TENNESSEE VALLEY AUTHORITY
"Second Quarter Fiscal Year 2012 Conference Call"

May 4, 2012, 10:00 AM ET
Tom Kilgore
John Thomas

OPERATOR: Good morning, and welcome to the Tennessee Valley Authority's second quarter fiscal year 2012 investor call. Today's call is being recorded, and at this time, I — for opening remarks, I would like to turn the call over to Mr. John Hoskins, Senior Vice President and Treasurer. Please go ahead, sir.

JOHN HOSKINS: Thank you. Good morning, everyone, and welcome to the Tennessee Valley Authority's second 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. Also attending our call today is Mike Skaggs, TVA Senior Vice President of Nuclear Construction.

Tom will lead off our discussion with a review of key events from the first half of fiscal year 2012 and provide an update on priorities for the remainder of this fiscal year. John will then provide an overview of TVA's financial performance for the first six months of fiscal year 2012 and our outlook for the second half 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 second quarter 10-Q 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 10-K and quarterly report on Form 10-Q for a discussion of factors that may cause results to differ materially from projections, forecasts, estimates, and expectations.

At this point, I will turn the call over to TVA's Chief Executive Officer, Tom Kilgore. Tom?

TOM KILGORE: Thank you, John. Good morning, and thanks to all of you for joining us on this call. As John said, I'm Tom Kilgore, President and CEO of TVA. I want to cover a few points briefly before John Thomas, our Chief Financial Officer reviews the highlights and answers questions about our second quarter performance.

First of all, there is a connection between the addition of natural gas generation and our decision to finish construction at Watts Bar Nuclear Unit 2. Both of these are really our priorities in our integrated resource plan to provide cleaner and lower cost energy for our customers. I'd just remind you that a balanced portfolio is really our aim. So our shift now, as you're seeing, we are idling coal plants and adding gas plants. In the past five years, we have actually added gas plants at Caledonia, South Haven, Magnolia, Lagoon Creek, and now John Sevier, and all of those total up either leased or owned capacity of generation about 4,000 megawatts of capacity. And the thing I'd point out to you is we started that long before low gas prices, so that just shows you that a balanced portfolio really does work.

Secondly, I'd like to highlight our decision last week to complete our construction of Watts Bar Nuclear Unit 2. Our Board voted to let us finish the job, put the plant in operation, and move ahead. We'll do this with a better understanding, better measurement systems on how we gauge our progress, and be more transparent about that.

We have made changes in our nuclear leadership and the work planning and the execution and in the transparency about verifying the progress of the job.

Finally, the point I wanted to make as John will tell you that we have less than our expected results financial this year, but even in the face of that, we're taking steps to keep industry in the Valley. I told the Board at our last meeting that we would be enhancing our Valley investment initiative so as to effectively lower the power costs of electricity to qualifying industries served by TVA. We think it's important, especially in these times, to make sure we keep jobs and industry in the Valley.

TVA is committed to being a national leader in low cost power, environmental stewardship, and job creation, and my point to you, as I finish and begin to turn this to John, is all of this is a part of our vision to achieve our low rates, high reliability, and act responsibility.

So with that, I'll ask John Thomas to take over and guide us through our results and performance during this last quarter.

JOHN THOMAS: Thank you, Tom. I'll begin with some highlights for primarily talking about the first six months. I have some references to how the quarter was in particular, but I'll primarily focus on the first half of, for us, the fiscal year.

So the highlights are that we are seeing lower rates overall for our customers. That's driven by lower commodity prices in natural gas and purchased power prices. As everyone's aware, natural gas is at extreme low prices. That's going through our fuel rate, but as well we're seeing lower rates through our base, and I'll talk a bit about that later in the presentation.

As a result of having lower revenue, which is coming through these lower rates and lower volume overall of sales, we have implemented what we're calling a diet and exercise, which is really focusing on cost containment and cost control through TVA's operations, and that's beginning to take hold, and we'll expect to see more of an impact of that in the second half. We're also focused overall on our project cash flows. In particular, as we're running more natural gas units and running our coal fleet less, then we're reprioritizing some of the maintenance schedules around our coal fleet, given they're not running as much, and building that into our plans.

We continue to be in a low interest rate environment, and that's positively impacting our results. Market returns for the year — the market has performed fairly well, as you would be aware, and in particular relative to our pension, which is our largest investment area, we're seeing good results this year.

And then, lastly, the John Sevier combined cycle plant that was brought in ahead of schedule and ahead of budget this year, given the natural gas prices, certainly is going to be advantageous for us this year, and, as Tom had indicated, that's just the implementation of our integrated resource plan in moving towards a balanced portfolio.

