliation between the non-GAAP measures and the nearest equivalent GAAP measures.

I'll now turn it over to the, CEO of Constellation, Joe Dominguez.

Joseph Dominguez {BIO 16668698 <GO>}

Thanks, Emily. Good morning, everyone, thanks for joining our call. And especially, I want to thank the new owners of Constellation to the call, it's gratifying to see the continuing and an expanding interest in our new company from all parts of the world.

We had a strong quarter delivering adjusted EBITDA of $592 million, which is a result of the strong operations and performance across the business. Dan will go through some of the details in his remarks and we look forward to your questions at the end.

As always, I want to start with a shout out to the talented women and men who help us to run this company and who listen in to these calls. Thanks for everything you do. Primary, the biggest news, during the quarter was the passage of the Inflation Reduction Act, which recognizes the vital role that cleaned carbon-free nuclear plays in meeting the country's climate objectives. We've had a little time now to absorb the transformational impact of the IRA to us, and in our minds test for big things.

First, it helps us to attract and retain talent. This business is about human capital and it's hard to keep people when you're constantly talking about plant closures. Thankfully, we're done with that. Second and to the same point, the IRA keeps the plants open for our communities and for America, and it's not just about the carbon benefits. It's about the local air pollution reductions. It's the jobs and economic benefits, especially in hard-hit areas of our nation, and it's about electric reliability and affordability.

We've said this before, but it bears constant repeating. The most important energy commodity in the world today is a reliable zero emission clean energy megawatt. I don't care how you make it, but producing affordable clean energy that shows up whenever and wherever you want, is the foundation of any modern energy system that deals with climate. The PTC begins to recognize the value of that scarce commodity, and we make more of it than anyone in America.

Third, the IRA provides our owners consistent returns by creating downside protection through commodity cycles with inflation protection. We wanted to take a minute this morning, highlighting the inflation protection mechanism of the PTC, given the concern that all businesses and investors rightfully have about a inflation at this moment in time. Our thinking is that inflation will be difficult to control for many reasons, and that the Fed stated goal of getting to 2% long-term inflation will be a significant challenge.

Fortunately, the PTC automatically adjust higher in these scenarios as you can see from this slide. In a 2% case, prices go to about $51 over the term of the PTC, and $57 a megawatt hour in a 3% case. This gives us great confidence in our ability to favorably manage longer term inflationary risks.

Fourth, the IRA gives us an interesting opportunity grow by upgrading our plants and to earn an enhanced PTC for incremental megawatts to grow by investing in hydrogen and to grow by extending the wise of our assets to 80 years. I'll talk about a couple of these more in a moment.

In some, the IRA gives our investors a very unique investment opportunity. A clean energy investment with unlimited upside to higher commodity prices, downside commodity risk protection provided by the U.S. government, unique growth opportunities in hydrogen, life extensions and operates, and structural inflationary risk protection. We were pleased to see that the S&P recognize that the IRA provide significant benefits as part of its reassessment of Constellation's risk profile and upgraded us to BBB while maintaining a positive outlook. A good investment credit rating is more important now than ever.

If I could turn to Slide 6, I think this is a slide I'm pretty excited to talk about. If -- what it depicts is the life of our existing assets. The blue is the current license life of our fleet. And as you can see, it starts to dwindle down beginning in 2030s and phases out by 2050. You can see in some of the other colors here, certain life expansions that we've already filed for or obtained in the case of a few of our plants.

The green that's shown on the chart is the additional life that we will get by going to 80 years. And just to provide some context on how big that opportunity is for Constellation in America. Just extending the life of Constellation's Clean Energy units, sat all the units in the country, just hours, just extending hours will create as much clean power for America to fight the climate crisis. As all of the renewable energy that's been built in America over the last 40 years. And it won't cost hundreds of billions of dollars to make it happen. It's bare for us at a modest cost through the NRC life extension process.

Last week we announced that we will be asking the NRC to renew the licenses of Clinton and Dresden in Illinois for an additional 20 years, allowing these plants to serve America to the middle of the century and beyond. The NRC process for renewals expected to take us about four years, and it will allow Clinton to run to 2047, and Dresden to run to about 2050. This is Clinton's initial license renewal, and with a subsequent renewal it has the potential to operate until 2067. With continued policy support, we believe that we'll be able to renew the licenses at all of our plants, which would mean parts of our existing fleet would be providing carbon-free always on generation well into the 2050s at least.

Once license life is extended, our clean energy nuclear plants would have an operating life that is longer than any existing renewable energy source. And in fact, longer than any new renewable energy source that would be put into service in the next decade. But this isn't just about competition with other technologies, we need every zero-carbon resource, and license renewal is a hugely important part of the climate tool chest. It gives our owners a unique investment opportunity for the long run.

