Q1 2013 Earnings Call

Company Participants

- Bette Jo Rozsa, Managing Director Investor Relations
- Brian Tierney, Executive Vice President and Chief Financial Officer
- Nick Akins, President and Chief Executive Officer

Other Participants

- Ali Agha, Analyst, SunTrust
- Anthony Crowdell, Analyst, Jefferies & Company
- Dan Eggers, Analyst, Credit Suisse
- Greg Gordon, Analyst, ISI Group Inc.
- Julien Dumoulin-Smith, Analyst, UBS
- Michael Lapides, Analyst, Goldman Sachs
- Stephen Byrd, Analyst, Morgan Stanley
- Steven Fleishman, Analyst, Wolfe Trahan

Presentation

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the First Quarter 2013 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later we will conduct a question-and-answer session. Instructions will be given at that time. (Operator Instructions) And as a reminder, today's conference is being recorded.

I would now like to turn the conference over to our host, Ms. Bette Jo Rozsa. Please go ahead.

Bette Jo Rozsa {BIO 16484334 <GO>}

Thank you, Trisha [ph]. Good morning, everyone, and welcome to the first quarter 2013 earnings webcast of American Electric Power. Our earnings release, presentation slides and related financial information are available on our website at aep.com.

Today we will be making forward-looking statements during the call. There are many factors that may cause future results to differ materially from these statements. Please refer to our SEC filings for a discussion of these factors.

Joining me this morning for opening remarks are Nick Akins, our President and Chief Executive Officer, and Brian Tierney, our Chief Financial Officer. We will take your questions following their remarks.

I will now turn the call over to Nick Akins.

Nick Akins {BIO 15090780 <GO>}

Okay. Thanks, Bette Jo. Overall, we had another good quarter and a solid start for the year, coming in at $0.75 a share on a GAAP basis and $0.80 per share on an operating basis compared with $0.80 per share for both GAAP and operating last year. The difference between GAAP and operating this year is primarily due to a storm change deferral that was reversed because of a law change in Virginia. So we'll talk about that a little bit later on, Brian will, I am sure.

But the big news is that we increased our dividend by 4.3% or $0.02 to $0.49 per share this quarter, which is our 412th consecutive quarter of paying a dividend. The real story here is the confidence that our Board and management team have as we set a firm foundation and strategy for continued growth. In our view, AEP is a company that is emerging from one of reacting to major issues such as Ohio regulation, environmental requirements and plant construction risk to a company that is quickly moving to a place where we can truly define a path for growth. Frankly, this is pretty refreshing to the management team and our employees.

We have a distinct opportunity to effectively allocate capital, control our costs through thoughtful and sustainable decision making. We allocate and optimize spending through our repositioning initiative and make solid investments in our operating companies, grow our transmission business and transition our fleet and generation resources, as well continue the formation of our competitive business for the corporate separation. All of this is to achieve a financial integrity and objectives that we set forth in the February Analyst Day meeting and achieve a growth rate of 4% to 6% on a long-term basis. So we're committed to that.

We've made much progress during the last quarter, but before going into those areas, let me first discuss what we've seen during the first quarter regarding the economy and customer demand. Brian is going to go into this in a lot more detail, but I just want to say that since the third quarter of last year, we see -- we continue to see weakness in the manufacturing industrial sector of our service territory economy. I think that's true for the country and in fact the world. Primary metals continues to be weak, but offset in our territory by the oil and gas activity in the Eagle Ford and Utica Shale areas. Those are probably the saving grace of keeping our industry also at where they are at. However, we are now also seeing improvement in the commercial and residential sectors, including increases in customer account. We continue to believe as the economy improves, our service territory is well positioned because of the energy-related activities in our service territory and will benefit as a result.

Overall, customer load declined slightly quarter-to-quarter, but this is mitigated somewhat by the leap year difference between this year and last year, but as we said earlier in the year, we continue to believe customer load will remain essentially flat for the year. This being the case, we are making advancements in other areas as we move forward to make sure that we are addressing some of these areas to ensure that we have a financial growth that we've talked about previously.

First in transmission, we remain our plan for continued growth and earnings contribution from our transmission business of $0.14 per share this year moving to the $0.36 per share in 2015 that we discussed earlier in the February Analyst Day. The pioneer project received Indiana Utility Regulatory Commission approval and we'll be moving forward with construction. A settlement agreement in Missouri related to the public utility status for our Transource Missouri joint venture, a transfer of property and the ability to own and construct has been filed in Missouri and we are awaiting approval there. Meanwhile, FERC related to Transource, the ALJ approved the rate and cap structure for this project. So we await the FERC commission approval for that as well.

Additionally, our Transcos continue to invest in our state footprints to enhance service reliability for our customers and are doing a great job in that respect. The recent FERC orders concerning order 1000 compliance impacting such areas as there are right-of-first-refusal, cost allocation in other areas haven't altered our strategy regarding transmission development and haven't also not changed our reported investment forecast that we provided earlier.

Other regulatory and legislative activities continue according to plan. Ohio has reaffirmed its commitment to the path we set previously for AEP's corporate separation and transition toward a competitive market. We recently received the final commission order regarding corporate separation, and together with final orders on the ESP, capacity and corporate separation, we are set to move forward from the Ohio perspective. At FERC, we await the orders regarding Ohio corporate separation, the Mitchell-Amos transfer, the pool termination and APCo-Wheeling merger, which we expect to have by Monday, which is the statutory deadline for the order. We did file a supplemental settlement agreement as well with -- and settled the relevant issues with the major parties in the case.

Cases are also filed in Kentucky, West Virginia and Virginia to complete the transfer of the Amos and Mitchell units to APCo in Kentucky. We expect the orders on these transfers in the June, July timeframe. These units are being transferred at net book value. They are fully controlled and will replace the capacity payments that these customers are already making through the existing pool. Even with lower gas prices, the units are of value to Kentucky and APCo customers, they are located in those states and much of the coal supply comes from these states as well. So the Mitchell and Amos units continue to be even more of a value in today's gas market for APCo and Kentucky customers.

Moving on, I'd like to refer you to the page four of the presentation, which is probably one of my favorite dashboards. I always call it the equalizer graph, but it shows the progress we are making in the various jurisdictions, but I want to focus on a couple of them. As you might recall from February Analyst Day presentation, I discussed primarily the regulatory lag issue in Indiana. And if you look at that graph ahead of 7%, I think that's probably what it was last time we reported.