Moving on to hard spots for the year, the mild weather has significantly impacted our results, as well as a sluggish economy. While we're not seeing any deterioration, we certainly aren't seeing any kind of growth out there.

Regulatory maintenance is still a challenge for us. We are continuing to invest in our nuclear fleet, in particular in terms of ensuring that the asset condition is addressed at Browns Ferry. As well — we continue to address in the transmission and the IT area related to the NRC SIP requirements, and so we are continuing to invest in areas that are

required from a regulatory and asset perspective, while at the same time focusing on areas where we can contain costs.

And then, lastly, the Watts Bar, the announcement recently, while we still believe that that is — will be a low-cost option and help our balanced portfolio for our fleet, the increased spending on that certainly is a hard spot.

To talk for a minute about weather, I have a chart that shows the — for the period of November through March, the cumulative heating degree days. The circle in the middle that shows 2,944, that would be the normal heating degree days that you would expect over these winter months. You can see in 2010, we were at 3,365, so that was a very cold winter. Last year was pretty close to normal at 3,081, but you can see 2012, the warmest in 50 years at 2,260, and that obviously has been the biggest driver in terms of our sales.

So I'll move into some of the specific statistics, beginning with our base revenue. Our base revenue was off $386 million from the prior year. That's 10.3 percent, and I reference specifically the second quarter change, which was 11.6 percent, so slightly worse in the second quarter, but you would have expected that more of the winter months. January and February were in the second quarter results.

Fuel cost recovery, I'd mentioned the low natural gas and purchased power prices. As well as because of the low load, we aren't running our higher cost units, so the overall average fuel cost is lower, as you would expect, and so that flows directly through our rates. We adjust our fuel cost every month. Some utilities do that on an annual basis, but we do that on a monthly basis, and so you can see the fuel cost recovery revenue down $236 million for the six months.

So total revenue off $624 million, or 10.8 percent. You can see that power sales overall are off 5.9 percent, and then, as I mentioned, the rates overall for our customers — it's a good rate environment here, and 6.5 cents per kilowatt hour versus 2011 at 6.9. I would mention that we had also enacted a base rate increase during this period, and so this is in spite of doing a 3 percent base rate increase, we're seeing effective rates that are lower by 5.8 percent.

Moving on to some of our operating expenditures, as you would expect, our fuel and purchased power expenses are down $314 million, and, again, that flows directly in through our fixed cost recovery — or fuel cost recovery mechanism. Operation and maintenance expenses, $60 million higher than last year. Probably the biggest item in that is our pension expense, which I think is roughly $60 million higher for the first six months as well versus last year.

On a net income, we did have a loss for the first six months, a loss of $267 million, and that's $472 million higher than what we had seen last year. Overall, cash provided by operations, down $466 million, really driven by three primary factors. One, obviously, the shortfall in revenue that we've seen because of the weather was the predominant driver. In addition, because we're not running our coal fleet as much, we've seen a little over a $100 million increase in inventory. That was a result of some of these coal contracts. While we are renegotiating and trying to extend some of the deliveries, we do have coal that we must take, and so some of our inventory is building.

In addition, we do purchase and hedge some of our natural gas under forward contracts. As the market has moved down, we've had to post additional collateral or margin on those gas contracts, and so the buildup in coal inventory and the additional margin that we've had to post for the natural gas has been a use of working capital for us.

On the net cash provided by — or, sorry, the net cash used in investing, you can see that's up $70 million year over year, and then net cash from financing, $27 million less than the previous period.

Next, focusing on the balance sheet in terms of the PP&E, you can see that as we continue to invest both in Watts Bar and John Sevier, whether — as well as our other maintenance capital, net of depreciation for the year, that's an increase of $261 million. Our overall bonds and notes outstanding are down $512 million, but, as you would be aware, we did the alternative financing on John Sevier in the second quarter of this year, and that was the billion dollars that you see represented here.

So, in summary, for the second quarter, we have seen lower rates overall for our customers; however, the milder weather and the lower effective rates have resulted in a shortfall in revenue for us. We're seeing lower fuel costs because of the load, as well as natural gas prices and then slightly higher O&M driven primarily by pension. And then, as I mentioned, we do continue to make the investments on our asset condition as well as the regulatory requirements.

I want to spend just a minute and give you a few comments around the outlook for 2012. I show these NOAA charts that give some insight into what they're predicting for the summer. This is something that changes quite frequently, but, as we sit today, there's a slightly better than normal chance that we would have above average temperatures for the summer, but we'll continue to monitor this and adjust accordingly as we get into the summer months. We've seen a little bit of warmer weather here at the end of April and into early May, but we'll see how the summer develops as we get closer.

