

TRANSCANADA PIPELINES LTD

Form 6-K

May 04, 2007

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 6-K

Report of Foreign Private Issuer

Pursuant to Rule 13a-16 or 15d-16 under

the Securities Exchange Act of 1934

For the month of May 2007

Commission File Number: 1-8887

TRANSCANADA PIPELINES LIMITED

(Translation of Registrant's Name into English)

450 1st Street S.W., Calgary, Alberta, T2P 5H1, Canada

(Address of Principal Executive Offices)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F:

Form 20-F ☐

Form 40-F ☒

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1): ☐

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7): ☐

Indicate by check mark whether by furnishing the information contained in this Form, the registrant is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes ☐

No ☒

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The following document is hereby filed with the Securities and Exchange Commission for the purpose of being and hereby is incorporated by reference into Registration Statement on Form F-9 (File No. 333-141122) of TransCanada PipeLines Limited:

1 First Supplemental Subordinated Indenture dated May 3, 2007 among TransCanada PipeLines Limited, TransCanada Corporation, with respect to certain provisions, and The Bank of Nova Scotia Trust Company of New York, as trustee.

2

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TRANSCANADA PIPELINES LIMITED

Date: May 4, 2007

By: /s/ Robert J. Pitt
Name: Robert J. Pitt
Title: Vice President, Finance Law

EXHIBIT INDEX

1 First Supplemental Subordinated Indenture dated May 3, 2007 among TransCanada PipeLines Limited, TransCanada Corporation, with respect to certain provisions, and The Bank of Nova Scotia Trust Company of New York, as trustee.

4

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221

591

354

General and administrative

138

132

261

300

Product development and design

94

70

205

140

Decrease in net income before taxes

\$

548

\$

449

\$

1,156

\$

855

Effect on basic and diluted earnings per share

\$

0.01

\$

0.01

\$

0.02

\$

0.02

As of October 27, 2007, there was \$5,639 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under all equity compensation plans. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. We expect to recognize that cost over a weighted average period of five years.

Note 11. Comprehensive Income

We follow the provisions of SFAS No. 130, "Reporting Comprehensive Income", which establishes standards for reporting and display of comprehensive income and its components. Comprehensive income reflects the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. For us, comprehensive income represents net income adjusted for foreign currency translation adjustments and net gains and losses on derivative instruments. The foreign currency translation adjustment included in comprehensive income has not been tax effected, as the investment in the foreign affiliate is deemed to be permanent. In accordance with SFAS No. 130, we have chosen to disclose comprehensive income in the consolidated statement of shareholders' equity in our annual financial statements.

A summary of comprehensive income that we recorded in accordance with SFAS No. 130 is as follows:

	Six Months Ended October 27, 2007	October 28, 2006
Net income	\$ 15,121	\$ 13,879
Net foreign currency translation adjustment	(45)	(250)
Net gain on derivatives	85	39
Total comprehensive income	\$ 15,161	\$ 13,668

Note 12. Subsequent Event

At the beginning of the third quarter of fiscal year 2008, we sold a significant portion of our investment in Arena Media Networks and realized a pre-tax gain of approximately \$2.5 million.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion highlights the principal factors affecting changes in financial condition and results of operations. This discussion should be read in conjunction with the accompanying consolidated financial statements and notes to the consolidated financial statements.

- 16 -

OVERVIEW

We design, manufacture and sell a wide range of display systems to customers in a variety of markets throughout the world. We focus our sales and marketing efforts on geographical regions, markets and products. The primary categories of markets include live events, commercial, transportation, schools and theatres, and international.

Our net sales and profitability historically have fluctuated due to the impact of large product orders, such as display systems for professional sport facilities and colleges and universities, as well as the seasonality of the sports market. Net sales and gross profit percentages also have fluctuated due to other seasonality factors, including the impact of holidays, which primarily impact our third quarter. Our gross margins on large product orders tend to fluctuate more than those for smaller standard orders. Large product orders that involve competitive bidding and substantial subcontract work for product installation generally have lower gross margins. Although we follow the percentage of completion method of recognizing revenues for large custom orders, we nevertheless have experienced fluctuations in operating results and expect that our future results of operations may be subject to similar fluctuations.

Orders are booked only upon receipt of a firm contract and, depending on terms, only after receipt of any required deposits related to the order. As a result, certain orders for which we have received binding letters of intent or contracts will not be booked until all required contractual documents and deposits are received. In addition, order bookings can vary significantly as a result of the timing of large orders.

We operate on a 52-53 week fiscal year, with fiscal years ending on the Saturday closest to April 30 of each year. Fiscal years 2008 and 2007 each contain 52 weeks.