Turning to Slide 7, I want to talk a little bit about hydrogen. Like many others, we think that clean hydrogen will play an incredibly important role in mitigating climate change and reaching sectors of our energy and transportation industrial uses that can't be reached through traditional electrification. Hydrogen can be used to create sustainable aviation fuels for airplanes, reduce emissions in steel manufacturing and other industrial processes, for fuel cells that provide power for long-haul trucking, and even to create fertilizers and other clean agricultural products.

The opportunities are virtually limitless, and the clean hydrogen provisions of the IRA specifically the ability to earn both a nuclear and hydrogen PTC, means that nuclear plants can become cogs in the clean hydrogen market. As you know, we will be the first produced hydrogen from nuclear energy through our pilot project at Nine Mile Point.

Last week, we also announced that we are member of the Midwest Alliance for Clean Hydrogen or MachH2, which will be applying for a hydrogen hub funding from the DOE. We see Constellation participating in three ways as shown on this slide. First, hydrogen by wire, they are think about customers that are already using hydrogen at their industrial processes and want to use clean hydrogen. In order to get the full tax credit, they're going to need to prove that they're powering their electrolyzers with clean energy, and that will translate into contract opportunities with us to provide clean 24/7 power through our Constellation business.

Second opportunity we have is to co-locate electrolyzers measures and make hydrogen by products at our sites. And the third opportunity is to power fuel cells with hydrogen, and that's what we're testing at Nine Mile along with NYSERDA and the DOE. Their you store hydrogen at times where the grid doesn't need power and then you run that hydrogen back through a fuel cell and produce energy to the grid when it's needed.

The key thing we're doing here is exploring optionality. So that we could use these three strategies interchangeably. And one of the technical things that we're trying to work on is being able to move from producing energy and putting that on the grid to making hydrogen with that energy, and going back and forth in a matter of 10 to 15 minutes. That way we'll always be able to support the grid when the grid needs energy, and when the grid doesn't need the excess energy we could be making hydrogen.

As we turn to Slide 8, I want to talk a little bit about our operations. Our power and renewable fleet performed well with power dispatch match made of 98.8%, and a renewable capture rate of 95.7%. Our nuclear fleet ran well, but not perfect at 96.4% in its capacity factor. Our fleet will end the year with industry-leading performance, performance that has led continually for a significant period of time now.

We continue to operate at a capacity factor that is about 4% better than the industry average. And put that in context for you on an open position at the PTC price for, a 4% higher capacity factor for our fleet translates into over $300 million of incremental revenue.

Turning to Slide 9, on our commercial business highlights. As I mentioned at the top, our Commercial business performed well during the quarter with strong volumes of electricity and gas delivered to our customers, and we close deals that provide carbon-free solutions to our customers.

We delivered 56 terawatt hours of electricity during the quarter, and we continue to see strong renewal and win rates across both, our Electric and Gas business. Those win rates are reflected on the chart. We reached an agreement with the City of Chicago and collaboration with Swift Current Energy to purchase 100% clean renewable energy by 2025. As part of the agreement, the City will source its large energy uses with 300 megawatts of our new solar facility under construction in Illinois, and will procure Renewable Energy Credits for its remaining uses. This agreement will help Chicago lead the way in the fight against the climate crisis. And yet, is another example of how we're helping our customers to meet their sustainability goals.

Finally, I want to spend a moment on used fuel. Turning to Slide 10, we often talk about the fact that nuclear has many ESG attributes. It's got the lowest life cycle carbon emissions of any technology. It produces more carbon-free power on less land than any other source, because of its incredible power density. It provides unprecedented, reliable and affordable energy to all communities, because we think reliability is just as important to society as sustainability. It provides family sustaining jobs in many poor communities across the country, and has a strong industry safety culture. And as I mentioned, through innovation, we could use that clean energy to decarbonize other sectors with hydrogen fuels.

But one of the questions we often get from investors is about spent fuel, for as we prefer to call it used fuel. So, I want to spend a few minutes talking about how fuel safety -- our fuel is safely and secured it stored at our sites. First, I don't think we get appropriate credit for this, but, we're the only large scale energy producing technology that takes full responsibility for all its waste, plans for its eventual disposal, and we pre-fund all of our plants retirement obligations. That's not true for any other energy source, whether it's fossil fuels or renewable energy. We know where every gram of spent fuel is located and how it is packaged, tagged and tracked.

In terms of volume, nuclear energy is extremely dense and produces less waste by volume than any other type of energy. For context, all of the spent nuclear fuel produced in the United States from the dawn of the civilian nuclear error when President Eisenhower gave his famous 1953 Atoms for Peace speech. Until now, all of it could fit inside a super walmart. By comparison, a single coal plant generates as much waste by volume in one hour as the entire U.S. nuclear power industry has produced during its entire history.