But I do have some positive news to report. We have -- the Indiana legislation that I discussed previously that included shortening up the regulatory lag and as well providing for a forward-looking test year, that actually did get through the House and the Senate and it's at the Governor's desk. It actually went to the Governor's desk yesterday and he has 10 days to sign it. We certainly expect that to happen. So that's some very good news addressing the regulatory lag issue that we had talked about previously.

And then when you look at SWEPCo, SWEPCo has Turk operational now. So AFUDC is falling off and we're now putting that plant into rates and the central issue around that at this point is that is the Texas case. Those hearings are complete in May. We expect an ALJ recommendation, and in June, the PUCT order should come about and that order will have rates retroactive back to January 29. So we should see that one pick up as well. So those are the two that we're very much focused on right now.

So we continue to also move forward on the EPA related mandates such as mercury HAPs, MACT and others as we transition our fleet with the planned retirements of over 5,500 megawatts during 2015-2016 timeframe and retrofit or refueling of 11,000 megawatt at a cost of around $45 billion over the 2012 to 2020 time period. About one third of the 45 billion are cost expectations related to the water and coal combustion residual activities. So we're very interested in the EPA's proposed rates -- proposed rules that were just released.

Most of the eight options in the proposed water effluent rule are largely in line with expectations, particularly the assumption that the coal combustion byproducts will be regulators and non-hazardous waste. However, there are some extreme options that are based upon emerging technologies and require additional bottom ash retrofits. So our comments will reflect our concerns that these requirements are not warranted.

Our repositioning initiatives continue and I am very pleased with the progress. We've engaged our workforce to redefine processes and resource requirements to achieve efficiencies and redeploy resources for growth. Lean activities have been initiated at our power plants. They continue to go through our power plants and then we also have reviews continue in areas such as IT and supply chain. These sustainable savings continue to keep us on track for the earnings targets we laid out for you in February, but even more important, engaged our employees to embrace a cultural change that will sustain us toward our path for growth and will benefit our customers, employees and shareholders.

This year we have initiated significant cultural review of our company to make sure that we do have an engaged workforce around those areas and strategic objectives that we have.

So at this point, I'll turn it over to Brian to give more details of where we stand. Brian?

Brian Tierney {BIO 15917272 <GO>}

Thank you, Nick, and good morning, everyone. Let's start on slide 5 with a reconciliation of this year's first quarter operating earnings to last year's. To begin with is very simple. First quarter operating earnings this year were $0.80 per share and last year's were also $0.80 per share. Items adversely affecting the quarterly comparison include a 2012 $0.05 effect of reversing a provision for an obligation to make certain contributions resulting from an Ohio order. That favorable item in 2012 was not repeated in 2013.

Off-system sales margins net of sharing were off by $0.04 per share due in large part to reduce capacity payments. The lower receipts from competitive retail suppliers and capacity sales in the RPM market account for about $0.05 per share and a decline in trading margin accounts for about $0.01 of the negative comparison. Offsetting these negative items by $0.02 per share are margins from physical sales of electricity, which were up 48%.

Later in the presentation, I will review a slide that demonstrates the competitiveness of AEP's eastern generation fleet even at relatively low market prices.

Customer switching and the related capacity treatment in Ohio had an unfavorable net effect on the quarterly comparison of $0.03 per share. This value reflects the loss of generation related margins on the switch load of an unfavorable $0.10 per share, partially offset by the capacity deferral provision of the ESP for a favorable $0.07 per share. As of March 31 of this year, approximately 53% of our customer load in Ohio had switched with about 3% having provided notice of intent to switch. As of December 31 of last year, those numbers were about 51% and 3% respectively.

Allowance for funds used during construction or AFUDC was off $0.03 per share in 2013, primarily due to the successful start up of the Turk Plant in December 2012. This resulted in a cessation of AFUDC on that facility.

Operations and maintenance expense net of offsets were up slightly, adversely affecting earnings by $0.02 per share versus the 2012 period. The higher expense levels were driven primarily by additional spending associated with scheduled generating plant outages. The quarter-on-quarter comparison include rate changes, which were favorable by $0.07 per share in the first quarter. This improvement in earnings through rate activity occurred in multiple jurisdictions.

Finally, weather was favorable by $0.10 per share when compared to 2012, primarily due to the unfavorable conditions across all of our jurisdictions last year with the exception of Texas whether weather was comparable. Weather was favorable $78 million versus last year's quarter, but much closer than normal this year. Remember that when we prepared our forecast and guidance for this year, we assumed normal weather. In summary, the adverse effect of several Ohio related items, lower AFUDC due to Turk going commercial and a slight increase in O&M were essentially offset by rate changes and a return to normal -- to more normal weather.

Turning to slide 6, you'll see that the first quarter's total weather normalized retail load was down 1.5% compared to last year. Nick mentioned the effect of the leap year and you are all aware that this year's first quarter had 90 days compared to last year's, which had 91. On a comparable day's basis, total overall load would have been only negative 0.4% rather than the actual 1.5%. Much of the results for this year's comparison were driven by the industrial sector, which was down 6% compared to last year, and I'll talk more about the industrial sector on the next slide.

In contrast to industrials, our residential and commercial sectors, both showed growth over last year's first quarter. The residential class was up 1.3%. Residential customer accounts were positive compared to last year's first quarter and weather normalized average usage per customer was positive 1.1%. This is the first increase in average residential customer usage since the second quarter of 2011.

The commercial customer class was up 0.5%, and you may recall that 2012 was the first year of commercial sales growth since 2008. Employment growth tends to be a strong indicator for commercial sales growth and that held true for AEP in the first quarter in that the areas where we saw the greatest employment growth also experienced the largest increases in commercial sales. AEP Texas experienced employment growth of 2.8% and had an increase in quarterly commercial sales of 3%. AEP Ohio experienced employment growth of 1.6% and had an increase in commercial sales of 2.2%. These are the properties experiencing growth associated with shale gas development; the Eagle Ford and Texas and the Utica and Ohio.