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For a summary of recently issued accounting pronouncements and the effects of those pronouncements on our financial results, refer to Note 3 of the notes to our consolidated financial statements, which are included elsewhere in this report.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The following discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On a regular basis, we evaluate our estimates, including those related to estimated total costs on long-term contracts, estimated costs to be incurred for product warranties and extended maintenance contracts, bad debts, excess and obsolete inventory, income taxes, stock-based compensation and contingencies. Our estimates are based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies require significant judgments and estimates in the preparation of our consolidated financial statements:

Revenue recognition on long-term contracts. Earnings on long-term contracts are recognized on the percentage-of-completion method, measured by the percentage of costs incurred to date to estimated total costs for each contract. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are capable of being estimated. Generally, contracts we enter into have fixed prices established and, to the extent the actual costs to complete contracts are higher than the amounts estimated as of the date of the financial statements, the resulting gross margin would be negatively affected in future quarters when we revise our estimates. Our practice is to revise estimates as soon as such changes in estimates are known. We do not believe there is a reasonable likelihood that there will be a material change in future estimates or assumptions we use to determine these estimates.

- 17 -

Allowance for doubtful accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. To identify impairment in the customer's ability to pay, we review aging reports, contact customers in connection with collection efforts and review other available information. Although we consider our allowance for doubtful accounts adequate, if the financial condition of our customers were to deteriorate and impair their ability to make payments to us, additional allowances may be required in future periods. We do not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions we use to determine the allowance for doubtful accounts. As of both October 27, 2007 and April 28, 2007, we had an allowance for doubtful accounts balance of approximately \$1.6 million.

Warranties. We have created a reserve for warranties on our products equal to our estimate of the actual costs to be incurred in connection with our performance under the warranties. Generally, estimates are based on historical experience taking into account known or expected changes. If we would become aware of an increase in our warranty reserves, additional reserves may become necessary, resulting in an increase in costs of goods sold. We do not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions we use to determine our reserve for warranties. As of October 27, 2007 and April 28, 2007, we had approximately \$10.9 million and \$10.5 million reserved for these costs, respectively.

Extended warranty and product maintenance. We have deferred revenue related to separately priced extended warranty and product maintenance agreements. The deferred revenue is recognized ratably over the contractual term. If we would become aware of an increase in our estimated costs under these agreements in excess of our deferred revenue, additional reserves may be necessary, resulting in an increase in costs of goods sold. In determining if additional reserves are necessary, we examine cost trends and other information on the contracts and compare that to the deferred revenue. We do not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions we use to determine estimated costs under these agreements. As of October 27, 2007 and April 28, 2007, we had \$6.5 million and \$5.3 million of deferred revenue related to extended warranty and product maintenance, respectively.

Inventory. Inventories are stated at the lower of cost or market. Market refers to the current replacement cost, except that market may not exceed the net realizable value (that is, estimated selling price in the ordinary course of business less reasonable predictable costs of completion and disposal), and market is not less than the net realizable value reduced by an allowance for normal profit margins. In valuing inventory, we estimate market value where it is believed to be the lower of cost or market, and any necessary charges are charged to costs of goods sold in the period in which they occur. In determining market value, we review various factors, such as current inventory levels, forecasted demand and technological obsolescence. We do not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions we use to calculate the estimated market value of inventory. However, if market conditions change, including changes in technology, product components used in our products or expected sales, we may be exposed to losses or gains that could be material.

Income Taxes. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating the actual current tax expense as well as assessing temporary differences in the treatment of items for tax and accounting purposes. These timing differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheets. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income in each jurisdiction, and to the extent we believe that recovery is not likely, a valuation allowance must be established. We review deferred tax assets, including net operating losses, and for those not expecting to be realized, we have created a valuation allowance. If our estimates of future taxable income are not met, a valuation allowance for some of these deferred tax assets would be required.

We operate within multiple taxing jurisdictions, both domestic and international, and are subject to audits in these jurisdictions. These audits can involve complex issues, including challenges regarding the

- 18 -

timing and amount of deductions and the allocation of income amounts to various tax jurisdictions. At any one time, multiple tax years are subject to audit by various tax authorities.

We record our income tax provision based on our knowledge of all relevant facts and circumstances, including the existing tax laws, the status of any current examinations and our understanding of how the tax authorities view certain relevant industry and commercial matters. In evaluating the exposures associated with our various tax filing positions, we record reserves for probable exposures. A number of years may elapse before a particular matter for which we have established a reserve is audited and fully resolved or clarified. We adjust our income tax provision in the period in which actual results of a settlement with tax authorities differs from our established reserve, when the statute of limitations expires for the relevant taxing authority to examine the tax position, or when more information becomes available. Our tax contingencies reserve contains uncertainties because management is required to make assumptions and to apply judgment to estimate the exposure associated with our various filing positions. We believe that any potential tax assessments from various tax authorities that are not covered by our income tax provision will not have a material adverse impact on our consolidated financial position or cash flow.

Stock-based compensation: We use the Black-Scholes standard option pricing model (Black-Scholes model) to determine the fair value of stock options and employee stock purchase rights. The determination of the fair value of the awards on the date of grant using the Black-Scholes model is affected by our stock price as well as assumptions of other variables, including projected employee stock option exercise behaviors, risk-free interest rate, expected volatility of our stock price in future periods and expected dividend yield.