Now, after our fuel is used to produce energy, it's placed in water pools to cool down, then it's placed in these 16 foots stainless steel containers that are shown on the picture in this slide. And there the material could be safely stored for hundreds and hundreds of years. These containers are designed to withstand earthquakes, storms, and projectiles, and they're completely passive, meaning they don't need any power or any source of energy to continue to operate. There's never been any unplanned radiation release from the containers and they emit less radiation than a frequent flyer receives in a year.

The safe storage of these materials gives us time to finally resolve disposal, warranty to free use the fuel as many technologies now propose to do. Look, it's not a perfect solution, but there are no perfect solutions in the energy sector, and we're extremely proud of what the industry has done. And we wanted to share this perspective, because we know how important it is to many of our owners.

Now, with that, let me flip it over to Dan.

Daniel L. Eggers {BIO 3764121 <GO>}

Thank you, Joe, and good morning, everyone. Starting with Slide 11, we earned $592 million in adjusted EBITDA in the third quarter, which was in line with our expectations. The Commercial business continue to produce strong results benefited in the quarter from favorability and customer load serving obligations, affected portfolio management, and successful load auctions. This favorability more than absorb derived from the shaping issues we discussed last quarter, as well as higher bad debt expense with our residential customers.

On the generation front, we ran into higher unplanned outages during the quarter which show Joe pointed to, any time we are running the plants whether planned or unplanned is an opportunity loss particularly at these prices, and with the wind up this summer and spot hour prices, replacement power costs were much higher than they've been in recent years which impacted our results even with overall output not down all that much. For context, everyday unit was out this summer cost between $1.5 million and $2 million a day in replacement power, compared to only a $0.5 million to $1 million a day in prior years.

Turning to Slide 12, let me start with the commodity markets. Spot natural gas prices remain volatile, but somewhat higher during the third quarter driven by irreverent hot summer and associated demand, higher competing fuel prices with international demand, and below average inventory. Spot power prices have follow the increase in gas prices, while energy demand also reflected the warmer than normal weather and post-COVID load recovery seen especially in Texas. Our hot spot warmest July on record, PJM and Ni-Hub each set records for their single warmest day, and Ni-Hub had its second warmest day on record.

Turning to fuel prices. During the third quarter, we saw increases largely on the same factors driving spot markets, elevated natural gas prices, higher coal and emissions prices, any anticipated supply impacts of announced coal retirements. We continue to see backwardation in 2024 and 2025 curves, compared to 2023. Although the steepness in backwardation has started ease. Since the end of the quarter, fuel prices for natural gas and power have remain volatile, and this is likely to continue given an underlying tight gas market both domestically and globally, uncertainty over winter weather here and in Europe, and the potential return to the Freeport LNG facility during the fourth quarter.

Moving to the gross margin table, 2022 total gross margin increased $50 million from the prior quarter, as a result of the strong performance of our commercial team. Open gross margin is up $50 million as a result of higher power prices in the Midwest and Mid-Atlantic, offset by the mark-to-market of hedges since we are effectively fully hedged this year. During the quarter, we executed a $100 million of new business between power and non-power.

In 2023, total gross margin increased by $100 million to $8.25 billion. Open gross margin is up $1.8 billion, largely offset by the mark-to-market of hedges, and $150 million of power and non-power new business was executed during the quarter. We continue to sell at higher prices than in previous quarters, and are now 92% to 95% ahead to cross the portfolio in 2023.

When we look forward, we're excited about the structural price support that PTC will provide our generation fleet for nine years, starting in 2024 through 2032. That said, recent prices have generally been well above the PTC derived support levels, and we have and plan to continue selling power to capture the prices in excess of the PTC four values and to support our customer business.

Turning to Slide 13. We are reaffirming our adjusted EBITDA guidance mid-point $2.55 billion, and narrowing our range to $2.45 billion to $2.65 billion. We're happy with our operational performance this year and are confident the decisions we are making for the long-term health of our company, some of which did bring us more towards the mid-point of our original guidance range. From an operations perspective, the commercial business is performing better than anticipated with the cost of serving load coming in lower than expected, plus some optimization opportunities around our fleet and load given the market volatility.

Our generation business continues to be an industry leader when we look utilization rates, expected to be over 94% for the year with cost still well below the industry. But we did have some in opportune outages at both nuclear and power that had higher replacement cost that we had experienced in a long time. And as I said, we've also made some strategic decisions around our business this year that have impacting current year earnings, but are the right decisions for our business going forward.

First, we've been talking with all of you this year about the organic growth opportunities ahead of us, including our work on hydrogen. As we see our finished pursue these growth outlets many of which further benefit from the IRA as Joe discussed. We have made the strategic decision to take on more growth related O&M to advance these efforts.

Second, as I talked about last quarter, we continue to find signs fixed price multi-year contracts for our customers in the phases of an extremely backward dated curve. We have long-standing relationships with our customers and signed multi-year deals, provide them with the budget certainty and visibility that they need to run their businesses. These contracts are weighing on our second half results and will likely carry into the first half of next year with that compelling economics for us over the full life of the contracts. Being a good partner to our customers is important to us, our Commercial business and positioning for a number of our future growth opportunities.

