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BKH - Q2 2013 Black Hills Corporation Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Black Hills Corp. 2013 second-quarter earnings conference call. My name is Glenn and I will be your coordinator for today. At this time all participants are in listen-only mode. Following the prepared remarks, there will be a question-and-answer session. (Operator Instructions).

As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to Mr. Jerome Nichols, Director of Investor Relations of Black Hills Corp. Please proceed, sir.

Jerome Nichols - *Black Hills Corp. - IR, Director*

Thank you, Glenn. Good morning, everyone, and welcome to the Black Hills Corp. 2013 second-quarter earnings call. With me today are David Emery, Chairman, President and Chief Executive Officer, and Tony Cleberg, Executive Vice President and Chief Financial Officer.

Before I turn over the call, I need to remind you that during the course of this call, some of the comments we make may contain forward-looking statements as defined by the Securities and Exchange Commission and there are a number of uncertainties inherent in such comments. Although we believe that our expectations and beliefs are based on reasonable assumptions, actual results may differ materially. We direct you to our earnings release, slide 2 of the investor presentation on our website and our most recent Form 10-K and Form 10-Q filed with the Securities and Exchange Commission for a list of some of the factors that could cause future results to differ materially from our expectations.

I will now turn the call over to David Emery.

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Thank you, Jerome. Good morning, everybody. I will start on slide 3 of the webcast presentation for those of you who are following along. Our agenda today will be very similar to the format we have had in previous quarters. I will give an update on key activities in the quarter. Tony will cover financials for the quarter and then I will discuss strategy and forward-looking issues.

Moving to slide 5, highlights of the second quarter, from a business standpoint we had colder weather than normal in our gas utility service territories. Quite a bit colder. About 20% colder than normal from a heating degree days and a standpoint about 70% -- 72% more heating degree days than last year during the same period. If you recall last year we had an extremely mild spring.

Highlights for the utilities, construction on our Cheyenne Prairie Generating Station is on schedule and within budget. That project is going very well.

At Colorado Electric, we filed a resource plan in April. We discussed that on the last call. But in that plan we identified a 40-megawatt gas turbine as the replacement for the 42 megawatt Clark power plant which is a coal-fired plant that has been retired.

We also recommended retirement of a couple of small gas-fired units in Pueblo for a total of 29 megawatts and then we filed certificates of public convenience and necessity, seeking approval for the new turbine and the retirement of both of those two smaller gas-fired units. We do have hearing dates set for November regarding the resource plan and to the CPCNs and hope to receive approval so we can start work on that turbine project.

Also at Colorado Electric, we issued a request for proposals for up to 30 megawatts of wind in April. We have received those bids. We used an independent third-party evaluator to evaluate those.

That process has been completed and the bid results were submitted to the Colorado PUC last Friday.

Our IPP subsidiary did submit a bid into that RFP. The hearing to go over results of that bid results will be on September 4 through 6.

Black Hills Power, we filed a rate request late last fall, in December; interim rates were implemented on June 16, subject to refund and we have hearing dates scheduled in October for that rate case.

In the meantime, we are responding to discovery requests and at least trying to reach some settlements with some of the parties in the case.

Also at Black Hills Power we filed a request with the South Dakota PUC for a construction financing rider for our Cheyenne Prairie Generating Station. That rider is very similar to the one already approved in Wyoming. In South Dakota we have hearings set in September, but we did implement the rider on an interim basis on April 1, again subject to refund.

And then, finally, our gas utilities purchased another small municipal gas system. We have continued our efforts to do that, and in this case we added a few hundred additional customers.

Moving on to slide 7, highlights for the nonregulated energy subsidiaries, on the power generation side we announced in May that we had reached an agreement with the city of Gillette, Wyoming, to sell them our CT 2, our combustion turbine 2 at our Gillette Energy Complex. That sale will close next year about a year from now after the current power purchase agreement from that unit expires.

Included with that transaction is a 20-year economy energy agreement with Gillette whereby if we can purchase energy for them cheaper than they can run that unit, we share in the savings from that. And that agreement continues for 20 years. So there's still some decent earnings potential for us from that unit going forward.

Finally, as I mentioned earlier, our IPP subsidiaries did bid into the Colorado Electric win RFP.

On the oil and gas front we drilled two wells on the Mancos Shale formation in the Piceance Basin. Those are the two wells we talked about last quarter in which we will earn 20,000 net acres in exchange for drilling and completing those two wells. To date, we have drilled and cased them, waiting on completion operations until we finish a water line into the wells for frac water and then make sure all of the gathering system is in place so we can turn the wells on as soon as they are completed. We expect both wells to be producing by year end.