We analyze historical employee exercise and termination data to estimate the expected life assumption. We believe that historical data currently represents the best estimate of the expected life of a new employee option. The risk-free interest rate we use is based on the U.S. Treasury zero-coupon yield curve on the grant date for a maturity similar to the expected life of the options. We estimate the expected volatility of our stock price in future periods by using the implied volatility in market traded options. Our decision to use implied volatility was based on the availability of actively traded options for our common stock and our assessment that implied volatility is more representative of future stock price trends than the historical volatility of our common stock. We use an expected dividend yield consistent with our dividend yield over the period of time we have paid dividends in the Black-Scholes option valuation model. The amount of stock-based compensation expense we recognize during a period is based on the portion of the awards that are ultimately expected to vest. We estimate pre-vesting option forfeitures at the time of grant by analyzing historical data and revise those estimates in subsequent periods if actual forfeitures differ from those estimates.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods or if we decide to use a different valuation model, the expense in future periods may differ significantly from what we have recorded in the current period and could materially affect our net earnings and net earnings per share for a future period.

RESULTS OF OPERATIONS

The following table sets forth the percentage of net sales represented by items included in our consolidated statements of income for the periods indicated:

- 19 -

Three Months Ended
October 27, October 28,

Six Months Ended
October 27, October 28,

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	2007	2006	2007	2006
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	70.2%	71.3%	69.9%	71.3%
Gross profit	29.8%	28.7%	30.1%	28.7%
Operating expenses	20.4%	17.1%	20.7%	19.0%
Operating income	9.4%	11.6%	9.4%	9.7%
Interest income	0.3%	0.4%	0.3%	0.5%
Interest expense	(0.2%)	0.0%	(0.3%)	0.0%
Other income (expense), net	(0.2%)	(0.5%)	(0.2%)	(0.3%)
Income before income taxes	9.3%	11.5%	9.2%	9.9%
Income tax expense	3.2%	4.3%	3.2%	3.5%
Net income	6.1%	7.2%	6.0%	6.4%

NET SALES

Net sales increased 17% to \$252.4 million for the six months ended October 27, 2007 as compared to \$215.7 million for the same period in fiscal year 2007. Net sales increased 6.4% to \$131.4 million for the three months ended October 27, 2007 as compared to \$123.5 million for the same period in fiscal year 2007.

The level of net sales generated through the first two quarters of fiscal year 2007 in all business units was limited as a result of capacity constraints within our manufacturing facilities, both in terms of space and personnel. This trend began in the second quarter of fiscal year 2007 and diminished to a large degree in the third quarter as a result of the ramping-up of facilities in Brookings and Sioux Falls, South Dakota. These capacity constraints did not exist in fiscal year 2008.

Commercial Business Unit. Net sales in the Commercial business unit grew during the second quarter and first six months of fiscal year 2008 as compared to the same periods of fiscal year 2007. For the first six months of fiscal year 2008, net sales increased 42%, and for the quarter, they increased 25% as compared to the same periods of last fiscal year. This increase is attributable to increases in both standard and custom orders. The largest growth in terms of dollars and as a percentage is attributable increases in sales in our outdoor advertising niche followed by a smaller increase in our standard Galaxy product line. During the second quarter of fiscal 2008, we experienced a lengthening of lead times in our Galaxy product line caused by supply chain challenges and plant execution. We have addressed these issues and expect that in the third quarter of fiscal 2008, this will not be an issue, however it did inhibit sales of these products in the second quarter of fiscal 2008, some of which were pushed out into the third quarter but also a loss of orders, which is difficult to quantify.

Overall, the Commercial business unit continues to benefit from increasing product acceptance, lower cost of displays, our expanding distribution network and a better understanding by our customers of the product as a revenue generation tool. The most significant factor for increasing sales has been the order volume of digital displays for outdoor advertising companies. This occurred primarily due to an increase in our customer base and the increasing number of displays being purchased by existing customers. We also believe that our recently introduced Valo digital billboard product line will help us maintain and potentially grow our market share due to its features and function. We believe that the outdoor advertising business has a few constraints, which to date our customers have been successful at overcoming. Taking this into account, we expect this portion of our business to continue to be an important driver of growth throughout fiscal year 2008. We expect that the Commercial business unit will continue to grow for the rest of fiscal year 2008.

As the outdoor advertising business has become a larger percent of our mix, we believe that the seasonality of that business could become a factor in the fluctuation of our net sales as the deployment of displays slows in the winter months. Generally speaking, seasonality is not a material factor in the rest of the Commercial business. Our rate of growth in the Commercial business unit could vary significantly

depending on our success in capturing and retaining the business of the major billboard companies as well as their rate of deployment.

Our growth in the Commercial business unit also depends to some degree on the state of the economy, which we do not believe had any adverse effects in the first six months of fiscal year 2008 as compared to the same period in fiscal year 2007.

Order bookings in the Commercial business unit were up 13% for the first six months of fiscal year 2008 as compared to the same period of fiscal year 2007. The smaller than expected increase was due to a lower level of orders in the second quarter of fiscal 2008 which was a result of lower than expected orders of Galaxy products. As discussed above, we attribute these lower orders to our lead times lengthening and also to the timing of orders in our billboard niche. Generally, orders increase due to the same factors as noted in sales.

