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GAS - Q3 2004 Nicor Inc. Earnings Conference Call

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David Maccarrone
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David Grumhaus
Copia Capital - Analyst

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Nicor earnings conference call. My name is Andrea, and I will be your conference coordinator for today. At this time all participants are in a listen-only mode. We will be facilitating a question and answer session towards the end of today's conference. If you require assistance press star followed by zero and a coordinator will be happy to assist you. As a reminder, this conference call is being recorded for replay purposes.

I would like to turn the presentation over to host of today's call Tom Fisher, please proceed.

Thomas Fisher - *Nicor Inc. - Chairman, CEO*

Good morning and thanks a lot for joining us today. I'm Tom Fisher, and with me are Russ Strobel, our President, Rick Hawley, our Chief Financial Officer, and Mark Knox our Director of Investor Relations. This morning we will discuss the items mentioned in our press release regarding our 2004 third quarter financial results, our outlook for 2004, and we will also provide an update on regulatory and legal matters.

When we have completed our remarks we will then take your questions.

Now, let me turn things over to Mark, who will highlight our 2004 results for the quarter and the nine month period.

Mark Knox - *Nicor Inc. - Director IR*

Thanks, Tom, and good morning. First, we want to remind you that this call will include certain forward-looking statements about the operations and expectations of our company, subsidiaries and affiliates. Although we believe these statements are based on reasonable assumptions actual results may vary materially from stated expectations. Information concerning the factors that could cause materially different results can be found in our filings with the Securities and Exchange Commission in yesterday's press release.

As we reported in our release yesterday third quarter 2004 diluted loss per share were 26 cents compared to earnings of 1 cents per share for the same period in 2003. Last year's third quarter included a 3.3 million gain associated with the wind down of our equity investment in Nicor Energy. This item positively impacted 2003's third quarter by about 4 cents per share. The absence of this item in our 2004 third quarter results, combined with overall lower results in our gas distribution and wholesale natural gas marketing businesses and increased interest expense more than offset higher operating results in our shipping and retail business.

Nine months ended September 30, 2004, diluted earnings per share were 62 cents compared to \$1.59 per share for the same period in 2003. Both periods included a few noteworthy items. 2004 year-to-date results included a first quarter litigation charge related to a settlement of securities class actions. 2003 year-to-date results included a net mercury-related insurance recovery and gains associated with the wind down of Nicor Energy, and also included a required change in accounting method at our wholesale natural gas marketing business, Nicor Enerchange, from fair value to accrual account. These items had a net positive impact of 26 cents per share on 2003 year-to-date results.

Removing the effects of these items for comparison purposes gives you 2004 year-to-date earnings of \$1.14 per share compared to \$1.33 per share in 2003. 2004 year-to-date results were impacted by lower operating results in our gas distribution business, Nicor Gas and Nicor Enerchange and increased interest expense which more than offset higher

operating results in our shipping and retail energy related products and services businesses in 2004.

Let me now turn things over to Rick for his discussion of our 2004 results and our outlook for the year.

Richard Hawley - *Nicor Inc. - CFO, EVP*

Thanks, Mark. Good morning, everyone. Our press release and 10-Q, which we expect to file later today, provide extensive detail on individual elements that contributed to our results, so I will not take your time on the call to go through line by line. Instead, I would like to give you an overall financial perspective of our results, and then address any specific questions you have on details in the Q&A portion of the call.

Before I get into the individual segments of the business, however, let me first put things into perspective. Earnings for the quarter were significantly impacted by unbudgeted items at Nicor Enerchange and Nicor Gas. Our 2004 annual outlook, provided in the second quarter, assumed a relatively flat year-to-year earnings comparison for the third quarter. However, fair value accounting adjustments related to the derivatives used to hedge the value of gas in storage at Nicor Enerchange, and increases in expected levels of bad debt expense, and legal and other costs associated with outstanding contingencies at Nicor Gas, reduced results to the levels reported.