Let me take some time here to provide some economic indicators for AEP service territory, which continue to experience comparable growth for the U.S. in terms of GDP growth and employment. For the quarter, GDP growth and AEP Western footprint was 3% compared to the 2% growth in the Eastern part of AEP service territory, and today's estimated 2.5% growth that has just come out for the U.S. It's worth mentioning that the effect of the sequestration and fiscal tightening from Washington is having less of an effect on AEP service territory relative to the U.S. Many of the cuts so far have been related to defense spending, which is more concentrated on the (inaudible) and less pronounced in AEP's Midwest footprint.

Employment growth for AEP at 1.5% was slightly favorable when compared to the U.S. as a whole at 1.4%. The unemployment rate for AEP service territory is currently at 6.9% compared to the 7.8% or so for the U.S. This is the first time the unemployment rate has fallen below 7% in AEP service territory since the end of 2008.

Turning to slide 7, you will see that four of our top five industrial sectors experienced negative load trends for the first quarter. A significant contributor to the 6% decline in overall industrial sales, as Nick mentioned, was related to the primary metals sector, which was down nearly 17% compared to last year's first quarter and much of that decline was associated with our largest customer. That company shut down a third of its production as a result of soft market conditions and filed for bankruptcy in the first quarter of this year. If you exclude this customer, total industrial sales would have been down 3.7% for the quarter.

Chemical manufacturing was down 4.4% for the quarter. It's important to note that last March one of our largest customers in Texas who was a cogeneration facility chose not to generate last year and instead purchase all of their electricity from SWEPCo. If you exclude this customer, chemical manufacturing would be down only 2.7% for the quarter. Similarly, petroleum and coal products were down 3% for the quarter, but this was influenced by two refineries that conducted temporary maintenance on their facilities in the first quarter. Excluding those two customers, petroleum and coal product sales were actually up 10.8% for the quarter, led by a new refinery that came online last summer in Texas.

The mining sector excluding oil and gas was down 2.9% for the quarter. Weak demand from utilities and exports have had a significant impact on coal mining operations in our service territory and you'll note that 90% of AEP's mining base is in our Eastern regulated operations. The paper manufacturing sector was essentially flat for the quarter with increases in Ohio sales, being largely offset by decreases in our Western regulated properties. In summary, the industrial sector continues to face challenges as the country tries to maintain its economic momentum.

When we originally put slide 8 together, we left the old title on it and later realized that it was not descriptive of what actually happened in the quarter. The old title was coal to gas switching and the new title that we have here gas to coal switching much more accurately describes what happened during the quarter. This slide breaks out capacity factors for our East and West coal and natural gas fleets. In both regions, coal capacity factors were up for the quarter, and in both regions, natural gas capacity factors were down significantly. In gross terms, AEP generated 34% less electricity subsidy from natural gas and 9% more from coal-fired generation. These results are related to two factors. First, the price of natural gas increased significantly, and second, our coal-fired generation fleet is very competitive even if gas prices below $4.

Henry Hub natural gas prices increased 41% quarter-over-quarter, NAP's delivered natural gas costs increased 35%. By contrast, AEPs cost of delivered coal only increased 7%. This is against the backdrop where AEP generation hub peak pricing increased 15% and around the clock pricing increased 14%. Dark spreads widen considerably while spark spreads compressed.

Turning to slide nine, we'll see that the impact of a modest increase in prices for energy had on a very competitive AEP East generation fleet, even when Henry Hub and delivered prices for natural gas are as well as the mid $3 range. On this slide, we've drawn the 2012 and 2013 supply stacks for AEPs Eastern generation fleet, which accounts the most of our system sales volumes. You'll see that in the first quarter of 2012, at an average around the clock price of $28.65 per megawatt hour, nearly 16,000 megawatts of capacity were in the money. By contrast, in the first quarter of 2013, and an average around on the clock price of $32.65 per megawatt hour, nearly 20,000 megawatts of capacity were in the money.

The 14% increase and around the clock pricing accounted for 24% increase in in-the-money capacity for AEP, even at these relatively low prices for electricity and natural gas. This is a very competitive generation fleet.

Let's now take a look at this year's financing activities on slide 10. During the first quarter, we made a significant amount of progress in securing new funds in an attractive interest rate environment. The company is using this capital to fund its investment program and bolster its liquidity position.

Specifically in February, we closed on the $1 billion 27 months delayed-draw term loan that will provide us with an interim financing as we capitalize the Genco in refinance the AEP Ohio. At the same time, we also closed on the amendment of our two core revolving credit facilities. This included the one-year extension of both facilities taking the new termination dates to June of 2016 and July of 2017. The amendment also increase the capacity for the June 2016 facility by $250 million, bringing our total revolver capacity to $3.5 billion.

TMC issued $200 million of senior unsecured notes and Ireland issued $250 million of senior unsecured notes. In all, we obtained $1.5 billion in new debt financing at an incremental $250 million in credit revolver capacity. (inaudible) emerging activity will be highlighted by the issue -- issuance of securitization and Appalachian Power. These two financings are expected to close this summer and should bring in a combined $655 million.

I really like to spend a lot of time with me on slide 11. This slide demonstrates the financial health of the American Electric Power and it's strong as it has ever been.

Our debt-to-total capitalization at 55% is at its lowest level in more than 10 years. Our credit metrics FFO interest coverage and FFO to total debt are solidly BBB and Baa2. Our qualified pension funding is now 94% and as we approach 100% funding, we continue to derisk the plan with 50% of the planned assets now invested in long duration fixed income instruments.

Over the past three years, we have invested $1.1 [ph] billion into the plan. This is good news for the current and future retirees as well as investors. Finally, with the increased size and tenor [ph] of our credit facilities, with the delayed draw term loan facility and with the modest uses of liquidity, the company's net available liquidity is as strong as it has ever been at $3.7 billion.

I can assure you that the financial strength demonstrated on the slide has not happen by accident. The management and Board of this company have been very purposeful in building the company's financial strength. Whether through careful capital allocation, O&M discipline was thoughtfully accessing the debt capital markets, we've been very focused on ensuring that the company has the liquidity and strength that needs to prosper in any variety of market and business conditions. I want you to know, we will continue to do so.

Let me close by saying that we are remain on track to achieve 2013 annual earnings per share in the guidance range that we announced on February 15 of $3.05 per share to $3.25 per share. We are maintaining the discipline around operations and maintenance expenses that you've come to expect from us. Lisa Barton and her team in transmission are on track to deliver $0.14 per share of earnings this year, up from $0.09 per share last year. The investment in critical transmission infrastructure should allow us to do earnings from that segment to $0.29 per share next year.