Live Events Business Unit. Net sales in the Live Events business unit declined by approximately 22% in the second quarter of fiscal 2008 as compared to the same quarter last year and are generally flat for the year to date over last fiscal year. During the first half of fiscal year 2007, orders for live events, primarily large sports venues, were unusually high. As a result, we had expected that the sales for the first half of fiscal year 2008 would be limited in growth potential. This is due to the volatility caused by large projects in general.

Growth over the long-term in the large sports venues is due to a number of factors, including the expanding market, with facilities spending more on larger display systems; our product and services offering, which remains the most integrated and comprehensive offering in the industry; and our network of sales and service offices, which are important to support our customers. In addition, we benefit from the competitive nature of sports teams who strive to out-perform their competitors with display systems. This impact has and is expected to continue to be a driving force in increasing transaction sizes in new construction and major renovations. Growth in the large sports venues is also driven by the desire for high definition video displays, which typically drive larger displays or higher resolution displays, both of which increase the average transaction size. We believe that the effects of the economy have a lesser impact on the sports market as compared to our other markets because our products are generally revenue-generation tools (through advertising) for facilities, and the sports business is generally considered to be a recession-resistant business. Net sales in our sports marketing and mobile and modular portion of this business unit were not significant in the first half of fiscal year 2007 or 2008. Net sales in both niches were less than 5% of total sales for the first half of fiscal year 2008.

An important factor in orders and net sales for the remainder of fiscal year 2008 will be our success in winning a limited number of large contracts expected to be awarded in the large sports venue market in fiscal year 2008. Each of these transactions could range in value from \$10 million to potentially \$20 million and, depending on which transactions (if any) we are awarded, we could see a significant variation in the level of net sales, primarily in the second half of the 2008 fiscal year, and in backlog. As of the end of the second quarter of fiscal year 2008, we have received verbal commitments and non-binding letters of intent for three projects for major league baseball that together should exceed \$35 million. Although it is difficult to project, we estimate that during the third quarter of fiscal year 2008, we will be working on one of these projects as well as the previously announced project for the Kansas City Royals facility. Overall, the ultimate net sales growth in the live events business unit is difficult to estimate for the 2008 fiscal year due to uncertainty over the timing of these projects, but assuming that we prevail in winning projects based on our current market share, net sales in our Live Events business unit could expand in excess of 15%.

Orders (as opposed to net sales) in the Live Events business unit were down in the first half of fiscal year 2008 as compared to the first half of fiscal year 2007 by approximately 7%. This decrease was primarily the result of the timing of the orders. We expect that the orders for the third quarter will increase significantly due the projects mentioned above.

Schools and Theatres Business Unit. Net sales in the Schools and Theatres business unit were up 29% in the second quarter of fiscal 2008 as compared to the same quarter one year ago. Year to date sales are up over 38%. The increase in net sales was due to the acquisition of the hoist business late in the second quarter of

- 21 -

fiscal year 2007 and more orders being booked as we further penetrate the market. The growth of this business is driven to a large degree by the depth, quality, performance and service of the products offered. Orders within this business unit have increased at a much higher rate and are up over 45% year to date as compared to last fiscal year, which has exceeded our expectations.

Transportation Business Unit. Net sales in the Transportation business unit increased 45% in the second quarter of fiscal year 2008, as compared to the second quarter of fiscal 2007, and year to date are up 40% over the first six months of fiscal year 2007. Orders for the first half of the year are up 12%. We believe that the increases in net sales and orders in this business are due to legislation passed during calendar year 2005 by the United States Congress that provided for increased spending on transportation projects, including large increases associated with intelligent transportation systems, and to us gaining market share. For fiscal year 2008 as a whole, we expect that sales will continue to grow in excess of 15% as a result of the gains we made in market share and the increased government spending, which we believe will continue.

International Business Unit. Net sales in the International business unit in the second quarter of fiscal year 2008 as compared to the second quarter of fiscal year 2007 were up 75% and on a year to date basis are down approximately 2%. The increase in the second quarter was attributable to the increasing success we are experiencing in Europe and Asia, which are the primary geographic areas of focus for us. Orders as compared to net sales have increased 45% year to date over the first half of fiscal year 2007. Due to the focus on large contracts on in our International business and the small number of contracts actually booked, this volatility is not unusual. Overall, we are making considerable investments in growing our business internationally, where we do not have the same market share as we do domestically, and we believe net sales will increase significantly in all of fiscal year 2008 as compared to 2007. We continue to see success with our efforts in Asia and, as a result of our expanding line of ProTour products, we expect that European sales will also expand. Orders in this business unit increased for the same reasons as noted in the individual domestic business units.

We occasionally sell products in exchange for the advertising revenues generated from use of the products. These sales represented 1% and less than 2% of net sales for the first six months of fiscal year 2008 and 2007. The gross profit percent on these transactions have typically been higher than the gross profit percent on other transactions of similar size, although the selling expenses associated with these transactions are typically higher.

The order backlog as of October 27, 2007 was approximately \$119 million as compared to \$121 million as of October 28, 2006 and \$142 million at the beginning of the second quarter of fiscal year 2008. Historically, our backlog varies due to the timing of large orders. The changes in the backlog were the result of the combination of the changes in orders and net sales discussed above.