And just a reminder, that agreement with the third party that allows us to earn that acreage has real strict confidentiality provisions. So there is very little that we can disclose as far as specific well results, reserves, or production information.

Moving on to slide eight, highlights from a corporate perspective. We made excellent progress toward our goal of improving our credit rating during the quarter. Two of the three agencies increased our corporate rating during the quarter.



S&P increased the BBB from BBB minus and now have us on a stable outlook. Fitch raised its rating to BBB from BBB minus and they have us on a positive outlook.

We closed the \$275 million term loan that expires in June of 2015, basically replacing two other term loans that we had that were set to expire this year, essentially allowing us a couple of years of flexibility to complete the long-term financing associated with that.

And then, finally, our Board of Directors declared another dividend, \$0.38 a share equivalent to \$1.52 on an annual basis, which continues our 43rd consecutive year of dividend increases.

Slide 9. During the second quarter we earned \$0.40 (see slide) per share from continuing operations as adjusted, compared to \$0.34 last year, an improvement of about 21%.

On slide 10 illustrates the changes in our income from continuing operations as adjusted for the second quarter of this year compared to last year. Basically we had lower performance in our electric utilities and, Tony, you will cover the details of that here shortly. And that lower performance in the electric utilities was more than offset by improvements in all of our other business segments.

Now I'll turn it over to Tony for the financial update. Tony?

Tony Cleberg - *Black Hills Corp. - EVP and CFO*

Thank you, Dave. Good morning. As Dave mentioned, second-quarter performance continued to show strength from 2012.

Moving to slide 12, we reconcile our earnings from continuing operations on a GAAP basis to earnings per share as adjusted, which is a non-GAAP measure. We do this each quarter and feel by isolating special items the earnings per share as adjusted better communicates our most relevant ongoing performance.

During second quarter of 2013, we have one special item which was the reduction of a \$0.28 non-cash mark to market gain on our \$250 million worth of interest rate swaps. The gain reflected an increase in long-term interest rates during the quarter.

So considering this special item, the second quarter's earnings per share as adjusted from continuing operations was \$0.41 compared to \$0.34, a 21% increase.

Also, I would like to point out that our trailing four-quarters EPS as adjusted was \$2.38. And this is an improvement of 32% over the comparable four quarters ending June 30, 2012.

Slide 13 displays our second-quarter revenue and operating income. Later I will explain major differences between years.

But here the main point is we are predominantly a regulated business, generating 86% of our operating income from electric and gas utilities in the second quarter. Our operating income improved by \$1.5 million compared to 2012, driven by improvements in power generation, coal mining -- and the coal mining segment. Utilities in total were flat year over year with improved performance in the gas LDCs offset by lower electric utility performance.

I will give more color on the operating income changes on a later slide.

Slide 14 displays our second-quarter income statement. On later slides, I will discuss the segment revenue and operating income in more detail. But here I want to mention several other noteworthy items that impacted the second-quarter performance compared to Q2 of the prior year.

The first item, interest expense net of interest income declined by \$3.8 million as a result of the debt declining by \$183 million. As you may recall, we paid off \$225 million of 6.5% notes in Q4 of 2012. On a segment basis, almost all of the interest expense reduction from 2012 accrues to the corporate segment.

The second item relates to a 34% tax rate in the second quarter. The tax rate was slightly lower than expected due to increased R&D credits, including the 2012 benefit of R&D credits.

The third item relates to performance incentive costs that are included in our operating expenses. Our performance plans are directly aligned with our stakeholders. Consequently, the 11% improvement in the stock price in the second quarter generated an additional compensation of expense of about \$1 million. These expenses are allocated to each one of the segments.

The last noteworthy item is our EBITDA. During the quarter, we achieved \$84.7 million in EBITDA, a decline of \$5.3 million from 2012. The oil and gas segments EBITDA declined by \$8.5 million primarily because we sold [to] Williston Basin oil and gas wells in Q3 of 2012.

Moving to the next slide, on top of slide 15, we displayed our electric utility segment revenue and operating income. The electric utility's revenue increased in the second quarter by \$8.3 million from 2012, due to increased rates of about \$5 million and increased op system sales of about \$3.5 million. This was partially offset by lower demand, driven by 13% fewer cooling days.

Our second-quarter operating income as adjusted declined \$3.7 million year over year, reflecting primarily increased op O&M costs. Gross margins were relatively flat with the improvements in the [CLFP] riders and higher rates offset by energy cost adjustments and 1.2% lower retail wholesale megawatt demand, our O&M costs increase for higher compensation expense, depreciation, and property taxes.