Third, as we said before, we are not immune to the pressures of a tight labor market and wage inflation. Coming out of this separation and reversal of plant retirements last fall, our vacancy rates were elevated and we've made significant progress in restaffing. We have reduced our vacancy rate from approximately 9% in February to 5% today. We are going to ensure that we have the best talent to run our plants, sell to our customers, and support our businesses. Accordingly, we took a look at our compensation packages and realize that we were out of step in some areas and it made adjustments to ensure we provide competitive pay.

Finally, as you all know, and many of you have benefited from, our stock price has performed very well this year. As part of the separation, we wanted to have an ownership culture and reinstated equity as part of our long-term compensation for our key managers through executives, and I would like to replicate this stock performance every year. This year its well above what was anticipated in our financial planning and is driving additional costs, particularly in 2022. We are having with our results this year and remain focused on driving long-term value for the company and our owners.

Finally, turning to the financing and liquidity update on Slide 14. Our balance sheet remains extremely strong and our risk profile is undeniably improved as a result of the IRA. As Joe mentioned, earlier this month, S&P upgraded our credit rating from BBB- to BBB while maintaining positive outlook, a significant credit positive story for us. Along with the ratings action S&P revised the business risk to Strong from Satisfactory, reflecting their view of a material improvement following the passage of the IRA. We want to thank our colleagues at S&P for their thoughtful review of our business. The upgraded S&P is also further evidence and acknowledgement of the stability of our cash flows and competitive advantages we have going forward. We are now two notches above investment grade of both S&P and Moody's.

We are maintaining our credit metrics that are well above our downgrade thresholds and remain committed to a strong balance sheet. Although, we are also encouraged by S&P's openness to us taken advantage of our strong balance sheet to find M&A opportunities as they come up over time. Beyond the validation of our metrics, business model and outlook, the ratings and parity between the agencies have some immediate benefits, including more favorable collateral requirements and credit terms of counterparties that have lowered our postings by several hundred million dollars since the quarter ended, as well as lower rates in long-term debt and commercial paper. Our liquidity position remains strong with more than $2 billion in unused capacity as of September 30.

As I close out, I'd like to remind everyone of the financial strength that separates apart from others in the market. Our strength allows us to pursue organic and inorganic growth opportunities to grow the business, while returning value for our shareholders. It also provides us with more opportunities to transact in volatile markets, where margins expand is risk is more appropriately reflected in pricing, and we're better position to service our customers. All while meeting any additional collateral postings without the need for additional liquidity in those associated costs.

I'd now like to turn the call back to Joe for his closing remarks.

Joseph Dominguez {BIO 16668698 <GO>}

Thanks, Dan. The company is strong, it's built for the long haul, and it's an essential company for America, as valuable as the IRA was to the company and to the nation. The thing I'm really proud of about is extending the life and beginning really to extend the life of our plant, what we did with Clinton and the announcement on rested, is our just the most important assets for America at this point in time.

Financially, we're executing well and our balance sheet is in great shape. Our investment grade credit rating is extremely valuable. So, I'll close with the value proposition. We're a unique company that can't be replicated and our assets as I said, are critical to meeting our climate goals. The IRA is derisks the business providing floor excellent inflation protection and exciting platform for growth. We owned nearly 25% of the U.S. nuclear fleet, producing the most carbon-free energy in the country, nearly twice as much as carbon-free energy as the next generator.

These plants can run for 80 years, a useful life that's longer than any other carbon-free generation that exist today, and in the case of renewables that will be build over the next decade. We provide hour to nearly 23% of all competitive C&I customers in the U.S., including 3/4 of the Fortune 100. This puts us in the best position to meet the growing demand for customer-driven carbon-free energy and sustainability products. We're the best operator of nuclear power plants in the country for now, and that delivers enormous value.

We generate strong free cash flow through our best-in-class operations, our retail and wholesale platforms, and our support for clean energy and our focus on cost. And finally, we intend to deliver value to you, our shareholders through our capital allocation strategy. We told you that we provide you with an update this year and we're working on that. But, as many of you know, there are some meaningful potential inorganic growth opportunities that align with our strategy and we need to see how these things play out before we can provide an update.

But as a reminder, our capital allocation strategy starts with maintaining strong investment grade credit ratings, which provide us a competitive advantage. We provide $180 million annual dividend growing at 10%. We believe there are opportunities to grow our business organically, and in organically, and we will see growth opportunities that exceed a double-digit unlevered return threshold, and will deliver long-term value to our customers. And when we don't have those opportunities or don't have those opportunities in a particular timeframe, we will return capital to our owners through a special dividend or share buybacks.

With that said, I'll open it up for questions, and I apologize for the noise on our end, there was a little glitch with the mic.