Let me move briefly to discuss quarter-to-quarter comparisons by business segment. Looking first at Nicor Gas. We told you at the beginning of the year, and again in the second quarter, that we expected lower results in 2004 for Nicor Gas, because of a continued trend of higher operating expenses driven by depreciation, increased labor, compliance, benefits and insurance-related costs and higher interest expense. Offset, in part, by increased property sales activity and pension returns. Except for what I'll discuss in just a second, results to date in our guidance for the full year remain consistent with those earlier estimates. However, in the third quarter we had to increase our provisions for bad debt expense and legal and other costs associated with contingencies related to the ongoing SEC and PBR contingency. These costs are the primary driver behind our updated earnings guidance for 2004 that I will discuss in a few minutes.

Moving to the shipping segment, as we outlined in the press release, it is performing above expectations year to date, and

despite some initial negative impacts from hurricanes in the third quarter, an increase to a slight degree in some costs, it is expected to finish the year ahead of our earlier expectations. Our retail energy related products and services businesses are performing slightly above expectations for the quarter and year-to-date, and we believe their operating results will finish the year at or above the amounts included in our earlier guidance to you as compared to 2003. Our wholesale natural gas marketing business, Nicor Enerchange, was negatively impacted in the third quarter by the price run up and volatility in the natural gas markets that you are all very familiar with.

Just to remind you, in that business, we run essentially a balanced book in that we match up natural gas we put in storage with forward sales, using NYMEX Futures and other financial derivatives, to effectively lock in a profit margin that will realize once the inventory is withdrawn and the financial derivatives are closed out. However, in between the time the inventory is put in the ground and everything is closed out, when you have a situation like we do now when natural gas prices are volatile, the GAAP earnings of Enerchange can fluctuate significantly. This is a result of a need to record the financial derivatives we use at fair value, and run changes thereto through Nicor Enerchange's income statement, while leaving the inventory valued at the lower of weighted average cost or market.

The required accounting produces what you see in the third quarter, a hit to income of approximately \$8 million pretax from the fair value accounting for open derivative positions while no recognition is given to the positive difference between the cost and projected market value of the natural gas we have in inventory that will achieve at the expected time of withdrawal. Looking out for the rest of the year, using the September 30 forward price curves, we estimate that Enerchange could end the year with positive GAAP earnings, although below our earlier expectations. However, reported results could vary significantly, depending on actual gas prices in the fourth quarter, and forward prices at December 31, 2004.

With that, I want to step back and summarize what all this means for our consolidated earnings guidance for 2004. As we stated in our press release yesterday, our 2004 earnings per share estimate could be up to 5 cents lower than the low end of our earnings per share range we provided at the end of the second quarter, and that was \$1.58 to \$1.78, or if you back out the litigation charge we took in the first quarter of 2004, a range of 2.10 to 2.30. That was our earlier guidance. And again we could be up to 5 cents lower than that. This

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estimate reflects our third quarter results and the estimated fourth quarter performance in all of our businesses. Our estimate does not reflect the impact of additional fourth quarter volatility in natural gas prices, and the impact of same on our reported earnings at Nicor Enerchange.

As a reminder, the range estimate also assumes, among other things, normal weather for the remainder of the year, no additional impacts associated with the Illinois Commerce Commission's PBR/PGA review or other related contingencies, including insurance recoveries related to Mercury. Finally, I want to remind everyone that future updates to our current earnings estimates will be provided at the time we release our most recent earnings, either on an annual or a quarterly basis.

Now, I want to move into a regulatory update. First, let me spend a few minutes discussing the regulatory filing made yesterday in our gas distribution business. I do not intend to go into all the specifics of the filing, which will be available in documents filed with the ICC, and at the website listed in last night's press release, but I will spend some time discussing our rationale for filing and our proposed changes in rate design. Nicor Gas is proposing an overall increase in business and residential rates of 83.3 million, an increase of 16.5% compared to base rate revenues, and that is our revenues essentially exclusive of gas cost.