Our outlook for the rest of 2012 is we would expect overall that our customers' rates would be lower, that we'll have stable fuel and purchased power prices at these low levels. I'm not sure that natural gas will stay below — or go back below $2, but we think that it will be generally in that range.

We are actively working on expense reductions. Our diet and exercise program, we're beginning to see the benefits of that, and that will impact the second half. We expect the overall favorable interest rate environment to continue for the rest of the year and then a heavy emphasis, as you would expect, in terms of project execution for the remainder of the period.

That concludes my comments. I'll turn it back over to John.

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

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

Our first question will come from Pam Sohn of *Chattanooga Times Free Press*. Please go ahead.

PAM SOHN: Hi, thank you, guys, for taking questions. I'm curious if you could talk a little bit more about the kinds of savings and reductions you expect to see in what you're calling your diet and exercise program, and if that includes layoffs or attrition or things like that that would affect profitability?

JOHN THOMAS: We'll come back to you in just a minute. We could not hear the question. We had some audio issues on that question. We'll come back to you in just a minute if you can hold on the line, please.

PAM SOHN: Okay. I'll be here.

JOHN THOMAS: Next question, please.

OPERATOR: Our next question comes from Matthew Kinnan of Fidelity Investments. Please go ahead.

MATTHEW KINNAN: Hi, good morning. Could you talk about changes in your capex plans for kind of 2012 and 2013? I think 2012 was originally estimated at $3.8 billion, but, given the sluggish economy and the new Watts Bar cost schedule, could you please talk about any changes?

JOHN THOMAS: Yeah, there's a couple of changes. One is that we've gone in and revisited the — and are continuing to look at our plans around Bellefont, as we're looking at the changes that you've heard about relative to Watts Bar. So overall, while we do expect higher spending this year on Watts Bar, it's more than offset by reductions that we'll see in our Bellefont projections. As well we had some other early development projects in terms of our capacity expansion, and we are delaying those based off what we're seeing in terms of the, really, demand response to our new seasonal demand and energy rates from our customers, and so overall we're revising down our capacity expansion spending for the rest of this period. As well, when we look at our diet and exercise program, some of that impacts some of our capital investment, our base capital, if you will, particularly on our fossil fleet. As we're running it less and running the natural gas plants more, we expect that through the second half of the year we'll have less maintenance spending within our fossil fleet.

So I would say overall the level of capital investment will be dropping for the second half. You know, if I were to — you know, order of magnitude, this is, you know, probably somewhere in the — in the half a billion dollar range, you know, plus or minus, but that would — what we're looking at as we go through our business planning exercise, which we really just started in the month of May, we'll begin to look at what the longer-term impacts of that — and later in the summer, we'll have a better update in terms of how this rolls through 2013 and '14, et cetera, but you can look generally for something in the half a billion dollar range, plus or minus $100 million.

MATTHEW KINNAN: Okay, great. Thanks. And then could you also update us on your financing plans? I think you have a maturity later this month. And also in March you issued a statement saying that you were calling some bonds, so could you kind of just give us some updated thoughts about that?

JOHN THOMAS: Yeah, so we — as you mentioned, we do have $1.8 billion maturing this year. I would at this point probably not expect that we would do any alternative financing on that this year, and as we get closer to those maturities, then we'll assess when and how we would go to market with that.

MATTHEW KINNAN: Great. Thank you.

OPERATOR: Our next question comes from David Flessner of *Chattanooga Times Free Press*. Please go ahead.

DAVID FLESSNER: May I return to Pam's question, then. The — in the diet and exercise that you referenced for first fiscal 2013 and then the current year and the then the next year, can you give a

little bit more discussion about how you're going to pare those expenses and how much you're looking at and what that may mean for staffing and or contract labor?

JOHN THOMAS: Yeah, so, as I mentioned with the question about our overall capital investments, there's, you know, roughly half a billion dollars that you would see in terms of our capacity expansion and our other realignment of our base capital spending projects as well as overall in terms of our operations and maintenance spending. We're still looking at what the full year impact of that would be. It's made up of — there are some reductions in positions. We didn't go into — we recently did a restructuring, Dave, as you're aware. We didn't go into that focused on trying to save money. It was really more about improving the effectiveness of the organization by reducing layers of management to improve the communication and the overall effectiveness throughout the organization, but there is, as a result of that, some reductions in positions that we would see this year. We'll see more of the impact on a full year next year. As importantly as what that means to our overall labor, there are also — we have almost as many contractors as we do TVA employees, and so we're looking at overall all labor expense, not just TVA labor, but I would say the lion's share of the productivity that we would see is coming out of these reductions around capacity expansion as well as how we rearrange the maintenance and outage projects and gain more efficiency with those.

DAVID FLESSNER: So would that translate into several thousand positions, do you think?