Questions And Answers

Operator

(Question And Answer)

Thank you. (Operator Instructions) Our first question comes from Shar Pourreza with Guggenheim Partners. Your line is open.

Q - Shar Pourreza

Hey, good morning guys.

A - Joseph Dominguez {BIO 16668698 <GO>}

Good morning, Shah.

Q - Shar Pourreza

Joe, maybe we can start with an update just on the market for the nuclear assets now that IRA has kind of been digested, couple of processes going on. What have you been seeing in the market? And is M&A just more or less likely at this point based on recent dialogues you've had? And then, do you have a firmer date in mind on when we could see a capital allocation update, if inorganic opportunities don't meet your threshold at least in the near-term?

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes, sure. Let me answer that last part first. I think, these inorganic opportunities will play themselves out by the time we speak again on our fourth quarter call. So, my view is we will know whether this stuff is going to be actionable for us by that point in time. But we are looking at some stuff right now.

I think the fact that the IRA got resolved gives us some sense -- gives everybody some sort of uniform sense around the forward price for these assets and that's very good. It doesn't resolve every evaluation question and each asset is very different. I spoke frequently about the importance of the size of particular nuclear assets and why we went two units a lot better than we like single-site units, so those variables are going to exist as we look at any particular asset going forward in theory.

I think I could speak to obviously there was a talent process to look at the sale of every asset that was a very complicated situation because it wasn't just a nuclear sale, but involves some fossil sales. So, any involvement we would have in that would require us to marry up with another buyer that would tend to fossil assets and talent announced recently that they didn't have any conforming bids that would buy all of the assets. As other things come on in the market, we will take a look at them, we've talked to all of you about that, and we're going to take a look at everyone.

We're going to be very disciplined. We think the business will consolidate, but we don't have the time frame that we're necessarily looking at, right? It's owner's willingness to transact that's going to drive it. So, I don't know, Shar, if it's going to resolve and that the floodgates certainly starts to settle a little bit in evaluation, but in the short-term looking to to the extent that we're looking at things, I think those will resolve by the time we're having the fourth quarter call, and then we will be able to return to a discussion of what capital return to shareholders should look like.

Q - Shar Pourreza

Okay perfect. That's what I wanted to level set. So, if something inorganic doesn't transpire, it takes some time. You're not married to having to disclose capital allocation before year end, so we can maybe expect it around the February call, when you report year-end results.

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes, I think, look, I think on the last quarter earnings call, I indicated that we would like to provide that information to our owners by the end of this year. And we were aiming for that. But things happened that we don't control and opportunities developed and we're going to explore those.

Q - Shar Pourreza

Okay, perfect. And then, lastly, I don't know, this shouldn't be a surprise. But I mean, obviously, you guys like everyone else are seeing labor and material inflation. We're getting a lot of questions on it this morning. Have you seen -- Joe, have you seen any moderation more recently at a high level? How should we sort of think -- should be thinking about maybe the potential pressures in '23 and beyond as it relates to your initial guide you guys rolled out with the Analysts Day earlier this year, which was just shy of $4.5 billion per year?

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes. Look, Shar, I don't think we're seeing anything unusual in this business. What is unusual about our business is the protection that we're afforded through the IRA. So, we wanted to spend some time at the top of this call, because I don't think it was necessarily focused on the price escalator that's built into the IRA in the event we're in an inflationary environment. But let me give it to Dan maybe. Dan, maybe you can unpack something there.

A - Daniel L. Eggers {BIO 3764121 <GO>}

Yes. Thanks, Joe. Thanks, Shar. It's a good question and I think Joe kind of hit off on the point. We are having the inflationary protection of the IRA. If you think about this year, right, the inflation environment has really been good to us from power crisis and moving higher inventory levels we haven't seen in the real long time, which is clearly helping the business. When I look at the cost, you want to indulge me for a second, I'll kind of break down our costs a little bit more for you, I mean overall O&M and budget perspective.

First off, a little bit under half of our O&M spend is associated with labor, right? So without half labor, half supplier and contract work. Of that O&M bill for labor, about 25% to 30% is going to be for our workforce that's going to be the representative population, our longest labor contracts go out until 2027. So, we have pretty good visibility on labor inflation rates on that piece of our labor bill, kind of in the 2.5% range.

On the non-union private things, we saw some of that this year with the hiring and recalibrating some of our pay levels. We are seeing upward wage inflation just as you are seeing everywhere else in the economy kind of top to bottom, so that's something we're keeping an eye on. Our focus is making sure we pay our people fairly and well, and so we're managing that for that something that's kind of the reality of the world in which we operate right now.