Earlier we provided some detail coverage of load. We are encouraged by the recent experience in our residential and commercial customer classes and are concerned by the quarterly results from industrials. Our guidance for the year factored in overall load growth of five-tenths of a percent. The industrial results for the quarter put us behind on load growth for the year, but not enough to put guidance in jeopardy.

Balance of your gas and power prices are higher than liquidated values for 2012. Delivery cost for coal are up, but much less than power prices. This widening of the dark spread should help Off-system sales margins, but the low prices paid by competitive retail suppliers for capacity and lower RPM pricing will continue to have its negative impact.

Our regulatory plans are on track relative to our assumptions and guidance. We have a positive track record of putting capital to work for the benefit of our customers and then earning return on that investment by efficiently getting it into rates. This year should continue that record. Of our assumed rate recovery, the majority has already been secured.

Finally, in terms of financial strength, I'll take you through some metrics that demonstrate the company is in peak financial condition. It is this strength that gave the Board of Directors the confidence to raise the dividend payout ratio and then to quickly follow on with an increase in the dividend itself. With the dividend increase, AEPs is now nearly 4%. That when combined with our stable regulated business profile and steady earnings growth, provide a total shareholder return proposition in the 8% to 10% range annually.

In summary, the company is financially strong and we're well on our way to meeting our stated goals.

With that, I'll turn the call over to the operator for your questions.

Questions And Answers

Operator

(Operator Instructions) And our first question comes from the line of Greg Gordon with ISI.

A - Nick Akins {BIO 15090780 <GO>}

Hi, Greg, how are you?

Q - Greg Gordon {BIO 1506687 <GO>}

Good, good. So two questions. One, when I'm looking at the slide, where you talk about gas to coal switching. Can you talk a little bit about the types of coal that you're burning and what the sort of the breakeven cost is between gas and coal of the types of coal you are burning that whether it's cap coal Illinois Basin PRB that's allowed you to switch back?

A - Nick Akins {BIO 15090780 <GO>}

Yes. Typically it's that cap coal and when you look at the cost breakpoint on delivered cost basis, when you're in that 325 to 350 range on natural gas, you start to see the switching occur. And based on natural gas prices, they obviously we've seen just -- just basically 108 degrees, you have the direction. That's a good thing.

And then I think the real issue is that, we've been able to change our contracting methodologies, particularly on the coal side and the natural gas side to be flexible enough to adjust our generation either way, and it's worked out positively for us.

Q - Greg Gordon {BIO 1506687 <GO>}

Our breakpoint, then on(inaudible) heard some from other companies, is that because of your delivery cost advantage being you are the mine mouth on the river?

A - Nick Akins {BIO 15090780 <GO>}

Yeah, that's right. We have distinct advantage from the river operation standpoint, and then also the mine mouth aspects of this well. So well that's a well delivery.

A - Brian Tierney {BIO 15917272 <GO>}

Hey, Greg, when you look at slide nine in our presentation and see how our supply stack lines up and you compare those prices to what natural gas prices where. Into our delivered natural gas was only 3.78 this year and look at how much more of our capacity goes in the money, even at that low natural gas price. So it's a very competitive fleet that we have. And I think we've demonstrated that quarter-on-quarter difference this year to last, even a pretty low natural gas prices.

A - Nick Akins {BIO 15090780 <GO>}

And we've also been able take the Northern OPCo, because of all of our units were well controlled [ph].

Q - Greg Gordon {BIO 1506687 <GO>}

Gotcha. Next and last question. Page 18, you go through a line-by-line comparison of what you did in your off-system sales business. It's clear that you obviously, you sold a lot more power and get more money. Can you take us through why the big deltas in the other areas and what -- those?

A - Brian Tierney {BIO 15917272 <GO>}

Yeah. So, capacity payments were comprised of two items, one is the difference in the credits price that we're getting in Ohio. So considerably less pricing there. The other was capacity that we were getting from the RPM market. So in the first quarter of 2012, the RPM volume that we sold was 1300 megawatts at the RPM price of $110 a megawatt day for about $16 million. And in 2013, the volume was about 640 megawatts that we cleared at a price of about $16 a megawatt day for $1.8 million.

So those items comprise the capacity difference, the marketing and trading was just lower realized volumes from that and you see that the sharing stayed about the same year-on-year and that resulted in the difference in total off-system sales.

A - Nick Akins {BIO 15090780 <GO>}

Yeah, really the deviations and we've got the capacity payment difference, that's right, yeah.

Q - Greg Gordon {BIO 1506687 <GO>}

Thank you, gentlemen.

Operator

And our next question is from the line of Dan Eggers with Credit Suisse. Please go ahead.

Q - Dan Eggers {BIO 3764121 <GO>}

Hey, good morning guys.

A - Nick Akins {BIO 15090780 <GO>}

Hi, Dan, how are you?

Q - Dan Eggers {BIO 3764121 <GO>}

Good. Just a follow-up on Greg's question. (Technical Difficulties) would have been even further, yeah, of the 3800 megawatt of additional economic generation in the first quarter. How many more megawatts are now economic as the curve is moved that much higher?

A - Brian Tierney {BIO 15917272 <GO>}

You mean for the balance of the year?

Q - Dan Eggers {BIO 3764121 <GO>}

Yeah.

A - Brian Tierney {BIO 15917272 <GO>}

It's considerable, Dan, it's probably another 3,000 megawatts.

A - Nick Akins {BIO 15090780 <GO>}

Dan, Keep in mind the part that kicks up on that curve is primarily peaker units that we don't expect to run that anyway. So you're getting much deeper into the base load capability of the system now and this -- and also keep in mind, this is the entire fleet perspective, not just the part that's going to be unregulated in the future.

A - Brian Tierney {BIO 15917272 <GO>}

And you could even do it yourself on this slide, you could draw on the balance of the year prices for either AP hub or AEP GEN hub, whichever you like and feel that crosses the line.

Q - Dan Eggers {BIO 3764121 <GO>}

And when you guys --

A - Brian Tierney {BIO 15917272 <GO>}

Now, go ahead.

