Tennessee Valley Authority
"Third Quarter Fiscal Year 2012 Conference Call"

Friday, August 3, 2012, 09.30 AM ET
Speakers: John Hoskins, Tom Kilgore and John Thomas

OPERATOR: Good morning and welcome to the Tennessee Valley Authority's Third Quarter Fiscal Year 2012 Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*" then "1" on your touchtone phone, to withdraw your question, please press "*" then "2." Please note this event is being recorded.

I would now like to turn the conference over to John Hoskins, Senior Vice President and Treasurer. Please go ahead.

JOHN HOSKINS: Thank you. Good morning everyone and welcome to the Tennessee Valley Authority's Third Quarter Fiscal Year 2012 Investor Call. Leading our discussion today is Tom Kilgore, President and Chief Executive Officer and John Thomas TVA's Chief Financial Officer.

Tom will lead off our discussion today with a review of key events from fiscal year 2012. John will then provide an overview of TVA's financial performance for the first nine months of fiscal year 2012 and our outlook for the last quarter of this fiscal year. We will then open up the call for a question and answer session.

Before we begin, I would like to point out that today's press release and TVA's 2012 third quarter 10Q are now available on TVA's website at www.tva.com. A replay of this call will also be available on TVA's website for one year. Today's discussion may include forward-looking statements that are subject to various risks and uncertainties. Please refer to TVA's SEC filings including our most recent annual report on Form 10K and quarterly report on Form 10Q for a discussion of factors that may cause results to differ materially from projections, forecasts, estimates, and expectations.

Now, I'll turn the call over to TVA's Chief Executive Officer, Tom Kilgore.

TOM KILGORE: Thank you, John. Good morning everyone and thank you all for joining us on the call. As John Hoskins says, I am Tom Kilgore, President and CEO of TVA. I want to cover a few points before John Thomas our Chief Financial Officer reviews the highlights from our third quarter performance. My remarks will be brief, John's will be longer and then we will entertain your questions.

Our strategic focus at TVA remains on the three 'R's', rates, reliability and responsibility, and we are making progress on all three of those areas despite what John will show you about lower revenues from a slow economy and a mild winter, and then a higher demand during this very hot summer. Low rates are one of the most important things TVA can do for our customers to build up our economy and to serve the people of the Tennessee Valley, and I want to point out that our rates to-date are favorable to last year. So we are improving and we have a strategy to get our rates back in the top quartile in the nation. But while we are doing that, we need to maintain our investment in our power system to keep it reliable.

And speaking of reliability, I want to remind everyone that our power system is one of the most reliable, safe, and efficient systems in the country. When temperatures hit triple digits as they did four straight days in late June and July, we showed clearly, why our customers can count on us. We met a new peak demand for June of 31,097 megawatts and a new weekend peak for the first two days of July of 30,771 megawatts. Our work to balance our portfolio continues and I am pleased to report that we are getting much better reports on our construction progress at Watts Bar and I am now more confident in our numbers and projections.

Operationally we are on our way to achieving a thirteenth consecutive year of 99.999% reliability in our transmission system. And on the generating side, Browns Ferry Unit 2 surpassed its previous continuous run record and is today 421 days online and I might say also, Sequoyah Unit 2 has been online 407 days, and if you add that to two spring outages, which those units are, so four out of our six units are doing very well. The other two are doing well also, but we have lower days on them.

Now, let me turn to responsibility. Our responsibility obviously is to help the region's environment and the quality of life and its economic growth. We've added cleaner burning natural gas plants at John Sevier. We added one last year at Lagoon Creek. So we've added gas capacity and we are using that heavily during these times when natural gas prices are low. And we are moving ahead on our clean air schedule for idling coal units. And even in this slow economy TVA again working with our local power customers has helped leverage private sector investments of more than $5.3 billion by 127 companies so far this year. And that's creating or retaining about 42,000 jobs.

So in summary, our power system is working well and we are keeping it that way in spite of the mild weather in the spring and now the hot weather in the summer. We have some challenges, but we are handling those. In a couple of weeks, our Board will consider our plan for next year and our budget for 2013.

So, I am going to turn it now to John Thomas who will give you a full report on the third quarter and the past year so far.