If I go to the contracting and supplier side of the equation, and really, this is predominately nuclear and power-related set when we get to this side of our dollars. About half of that spend is kind of what 20 major partners, so large partners to the company are big providers. We generally sign multiyear contracts with them with inflation caps or bands around them. That's helped to manage some of that inflation in the 2%, 3% range. Obviously, there's some news in sensitivities we go through renewals and there are some causes for things like (inaudible) escalation and things like that. It hasn't been a huge drag so far, but something working in an island. And now, on the other half of the supplier, right? These are going to be a wider range of suppliers, smaller, shorter contracts, things like that. So far, we've managed that inflation pretty well and certainly well below we've seen in the market, but it's something we'll keep an eye on.

Given our size and how we buy, we get benefits of both buying. We also buy an inventory. So we spaced out some of those costs they roll through particularly when we think about nuclear inventories or things like that which will help us to manage our costs.

A couple things that I called up in my script today when you think about for kind of next year. The growth spending that we had this year, I think you should expect us to continue to make some investments in growth. This is an important opportunity for us in putting money to work there to help fuel that opportunities important on the stock comp, which was fairly notable amount of money this year. That the tails on that are pretty small, to be honest. Most of that gives time to this year just on how the true-ups work. So, there's a little bit there, but in the scheme of, what our own understand is, it's pretty, pretty tiny. So, that's probably how I think about O&M as you kind of look at your model and our plan will be to refresh all these numbers for all of you on the fourth quarter earnings call in a normal course.

Q - Shar Pourreza

Perfect. Thank you guys. Very, very helpful disclosures. Thanks. Bye.

A - Daniel L. Eggers {BIO 3764121 <GO>}

Thanks, Shar.

Operator

Thank you. One moment for our next question. And our next question comes from Steve Fleishman with Wolfe Research. Your line is open.

Q - Steve Fleishman {BIO 1512318 <GO>}

Yes. Hi, good morning. Thanks. So, just on the -- Joe, one of the growth avenues you mentioned is operates of nuclear. Could you talk to what the operate potential might be of the fleet and any timing on that?

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes, Steve. First of all, good morning. So, as we dug into the IRA a little, one of the things that we're saying is that the way we interpret this on and I think as everyone interprets, the bill is that for incremental carbon-free megawatt shift, this isn't perfectly accurate, but you basically get a double PTC for those incremental angle loss[ph]. So, Bryan Hanson, and our Chief Nuclear Officer, David Rhodes have kicked off across us to look at different upgrades that might be available to us. Also, we've looked at these for a number of years, so we're not starting from scratch.

We'll be looking at the economics of those upgrades over the fourth quarter. I think what we're in a position where we will start to be able to provide an update on the fourth quarter call. I think it's fair to say, it could be hundreds of megawatts, but we need to look at the economics to see if they make sense. What's good about that, right, is that, when you increase the output of the machine, you're not adding people, so they are operated without incremental O&M cost associated with running machines. And in some cases, it involves adopting technologies that actually allows us to become even more efficient from an O&M perspective. So, we need to get cost from vendors and we need to study the implementation cost. But that's something I think that's going to be available to knit us now and we'll be able to talk on the fourth quarter call. I don't think I'd give you more color than that right now.

Q - Steve Fleishman {BIO 1512318 <GO>}

Okay. And a double PTC would essentially be kind of one for being like a new carbon-free megawatt and then another for being nuclear PTC essentially.

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes, let me turn it over to Kathleen Barron, who's here with me to explain how it works.

A - Kathleen L. Barron {BIO 19492153 <GO>}

Hi, Steve. Yes. Joe's talking about the tech neutral credit that is for any carbon energy[ph] resource that goes into service at the end of 2024. So, you would no longer be eligible for those incremental megawatts for the existing neutral PTC you would transition into that, new carbon-free tech neutral credit that's roughly double the value.

A - Joseph Dominguez {BIO 16668698 <GO>}

(inaudible) 45-megawatt credits, right?

A - Daniel L. Eggers {BIO 3764121 <GO>}

That's right.

Q - Steve Fleishman {BIO 1512318 <GO>}

Yes. Okay, thank you. And then just going back to the prior question on O&M, I know you don't want to really define all that at the moment. But just with respect to the part that's related to growth initiatives, can you give us a sense of kind of how much you're willing to size that? And then to degree that you start moving forward with projects, would it get capitalized into those? So, it's kind of temporary. Just how to think about how big the (inaudible).

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes, Steve. I don't know. I don't want to put it too fine a point on us. We're still trying to understand some of these opportunities. It's killing us. I don't want to give you an exact number, but it's going to be less than 1% right now of our O&M is going to that kind of spend just by context. Okay? So, that's probably I would think about it. I don't think I'm seeing or getting any number above that if that's helpful.

As we look forward, as we go from kind of this work to moving forward on projects, you're right, we will start to capitalize them once we have sizable projects with a plan and a business commitment to move forward. I think we'll probably have some level of O&M spend to capitalize on growth for maybe several years to come or longer, because there's always going to be work on trying to develop the next project even as one gets underway, right? So, one hydrogen project could go and it would be the work on the next one or the other behind the meter opportunities, they will have some sustaining growth O&M there, but it has been moved to commercializing a project that would be capital.