Q - Dan Eggers {BIO 3764121 <GO>}

When you guys talk about the coal inventory situation, you have the normalization, are you guys assuming to get the day's cover using a historic burn rate or using some sort of modified lower burn rate to figure out the number of days in inventory?

A - Brian Tierney {BIO 15917272 <GO>}

That's a -- it's a full load burn rate. So it's the units that we have at full load burn, those numbers of days. So the historical measure that we've used.

A - Nick Akins {BIO 15090780 <GO>}

Which we've done pretty well on managing our inventories during this process and that goes with the flexibility issue. We're still at 43, 44 days of inventory. So (inaudible) into the summer peak period in a pretty good fashion.

Q - Dan Eggers {BIO 3764121 <GO>}

Okay. And I guess it's on load, you also give a lot of detail, but against the plan for this year relative to pretty slow start in the first quarter even with your normal, little better-than-normal weather. What gives you guys confidence that you're going to make catch-up over the remainder of the year to get to that positive demand growth and you hearing comments from your industrial customers who are out of more clarification when they're going to back on?

A - Brian Tierney {BIO 15917272 <GO>}

I mean, I think the story that you've see on those slides kind of mail, the residential and commercial are up and we're seeing the difficulty in industrial. We may not make the five-tenths of load growth that we forecasted for the year, but your earlier question highlights an offset to that and that if off-system sales are up a bit, because prices are up even from when we came around February 15 that puts more of the fleet and the money and that should help offset some of the load challenges that we might have through the balance of the year or so.

A - Nick Akins {BIO 15090780 <GO>}

We're also yet to look at the mix, you have to look at the mix of the customers too, if you have residential and commercial improving the margins associated with those customers are higher than your industrial customers. So it's not a one to one top of the deal that you're looking at. And that's why till that we need the industrials manufacturing to continue to improve and hopefully that will occur and a lot of (inaudible) sustain in the third quarter of the year, but it's a matter of making sure that's sustainable so that the commercial and residential can continue to drive.

In the past, our residential and commercial have been really struggling themselves and now we're seeing an uptick there and that's what making the difference. And also I think the weather was better than last year, but the weather was still normal.

Q - Dan Eggers {BIO 3764121 <GO>}

When you guys.

A - Brian Tierney {BIO 15917272 <GO>}

Go ahead Dan.

Q - Dan Eggers {BIO 3764121 <GO>}

I mean, when you guys see weather normalized always complicated, when you have your big deltas from one period to another. When you look at residential, you've given the big move after having not trended well for so long. Are there underlying commentary you're seeing that gives you confidence if that holds rather than just being kind of a fluctuation to what happened in weather for the period?

A - Nick Akins {BIO 15090780 <GO>}

Yeah, I think customer accounts. I think always -- may be the 25 year olds are probably moving out of house, but we're seeing customer accounts go up, we're seeing construction improved. But as said, that underlying industrial primary metal side, but that's all tied to the world market. So, we're watching that very closely. Brian.

A - Brian Tierney {BIO 15917272 <GO>}

Dan, we get worried about that when you have large weather affects in the period. And relative to normal, we were about $10 million positive than normal weather. So we forecasted normal for the quarter, we had normal weather significant compared to the last year, but compared to normal trade on top of that. So we're not concerned that weather is impacting those numbers in any significant way.

Q - Dan Eggers {BIO 3764121 <GO>}

Great. Thank you, guys.

Operator

The next question is from the line of Anthony Crowdell with Jefferies. Please go ahead.

Q - Anthony Crowdell {BIO 6659246 <GO>}

Hey, good morning. I'm not sure how much color you want to give on this, but you mentioned before some of the cost advantages you have with River Operations or delivering coal via barge versus rail. I was wondering, if you could talk about that or just help us for modeling purposes to assume what the cost advantage would be?

A - Nick Akins {BIO 15090780 <GO>}

Yeah, I think the main aspect of this is that -- the main aspect of this is that we are with the River Operations, we deliver coal to our power plants at cost. And then secondly, we also from a mine mouth perspective, these mines are relatively closer there. So if they are any railroad movements associated with it. They can still have high rates, but they're very short hauls. And an overall, the position that AEP has, because of our buying stream, because of the large amount of tonnage that we purchase from all across the country. That really imputes to practically the $2 per ton advantage. So, when you look at that across the entire fleet is pretty good advantage.

Q - Anthony Crowdell {BIO 6659246 <GO>}

I know, some competitor talking about the flexibility and like the whole coal supply chain, when gas prices really dropped and the cost of -- not only the minor orders but the rails are very I guess flexible. I mean do you see a change with gas price now about four hours, if maybe them trying to get back to previous levels like rates at previous levels?

A - Nick Akins {BIO 15090780 <GO>}

You're talking about the rail roads?

Q - Anthony Crowdell {BIO 6659246 <GO>}

Yeah, or the coal mining (inaudible)

A - Nick Akins {BIO 15090780 <GO>}

No, we don't see that. We have long term contracts in place for coal supply from the delivery perspective. And there's plenty of coal out there. I mean we -- in '07, we were at 80 million tons of coal a year, we're at around 54 million tons this year. So there is a lot of -- a lot of ability to pick up production. So I think we're in a good shape.

Q - Anthony Crowdell {BIO 6659246 <GO>}

Great. Thanks for the time guys.

Operator

And our next question comes from the line of Stephen Byrd with Morgan Stanley. Please go ahead.

Q - Stephen Byrd {BIO 15172739 <GO>}

Good morning.

A - Nick Akins {BIO 15090780 <GO>}

Hi Steve. How are you doing?

Q - Stephen Byrd {BIO 15172739 <GO>}

Great. I wonder if you could talk a little bit about how your plans for tracking your merchant generation, I guess when it goes merchant. And we've had a power price up list, but generally the historic revenues had on those assets relative to the market, there's a delta between the two. As you think about your growth prospects, how do you think about that delta and what you would assume you could achieve in getting long-term contracts for your higher generation if you're -- and following my question on that delta?

A - Nick Akins {BIO 15090780 <GO>}

Yeah. We just keep in mind, the only ones that are going to survive of this process after retirements will be that the 9000 megawatts of generation, all fully controlled, all welled in the market. And when we look at it even with the capital piece of it, in the future it's still looking very, very attractive.