Moving down slide 15, gas utilities revenue increased \$35 million or 50% driven by 72% increased heating degree days. Operating income improved by \$3.5 million or by 49% in the second quarter compared to 2012. Distribution decatherms sold increased about 65% year over year and was driven by higher-than-normal heating degree days.

As you will recall, last year was unusually mild with heating degree days lower than normal by 31% in the quarter. Gross margins increased by \$7.2 million, offset by O&M expenses of \$3.7 million, including higher cost for incentive compensation. All in all, the gas utilities performed very well in the quarter.

The next segment on slide 16, power generation, improved compared to last year's performance. We are pleased with the performance and the availability and the earnings that we continue to see from Colorado IPP.

Moving down slide 16, the coal mining segment, we saw the operating income improve in the quarter by \$1.8 million from 2012. The tons sold increased by 10% and the mining cost per ton decreased by 13%. The lower cost per ton reflects the reduction in removal of overburden. We are encouraged by the continued improvements that we see at our coal mine.

Moving on to oil and gas on slide 17, the segment performed as expected. Two major items in 2012 impact the year-over-year comparison.

First is we delayed our natural gas drilling program last year because of low prices. So our gas production declined by 27% year over year. The second item is we sold most of our oil-producing properties in the Williston Basin last fall. So our oil production declined by 58% year over year. Overall, production in the second quarter declined by 34% compared to 2012.

From the cost perspective, our O&M expenses declined by \$8.2 million with lower depletion of \$7.8 million. The actual depletion rate during Q2 was \$1.82 per MMCFE which was higher than our initial guidance assumptions. Some of the non-operated wells in the Bakken came online near year-end 2012, which increased our cost pool.

Sequentially from the first quarter to the second quarter, total production declined by 6% driven by a 33% decrease in oil production and a 3% decline in our gas production. Again, sequentially, from first quarter prices received increased by 6% for oil and decreased by 21% for natural gas.

Moving on to our capital structure, slide 18 shows our current capitalization. At quarter end our net debt to capitalization ratio was 50%, about flat with the first quarter. Our credit metrics continued to improve since the first-quarter earnings release. As Dave said, both S&P and Fitch have upgraded our credit ratings. Both S&P and Fitch now rate our unsecured credit at a BBB flat.

With the cash flow from operations and our debt capacity we have ample funding available to support our growth over the next few years.

In the press release on slide 19, we reaffirmed our 2013 earnings guidance in the range of \$2.20 to \$2.40. This is for EPS as adjusted and excludes special items. We have not changed our published assumptions because we believe, in total, the assumptions are reasonably accurate for the guidance range.

Moving to slide 20, to conclude, we are pleased with the second-quarter's performance and our outlook. In Q2, the cool weather helped our gas utilities perform well and we continue to manage all of our operations effectively.

And with those comments, I'll turn it back to Dave.

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Thank you, Tony. Moving on to slide 22, we have five major strategic objectives really focused primarily on being an industry leader in everything we do.

We want to be a leader in operational performance, earnings growth, our earnings upside opportunities primarily provided by our oil and gas properties, and our track record of 43 consecutive annual dividend increases. We also want to continue improving our credit rating and we have made great progress in that regard.

Moving on to slide 23, related to operating performance there's several metrics on here. All exhibit exceptional performance relative to our peers in the areas of safety, reliability and several other efficiency measures.

On slide 24, this illustrates our superior plant availability and starting reliability. It also demonstrates that we have an extremely modern generation fleet, as you can see by the fleet age there, and that our power plant construction safety record is great. We have provided an update on that chart with zero accidents to date on our Cheyenne Prairie Generating Station.

Slide 25 sets out our generation by fuel type and further illustrates the recent and ongoing modernization of our generation fleet. When we look at the impositions of new government regulations from a customer impact perspective, we are essentially through the majority of that impact once we complete the Cheyenne Prairie Station. So our fleet is very modern and won't require a lot of additional modifications.

On slide 26, from an earnings growth standpoint we expect continued strong earnings growth driven by capital spending. That spending will be done to meet customer needs in our utilities and also to grow our nonregulated energy businesses. For the next several years, capital spending is projected to continue to be far in excess of our depreciation.

Slide 27 simply provides more detail regarding both historical and projected capital expenditures by business segments, gives you an opportunity to see particularly in the electric utility business where we are spending some of that capital, and then really breaks that schedule out by individual subsidiary.