GROSS PROFIT

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Gross profit increased 11% to \$39.2 million for the second quarter of fiscal 2008 as compared to \$35.4 million for the second quarter of fiscal year 2007. For the six months ended October 27, 2007, gross profit increased 23.2% to \$76.1 million compared to \$61.8 million for the six months ended October 28, 2006. As a percent of net sales, gross profit was 29.8% and 30.1% for the three and six months ended October 27, 2007 as compared to 28.7% and 28.6% for the three and six months ended October 28, 2006, respectively.

The gross profit percentage increase for both the quarter and six months ended October 27, 2007 was due overall to the higher costs incurred in the 2007 fiscal year as we brought capacity on line and the impact of cost overruns on a couple of projects as compared to the same periods in fiscal year 2008. In addition, we have benefited from some declines in raw materials pricing, which impacted primarily the first quarter of fiscal year 2008. The increase in gross profit percentage was not as high as we had expected due to the impact of cost overruns in the second quarter of fiscal year 2008 as well added costs in manufacturing due to the supply chain issues in our Galaxy product line described above. We also had some additional unexpected warranty costs in the second quarter of fiscal year 2008 on a few larger projects. Partially offsetting these factors, we had a somewhat stronger mix of products favoring the higher margin standard products.

- 22 -

We strive toward higher gross margins as a percent of net sales, although depending on the actual mix, performance on larger projects, and our ability to execute on the business and level of future sales, margin percentages may not increase and are likely to remain below the levels of the last fiscal year in the upcoming quarter due to the continuation of efforts to expand facilities.

We expect that gross profit margins may decline slightly in the third quarter of fiscal year 2008, primarily as a result of the large major league baseball projects that are booked or are expected to be booked during the quarter. However, depending on the competitive environment, the actual mix and the level of future sales, and other factors described elsewhere, margin percentages may decrease more than expected from the level of the second quarter of fiscal 2008. We also believe that the gross margin percentages could increase slightly in fiscal year 2008 as a whole as compared to fiscal year 2007; however, the impact of the large sports contracts mentioned above, to the extent we are successful in winning them, could have an adverse impact on the margin percent due to the competitive nature of that business but should drive improvement in earnings per share.

OPERATING EXPENSES

Operating expenses. Operating expenses, which are comprised of selling, general and administrative expenses and product design and development costs, increased by approximately 28.1% from \$21.0 million in the second quarter of fiscal year 2007 to \$26.9 million in the second quarter of fiscal year 2008. As a percent of net sales, operating expenses increased from 17.0% of net sales in the second quarter of fiscal 2007 to 20.4% of net sales for the second quarter of fiscal 2008. For the six months ended October 27, 2007, operating expenses increased 28.7% from \$40.8 million for the six months ended October 28, 2006 to \$52.5 million for the six months ended October 27, 2007.

Selling Expenses. Selling expenses consist primarily of salaries, other employee-related costs, travel and entertainment expense, facilities-related costs for sales and service offices, and expenditures for marketing efforts, including collateral materials, conventions and trade shows, product demos and supplies.

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Selling expenses increased 22.2% to \$15.2 million for the three months ended October 27, 2007 as compared to \$12.4 million for the same period in fiscal year 2007. Selling expenses increased 20.7% to \$30.0 million for the six months ended October 27, 2007 from \$24.9 million for the same period in fiscal year 2007. Selling expenses increased to 11.5% of net sales for the second quarter of fiscal year 2008 from 10.0% of net sales for the second quarter of fiscal year 2007. For the six months ended October 27, 2007, selling expenses were 11.9% of net sales as compared to 11.5% of net sales for the six months ended October 28, 2006.

Selling expenses for the quarter ended and six months ended October 27, 2007 were higher than selling expenses in the quarter and six months ended October 28, 2006 as a result of an increase in personnel costs, which was due primarily to increases made during fiscal year 2007 as we built our sales infrastructure across all business units; increased travel and entertainment costs; more depreciation; and the increased number of sales and services offices and other costs associated with a higher number of employees. The increase in the number of employees was planned to cover growth expectations across all markets and included the impact of hiring additional personnel to support various other investments made in growing areas, such as our services business, which is a core strategic growth area of our company. The increase in travel and entertainment expense is due to having more employees and higher sales. Higher depreciation costs are primarily due to the increased investment in demonstration products and the support needs for the greater number of employees.

We expect to continue to invest in organic growth which, combined with the ramp-up of personnel in the later half of fiscal year 2007, will cause selling expenses to increase in fiscal year 2008 as compared to fiscal year 2007. However, as a percentage of net sales, we believe that selling expenses could decrease as a percent of sales for fiscal year 2008. During the first quarter of fiscal year 2008, we took steps to slow the rate of growth of selling expenses and, on a quarterly basis, we will reevaluate where we are as a percentage of orders to ensure that we meet our goal of reducing selling expense as a percentage of sales. This expectation could change based on how much investment ultimately we make in current initiatives underway, including our geographical

- 23 -

expansion. We expect that during the remainder of fiscal 2008, we will continue to invest in our services business within our markets to build the infrastructure to better support our customers for the long term.