JOHN THOMAS: Thank you, Tom. I want to start with just the highlights for the quarter. We continue to see low rates for our customers. We did have higher electricity sales. We had lower commodity prices in particular natural gas, which has also influenced purchased power. We are beginning to see the traction from our diet and exercise, the response to the lower revenues that we had seen coming through the winter months. We still continue to invest in the key expansion programs for future generation needs as well as our environmental projects that Tom mentioned.

Interest rate environment, interest rates are low and continue to be favorable for the financing of our expansion projects and the John Sevier Combined Cycle Facility came online with the low natural gas environment has certainly helped us in preparing for these hot summer months.

There certainly are some hard spots that we are faced with, this sluggish economy that we don't see recovering in the short-term that we are going to have to deal with. Again the regulatory maintenance and so that pressure in terms of our overall investment, working capital that I talked a bit about last quarter in terms of…we still have coal under contract while we are burning natural gas that we have built inventory this year that we would look to burn some of that off as we move into our fourth quarter, and then into next year as well. We still have relatively high margins posted on our natural gas contracts.

And then lastly, hydro generation for the quarter, our hydro generation was down approximately 50%. Luckily with the somewhat mild weather earlier in the spring, we were able to run our other lower cost generation but that still does put some pressure on overall fuel and purchase power.

Next, I want to show a trend chart that covers our sales showing by month comparison to fiscal year 2011, as well as our plan for 2012. And as you would remember from our last call, coming all through the winter months, our sales were consistently below the last year and below our plan. We did see a tick up in terms of May and June, but that was not enough to make the overall year favorable, but it did lead to somewhat favorable sales results for the quarter.

And so, I will move in and talk about the specific numbers that are included in our results, and I'll cover the quarter and then I'll cover the year-to-date numbers. Last quarter, I just covered the year-to-date because there was a lot of consistency. But if you focus on this quarter, starting with total revenue, our revenue was up 4.5% to $2.777 billion and that was driven by the higher sales. So sales were up 5.8%, and you can see compared to last year our average rates were comparable, even though our sales were higher. You would have expected our rate to be slightly higher. With the higher sales, we would have been running higher cost generation, but with the overall fuel and purchase power and the rate favorability that we see in our costs that offset any pressure that we would have had. So overall, higher sales and higher revenues through the third quarter.

Now breaking into our expenses, Fuel and Purchased Power was essentially on par with last year. However, as I said, we had 5% more sales, so you would have expected our Fuel and Purchased Power to be higher; however, because of the rate favorability it's actually lower. Rates meaning…the rates that we have to pay in the cost of our generation.

Operation and maintenance is favorable for the quarter, $112 million or 11% and that's where you see the impact of the diet and exercise program that we put in place to respond to the revenue challenges we have. As well, we had fewer nuclear refueling outages this year than we had last year. And so, that leads to some of the reduced spending as well.

So overall, in terms of net income or loss, we did have a loss of $23 million for the quarter and that was $217 million ahead of last year, where we had a loss of $240 million.

In terms of the cash provided by operations, you can see that that was slightly ahead of plan at $15 million. The higher sales that we had in the quarter will result in higher cash flow in our fourth quarter. A lot of those sales were in June, and we'll get the cash from that as we move into the fourth quarter.

Cash flow….cash used in investing, you can see was slightly lower than last year, but we continue to invest in our capacity expansion as well as our Clean Air Programs. And then the cash from financing, essentially the same as last year.

Then covering the nine-month period now, so switching from quarter to the nine months and as you can see our power sales are actually down 2%. So even though the quarter was strong in terms of sales and revenue, it did not offset the first two quarters of the year, sales being down 2% and revenue being down more importantly 6%. That's driven by as you can see our fuel cost recovery. So fuel costs overall for the year is quite favorable driven by the volume aspect as well as the overall fuel rates themselves. And then base revenue down 5.4%, for almost $300 million. That's the pressure that's been created where we as an organization have had to respond with our diet and exercise program.

The good news overall for our customers, as you can see is that our power rate at 6.6 cents a kilowatt hour is 4% lower than what it was last year. And so, as we move into the hot summer months that's certainly good for our customers that their bills won't be quite as high as they would otherwise have been in the heat of the summer.

Fuel and Purchased Power, as you can see, is down $325 million, so 10% and that directly corresponds to the lower fuel recovery that you've seen in our revenue. And then for the year, $52 million worth of O&M expense favorability. That shows we are starting to get traction and you saw the larger number in the third quarter. Some of the diet and exercise favorability we are seeing is offset by higher depreciation, as we have idled some of our coal units, we have accelerated from depreciation on that.