This is Nicor Gas' second filing in 20 years and the first in nearly 10 year. Despite one of the nations best records for efficiencies and our continuing efforts to control costs, Nicor Gas' cost have gone up significantly, while revenues have not kept pace, resulting in a decline in our earnings and actual return on rate base. This is something that is not news to all of you. We have been discussing this in all of our previous calls. We are requesting an increase in base rates to cover those higher operating costs including depreciation and to cover the debt and equity cost associated with capital investments we've made over the last ten years. We are proposing returns on equity and rate base of 11.37%, and 9.34%, respectively, and that compares to the 11.13 return on equity and 9.67 return on rate base in our 1995 filing. Our capital structure is not markedly different from that approved in our last order that became effective in 1996.

In summary, the increase in our base rates would help us recover the rising costs of doing business, including healthcare, labor related, and compliance and other operational costs, and again, allow us to recover the capital costs incurred, and costs that we continue to incur to maintain

system integrity, improve service to customers, and to expand our system to meet the continuous growth in our service territory.

Just to let you know, we are also proposing certain changes in our rate filing. Three of which I want to bring to your attention. We are proposing in this filing to recover the commodity portion of bad debt expense through our PGA clause, and we are proposing to fully credit the net revenues received from the Chicago hub through the PGA clause. We are also proposing a change from using a 30 year average to a 10 year average for calculating normal weather. This change would result in a reduction in our normal degree days from 6,000 to 5,830, which we believe is more representative of the current weather patterns in our service territory.

Now, moving to the next subject, just a brief update on legal matters. The short version of this is there is not much to report from our last earnings call. With respect to the ICC's review of the PBR, at this time the hearings remain stayed, while parties undertake additional discovery relating to third party audio tapes of telephone calls involving Nicor Gas personnel and a third-party that helped Nicor Gas manage the PBR. Despite our ongoing efforts to do so, a court order still prevents us from releasing the content of these tapes to others. In the meantime, the ICC is also working with us through the judicial process to obtain these tapes.

We continue to obtain access to and review this information and any other information that is provided to us from these third parties. A review of the additional information that we completed in the third quarter resulted in a \$1.8 million adjustment to our previously recorded liability. We will continue to work to resolve the PBR issues as soon as possible but it is difficult to predict when these issues will be resolved. The remaining related SEC and other legal matters remain essentially unchanged. We continue to cooperate and work with the other interested parties, but there is really nothing to report at this time.

Let me turn things over to Tom who will wrap things up a.

Thomas Fisher - Nicor Inc. - Chairman, CEO

I would like to close by just emphasizing a few points. Nicor Gas, as you all know, has a long track record of efficiently managing its gas distribution operations and this will continue to be a primary focus for us here at Nicor. As our core business, Nicor Gas' success remains fundamental to Nicor's overall

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success, and will continue to provide a very strong foundation upon which we can build. Our request for rate relief is a needed and appropriate step to maintain the financial metrics of our utility that benefits our customers, our employees and our investors who provide the capital necessary for our business. Our other energy related businesses, not withstanding the accounting requirements that Rick discussed in detail, are profitable and are adding real economic value to our business. Tropical shipping continues to produce consistent and improving results, both from an earnings and a cash flow perspective.

Finally, as we reflect back on September, and the impact the hurricanes had on tropical shipping, I'm extremely proud of the efforts of Tropical's employees, who's responsive and decisive actions, despite, in many cases, their own personal losses and concerns, minimized the impact of these hurricanes on both our operations, and, just as importantly, the service that we provide to our customers.

With that, we'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

Ladies and gentlemen, this is your question and answer session. If you would like to ask a question or make a comment, please, key star one on your touchtone phone. If your question has been answered and you would like to withdraw, please, key star 2. Again, that is star one for questions. One moment while we compile the list. Our first question comes from Faisal Khan from Credit Suisse First Boston. Please proceed.