General and Administrative. General and administrative expenses consist primarily of salaries, other employee-related costs, professional fees, shareholder relations fees, facilities and equipment-related costs for administration departments, amortization of intangibles and supplies.

General and administrative expenses increased 39.0% to \$6.4 million for the second quarter of fiscal year 2008 as compared to \$4.6 million for the second quarter of fiscal year 2007. General and administrative expenses increased 48.8% to \$12.4 million for the six months ended October 27, 2007 as compared to \$8.4 million for the six months ended October 28, 2006.

General and administrative expenses increased to 4.9% as a percent of net sales for the second quarter of fiscal year 2007 from 3.7% of net sales for the second quarter of fiscal year 2007. For the six months ended October 27, 2007, general and administrative expenses increased to 4.9% of net sales as compared to 3.9% of net sales for the six months ended October 28, 2006.

General and administrative expenses increased for the second quarter of fiscal year 2008 as compared to the second quarter of fiscal year 2007 due to increases in personnel and related costs across all areas within general and administration due to our growth as mentioned above, information systems maintenance and support costs, training and recruiting costs and international expansion. We expect that general and administrative costs will increase in the third quarter of fiscal 2008 as compared to the second quarter of fiscal year 2008.

Product Design and Development. Product design and development expenses consist primarily of salaries, other employee-related costs, facilities and equipment-related costs, and costs of supplies.

Product design and development expenses increased 33.8% to \$5.3 million for the three months ended October 27, 2007 compared to \$3.9 million for the same period in fiscal year 2007. Product design and development expenses increased 32.7% to \$10.0 million for the six months ended October 27, 2007 as compared to \$7.6 million for the six months ended October 28, 2006.

Product design and development expense was 4.0% of net sales for the second quarter of fiscal year 2008 and 3.2% of net sales for second quarter of fiscal 2007. Product design and development expenses were 4.0% and 3.5% of net sales for the six months ended October 27, 2007 and October 28, 2006, respectively.

Generally, product design and development expenses increase when our engineering resources are not dedicated to long-term contracts, as the same personnel who work on research and development also work on long-term contracts. We expect that product design and development expenses will approximate 4% of net sales for all of fiscal year 2008.

INTEREST INCOME AND EXPENSE

We occasionally generate interest income through product sales on an installment basis, under lease arrangements or in exchange for the rights to sell and retain advertising revenues from displays, which result in long-term receivables. We also invest excess cash in short-term temporary cash investments and marketable securities that generate interest income.

Interest income decreased 9.4% to \$0.5 million for the three months ended October 27, 2007 compared to the second quarter of fiscal year 2007. For the six months ended October 27, 2007, interest income decreased 26.7% to \$0.8 million from \$1.2 million for the six months ended October 28, 2006. The change for the six months as a whole was the result lower levels of interest-bearing marketable securities. We expect that the amount of interest income will decrease slightly in the third quarter due to the decline in interest on trade receivables.

- 24 -

Interest expense is comprised primarily of interest costs on our notes payable and long-term debt. Interest expense increased to \$0.3 million for the three months ended October 27, 2007 as compared to \$0.1 million for the second quarter of fiscal year 2007. For the six months ended October 27, 2007, interest expense increased 825.9% to \$0.8 million from \$0.1 million for the six months ended October 28, 2006. The increase is due to higher average borrowings.

OTHER INCOME (EXPENSE), NET

Other income (expense) decreased from the second quarter of fiscal year 2007 as compared to the second quarter of fiscal year 2008. For the first six months of fiscal year 2008 and 2007, other income (expense) was (\$0.5) million, respectively. The change results from the effects of earnings attributable to unconsolidated affiliates and from currency gains and losses.

At the beginning of the third quarter of fiscal year 2008, we sold a significant portion of our investment in Arena Media Networks and realized a pre-tax gain of approximately \$2.5 million.

INCOME TAX EXPENSE

Income taxes were approximately \$4.3 million in the second quarter of fiscal year 2008 and \$5.3 million for the second quarter of fiscal year 2007. For the first six months of fiscal year 2008, income taxes increased to \$8.1 million as compared to \$7.6 million for the first six months of fiscal year 2007. The effective tax rate for the six months ended October 27, 2007 was 34.8% as compared to 35.5% for the first six months of fiscal year 2007. The effective rate was lower in fiscal year 2008, as a greater amount of net income was recognized in lower-rate tax jurisdictions such as China and Macau. We expect that the effective tax rate for the 2008 fiscal year will approximate 35% but could vary depending on the mix of income in foreign jurisdictions and the potential for reinstatement of the research and development tax credit beyond calendar year 2007.

LIQUIDITY AND CAPITAL RESOURCES

Working capital was \$42.3 million at October 27, 2007 and \$44.9 million at April 28, 2007. We have historically financed working capital needs through a combination of cash flow from operations and borrowings under bank credit agreements.

Cash provided by operations for the six months ended October 27, 2007 was \$26.0 million. Net income of \$15.1 million, plus depreciation and amortization of \$10.2 million, stock-based compensation of \$1.2 million and increases in accounts payable, customer deposits, accrued expenses and income taxes payable caused an increase in cash provided by operations. This increase was offset by increases in costs and estimated earnings in excess of billings, accounts receivable, inventory and notes receivables and decreases in billings in excess of costs and profits.