Slide 28, helping to drive our future earnings growth is our Cheyenne Prairie Generating Station which I talked about earlier. That new 132 megawatt plant is jointly owned by Black Hills Power and Cheyenne Light. Construction commenced in April and progress has been excellent. We still expect that plant to be in service by the fourth quarter of next year, and so far from a budget standpoint we are well within budget as well.

Slide 29 provides an update, regulatory update for our utility properties. Essentially all of this information has been covered in a previous slide; it just provides it in a summary format here, particularly key dates for various regulatory proceedings in the bottom right corner of the slide.



Moving on to slide 30. From an earnings upside perspective, we are very focused on proving up and capturing the substantial value of our existing oil and gas properties. We are going to focus on those existing properties, primarily the Mancos resource we have been discussing, and also participate in some limited exploration opportunities, focusing primarily on oil place that have impact for reserve potentials.

Our 2013 program I discussed earlier. We have drilled those two horizontal Mancos wells and will complete those wells in the fourth quarter, which will allow us to earn the 20,000 acres of additional leasehold in the Mancos from a third party.

We are also evaluating some selective oilwell exploration drilling and may drill two or three crude oil wells in the Powder River Basin between now and the remainder of the year. Probably won't disclose a lot of details about those wells until they have been drilled and completed.

Moving on to slide 31, our existing oil and gas leases in the Piceance and San Juan Basins have net resource potential in excess of 2 trillion cubic feet of natural gas. We believe that is a fairly conservative number based on current well spacing in that play and believe that it could be higher as we get more information from a technical standpoint.

The table does not include the 20,000 net acres that we have yet to earn from the third party for drilling the two wells this year. Once we do that, it will increase our Mancos holdings by almost 27%.

On slide 32, we continue to be very proud of our track record of increasing dividends for 43 consecutive years. And as you can see, this year our annualized rate is a larger increase than the annualized increase we have had over the last several years reflecting our confidence in the balance sheet as Tony elaborated on and the strength and cash flows from some of the larger projects we have completed over the last couple of years.

Finally on slide 33 we remain focused on improving our credit rating and as we discussed earlier, we made excellent progress with two out of the three rating agencies; we will continue to focus on getting an upgrade from the third.

Slide [4], this is our scorecard where it sets forth our key objectives for 2013 and illustrates our progress to date towards those objectives. This is something we have done for several years, basically holding ourselves accountable to you, our shareholders, to make sure we are accomplishing our strategic objectives.

And then, lastly, on the following slide is just a brief reminder of our Analyst Day for you sellside and buy-side analysts. If you are interested in participating, please contact us at the Investor Relations contact information.

That concludes my remarks. I would be happy to entertain any questions anybody might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Kevin Cole, Credit Suisse.

Kevin Cole - Credit Suisse - Analyst

Good morning. Just over the Mancos today. So on the two test wells are you expecting reserves in line with the 68 BCF that you realized in the past? Or highlighted on slide 31 as well.



David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Yes, from a reserve perspective, Kevin, we are not comfortable disclosing anything based on the terms of our confidentiality agreement. I would say that drilling and everything have gone very much according to plan to date, but beyond that I am really not comfortable commenting on specifics, reserves, or anything else.

Kevin Cole - *Credit Suisse - Analyst*

Have you provided the well technology like the expected length of the lateral and the number of frac stages you are going to use?

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

We have not.

Kevin Cole - *Credit Suisse - Analyst*

Okay. And back to the original 74,000 acres, what is the status of the BLM approval to allow you to start drilling wells there as well?

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Yes, we have six permits that have been approved. Two are what we would consider to be ready now. Four of them had conditions of approval which we felt were overly onerous. In a nutshell, basically they are requiring us, or trying to require us, to do a whole bunch of environmental studies which are well beyond the scope of the drilling activity we are proposing. And so we are working with the BLM really trying to get a couple of those conditions removed.

We could drill the wells and cooperate with those conditions, but I think they are a very large overreach by the BLM. So we are trying to be careful about how we proceed with those but don't feel that some of those studies are necessary. So we are visiting with them to try to see what we can work out for an arrangement between us.

We are in the process of filing several more permits and, really, the intent is to have around 18 permits available by next spring in the Piceance Basin.

Kevin Cole - *Credit Suisse - Analyst*

Okay. And I guess -- sorry, to what you said there's two permits that could be ready to go?

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Yes.

Kevin Cole - *Credit Suisse - Analyst*

Are you willing to -- are you expecting to drill those this year as well?

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

We have not made a decision to do that yet. Probably will not.

Kevin Cole - *Credit Suisse - Analyst*

From where you sit today are those two wells, those locations looking to be in line with what we saw in 2011? Or are you thinking there may -- like more prolific [earth]?