Faisal Khan - *Credit Suisse First Boston - Analyst*

Yes, it's Faisal Khan from CSFB. Quick question. If you're -- if, with this increase or proposed rate increase of roughly 16%, how would that compare now to your other peers in Illinois in terms of rates? Will you still be among the lowest, will that still be one of the lowest rates in the state or how would that compare?

Thomas Fisher - *Nicor Inc. - Chairman, CEO*

Our rates would still be significantly below any one else's rates under our proposal.

Faisal Khan - *Credit Suisse First Boston - Analyst*

And, if you don't mind me asking, what was your previous rate base when you filed in '96?

Richard Hawley - *Nicor Inc. - CFO, EVP*

Authorized was one million 370 or -- excuse me a billion 370 or so.

Mark Knox - *Nicor Inc. - Director IR*

Yes. 1 billion 372.

Faisal Khan - *Credit Suisse First Boston - Analyst*

Okay. A billion 372. And over the -- over the last ten years you talked about how you made these capital investments. Is there any significant capital investment you made in either mains or pipes that you could point to that is significant or is it just overall a continuing investment in the system?

Richard Hawley - *Nicor Inc. - CFO, EVP*

For the most part it is overall, and you hit two of the biggest ones, obviously, we add about 30,000 customers, so, you have those costs. You have investments we've made in transmission and mains, and, remember, we have the storage fields that we operate so there are investments in there. We are currently upgrading our customer information system. But, over the last ten years we spent about a billion dollars or so.

Faisal Khan - *Credit Suisse First Boston - Analyst*

Okay. You talked about recovering one cost I didn't quite get that one. Chicago hub costs or Chicago hub something. I just wanted to understand what that was.

Richard Hawley - *Nicor Inc. - CFO, EVP*

If you remember, the Chicago hub results come from operating the storage we have access to over base customer needs. We do have that managed to create value, and we credit that back against gas, basically the gas distribution revenues, and in this proposal we are just actually proposing that the revenue that we earn out of that activity go right

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through the PGA so it gets updated. As you know, in our PGA filings we update monthly what your costs are.

Faisal Khan - *Credit Suisse First Boston - Analyst*

Got it, thank you.

Operator

Our next question comes from Mike Weinstein from Zimmer Lucas. Please proceed.

Mike Weinstein - *Zimmer Lucas Partners, LLP - Analyst*

Hi, guys. How are you doing?

Thomas Fisher - *Nicor Inc. - Chairman, CEO*

Good morning.

Mark Knox - *Nicor Inc. - Director IR*

Good morning.

Mike Weinstein - *Zimmer Lucas Partners, LLP - Analyst*

In regard to the rate case, you said that the cap structure hasn't changed significantly since '95. Currently, because of seasonal gas requirements and seasonal short-term debt requirements, I look at the cap structure as changing seasonally pretty significantly, and at the end of '03 last year it was again a 36.7% common equity ratio. Would it be right to assume that the commission would not look at a 36.7 as the correct capital structure that they would -- you know, do they have discretion on this, or is there some sort of statutory requirement that they exclude short-term debt?

Richard Hawley - *Nicor Inc. - CFO, EVP*

You hit a number of things. First, you are right we do have high seasonal debt and that is impacted more significantly by the high cost of gas to borrow, and that is why we have a seasonal line of credit in place. When we talk about our capital structure, it is the long-term debt and equity, exclusive of short-term debt, which is the methodology the commission used in the last case and the methodology on which we filed, so, and that, if you look at just an easy reference point in our

last filing back in '95, we had about a 58% equity ratio and we have got just north of 56% at this point in time.

Mike Weinstein - *Zimmer Lucas Partners, LLP - Analyst*

Okay. And along the same lines, you know, obviously the PBR case is still in dispute and everything, but, I would assume that any kind of changes to the capital structure that might result as a result of the resolution of that PBR case would not be included in the test period? Is that the intention of the filing right now, or how you understand it?

Richard Hawley - *Nicor Inc. - CFO, EVP*

Again, we've made no adjustments with respect to the PBR in our filing.