The changes overall in operating assets and liabilities are due generally to the impact of the timing of cash flows on projects, which can cause significant fluctuations in the short term. As a result of various initiatives underway, including changes in manufacturing, purchasing, collections and payment processes, we expect to continue improving our cash flow relative to sales.

Cash used by investing activities of \$22.8 million for the first six months of fiscal 2008 included \$22.4 million for purchases of property and equipment. During the first six months of fiscal year 2008, we invested approximately \$6.5 million in manufacturing equipment, \$8.6 million in facilities additions, \$4.4 million in information systems infrastructure, including software, \$1.8 million in product demonstration equipment, \$1.0 million in rental equipment and \$0.1 million in office equipment. These investments were made to support our continued growth and to replace obsolete equipment.

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In the second quarter of fiscal year 2008, we completed construction of a new building in Brookings, South Dakota to be used primarily for office and warehouse space. We expect the total cost of the building and furnishings to be approximately \$17.5 million. We funded approximately \$2.0 million of the cost of furnishings through operating leases. We also continued to invest in equipment for our Redwood Falls, Minnesota manufacturing facility. We consider these two areas to be the completion of the major capacity expansion

- 25 -

efforts we began in fiscal year 2006. We expect to invest approximately \$25 million in capital expenditures through the rest of fiscal 2008. We believe that in fiscal year 2009, investments in capital assets will decrease and that, over the long term, we will increase our cash and marketable securities while decreasing the level of debt.

During the second half of fiscal year 2008, we expect to invest approximately \$2 million in remote media applications primarily in companies building out digital LCD networks..

Cash used by financing activities of \$1.5 million consisted of the dividend paid to shareholders of \$2.8 million on June 20, 2007, which was offset by borrowings on notes payables and by option exercises and excess tax benefits from equity-based compensation. We expect that as a result of the sale of our investment in Arena Media as described above, we will reduce debt levels in the third quarter.

Included in receivables as of October 27, 2007 was approximately \$1.5 million of retainage on long-term contracts, all of which is expected to be collected in one year.

We have used and expect to continue to use cash reserves and bank borrowings to meet our short-term working capital requirements. On large product orders, the time between order acceptance and project completion may extend up to and exceed 18 months depending on the amount of custom work and the customer's delivery needs. We often receive a down payment or progress payments on these product orders. To the extent that these payments are not sufficient to fund the costs and other expenses associated with these orders, we use working capital and bank borrowings to finance these cash requirements.

Our product development activities include the enhancement of existing products and the development of new products from existing technologies. Product design and development expenses were \$5.3 million for the quarter ended October 27, 2007. We intend to continue to incur these expenditures to develop new display products using various display technologies to offer higher resolution and more cost effective and energy efficient displays. We also intend to continue developing software applications for our display controllers to enable these products to continue to meet the needs and expectations of the marketplace.

We have a credit agreement with a bank which provides for a \$45.0 million line of credit and includes up to \$10.0 million for standby letters of credit. The line of credit is due on November 15, 2008. The interest rate ranges from LIBOR plus 75 basis points to LIBOR plus 125 basis points depending on certain ratios. The effective interest rate was 4.68% at October 27, 2007. We are assessed a loan fee equal to 0.1% per annum of any non-used portion of the loan. As of October 27, 2007, \$25.2 million was advanced under the line of credit. The credit agreement is unsecured and requires us to comply with certain covenants, including the maintenance of tangible net worth of at least \$75 million, a minimum liquidity ratio, a limit on dividends and distributions and a minimum adjusted fixed charge coverage ratio. Daktronics Canada, Inc. has a credit

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agreement with a bank which provides for a \$0.4 million line of credit. The line of credit is due on April 30, 2008. The interest rate on the line of credit is equal to 1.5% above the prime rate of interest and was 6.25% on October 27, 2007. As of October 27, 2007, no advances under the line of credit were outstanding. The line of credit is secured primarily by accounts receivables, inventory and other assets of the subsidiary.

On May 24, 2007, our Board declared an annual dividend payment of \$0.07 per share on our common stock for the year ended April 28, 2007. Although we intend to pay regular annual dividends for the foreseeable future, all subsequent dividends will be reviewed annually and declared by our Board of Directors at its discretion.

We are sometimes required to obtain performance bonds for display installations, and we have a bonding line available through a surety company that provides for an aggregate of \$100 million in bonded work outstanding. At October 27, 2007, we had approximately \$11.5 million of bonded work outstanding against this line.