Overall for the year, through the nine months, you can see $290 million loss versus last year a $35 million loss, predominantly driven by the weather.

Overall, net cash provided by operations, $1.252 billion or a change of $451 million. The predominant incremental item that you see in terms of our cash provided by operations is the building of coal inventory that I mentioned as well as the natural gas margins that we've posted.

In terms of the investing, you can see $1.9 billion essentially, so again that you can see through the year the commitment we have made to capacity expansion and to the Clean Air Programs as well as reinvesting overall in terms of the maintenance of our facilities; and then cash provided by financing at $355 million.

Just to quickly give a summary of the balance sheet, you can see the Plant, Property and Equipment. So this is net of depreciation, going up by $271 million and so that's the investment that we are making. The actual investment certainly is higher than that. As I mentioned, we had accelerated depreciation associated with some of the coal units that we have idled. So we continue to see our Plant, Property and Equipment grow. And then you can see the financing activity changes in terms of the variable interest entities debt, which is really the John Sevier alternative financing transaction that we did.

So in summary, we are happy that, as Tom mentioned, having low rates for our customers is one of our key parts of our vision and priorities and we were seeing that this year. Some of that driven by mild weather, which has then forced us to respond as an organization with the diet and exercise programs, and some of that by lower fuel costs, the load being lower then has helped because we are not having to run higher cost generation as well as the natural gas prices. This is the primary area where you see the benefits of TVA having a somewhat balanced fleet of generating resources, and we are able to take advantage as market price changes and part of our vision, certainly is to achieve even a better balance moving forward, and that's where our capital investments are going.

Overall the lower revenues in, we've seen the organization respond very well in terms of being more frugal in our daily activities. And then, as I mentioned we did have fewer nuclear refueling outages.

And so, that concludes my remarks around both the quarter and the year-to-date performance.

JOHN HOSKINS: Thank you John, operator we are now prepared to open the call up for questions.

Q&A

OPERATOR: We will now begin the question and answer session. To ask a question you may press "*" then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press "*" and then "2." At this time, we will pause momentarily to assemble our roster.

Our first question will come from David Flessner of The Chattanooga Times Free Press. Please go ahead.

DAVID FLESSNER: Good morning.

MALE SPEAKER: Hi, David.

DAVID FLESSNER: I wonder with the losses you've had through the first three…nine months of this year, if you can give me guidance about the balance of the year? Do you anticipate now ending up with a net loss, and as you go forward and look at rates for 2013, is it going to be necessary that the freight structure be adjusted in order to continue to offset… where these one-time weather adjusted causes for rates or fundamentally, is your structure a little too low at this point to cover your costs?

JOHN THOMAS: It was as we looked through the fourth quarter, you can see that even with, you know, again it was the beginning of the summer Dave, but the hot weather we had in June wasn't enough to make up for the warmest winter in 60 years; and we are predicting normal weather through the fourth quarter. So, I would anticipate that we would end the year with a net loss. TVA has had losses in the past as well, so this is not a unique thing. But I'd say as we move into next year, you know, we plan for normal weather and well we don't know the end result of what our rates will look like next year until we have our budget and business plan discussion which is on August 16 that you will see that with the board, I would say that a substantial part of what you are seeing in terms of the pressure this year and the loss was because of abnormal weather and we are planning for normal weather. And so, we wouldn't expect to see that $500 million shortfall that we are seeing this year.

DAVID FLESSNER: Thank you.

OPERATOR: Our next question comes from Pam Sohn of Chattanooga Times Free Press. Please go ahead.

PAM SOHN: Thank you. You guys had mentioned that regulatory costs…regulatory maintenance was higher, and I wondered if you might expand on that a little bit?

JOHN THOMAS: It's in a of number of areas, but the two that you see that are the most substantive for us is around the environmental regulations where we are having to put clean air equipment on some of our existing coal units. And so we…moving into next year…last year our board had approved Clean Air Projects on two of our plants, and so we expect in our plan going forward we will have two plants that we're installing or enhancing the clean air equipment, and the other would be in the nuclear space in what you see in terms of, you know, certainly the Fukushima response, and what the implications of that would be. So we don't…we don't fully know what all of the costs and implications of those, you know, regulation that come out of that will be, but we will certainly comply with whatever they are. And it will be incremental expense. So, those are probably the two predominant areas.