JOHN THOMAS: I wouldn't say several thousand. No, I would say that we'd be somewhere less than a thousand.

DAVID FLESSNER: In the current fiscal year and then more next year?

JOHN THOMAS: I wouldn't say more, but you'd get the — you'd certainly see the full year impact in 2013.

DAVID FLESSNER: And you're projecting 7 percent fewer revenues now for the entire year than you budgeted?

JOHN THOMAS: That's right.

DAVID FLESSNER: About $800 million less than you budgeted, $700 [million] to $800 million less than you budgeted in sales?

JOHN THOMAS: We'll probably be around, I would say, $600 million.

DAVID FLESSNER: And what is the impact of that, and do you see that as a significant lasting change that — will you recoup that in subsequent years, do you think, or are you —

JOHN THOMAS: Well, you know, the lion's share of this is because of the weather, and so, yeah, we would expect going forward we'd plan for normal weather, so we would think we'll have normal weather going forward. You know, there is some impact, as I mentioned, from — as we've implemented our seasonal demand in energy rates, we're seeing greater demand response from our customers, so there may be some lasting impact as a result of that. I would say generally about two third of this is weather and maybe a third of this is demand response. We would expect the demand response to continue but not the weather.

DAVID FLESSNER: And, finally, with gas prices as they are, do you anticipate a fuel switch by much of your customer base? Are there implications of more people moving from heating and appliance use, from electric to gas in the Valley?

JOHN THOMAS: You know, we're not — we're not expecting significant switching capability that exists in the very short term, but we're still — as we get to our business planning, we'll look at the long-term impacts of a scenario of sustained low gas prices.

OPERATOR: As a reminder, if you'd like to ask a question, please press star and then 1. And our next question comes from Blake Farmer of WPLN. Please go ahead.

BLAKE FARMER: Thank you. What do the overruns at Watts Bar do to TVA's borrowing capacity? I know you've been turning to the alternative financing. I didn't know if it crimps things even more.

JOHN THOMAS: Yeah, so relative to it, we have a statutory debt limit of $30 billion, and we're currently just over $24 billion, so we've got about $6 billion worth of headroom there, and through our financial guiding principles, we pay off about a billion dollars a year as well, so we actually create more headroom every year as we go through, and then we — for our capacity expansion projects, we do finance those. So the $2 billion, obviously, would be an increase, so that would put pressure on that, but it's not a short-term issue for us. It's not in the next couple of years, but it is something that we're actively evaluating. As we recast through our business plan our long-term capacity expansion spending needs, we'll fold that in. I would say it does create pressure, but it's more of a longer-term issue than it is an immediate type issue.

BLAKE FARMER: And if I could ask this too, you know, I know TVA's talking about the need for a balanced portfolio, but, you know, when you look at John Sevier coming in under budget and early compared to a Watts Bar and John Sevier producing not that much less power, I just wonder if there are thoughts of, you know, maybe — you know, natural gas being — you know, maybe to be a little larger part of the portfolio. What's the conversation there?

TOM KILGORE: Well, let me address this. This is Tom Kilgore. If you look back and see what we've done in the past, as I said, in the past five years, we've added about 1,100 megawatts of nuclear. That's the refurbishment of Browns Ferry 1, and we've added 4,000 megawatts of gas, so you can see we're already doing what you're suggesting. But that's not to get a very high percentage in gas to the detriment of everything else. Our goal, because we've modeled this in several ways and we've taken everything from economic malaise to another growth spurt and all of these different things — our integrated resource plan says that our best strategy is just to have a balanced portfolio.

And I'll illustrate that this way. We made the decision to build John Sevier not when gas prices were low but when gas prices were in the $5 to $6 range, and that decision was a strategic decision, and it's paying off now. We think that keeping this balance, with having nuclear be a base part of the portfolio, is still a good decision. Actually, Watts Bar will, you know, come in at a price that's slightly less than what we currently are charging for our wholesale rates, so we still believe that a balanced portfolio is the best thing to aim for, and then fuel prices will come and go. I mean, I don't think any of us are willing to bet on $2 gas for the next ten years, and so, you know, unless you're willing to take that bet, then you become a speculator, because you're speculating that gas is going to stay at $2. We don't want to speculate. We're going for a balanced portfolio.

BLAKE FARMER: Thank you.

OPERATOR: This concludes our question-and-answer session. I would like to turn the conference back over to Mr. Hoskins for any closing remarks.

JOHN HOSKINS: Thank you. I would like to thank everyone for participating on today's call. Also, if anyone has any additional follow-up questions, please contact TVA's Investor Relations

or Media Relations with the contact information that's provided in today's press release. This concludes today's call. Thank you.

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