Mike Weinstein - *Zimmer Lucas Partners, LLP - Analyst*

What is the test year?

Richard Hawley - *Nicor Inc. - CFO, EVP*

We are using a forward test year of 2005.

Mike Weinstein - *Zimmer Lucas Partners, LLP - Analyst*

Okay. And -- okay. I guess the only question I had was you added a billion dollars of rate base in the last ten years or a billion dollars of CapEx. Do you have any idea what the net addition to rate base is above the 1.372 that was in the last case?

Richard Hawley - *Nicor Inc. - CFO, EVP*

I actually do know what rate base is, if you would like to know that?

Mike Weinstein - *Zimmer Lucas Partners, LLP - Analyst*

Sure, go ahead.

Richard Hawley - *Nicor Inc. - CFO, EVP*

A billion 450.

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Mike Weinstein - Zimmer Lucas Partners, LLP - Analyst

So, it's a new rate base that you are filing with?

Richard Hawley - Nicor Inc. - CFO, EVP

Yeah.

Mike Weinstein - Zimmer Lucas Partners, LLP - Analyst

Okay, great. Thank you, that's it.

Operator

Our next question comes from David Maccarrone from Goldman Sachs. Please proceed.

David Maccarrone - Goldman Sachs - Analyst

A couple of follow-ups on the earlier questions. What is, given the answer to the last question, the test year 2005, what is the level of earnings that is included in the rate filing, relative to 2004, if you assume the bottom, the 5 cents below the bottom end of the range?

Richard Hawley - Nicor Inc. - CFO, EVP

I'm sorry you asked about what they are in 2005, or what the 2004 earnings are?

David Maccarrone - Goldman Sachs - Analyst

Well, with, what is the 2005 level of earnings implied in the filing operating income wise?

Richard Hawley - Nicor Inc. - CFO, EVP

Sure and one thing I will remind everyone, too, that we have made the filing and -- and more numbers than even all of you could want are going to be on file on the website, so we certainly want to talk about top level numbers, but we won't get into a huge number of details, but those numbers, the projected income statement for '05 has a utility operating income before tax of about \$110 million.

David Maccarrone - Goldman Sachs - Analyst

Before tax you said?

Richard Hawley - Nicor Inc. - CFO, EVP

Yeah.

David Maccarrone - Goldman Sachs - Analyst

Okay. And then if we are to look at that slightly below the range estimate for '04, how much impact is -- is going to occur in 2005 from the reversal of the fair value accounting impact that occurred in 2004?

Richard Hawley - Nicor Inc. - CFO, EVP

Well, if you -- we have accumulated, I'll say unrealized losses the fair value adjustments or open derivative positions at the end of the quarter of \$13 million, and we've got about \$15.5 million worth of value in the inventory, so over the withdrawal period, which includes the fourth quarter and the first quarter of next year, those numbers out of -- we have already taken the hit for the \$13 million, so you should see the 15 turn around, which quarter it is going to turn around, if you tell me exactly what cash and forward prices are going to do, I could probably give you that, but, all I can say is it will turn around over the next two quarters for the most part.

David Maccarrone - Goldman Sachs - Analyst

Okay. And then on tropical shipping, how enthusiastic are you about the prospects for 2005, considering the hurricane damage that occurred? I know that construction activity is a major opportunity for tropical. Can you talk about that a little bit?

Richard Hawley - Nicor Inc. - CFO, EVP

Tom can give you a far better answer, but, let me tell you about the numbers. When we reference hurricane costs, just to put it in context, we had just north of a million dollars probably of additional costs, having boats float around in the ocean while we kept them out of the hurricanes waves and things like that, over time, so it was not a major cost impact. It was just reduced good results for the quarter just down a little bit. There will be reconstruction efforts. We are seeing

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strong volumes and I would expect to see strong volumes continue for tropical.

Thomas Fisher - Nicor Inc. - Chairman, CEO

I think both for this quarter as well as into next year.