So, it's a matter of how comparative your generation is knowing from marginal cost perspective within obviously the amount of capital left in. And I think we're going to wind up in great shape there. As far as the hedging practices associated with it, we -- that's why we're putting our wholesale shop has been in the market for years from a long-term customer perspective.

And those discussions were occurring now in preparation for the separation of generation. So that's moving along, I think obviously our main intent is to make sure that this generation looks as regulated as it can. We anticipate hedging about 30% of it with retail. Once we have the generation in our retail mix where our -- compare the retailer can use that generation. We'll be able to give the longer-term contracts and those types of things as well. So there is -- giving this generation over something that's incredibly important for us, but also will help us in terms of those hedging practice. So, we have great relationships with munis, co-ops, long-term customers on our third-party basis and we'll continue to advance those.

Q - Stephen Byrd {BIO 15172739 <GO>}

Okay. So, as we look at that that's very helpful color. If you look at the four curve today, does that pose any headwind to achieving that 46% as you move from the current contracts, you have two market or is that sort of already generally anticipated as you think about your overall growth?

A - Nick Akins {BIO 15090780 <GO>}

Yeah it's already anticipated with the 46% is generated from the -- remains the regulated fees, even in 2015 and this is unregulated, the 46% comes from that 86% that's still regulated and regulated jurisdiction, so and with transmission as well, so the 46% is looking pretty good.

A - Brian Tierney {BIO 15917272 <GO>}

Stephen, there is no large uptick associated with the newer capacity or energy prices within that 46% estimate.

Q - Stephen Byrd {BIO 15172739 <GO>}

Okay, that's very helpful. If I could just shift quickly to the dividend, got a really, really good increase here and as we look out your payout ratio, is happily fairly low. So it looks like you still have more flexibility. Could you just talk a bit generally about as you look forward here. I know you just gave us a good increase but folks are always thinking about more -- the payout ratio looks on the 14 basis is still below that 60% to 70% range. Could you just talk a little bit about it, how do you think that dividend over time?

A - Brian Tierney {BIO 15917272 <GO>}

That dividend increases already old news, isn't it?

Q - Stephen Byrd {BIO 15172739 <GO>}

Sure, it is.

A - Nick Akins {BIO 15090780 <GO>}

Whether we don't (inaudible). So our Board will continue to evaluate its dividend policy and there is no quarterly basis, when we look at it in and they did -- and it's probably the same answer I gave in February was that they continue to view dividend growth being in line with their earnings growth of the company, and they look -- in that 60% to 70%, so that we can track the regulated companies. We believe that we should be viewed as a regulated company, we still track to a discount to the regulators, which I don't understand that. But secondly, we want to move this company to a point where this is attractive at a premium to the regulated because of we spend a lot of time cleaning the decks here, we're clearing up the story of AEP and a lot of positive things are occurring. So I think we believe obviously, it remains the same, but something that the Board is very, very -- dealing with [ph].

Q - Stephen Byrd {BIO 15172739 <GO>}

Great. Thank you very much.

Operator

And our next question is from the line of Julien Dumoulin-Smith with UBS. Please go ahead.

Q - Julien Dumoulin-Smith {BIO 15955666 <GO>}

Hi, good morning guys.

A - Nick Akins {BIO 15090780 <GO>}

Hi, Julien.

Q - Julien Dumoulin-Smith {BIO 15955666 <GO>}

So, first quick question, perhaps a clarification if you will. On the industrial segment and sales, the decline in the first quarter here, you mentioned a bankruptcy, is this a permanent reduction at least from what you can tell, or how do you anticipate this playing out to the back half of the year and subsequent years?

A - Brian Tierney {BIO 15917272 <GO>}

We're anticipating Julien, it'll continue to operate at there, two thirds of capacity through the balance of the year. We think there is -- obviously market conditions in aluminum are not very good. There is some political, well, I think to try and keep that plant operating associated with the jobs that are there. And I think that continue to operate at this two thirds level since last summer and we anticipate that they'll be that through the balance of the year.

A - Nick Akins {BIO 15090780 <GO>}

Some of this is driven through the primary metals driven by the world market. So we're going to have to see particularly Europe and then China things picking up there. But here in the U.S., the manufacturing capability is there. There are expansions going on and it's -- we have a list of future expansions that are occurring, that have been announced that many of them in our Western footprint or Eastern footprint has a manufacturing capability. We just need the economy to turn around and certainly the U.S., is a big part of making that happen.

I hope that after we get through all the tax issues and the budget issues and certainly the debt issues with Congress that the economy going to start to pick up with some faith that they can't invest. And when that happens and in particular, when the President decides what he's going to be relatively the Keystone Pipeline and all the other energy related infrastructure areas, the ADP service territory is prime, because of shale gas, because of coal, because of all of these resources that are indigenous in our foot print. We are manufacturing -- (Technical Difficulties)

Q - Julien Dumoulin-Smith {BIO 15955666 <GO>}

Great. Secondly here if you don't mind, now that you're further long in (inaudible). What are the key issues that you're identifying and how might you address those?

A - Nick Akins {BIO 15090780 <GO>}

Well, I think generally from the intervener testimony and others that there is -- they understand that the assets are very favorable, there are questions about whether we should go out for bid, which this is the case in our opinion that this is energy and capacity that the customers are already paying for. It's a transfer at net book. So effectively it's a rate base replacement for a capacity payment that was occurring before.

So, and when you evaluate our valuation, it's less than a new build and a long-term basis and even on a short-term basis today, it's a very advantageous for the customers in Kentucky and APCo territories. So, we have a strong message, the commission certainly is our view and we have discussions with the Governor's and others at their receptive. because they understand these states, they have coal-fired generation, they're located in those states. The supply of the coal comes from these states. We just deal late last year that kept some Virginia and Kentucky monitors at work.

Those are important socioeconomic factors to consider when you look at these types of assets. So, the cases move on, we'll see where they go and I think they could have discussions about the transfer process helping those but that to me, I think we're in very -- we have a very strong message.

Q - Julien Dumoulin-Smith {BIO 15955666 <GO>}

And then a quick last question here. You've talked before about your desire to grow transmission. Giving FERC 1000 tweaks on ROFR [ph], is that change the game plan here to that expand the map for you or is this more of a defensive prospective?