PAM SOHN: Thank you. Can I ask a follow up on that?

JOHN THOMAS: Sure.

PAM SOHN: Can you…can you put a number on that? If you already have I apologize, I've missed it.

JOHN THOMAS: No, we are still assessing, what the full impact would be, as well as, I don't know…the full requirements have been defined at this point. So, we don't know what the full actions will be, it's hard for us to say what the full cost would be.

PAM SOHN: Thank you.

OPERATOR: Once again, if you'd like to ask a question, please press "*" then "1" at this time. And our next question comes from Mary Powers of Platts. Please go ahead.

MARY POWERS: Hi, good morning and thanks for having this call.

MALE SPEAKER: Good morning, Mary.

MARY POWERS: Good morning. So can you give us a little more color about what you said in the beginning about Watts Bar to, you know, the construction and…

TOM KILGORE: I'll make a comment on that. When we started Watts Bar, we started with a budget of about $2.5 billion, and as we progressed, it became evident last year that that wasn't going to be enough. So we went back and did an estimate to complete, and did a very rigorous drilldown on that and then had two companies come in from outside, kind of test our logic and our numbers. And of course, we took that back to the Board and got a new estimate. But we are following that much more rigorously now by every commodity and knowing where every commodity stands. And you know progress reports are coming to me every week, and we are doing well.

Our cost performance index is right at 1.0, which means they are on track. They've spent very little of contingency that we have in there. So, we are doing well, I noticed a report on the newswire this morning that somebody said they thought we were basically pilfered too many parts off of that, and there was some underlying things. I would just tell you that a lot of that including the remarks about Westinghouse and Siemens, the actual turbine is on the turning gear. It's been on the turning gear for a while, so we just are more comfortable because we got lots done and we are following that very closely on a weekly basis.

MARY POWERS: And can I ask a follow up?

TOM KILGORE: Sure.

MARY POWERS: So, how about…have you made any other decisions about coal retirements? You mentioned something that you had earlier kind of briefly made a comment about.

TOM KILGORE: We had…we committed to the EPA to idle about 2,700 megawatts between the time of the settlement and 2017; I believe is the last date on the commitment. We have idled some other units, some early and we idled some, but we also brought a couple of those back this summer. So we didn't retire them. We idled them, and during the hot weather we brought them back. Now, we brought them back because we have Raccoon Mountain, which is an older plant. Mary, you might have been there, I don't know. If you haven't you ought to come up and go through it. It's a pump storage unit and it is about 30, late 30s (years old), let's see '77 until now. So it's on up in years and we found cracks and the rotors were taken all four of those off, have taken all four of them off. So we brought back some of these coal units to offset that loss of Raccoon Mountain. So, we are on plan. We are actually slightly ahead in terms of the idling, but that's economic. That's to save money in our system for our customers, and I feel pretty good about that.

MARY POWERS: Okay. Great, thank you.

OPERATOR: Our next question is a follow up from David Flessner of The Chattanooga Times Free Press. Please go ahead.

DAVID FLESSNER: Thank you. I just want to clarify. Can you put any numbers on the diet and exercise program, how much savings you've achieved at this point?

JOHN THOMAS: Yeah, the…you know at this point we are looking at a couple of $100 million overall that we are seeing in the items that physically focused on productivity initiatives.

DAVID FLESSNER: Okay. Some of that deferred capital expenditures are you talking about actual...

JOHN THOMAS: No, that was just the productivity-related items. If you look at the impacts on our capital programs not our investment in our plants, but our capacity expansion and other where we have restructured our spending, that's about $500 million that we have taken out of our plan for the year.

TOM KILGORE: And Dave I would just add, that is doable because the economy is not coming back as fast as we'd like. So we've done that, that's not something we necessarily want to do in that and if the economy starts recovering we think we are positioned to get back into that capacity addition.

OPERATOR: At this time, I am not showing any further questions. I'd like to turn the conference back over to John Hoskins for any closing remarks.

JOHN HOSKINS: Thank you. I would like to thank everyone for participating in today's call. Also if you have any follow-up questions, please contact TVA Investor Relations or Media Relations at the contact information provided in today's press release. This concludes today's call.

OPERATOR: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.