David Maccarrone - Goldman Sachs - Analyst

Do you think that is a one or two quarter phenomena, or is this a sustained level of activity that might even carry to 2006?

Thomas Fisher - Nicor Inc. - Chairman, CEO

Well, there is a lot of things happening right now in the Caribbean, and how long it will last is any one's guest. Right now there is a lot of things even beyond hurricanes. The hurricanes and the impact they had in terms of reconstruction activities that are very positive for the business right now.

David Maccarrone - Goldman Sachs - Analyst

Okay. Thank you very much.

Operator

Again, ladies and gentlemen, if you would like to ask a question, please key star one on your touchtone phone. Our next question comes from David Grumhaus from Copia Capital. Please proceed. If your phone is on mute, sir, please unmute your line.

David Grumhaus - Copia Capital - Analyst

Sorry about that. Good morning. Couple questions for you. In the filing decision to tie the gas bad debt expense to the annual, I guess fuel -- can you talk through the logic of that? Is that basically acknowledging that bad debt is very high right now, and you don't know if it is going to go higher or come down and you want to see your recovery adjusted each year? If you could talk through the logic on that, that would be helpful?

Russ Strobel - Nicor Inc. - President

Sure, David. This is Russ Strobel, you see it on one of the real keys to it, the other principal rationale is that bad debt does

tend to move with gas costs, and when you don't collect -- when you have bad debt that relates to commodity that really is part of our commodity cost and ought to be run through the PGA, and fits very nicely in the language of the PGA true up regulation, so it is really both of those things that we think really justifies running the commodity part of the bad debt through the PGA. The Company retains its incentive to manage bad debt effectively, because even when you run the commodity part through the PGA, which is about two thirds of the bad debt cost you still have 8 or 9 or \$10 million in delivery charges so you have a very large incentive to control your bad debt expense. We think it as potential win-win.

David Grumhaus - Copia Capital - Analyst

I guess, secondly, the decision to put the Enerchange revenues in. Was that basically a concession that you don't want the legal -- legal issues surrounding the PRB to get in the way of the rate case and this was a concession you could make?

Thomas Fisher - Nicor Inc. - Chairman, CEO

Let me turn that over to Russ, but first say it is not the Enerchange it is the hub.

David Grumhaus - Copia Capital - Analyst

The hub, sorry.

Russ Strobel - Nicor Inc. - President

The primary rationale for that is that we are going to be increasing PGA expense by the amount of the commodity bad debt component, and we look at this as a way to ameliorate or offset part of that increase by setting the hub revenues back through the PGA, to partially or wholly offset the increase in PGA expense from bad debt.

David Grumhaus - Copia Capital - Analyst

Lastly, just going back to the question on the derivative position, it sounds like there is 15 million of reversal that you will pick up over the next few quarters. Can you talk about that in the guidance what you assumed how that will lay out between the fourth quarter and the first quarter of next year?

Richard Hawley - *Nicor Inc. - CFO, EVP*

Sure, if you look with the turn around and remember the other thing that is going on is there are some buys and sells of inventory over the course of the quarter, and all of this is based on the forward curves today. So, things could -- all that value and all the mark-to-market loss could turn around if gas prices go back to four bucks, I guess. What we have done, assuming normal levels of volume at Enerchange, and the forward curves that we are seeing now, is probably, 90% of what we would see turn around in the fourth quarter, which would put Enerchange just under what our expectations were for them during the year.

David Grumhaus - *Copia Capital - Analyst*

Great. That's helpful. Thanks for all the time.

Richard Hawley - *Nicor Inc. - CFO, EVP*

Thanks for the call.

Operator

Ladies and gentlemen, this concludes the question and answer portion of today's call, I would like to turn the presentation back to Tom Fisher for closing remarks.

Unidentified

Thank you very much for your interest in Nicor. Thanks for joining us today, and we look forward to talking with you next quarter.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes your presentation. You may now disconnect. Good day.

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