A - Nick Akins {BIO 15090780 <GO>}

I think it's in line with what our strategy has been, we've been for the development of competitive transmission, we've developed our Transource to the focus on achieving that critical mass within our service footprint of reliability type activities. But we are positioned to be with Transource, a strong competitive transmission provider in this country. So we continue with the joint ventures, we continue with the adjacent companies that we do business with, there is a lot of opportunity there. And we're also very careful about what we ask for incentives for. We ask for incentive structures relative to ROE based upon the way we perceive the risk of those projects. And I think the more transmission providers do that and are very solid and factual about what they ask for I think for good respond.

Great. Thank you for the time.

A - Nick Akins {BIO 15090780 <GO>}

Yeah. And keep in mind the transmission piece of it, the earnings is already projects that are in place with the ROEs approved and the structures approved. So, I'm going to check there too.

Operator

Our next question is from the line of Steven Fleishman with Wolfe Trahan. Please go ahead.

Q - Steven Fleishman {BIO 1512318 <GO>}

Yeah. Hi, good morning Nick. Couple of quick questions. Just first on the sales issue, it's kind of hard that exactly estimate the difference in margin between residential, commercial, industrial turn that into an overall number. So, I mean if you just look at the first quarter, where the residential commercial off industrial down a lot. Could you give us a sense of how you are on track versus budget there? On sales, so we can kind of get a sense for the year.

A - Nick Akins {BIO 15090780 <GO>}

Few slide, which I am looking for. Its 15. There give you some sense for how we were versus last year. If you look at how we're doing, we're behind a bit Steve, and I can get you the detailed numbers later. But as you can see, our $0.80 on top of the $0.80 whatever we lost in terms of that we made up for in weather -- and weather and rate changes. So, we can get to the detail later. But we're right on track for the year.

Q - Steven Fleishman {BIO 1512318 <GO>}

Okay.

A - Nick Akins {BIO 15090780 <GO>}

Margins are extremely lean on the industrial side.

Q - Steven Fleishman {BIO 1512318 <GO>}

Right. Yeah.

A - Nick Akins {BIO 15090780 <GO>}

And then -- so you're replacing it with and typically the margins for commercial customers are significantly higher than industrials and residential are significantly higher than commercial. So, it's a measure of what that is. We'll try to get you some additional information on that.

Q - Steven Fleishman {BIO 1512318 <GO>}

Maybe to ask another way. If the trend in Q1 continued for the rest of the year, where residential was better than your thought, but industrial was worse?

A - Brian Tierney {BIO 15917272 <GO>}

Yeah.

Q - Steven Fleishman {BIO 1512318 <GO>}

Will this be on track for the year then?

A - Brian Tierney {BIO 15917272 <GO>}

Probably -- that's going go a long way, it go a long way in mitigating the impact of the industrials. And keep in mind whatever is released from an industrial from the energy perspective, we're selling in the market as well. So, I think there are a lot of mitigating issues there.

See, when you combine that with what we're seeing in off-system sales and how we're on track for the rate changes, we're right on top of where we anticipated being relative to budget.

Q - Steven Fleishman {BIO 1512318 <GO>}

So kind of an a gross margin basis when you put all that stuff here on track?

A - Nick Akins {BIO 15090780 <GO>}

Great thing about the diversity of AEP, I mean from the regional footprint, but also the customer side, we typically are third commercial, industrial and residential and it's a good thing when that's happening out. What we have to watch for is the industrials were moving up largely recovered from 2007 by the second quarter of last year and then we started to see some movement down on industrial as well.

The commercial and residential, we're tracking down as well but what sustained industrial activity, the commercial industrial started to move up. So what we need to see is the industrial and commercial -- the industrial and manufacturing base continue to improve, so that we can have the sustaining quality of increased residential and commercial sales.

So that sort of cycle global one like the other. And we just -- and you're right in terms of the concerns that if we continue to see deterioration in industrial and manufacturing, it will have a tempering effect on the increases in the other two categories. So we're watching that very closely.

It is promising that customer counts moving up and the economy is starting to prosper in some areas, again.

Q - Steven Fleishman {BIO 1512318 <GO>}

Okay. One other general question. I think this is the first PJM capacity auction it will be and is not NFRR entity? And I'm just curious kind of if you have any thoughts on what to expect and what your inclusion might mean if anything for how much PLM to that long-or short?

A - Nick Akins {BIO 15090780 <GO>}

Well, you know, it's -- and it's not the first one, I think we've already been involved with one, we can -- we expect this, what to be pretty consistent with the last one, give or take near 10%. But it's -- I continue to be concerned about the way demand side management has an advantage over steel in the ground in terms of the capacity markets in that structure and that needs to change because, if you ever want to continue making long-term investments to ensure the stable supply of energy to our customers, we need to make sure that there is a structure in place that's compatible for all parts of resources.

So that's what I'm concerned about, within PJM, there is no long-term pricing structure for anyone to go out and build and construct and finance new capacity and we have demand side management that is bidding in just for a few hours during the year they don't have the same level of commitment. That's the issue within PJMs and that's really makes capacity market, it's hard to read.

Q - Steven Fleishman {BIO 1512318 <GO>}

Great. Thank you.

Operator

Our next question comes from the line of Michael Lapides with Goldman Sachs. Please go ahead.

Q - Michael Lapides {BIO 6317499 <GO>}

Yeah. Hey, guys.

A - Nick Akins {BIO 15090780 <GO>}

Hey, Michael.

Q - Michael Lapides {BIO 6317499 <GO>}

First of all congratulations. Because over the last two to three years, Nick, Brian (inaudible) management team have done a very, very good job of transforming AEP. I have one or two questions though just in terms of how you're trying to think strategically about both the non-regulated business and the regulated business. I'll start on the non-reg. And when you look at the portfolio and the size of the retail book, what you don't have is a lot of scale or diversity, meaning you don't have a ton of asset diversity, you have almost no regional diversification on the non-regulated side. And your retail business while growing is small relative to the industry.

And I'm just curious, any of the McKinsey [ph] guys running around your building at some point would probably hate to hear me use this reference. But if you had to plot your non-reg -- related business or consulting major cashcow or harvest or I think it was star for the growth businesses, how would you kind of think about that business strategically, long-term and your intend for it?

A - Nick Akins {BIO 15090780 <GO>}

Well, Michael, I've stated previously that we are regulated company and we're focused on being a regulated company, if we can make this comparative business look towards our regulated with the hedging associated with it, then that certainly help us focus on what we do with that business going forward.