A - Daniel L. Eggers {BIO 3764121 <GO>}

And Steve, it's kind of everything. If the hydrogen starts, we started from a position earlier in the year where frankly, we just needed to learn a lot before we can do this track. The hub work, the work is investigating upgrades and other growth opportunities, all that stuff as a starting company essentially that hasn't done a lot of those investments over the last few years required us to bring in some talent, some consultants and other experts to get smarter about that. And that's at a cost this year. It's smart, it's good investments. It's what we need to be doing.

Q - Steve Fleishman {BIO 1512318 <GO>}

Okay, great. Thank you very much.

Operator

Thank you. One moment for our next question. And our next question comes from Paul Zimbardo with Bank of America. Your line is open.

A - Joseph Dominguez {BIO 16668698 <GO>}

Good morning, Paul.

Q - Paul Zimbardo {BIO 18277958 <GO>}

Hi, thank you. Good morning. Just to kind of pull together this stream of questions. Could you give expectations on all in how much you expect O&M to change year-over-year into 2023?

A - Daniel L. Eggers {BIO 3764121 <GO>}

Hi, Paul. As I said, I will give that -- we will give that update on the fourth quarter earnings call when we can give a comprehensive view of all the pieces put together including the rolling forward of our various margin outlooks. There is probably a lot of it early, I think it gets kind of fair when you think about some of the things enumerated on a prior question with Shar that we are seeing some pressures where we do our best to mitigate that as we can but I think you're fair to understand that there are some challenges out there in this inflationary environment.

Q - Paul Zimbardo {BIO 18277958 <GO>}

Okay. Understood. And then separately, could you just elaborate a little bit on how the change in interest rates influences the plan for capital allocation, more specifically the right level of leverage perspectively? Just kind of how you think about that, whether it's on a quote, unquote floor from a PTC level of EBITDA or the higher market levels as well?

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes. I think we're comfortable with where the balance sheet is right now. I think the flexibility that affords us is attractive, right? And we saw the support of the agencies, which we're happy about. We also kind of look at the balance sheet as a tool we can use when we look at some of these potential larger investment opportunities. The idea of using the balance sheet to support them is going to be available to us. So, we're good with where the leverage is right now and in the ability to flex it, when opportunities come up.

When I think about the return on capital as we make new growth investments or a threshold we look at for M&A or anything else we talked about, a double-digit unlevered return at the Analysts Day that is still our North Stars, we're evaluating opportunities and projects internally, and I don't see that changing at this point in time. So, that's pretty well where we are.

Q - Paul Zimbardo {BIO 18277958 <GO>}

Okay, great. Thanks a lot.

A - Joseph Dominguez {BIO 16668698 <GO>}

Thanks, Paul.

Operator

Thank you. One moment for our next question. And our next question comes from David Arcaro with Morgan Stanley. Your line is open.

A - Joseph Dominguez {BIO 16668698 <GO>}

Good morning, David.

Q - David Arcaro {BIO 20757284 <GO>}

Good morning. Thanks so much for taking my question. Good morning. On hydrogen, I was wondering what's the current state of commercial discussions with partners or suppliers. Wondering, if any of the different kind of business opportunities by wire or co-locating fuel cells might be farther ahead than others at this stage.

A - Joseph Dominguez {BIO 16668698 <GO>}

We're -- look, we're in kind of (inaudible) space with a lot of folks here. So, I would say that there have been very expensive conversations on all fronts, in both the co-location as well as providing energy to customers who want to produce hydrogen at their own site. And what we were hopeful is that by the first quarter, we will be in a position where we're going to be able to start to announce on commercial deals and commercial activity. The hub proposal is going to take a little bit longer. Kathleen, if you want to share a little bit of your thoughts on the timeline for that work. But that also has some commercial contracts that will be a significant part of that work. So, in a sense, that stuff has to be done before the deal we can grant, that's funny.

A - Kathleen L. Barron {BIO 19492153 <GO>}

That's exactly right, Joe. It is a deployment hub. So, the announcement that went out last week about the MachH2 Coalition in Illinois, and the breadth of that demonstrates how many commercial parties are involved to create a bid to the DOE that demonstrates all the different potential production pieces and use cases and the midstream sort of connection between the two.

So, as part of that announcement, we have a number of different hydrogen producers, transportation companies, clean fuel producers, national labs, NGOs, and a number of governors and senators expressing support for the alliance as announced. The next step will be to get the bid together for the DOE, which is due in April. And then, later in 2023, we will find out where DOE is going to direct that $8 billion of government matching dollars to get the hubs into development and ultimately into production later in this decade.

But as Joe said, we have had some really great conversations across the hydrogen value chain just to pull together that -- just for that alliance to be pulled together, which is making folks at least in the Midwest super excited about the potential there for building out the clean hydrogen economy.