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Well, I think the issue that is going to affect productivity and reserves really comes down to lateral length and frac stages, your earlier question. I think we would anticipate drilling these next wells that we drill with longer laterals probably 8,000 feet or 9,000 feet instead of the 4,000 to 5,000 that we drilled in late 2011. And 30 to 40 frac stages instead of 20-ish like we did last time, and would expect a proportionate increase in reserves associated with that.

We have not finalized our specific well procedures for those wells yet. We just got the permits and we are not prepared to drill those yet. But I would expect we have a little bit different procedure than last time.

Kevin Cole - *Credit Suisse - Analyst*

That's great. Thank you. Sorry, one last question and then on where the general play -- [I saw] the general Mancos, where are we at in determining the proper acreage spacing from 160 to 80 to eventually 40?

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Good question. Some of the offset operators are continuing to talk about their results. In particular I think you might want to review some of WPX's public information. They don't disclose specifically what they say their anticipated spacing is, but if you look at their resource recovery per acre it is significantly higher than what we are disclosing.

So I can't specifically answer what others are thinking about spacing other than to say it is the same rock basically. So if they are projecting a lot higher reserves per spacing unit or per acre then they have to be looking at reduced spacing that is quite a bit tighter than what we're showing currently.

Kevin Cole - *Credit Suisse - Analyst*

Okay.

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

But WPX has some good information on that and could answer some of your questions.

Kevin Cole - *Credit Suisse - Analyst*

Sorry, one last E&P question. On one of your last E&P slides you indicated that you are in the process of looking to acquire more oil property.



David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Yes, not so much acquire, but in a more -- maybe acquire some leasehold and drill some prospects. Powder River Basin in particular is a very mature oil basin that still have some good opportunities left, particularly in the oil price ranges \$80, \$90, \$100. And so we are looking at those. And there is a chance we may drill up to three wells yet this year in the Powder River Basin.

Kevin Cole - *Credit Suisse - Analyst*

Great. Thank you.

Operator

(Operator Instructions). Chris Ellinghaus, Williams Capital.

Chris Ellinghaus - *Williams Capital - Analyst*

Do you feel this quarter is indicative of where you are headed in terms of your coal run rate?

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

I would say it pretty much met expectations. It wasn't anything unusual in the quarter.

Chris Ellinghaus - *Williams Capital - Analyst*

Let me rephrase that. Do you feel like you have completed the ramp-up of the turnaround and the improvement in margins?

Tony Cleberg - *Black Hills Corp. - EVP and CFO*

The improvement that we saw this quarter we are probably not going to see that kind of improvement consistently. So this was a big step function this quarter and we were up \$1,8 million on operating income.

But we hope to continue to get a little bit of improvement out of that.

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

And we will keep focusing on efficiencies, but all of our staff reductions and production levels and all of those things are largely completed.

Chris Ellinghaus - *Williams Capital - Analyst*

And given the quarter for oil's perform -- or E&P's performance, have you got any update on your thinking about how negative E&P can be on a continuing basis?



David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Not really. I think if you look at E&P's results, they are not really different from what our expectations were and continued results from E&P in that range are included in our guidance range, if that answers your question.

Chris Ellinghaus - *Williams Capital - Analyst*

On the corporate level, should we be seeing on a whole the corporate drag slightly increasing over time as you complete -- as you go through the construction phase on Cheyenne Prairie?

Tony Cleberg - *Black Hills Corp. - EVP and CFO*

I don't think so. The big improvement in the corporate line this year is really the interest expense reduction. So --.

Chris Ellinghaus - *Williams Capital - Analyst*

So, I'm just thinking as you go through the construction phase on Cheyenne Prairie that interest expense will start to run up a little bit more.

Tony Cleberg - *Black Hills Corp. - EVP and CFO*

It probably will. But most of it should be recoverable. So the interest expense will increase, but the way the riders work is it should show up in operating income.

Chris Ellinghaus - *Williams Capital - Analyst*

And assuming that South Dakota approves the rider.

Tony Cleberg - *Black Hills Corp. - EVP and CFO*

Yes, that's our assumption.

Chris Ellinghaus - *Williams Capital - Analyst*

Okay. Thanks.

Operator

(Operator Instructions). At this time we have no further questions. And I would now like to turn the call over to David Emery for closing remarks.

David Emery - *Black Hills Corp. - Chairman, Pres., and CEO*

Thank you. Thanks for attending the call this morning, everyone. We appreciate your continued support and your interest in Black Hills. Enjoy your day. Thank you.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect and have a great day.

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