And keep in mind too, that the fleet that's you're talking about is one of the larger unregulated fleets in the country will be 9,000 megawatts, it is centrally located within the area of PJM area, but it also, as you know, two thirds coal, one thirds gas, two thirds with fully controlled units that are well within the mining a third natural gas, which is going to be at -- probably at the market price. So, we see -- I mean we see this business, particularly if you look at it in its breadth, not just the matter of the generation margins and sales. On the retail side, we're focused on hedging that generation, focused on not megawatt hours, but margins and we're focused on the wholesale activity that we've been doing for years to be complimentary.

So the has a total package, but I think even if you look at the generation assets from sales, they are competitive in the market. So, I don't care if I have 50,000 megawatts in a market that I'm competitive or 2000. So it really is a matter of where these units stack up in the marketplace and they stack up well.

And then secondly, how you're complementing that business and what your focus is. If we wind up with a competitive business that looks like something our shareholders are interested in but doesn't provide the volatility that makes us look like a regulated utility. And that's fine. But, we'll have to get there and see where it takes us.

Q - Michael Lapides {BIO 6317499 <GO>}

Okay. On the regulated side, when you look across your service territory and you've done a good job of positioning the transmission side of the business to grow and kind of we all know that transmission has its challenges just in terms of the timeline of growth, but that's a more of a national issue, not company specific. But when you look at distribution and you look at generation, how do you think about where over the next 5 to 7 years your greatest rate base growth opportunities lie?

A - Brian Tierney {BIO 15917272 <GO>}

Well, I think the grace rate base opportunities are in transmission and distribution, because if you believe that you're being into an area where we have generation. But we're also taking a broader view of what resources are, which includes transmission from an optimization standpoint includes renewables, includes smart grid technology type applications.

I think we're in a pretty good position, because we don't have any real large central station generation activities going on. And we are advancing transmission and distribution. The infrastructure requirements associated with that are tremendous in this industry and it gives us a distinct opportunity to continue to invest to ensure the service reliability of our customers.

So we have -- we have a real opportunity here that not be and I guess, it goes to my earlier conversation to not be all of our focus of our customers working on backing on activities, like a massive amount of environmental spending, a massive amount of a new generation that's very, I'd say the density level is pretty high. So from a capital standpoint, we have the opportunity to put capital where it will make the most beneficial effect for our customers and as well our shareholders. So, we are trying to move as much as we can to transmission and the distribution side infrastructure.

Q - Michael Lapides {BIO 6317499 <GO>}

Got it. Thank you, Nick. Much appreciated.

A - Nick Akins {BIO 15090780 <GO>}

Yeah. And also I would add to that from a regulated standpoint, we do have a large amount of our service territory that still regulated from a generation perspective. So we'll continue to invest in those facilities as well.

Operator

And our next question is from the line of Ali Agha with SunTrust. Please go ahead.

Q - Ali Agha {BIO 1509168 <GO>}

Thank you. Good morning.

A - Nick Akins {BIO 15090780 <GO>}

Hi, Ali.

Q - Ali Agha {BIO 1509168 <GO>}

First question on the Ohio customer switching. Is that currently on track with how you budgeted that and what's in the ESP order. And also related to that, I think for the year, your budget had the gross margins for Ohio utilities down but through the first quarter you're flat. So should we assume that Ohio is doing better than planned and it is a best out of it?

A - Nick Akins {BIO 15090780 <GO>}

Yeah, we're largely on track with the agreement, I think 53% of our customer loan switch another 3% in the queue, so it's moving along at a steady pace and we see that continuing. So I'd say that we're largely on pace and moving forward.

Q - Ali Agha {BIO 1509168 <GO>}

And it includes the overall earnings contribution as well, you think that's still on budget as well?

A - Nick Akins {BIO 15090780 <GO>}

Yeah. Yeah.

Q - Ali Agha {BIO 1509168 <GO>}

Okay. A separate question on -- after this SWEPCo Texas rate cases down, can you remind us what would be the next big rate case coming up for you guys?

A - Nick Akins {BIO 15090780 <GO>}

Well, as a result of the legislation in Indiana, that gives us a distinct opportunity to focus there on achieving better results -- rate related to the regulatory lag. So it gives us an opportunity to do that and I think Virginia has also an opportunity for us as we complete the corporate separation and move forward with that kind of activity. So, I'd say, those are the two jurisdictions and then we continue to look at other areas as well. But I'd say those are probably the two larger ones and keep in mind we are making a very large investment in R&D associated with the nuclear long cycle management process, it's $1.2 billion, $1.3 billion and that's largely in process of being recovered. So there are some areas of spending that will be -- that we'll be doing. But I'd say that the stage is set.

Q - Ali Agha {BIO 1509168 <GO>}

Understood. And last question, I recalled the past Brian or Nick you guys have said in the context of the 4% to 6% annual EPS growth that you've been targeting that through this transition period in Ohio, I guess through '12 to '15 period more likely the lower end and the high-end with that more sense, is that still the way to thinking about this?

A - Brian Tierney {BIO 15917272 <GO>}

No, I don't think we said that. We're anticipating the 4% to 6% of the 2013 base. So the full range of the range that we talked about is in place even during the transition period.

Q - Ali Agha {BIO 1509168 <GO>}

Of the '13 base and Brian -- over -- is that a five year look forward or how should we think about that?

A - Brian Tierney {BIO 15917272 <GO>}

Just until further notice.

Q - Ali Agha {BIO 1509168 <GO>}

Until further notice. Thank you.

A - Brian Tierney {BIO 15917272 <GO>}

Thanks.

Operator

And at this time, there are no other questions, please continue.

A - Bette Jo Rozsa {BIO 16484334 <GO>}

Well, thank you for joining us for today's call. And as always, the IR team is available to answer your any additional questions that you may have. And Trisha, can you give the replay information.

Operator

Certainly. Ladies and gentlemen, today's conference will be made available for replay after 11 A.M. Eastern Time today until May 3rd at mid night. You may access AT&T Executive playback service at any time by dialing 1-800-475-6701 and entering the access code 287270. International participants may dial 1-320-365-3844. That does conclude your conference for today. Thank you for your participation and for using AT&T Executive TeleConference service. You may now disconnect.