We believe that based on our current growth estimates over the next 12 months, we have sufficient capacity under our lines of credit. Beyond that time, we may need to increase the amount of our credit facilities

- 26 -

depending on various factors. We anticipate that we will be able to obtain any needed funds under commercially reasonable terms from our current lender. We believe that cash from operations, from our existing or increased credit facility, and from our current working capital will be adequate to meet the cash requirements of our operations in the foreseeable future.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

FOREIGN CURRENCY EXCHANGE RATES

Through October 27, 2007, most of our net sales were denominated in United States dollars, and our exposure to foreign currency exchange rate changes was not significant. Net sales originating outside the United States for the second quarter of fiscal year 2008 were 10.2% of total net sales. We operate in various countries in Europe, Asia and the Middle East and in Canada through wholly-owned subsidiaries. Sales of those foreign subsidiaries comprised 8.1% of net sales in the second quarter of fiscal year 2008. If we believed that currency risk in any foreign location was significant, we would utilize foreign exchange hedging contracts to manage our exposure to the currency fluctuations.

We expect net sales to international markets in the future to increase and that a greater portion of this business will be denominated in foreign currencies. As a result, operating results may become subject to fluctuations based upon changes in the exchange rates of certain currencies in relation to the United States dollar. To the extent that we engage in international sales denominated in United States dollars, an increase in the value of the United States dollar relative to foreign currencies could make our products less competitive in international markets. This effect is also impacted by the sources of raw materials from international sources. We will continue to monitor and minimize our exposure to currency fluctuations and, when appropriate, use financial hedging techniques, including foreign currency forward contracts and options, to minimize the

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effect of these fluctuations. However, exchange rate fluctuations as well as differing economic conditions, changes in political climates, differing tax structures and other rules and regulations could adversely affect our financial results in the future.

INTEREST RATE RISKS

Our exposure to market rate risk for changes in interest rates relates primarily to our debt and long-term accounts receivables. We maintain a blend of both fixed and floating rate debt instruments. As of October 27, 2007, our outstanding debt approximated \$27.1 million, substantially all of which was in variable rate obligations. Each 100 basis point increase or decrease in interest rates would have an approximately \$0.2 million annual effect on variable rate debt interest based on the balances of such debt as of October 27, 2007. For fixed-rate debt, interest rate changes affect its fair market value but do not affect earnings or cash flows.

In connection with the sale of certain display systems, we have entered into various types of financings with customers. The aggregate amounts due from customers include an interest element. The majority of these financings carry fixed rates of interest. As of October 27, 2007, our outstanding long-term receivables were approximately \$23.4 million. Each 25 basis point increase in interest rates would have an associated annual opportunity cost to us of approximately \$0.2 million.

The following table provides information about our financial instruments that are sensitive to changes in interest rates, including debt obligations, for the three quarters ended April 28, 2008 and subsequent fiscal years.

- 27 -

	2008	2009	2010	2011	2012	Thereafter
Assets:						
Long-term receivables, including current maturities:						
Fixed-rate	\$ 5,654	\$ 4,355	\$ 3,850	\$ 2,704	\$ 2,605	\$ 4,213
Average interest rate	6.3%	7.0%	7.7%	7.9%	7.7%	8.6%
Liabilities:						
Long- and short-term debt						
Variable-rate	\$ 25,243	\$ -	\$ -	\$ -	\$ -	\$ -

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Fixed-rate	\$ 51	\$ 546	\$ 29	\$ 28	\$ -	\$ -
Average interest rate	6.1%	5.7%	0.0%	0.0%	0.0%	0.0%
Long-term marketing obligations, including current portion						
Fixed-rate	\$ 415	\$ 277	\$ 178	\$ 55	\$ 20	\$ 13
Average interest rate	4.6%	7.7%	8.1%	8.8%	8.6%	8.3%

The carrying amounts reported on the balance sheet for long-term receivables and long- and short-term debt approximates their fair value.

Substantially all of our cash balances are denominated in United States dollars. Cash balances in foreign currencies are operating balances maintained in accounts of our foreign subsidiaries and accounts to settle euro-based payments. These balances are immaterial as a whole.

Item 4. CONTROLS AND PROCEDURES

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our “disclosure controls and procedures,” as that term is defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934, as of October 27, 2007, which is the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of October 27, 2007, our disclosure controls and procedures were effective.

Based on the evaluation described in the foregoing paragraph, our Chief Executive Officer and Chief Financial Officer concluded that during the quarter ended October 27, 2007, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Not Applicable

Item 1A. RISK FACTORS

The discussion of our business and operations included in this Quarterly Report on Form 10-Q should be read together with the risk factors described in Item 1A. of our Annual Report on Form 10-K for the year ended April 28, 2007. It describes various risks and uncertainties to which we are or may become subject. These risks and uncertainties, together with other factors described elsewhere in this report, have the potential to affect our business, financial condition, results of operations, cash flows, strategies or prospects in a material and adverse manner. New risks may emerge at any time, and we cannot predict those risks or estimate the extent to which they may affect financial performance.

- 28 -

Item 2. unregistered sales of equity Securities and Use of Proceeds

Not Applicable

Item 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable

Item 4. Submission of matters to a vote of security holders

Not Applicable

Item 5. Other Information

Not Applicable

Item 6. Exhibits

The following exhibits are filed with this Quarterly Report on Form 10-Q:

- 31.1 Certification of the Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
- 32.2 Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).

- 29 -

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

/s/ William R. Retterath

Daktronics, Inc.

William R. Retterath,

Chief Financial Officer

(Principal Financial Officer

And Principal Accounting

Officer)

Date: November 21, 2007

- 30 -