Q - David Arcaro {BIO 20757284 <GO>}

Okay great. Thanks so much for the color there. Then, I was just wondering in the quarter on the unplanned outages that you saw, wondering if there were any common kind of underlying causes there or any need that you might see for additional kind of spending related to the issues like maintenance CapEx or anything that might be lingering beyond last quarter.

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes, it's nothing unusual and nothing that we think is going to affect future operations or projects. We have some one-off issues and probably the longest outage which we had a vendor provided part that didn't perform up to expectations and missed the specifications for that part that created an issue for us. The reality is these sorts of things happen every year. But every year, we're not talking even in the Exelon days about outages, but at these very high prices, you lose 10 days or a little bit more at Nine Mile, which is one of the outages that occurred during the quarter and it becomes a significant drag, it adds up quite quickly.

So, let me flip it over to Bryan Hanson to see if there's anything else he wants to share here.

A - Bryan Hanson {BIO 18995088 <GO>}

No, I think you covered it, Joe. There's nothing extraordinary about any of the issues we had. We will provide some more vendor oversight to make sure the quality of parts that we get meet our standards. And again, we have very high expectations of how we operate these plants. And so, when a piece of equipment isn't performing right, we'll take the plant down, make the repairs and restart them. And I'm just so pleased wrapping up our refuel audit season here in the next couple of weeks with four outstanding refuel outages this fall, and we're on track to make, like Dan said, better than a 94% capacity factor for year end, which would be industry-leading as always.

Q - David Arcaro {BIO 20757284 <GO>}

Okay, understood. Thanks so much. I appreciate it.

Operator

Thank you. One moment for our next question. And our last question comes from Durgesh Chopra with Evercore ISI. Your line is open.

Q - Durgesh Chopra {BIO 20053859 <GO>}

Hey. Good morning, team. Thanks for giving me time here. Just -- Hey, Dan, just wanted to check in, on the Analysts Day, you had this free cash flow -- unidentified free cash flow guidance of $1.8 billion to $2.2 billion. The gross margin is tracking higher since then, but then you have some O&M related to towards some growth projects. So how should we think about where are we tracking in that range? If you could just update us there.

A - Daniel L. Eggers {BIO 3764121 <GO>}

Yes. We're not refreshing that specifically here. I would say on the year, our EBITDA has done well, our CapEx is tracked online, and I think our performance this year is certainly consistent with our expectations that we have in that line that page in the Analysts Day. I think about next year and we're always going to go through budgeting process. But the price outlook in the market conditions have improved for next year. Obviously, we had a cost discussion that was going on today, but I think we feel good about the numbers we shared with you in the spring.

Q - Durgesh Chopra {BIO 20053859 <GO>}

Awesome. Thanks. And then, just maybe a finer point. On the Q4 call, what should we be expecting? Should we be expecting 2023 guidance looks like, but could we expect a longer dated EBITDA guidance? Some of the investors have talked about perhaps providing a floor. So, in addition to the capital allocation update, how should we think about sort of pro forma EBITDA guidance ranges?

A - Joseph Dominguez {BIO 16668698 <GO>}

Yes, I think we will give you this '23 guidance for sure. We will give you some gross margin disclosures and hedge disclosures certainly through 2024. There's a little bit of complexity as you're well aware without clarification from treasury on how gross receipts are going to be calculated. That does have a bearing bolt on EBITDA and free cash flow and how they're going to look. So, I think we want to get through that process and have little more clarity there before we probably extend beyond a '23, '24 look. That could also complicate a little bit how we talked about a base EBITDA number, but it's something we're trying to get our arms around as we know that you guys would like to see it. But we also want to make sure we have a well-reasoned number that's supportive of (inaudible) treasury.

Q - Durgesh Chopra {BIO 20053859 <GO>}

Understood. Thanks so much, guys. I appreciate it.

Operator

Thank you. I'd now like to turn the conference back to Joe Dominguez for closing remarks.

A - Joseph Dominguez {BIO 16668698 <GO>}

Well, thanks everybody for joining us today, and like I said, at the outset to many of our new owners for their interest and involvement in the company. It was a terrific quarter. We knew -- look, we knew walking into this call, folks were looking for us to probably increase guidance and we've talked a little bit about the inflationary pressure of labor, but yes, that's a piece of it, but there's growth costs that we had this year as we investigated opportunities, their stock compensation issues, because our employees are enjoying the outside that many of you have enjoyed already.

And we've had a fairly significant shaping situation with our contracts. Contracts that we like very, very much and happy to have been able to do that business, and then, we had a few extra days and unplanned outages. But other than that, the business is performing just to all of our expectations, and we're very excited about the future. So, look forward to entertaining you again on fourth quarter call, and until then, be safe, take care of yourselves, and (inaudible).

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone have a great day.